Parliamentary
and Health Service
Ombudsman

Equitable Life:
a decade of regulatory failure

Part one: main report

HC 815-I

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Foreword

Background

> *The most complex, wide-ranging and onerous investigation which the Office has ever undertaken*[1].
>
> *By far the longest and most detailed* [report] *produced by the Office* [which] … *resulted in the provision of the most substantial remedy ever to result from an investigation*[2].

These were the words used by two of my predecessors to describe the Barlow Clowes investigation conducted by my Office in the late 1980s. The reader of this report, which sets out the results of the investigation I have conducted into the prudential regulation of The Equitable Life Assurance Society during the period prior to 1 December 2001 – and the reader of other recent reports I have published – will, I am sure, agree with me that those accolades, if such they be, can no longer be accorded to the Barlow Clowes case.

A much more substantial remedy than was secured in the Barlow Clowes case has resulted from my March 2006 report on final salary occupational pensions. And this report is approximately ten times the length of my predecessor's report on Barlow Clowes, has taken four times as long to produce, and has involved the devotion of resources which go significantly beyond those which supported the completion of that earlier report.

In part, all this is a natural consequence of the differing scope of the two reports. Equitable is a much bigger company than Barlow Clowes was. This report covers events which occurred over a much longer time period than was covered in the Barlow Clowes report.

In addition, I have received many more hundreds of complaints about the prudential regulation of Equitable than were received by my predecessors in respect of Barlow Clowes. The number of interested parties with whom I have engaged while conducting this investigation far surpasses those who had any involvement in the Barlow Clowes case – and the range of interests that those parties represent has been much more complex (and perhaps less uniform) than was so in the earlier case.

However, both cases share some similarities. Both cases were about regulation in the field of financial services. Indeed, and perhaps most important of all, both cases involved the financial security of many ordinary citizens and the loss of some of their savings and investments. The resulting issues go to the heart of longstanding (and perhaps ongoing) debates both as to what should be done to protect those investing in the products of financial services providers and as to how to handle situations where things go wrong.

As will be seen later in this report, this case has raised, in such a context, similar issues as were raised in the Barlow Clowes case. Such issues include the appropriate role of financial regulators, what potential and existing investors can expect from the system of financial regulation, and whether it would be in the public interest for the taxpayer to be expected, as complainants have advanced should be the case here, to remedy losses sustained in a context where such regulation did not necessarily cause any losses sustained but also did not prevent any such losses arising or mitigate their effects.

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[1] Sir Anthony Barrowclough, in paragraph 62 of his Annual Report for 1988, commenting on the investigation while it was underway. *Second report – Session 1988-89* (HC 301), 12 April 1989.

[2] Sir William Reid, in paragraph 64 of his Annual Report for 1989, commenting on the report after its publication. *Third Report – Session 1989-90* (HC 353), 18 April 1990.

And both cases have involved a substantial degree of Parliamentary and public interest. My predecessor reported[3], in words that resonate with me and which I would endorse, that:

> *Members, and the investors on whose behalf they approached me, are understandably anxious that I should complete my investigation as a matter of urgency. But I am having to urge that they be patient while all the necessary evidence is collected, examined and assessed.*

The time taken to publish this report

As was clear to my predecessor, ensuring that an investigation is completed as speedily as possible and ensuring that it is conducted in such a manner as to produce a robust, authoritative, and soundly-based report are often competing pressures. I too have faced such competing pressures in this case.

When I announced my decision in July 2004 to conduct the investigation which led to this report, I said that I could not be specific about how long my investigation would take. I expressed the hope that this investigation could be conducted within a reasonable timetable, as I was conscious that significant numbers of people – many of them elderly – had told me that they were in difficult financial circumstances.

I regret that it has taken much longer to publish this report than I hoped would be the case at the outset of this investigation.

I recognise that the time that I have taken to conclude the investigation and publish this report has added to the frustration and anxiety that many of those who have complained to me have felt about the events covered by this report – and that this has done little to mitigate the uncertainty that they feel about their future financial position. I am very sorry that this has been the case.

I also recognise that the time taken to publish my report has meant that those whose actions have been subject to review have had to await my determination of the complaints made about them for longer than they might first have expected. That too is a matter for regret.

As with the inspectors appointed in June 1988 to investigate the affairs of the Barlow Clowes group of companies, whose report was published in July 1995, the publication of this report has been affected by the complexity and range of the matters investigated, the sheer amount of evidence to be analysed, and the need to ensure that those whose actions were potentially subject to adverse criticism – and those representing the people whose complaints this report will determine – had a proper opportunity to respond to my provisional findings and conclusions prior to publication of this report.

My preliminary observations

Before setting out the results of the investigation, I would like to make a number of preliminary observations. They relate to questions of fairness and due process; to the relationship between this report and the report of my first investigation into the prudential regulation of the Society, published in June 2003; to the subject matter of this report – regulation; and to the absence of a single inquiry covering all aspects of what has been termed '*the Equitable Life affair*'.

[3] As for footnote 1.

Fairness and due process
First, I should record that representations have been made to me in the course of my investigation, and in particular following the issue of my draft report to the public bodies whose actions were the subject of complaint, that the process that I have followed has not been fair. I have considered those representations very carefully and responded to them in detail, although I have not reproduced those exchanges in this report.

Chapter 3 of this report sets out the process that I have followed in conducting this investigation. I am satisfied that the process I have adopted has been fair and has given those complained about ample opportunity to respond to the allegations made against them, to submit evidence and to respond to my emerging findings.

The relationship between my two reports
My second preliminary observation is that this is not the first report that I have produced in relation to the prudential regulation of the Society; and that, in relation to certain matters, the conclusions in this report differ from those reached in my first report, published on 30 June 2003.

The complaints which gave rise to the two investigations leading to those two reports were different and only some issues are common to both reports. However, in the light of a fresh investigation of the relevant matters I have reconsidered conclusions set out in the first report – something which, when in July 2004 I reported my decision to conduct this investigation, I gave an undertaking to Parliament that I would do.

There are three principal factors which help to explain why some conclusions set out in this report differ from those set out in my first report.

- First, the inclusion of the Government Actuary's Department within my jurisdiction at the outset of the second investigation has had a material effect on the approach that I was required to adopt. In the first investigation, I could only assess whether the actions of the relevant regulators constituted maladministration in the light of the advice that those regulators had received from their professional advisers in the Government Actuary's Department. In the second investigation, I have had to consider the acts and omissions of those regulators and their professional advisers when assessing whether or not maladministration occurred.

- Secondly, the time periods covered by the two investigations were very different. My first report only considered events occurring from 1 January 1999 to 8 December 2000. This second report covers the whole period prior to 1 December 2001. The events considered and the acts and omissions reviewed in the course of the second investigation have thus been considerably more extensive than was the case with the first investigation. For the first time, I have been able to examine how the issues which arose during the period considered by the first investigation developed over time in an earlier period that was not covered by that investigation – and I have also been able to examine how (some of) those issues were eventually resolved in a later period than that covered by the first investigation.

- Thirdly, the evidence available to me in the course of this investigation was considerably more comprehensive than that available at the time of the first investigation. That is partly a function of the broader jurisdiction and more extensive time period covered in the investigation leading to this report. But, as I reported to Members of Parliament during the course of the second investigation, substantial additional evidence was provided to me that was not available during the first investigation. Much of this new material has been central to establishing what standard should be applied to the actions under investigation.

These three factors – a broader jurisdiction, a more extensive time period, and a more comprehensive evidence base – all help to explain, in relation to those matters covered in both reports, the differences between the conclusions reached following the first and second investigations.

One lesson that can be learned is that, where a technical jurisdictional obstacle might have a significant detrimental impact on the efficient conduct of an investigation, action should be taken – as was taken at the beginning of the second investigation – to seek the removal of such an obstacle, if that is possible.

It is against that background that I have reconsidered conclusions set out in my first report and, where I have considered it appropriate to do so, I have reached conclusions which differ from those set out in that first report.

For the avoidance of doubt, the conclusions set out in this report supersede and replace those set out in my first report. That first report, for the reasons set out above and in this report, can no longer be regarded as having any validity.

The focus of my report – regulation
My third observation relates to the fact that my investigation has been focused on regulation. That may seem like a trite observation – but there are two direct consequences of such an observation that I believe should be emphasised from the outset.

My investigation has been conducted in response to complaints about injustice claimed in consequence of alleged maladministration by regulators. It has not been – nor could it have been – focused on the actions of the entity being regulated, which in this case was Equitable. The underlying 'true' position of the Society at any one time is thus not central to my findings. I have focused only on the actions which the relevant regulators should have considered and/or taken on the basis of the information in their possession, however accurate that information was or might have been found to be had further investigation of the true position been undertaken at the time.

It will become apparent to the reader of this report that my investigation has identified numerous instances where issues arose which should have provoked regulatory consideration. On many such occasions, either no consideration or insufficient consideration was given by the relevant regulators.

Such regulatory considerations, rather than the commercial position of the Society, have thus been my central focus. It has been no part of this investigation to attempt to make findings about the actions of the Society. The legal framework within which I must operate would not permit me to do so.

I recognise that, had the relevant regulators acted on all those occasions when they should have acted, the Society might have responded appropriately and thus enabled a satisfactory resolution of some or all of the apparent regulatory issues to be achieved. It is not possible now, given the passage of time, to identify conclusively in relation to every issue what would have transpired had such appropriate regulatory action been undertaken.

This report examines how the relevant regulators discharged their responsibilities; it does not seek to come to definitive conclusions about the underlying position of Equitable.

An equally important consequence, which is the second consequence referred to above, is the need to have proper regard to the nature of regulation and to some central dilemmas faced by those exercising any regulatory functions.

I am acutely aware that those exercising regulatory functions are often placed in very difficult situations in which they have to exercise judgement in relation to complex matters which require the balancing of a range of often competing pressures and interests.

This is especially the case where they are granted powers by Parliament to protect the interests of citizens but where the use of such powers, if exercised prematurely or without a sound basis, might bring about precisely the outcome – detriment to the interests of those citizens – which the system of regulation was designed to avert.

It is relatively easy for anyone to identify instances where the acts or omissions of others have turned out not to be the most optimal solution to a particular problem – but it is less easy to put oneself in the position of the person who had to take the relevant decision at the appropriate time. In this context, regulators are very often '*damned if they do'* take action, while at the same time being '*damned if they don't'*. This is something that I readily acknowledge and have borne in mind throughout this investigation.

When reviewing the acts and omissions of regulators, it seems to me that key to recognising this dilemma is the adoption of an appropriate standard, derived from the contemporaneous framework of law, guidance, and established good practice, against which such actions can be objectively measured and assessed.

This report has been guided by the development of such an appropriate standard. It has not been prepared having regard to a counsel of perfection, judging the relevant regulators by impossible standards or against measures of what is only now deemed appropriate, measures which bear no resemblance to the context which existed at the relevant time. Anyone's opinion as to what the purpose of regulation should be or as to how it should be conducted can be of no consequence in the context of an investigation conducted by any Ombudsman if that opinion is far removed from the reality of the regulatory system as it was constructed by Parliament and as it was required to be operated at the time.

The focus of my investigation has had to be on the role of the relevant regulators and not on the actions of the Society. It was also necessary to apply a standard that was grounded in the reality of the relevant regulatory regime as it existed at the relevant time and not in my own opinion as to what such a regime should have looked like.

Those are both considerations that have been central to my investigation. However, neither has received universal acceptance among the parties to the complaints. A small minority of complainants consider that no report is worthwhile unless it makes determinations in respect of the actions of the Society and all the other actors with some role in its story. That I simply cannot do.

The public bodies whose actions have been under investigation have submitted that the responsibilities of other actors than the prudential regulators and their advisers should be taken into account, in order not to '*leave the reader with the incorrect impression that it was only, or even mainly, the prudential regulator who bore responsibility for Equitable's subsequent difficulties*'. However, I can make no determinations in respect of the responsibilities of bodies not in my jurisdiction. Hence my report does not seek to explain what caused the '*difficulties*' of the Society, but instead seeks to determine whether maladministration on the part of the prudential regulators and the Government Actuary's Department (GAD) occurred and, if so, whether any such maladministration caused injustice to those who have complained to me.

While I regret this lack of universal acceptance of the consequences of my role and powers, I am satisfied that the approach that I have adopted to these questions is the only correct one.

The absence of a single inquiry

My final preliminary observation follows from what I have said above and relates to the absence of a single inquiry covering all aspects of what has been termed '*the Equitable Life affair*'.

As I have noted above, the time that it has taken to publish this report is considerably longer than I had expected and that is a matter of regret. However, this is compounded by the fact that this report is only part of an extended series of reports, published following various inquiries, investigations and other proceedings related to Equitable. The four years that it has taken me to publish this report are only part of the almost eight years since the Society closed to new business.

I have great sympathy with those who have told me that they find it wholly unsatisfactory that they have had to wait more than seven years since they first were affected by the relevant events for this determination of their complaints. I do not think it acceptable that the response to the problems at the Society – and consideration of the complaints that have been made about those problems – has been handled through such a protracted process.

Indeed, as I note in Chapter 3 of this report, in July 2002 my predecessor, in his annual report for 2001-02, had even then drawn Parliament's attention to the unsatisfactory nature of this situation, saying:

> *The root cause of the problem, in my view, is the failure of the authorities to establish at the outset a single inquiry with terms of reference covering all aspects of the Equitable Life affair, including issues of possible personal injustice due to maladministration and redress for such injustice if it should be demonstrated*[4].

The existence of the Baird Inquiry, an internal Financial Services Authority (the FSA) inquiry, and the establishment of the Penrose Inquiry by the Government were, of course, to the forefront of my predecessor's mind when he considered whether he should investigate the prudential regulation of the Society.

The possibility that those inquiries would enable the consideration and resolution of the complaints that had been made about the role of the relevant regulators without the necessary restrictions on my Office's role was central to the decisions that he took. Indeed, my predecessor reported that he had drawn the situation to the attention of the Public Administration Select Committee and noted:

> *I was strongly criticised in Parliament and the media for deferring a decision on whether to investigate some of those complaints until the Penrose Inquiry set up by the Government, which will consider a much wider range of issues than my statutory remit allows, had reported ... It seems to me plainly inefficient, and potentially unfair, to have two simultaneous but separate investigations covering much the same ground and taking evidence from much the same sources...*[5]

That my Office could only ever conduct an investigation that was limited in scope and reach – focusing only on the actions of the prudential regulators during the period prior to 1 December 2001 – was a consideration that guided my decision to embark on a consultation exercise prior to coming to a decision as to whether to conduct this investigation. Despite recognition of the inherent limitations that were inevitably placed on any investigation I conducted, given the jurisdiction that Parliament has bestowed on me, respondents to that consultation

[4] Eighth Report, Session 2001-02: *Annual Report for 2001-02* (HC 897), 2 July 2002, at paragraph 1.12.
[5] Eighth Report, Session 2001-02: *Annual Report for 2001-02* (HC 897), 2 July 2002, at paragraph 1.10.

were overwhelmingly in favour of my conducting a further investigation.

It seems to me that there is a direct link between the time that it has taken since the closure of the Society to new business to seek a final resolution of the complaints made about that closure and related matters and the piecemeal approach that the Government has adopted to handling the relevant issues.

The failure at the outset to establish a single inquiry which was not hampered by terms of reference or a statutory jurisdiction which limited the issues that could be addressed and resolved has resulted in such an extended and long drawn out process. The adage '*justice delayed is justice denied*' has rarely been far from my thoughts as publication of this report has drawn nearer. And the continual uncertainty that this has caused for many individuals – and also for the Society itself – must have been difficult to bear.

I find it hard to accept that the establishment of a comprehensive inquiry was not possible in this case. The situation at Equitable was not unique. It shared a number of factors with other situations in other spheres of political life which have arisen and been resolved.

There are, of course, a number of mechanisms that could have been adopted. Key to the speedy and effective resolution of the issues relevant to the closure of the Society and related matters was the adoption of a mechanism that, in the particular circumstances of this case, was fit for purpose. Ensuring that inquiries or other means of explaining events and of resolving complaints, claims, and disputes are fit for purpose is critical to their success and to public confidence in them.

It seems to me that the principles which underpin fitness for purpose are that:

- those conducting the investigation or inquiry should be appropriately chosen and wholly independent from those under investigation: confidence in the robustness of the process will only be achieved where all the parties believe that the person or persons undertaking the inquiry are suitably competent and that the process will be fair and balanced;

- there should be clarity of purpose: the terms of reference of each inquiry or investigation should be clearly set out when it is established and should, at the very minimum, provide the means to achieve four aims:

  (i) the relevant events and actions should be established on a factual basis;

  (ii) who or what caused the adverse outcome should be determined - while identifying where hindsight has informed this judgment;

  (iii) appropriate redress should be identified for any individuals or groups of individuals who have suffered as a result; and

  (iv) lessons for the future, in terms of law, policy, practice and behaviour, should be identified and recommended in such a way that they can be implemented and that such recommendations can add value;

- the particular mechanism chosen should be the most appropriate in the circumstances of each case and the form of the inquiry or investigation should follow: whether it should be held in public or in private, for example, or whether it should adopt an inquisitorial or adversarial approach should be informed by the context of the relevant events; and

- the inquiry or investigation should be provided with the necessary resources to enable it to fulfil its mandate in a timely and effective manner, with access to appropriate levels of funding, staff, professional advice and powers to obtain information, evidence or papers.

In the case of '*the Equitable affair*', no such comprehensive and fit for purpose inquiry has ever been established. Some – such as the two investigations that my Office has conducted – have been unavoidably limited in terms of jurisdictional reach. Others have been conducted within terms of reference that precluded the attribution of responsibility or the recommendation of redress or at least did not specify that either or both should be undertaken. Still yet others have focused solely on lessons to be learned for future practice.

That this is the case seems to me both iniquitous and unfair. Whatever else results from the publication of this report, I hope that I never again have to draw Parliament's attention to such a disjointed process for resolving complaints that have affected so many of the constituents of almost every Member.

Acknowledgements

The completion of the investigation and the publication of this report would not have been possible without the co-operation of a large number of people. These include the direct parties to the complaints – the lead complainants and those members of certain policyholder and annuitant action groups they appointed to act as their representatives and also the officials of the three public bodies whose actions were subject to investigation, being Her Majesty's Treasury, the Government Actuary's Department, and the Financial Services Authority. In addition, I have greatly benefited from the input of a range of interested parties, including the Society itself.

I am extremely grateful for the considerable assistance that all these parties have provided to us at every stage in the investigation process. I would like to place on record my special gratitude to those in the action groups representing the lead complainants, as they largely contributed to the investigation on a voluntary basis without having the considerable resources to enable them to do so that were available to the other parties.

I hope that the burden that the provision of such assistance may have placed on all who have contributed to my investigation was not too onerous – it has certainly been of considerable value to us.

Finally, I would like to record my thanks to the team of people who have helped me to carry out this investigation and produce this report. That includes my in-house investigation team, and everyone in my Office who has supported them in a variety of ways, as well as my external advisers, both legal and actuarial. This report would not have been produced without them and I am indebted to them all.

Ann Abraham
16 July 2008

This report contains references to, and extracts from, legal opinions and advice and their contents obtained by the Equitable Life Assurance Society and provided by it to -

(a) the public bodies responsible for the prudential regulation of insurance companies in the course of normal exchanges between a regulated body and its regulators for the specific purpose of allowing those regulators to fulfil their regulatory functions; and

(b) Lord Penrose in the course of normal exchanges between the Society and Lord Penrose and his Inquiry team for the specific purpose of allowing Lord Penrose to fulfil his terms of reference.

After the House of Commons had ordered the report of Lord Penrose to be published on 8 March 2004, all the documents obtained by Lord Penrose were retained by the Treasury.

In turn, I obtained this material from the Treasury for the specific purpose of carrying out my investigation into the prudential regulation of the Society, following my decision to carry out such an investigation which was reported to Parliament on 19 July 2004.

I acknowledge that the Society has waived privilege in this material only for the above specific purposes and that the Society does not intend any wider or general waiver of privilege by not objecting to the inclusion of, or extracts from or references to, this material in this report as published.

Contents

List of tables

Acronyms commonly used within this report

Acronym	Definition
ABI	Association of British Insurers
BRV	Bonus Reserve Valuation
DAA	"Dear Appointed Actuary"
DTBP	Differential Terminal Bonus Policy
DTI	Department of Trade and Industry
EMAG	Equitable Members Action Group
FSA	Financial Services Authority
FTSE	Financial Times Stock Exchange
GAD	Government Actuary's Department
GAO	Guaranteed Annuity Option
GAR	Guaranteed Annuity Rate
GN1	Guidance Note 1
GN8	Guidance Note 8
GPBR	Gross Premium Bonus Reserve
HMT	Her Majesty's Treasury
IFA	Independent Financial Adviser
IRECO	Irish European Reinsurance Company
LAUTRO	Life Assurance and Unit Trust Regulatory Organisation (UK)
MVA	Market Value Adjustment/Adjuster
NPV	Net Premium Valuation
OFT	Office of Fair Trading
PPA	Policyholders Protection Act 1975
PPB	Policyholders Protection Board
PRE	Policyholders' Reasonable Expectations
RPI	Retail Prices Index
RCA	Reinsurance Claims Amount
RCE	Reinsurance Claims Event
RMM	Required Minimum Margin
RSP	Recurrent Single Premium
SIB	Securities and Investments Board
SLA	Service Level Agreement
TB	Terminal Bonus

Glossary

Term	Explanation
1967 Act	The Parliamentary Commissioner Act 1967, from which I derive my powers.
1982 Act	The Insurance Companies Act 1982, which governed the prudential regulation of life insurance companies. Its provisions were repealed during 2000 and 2001, being replaced by the Financial Services and Markets Act 2000.
Admissible assets	Assets that the applicable Regulations permit to be taken into account for the purposes of determining an insurance company's solvency position.
Annuity	An arrangement by which a life insurance company pays someone a regular income, usually for life, in return for a lump sum payment.
Appendix valuation	The valuation produced by the Society within its *regulatory returns* to demonstrate that its chosen alternative valuation, the main valuation, produced a result at least as strong as that prescribed in the applicable Regulations.
Appointed Actuary	The actuary appointed by life insurance companies under section 18 of the *1982 Act*. Each life insurance company was required each year to cause the Appointed Actuary to undertake an investigation into the financial condition of that company. The abstract of the results of that investigation was included within the *regulatory returns*.
Asset shares	The value of a life insurance policy, calculated as the accumulation of *premiums* paid with actual investment returns, net of *expenses* and charges for the cost of guarantees.
Available assets	An insurance company's free assets less any implicit items.
Benefits	The amount paid by an insurance company when a claim is made.
Bonus	The amount added to the guaranteed part of the sum insured of a *with-profits* insurance policy. It may be added during the term of the policy (i.e. yearly or *reversionary*) or when the policy matures (i.e. final or *terminal*), or both.
Commission	The sum paid by an insurance company to a broker/intermediary/agent for selling policies.
Current annuity rate	The rate governing the amount that an insurance company would pay on an immediate retirement, expressed as a percentage of the fund converted to pension. This was based on current conditions in the financial markets and the age and gender of the policyholder.
Differential terminal bonus policy	The policy whereby the Society reduced the *terminal bonus* paid to a policyholder who took *benefits* to which was applied a *guaranteed annuity rate*. The *benefits* were reduced by such an amount as to make the resulting pension equal to that paid to a policyholder who opted to take benefits at the *current annuity rate*.

Dual role	The holding by one person simultaneously of the positions of Chief Executive and Appointed Actuary.
Equities	Shares in a company that entitle the owner to some of the profits or earnings the company makes. Equities may or may not be listed on the stock exchange.
Expenses	Costs incurred in the running of the business, including any *commission* paid to sales staff.
Estate	The balance of *admissible assets* over *Mathematical Reserves* held back from bonus distribution to *with-profits* policyholders as a buffer against major fluctuations in investment values or in underwriting experience or in the central costs of administration.
Form 9	A summary within the *regulatory returns* of the assets allocated towards the *required minimum margin* and including a statement of the company's *regulatory solvency* position.
Free assets	The excess value of assets and implicit items over the liabilities.
Free asset ratio	The excess of the *free assets* and implicit items of an insurance company over the *required minimum margin*, expressed as a percentage of the total assets determined within the *regulatory returns*.
Freedom with publicity	The concept that, in return for putting detailed and prescribed information about an insurance company's business and financial condition into the public domain, the commercial freedom of such a company would not be constrained by regulation. The aim of this approach was to enable investors and potential investors to be provided with sufficient information about an insurance company to make informed choices about whether that company was an appropriate investment vehicle for that individual.
Future profits implicit item	An asset relating to an insurer's ability to generate future profits that, if used, would count towards the *required minimum margin* of the insurer. At the time covered by this report, such an asset could only be used by an insurance company if it had been granted a *Section 68* Order by the prudential regulators.
Group personal pension	An arrangement made for the employees of a particular employer to participate in a personal pension scheme on a group basis.
Guaranteed annuity rate	The rate governing the amount that an insurance company would pay on an immediate retirement, expressed as a percentage of the fund converted to pension. Unlike the *current annuity rate*, this was based on a rate specified within the policy and expressed as a guarantee.

Guaranteed investment return	An amount by which basic *benefits* are guaranteed to increase each year before the addition of *reversionary bonus*. Also known as a guaranteed interest rate.
Guaranteed policy fund	The current accrued value of the fund guaranteed to be available to *with-profits* policyholders at *vesting* to purchase a pension. This was shown in personalised annual bonus statements sent to the Society's *with-profits* policyholders. Until the *vesting* date, the *guaranteed policy fund* continued to grow each year with the addition of any *guaranteed investment return* and *reversionary bonuses*.
ICAS Regulations 1983	The Insurance Companies (Accounts & Statements) Regulations 1983. These prescribed the information that had to be disclosed within the *regulatory returns* and set out the way in which that information had to be presented. These governed the returns submitted prior to 23 December 1996.
ICAS Regulations 1996	The Insurance Companies (Accounts & Statements) Regulations 1996. These prescribed the information that had to be disclosed within the *regulatory returns* and set out the way in which that information had to be presented. These governed the returns submitted after 23 December 1996.
ICR 1981	The Insurance Companies Regulations 1981. These made provision for how an insurance company was to value its assets and determine its liabilities and governed the period covered in this report prior to 30 June 1994.
ICR 1994	The Insurance Companies Regulations 1994. These made provision for how an insurance company was to value its assets and determine its liabilities and governed the period covered in this report after 1 July 1994.
Income drawdown	A way of taking regular income directly from a pension fund instead of buying an *annuity* straight away.
Interest rate differential	The difference between the assumed gross bonus rate and the interest rate used for discounting the liabilities.
Investment reserve	The net realised and unrealised appreciation in investments in the *with-profits* fund, after transfers to and from the long-term business fund.
Loading	An extra *premium* charged in recognition of a higher risk, such as poor health or a dangerous job on the part of the person insured.
Life insurance	Long-term policies which pay out on death or, in some cases, on earlier *maturity* of the policy, such as endowment, term, or whole life policies.

Maturity	An agreed date when a life or pension policy comes to an end and the value is paid out.
Market value adjuster	A reduction in the value of a claim on a *with-profits* policy in order to reflect fairly the movement of assets underlying the policy.
Mathematical Reserves	The provision made by an insurer to cover liabilities (excluding liabilities which have fallen due) arising under or in connection with contracts for long-term business. Those provisions were determined by the *Appointed Actuary* in accordance with *ICR 1981* and *ICR 1994*.
Mutual	An insurance company which is owned by some or all of its policyholders.
Net premium	A *premium* net of reinsurance ceded but gross of *commission*, and excluding premium tax.
New business strain	The requirement for capital to support the writing of new business.
Policyholders' reasonable expectations (PRE)	An expression derived from the words '*the reasonable expectations of policy holders or potential holders*' in the statutory grounds for the use of intervention powers by the prudential regulators, under section 37(2) of the *1982 Act*.
Premium	The amount paid by the policyholder for insurance.
Prudential regulation	At the time covered in this report, the regulation of insurance companies with respect to their solvency position, whether they were acting soundly and prudently in line with the interests of their policyholders, and in such a manner as to be able to fulfil the reasonable expectations of their existing and potential policyholders.
Quasi-zillmer adjustment	An adjustment made by the Society to its business to give the same effect as *zillmerisation*.
Recurrent single premium	Life insurance policies which did not require regular premiums to be paid. This type of business accounted for the majority of the Society's policies.
Regulatory returns	The annual returns made by a life insurance company to the prudential regulators, as required by section 22 of the *1982 Act*.
Regulatory solvency	Also sometimes known as technical solvency. Not to be confused with *solvency* in absolute terms. Section 32 of the *1982 Act* required insurance companies to hold assets which exceeded their liabilities by at least the margin prescribed by the applicable Regulations. Those were the *ICR 1981* and, from 1 July 1994, the *ICR 1994*. A failure to meet and maintain this requirement meant that a company was insolvent for regulatory purposes.
Reinsurance	An arrangement whereby one party (the reinsurer), in consideration for a premium, agrees to indemnify another party (the cedant) against all or part of the risk assumed by the cedant under a policy or policies of insurance.

Required minimum margin	The amount by which the value of a life insurance company's assets was required by section 32 of the *1982 Act* to exceed the amount of its liabilities in order to meet its *regulatory solvency* requirements.
Resilience reserves	Reserves, calculated in accordance with *ICR 1981* or *ICR 1994*, which relate to an insurance company's ability to cover mismatches of assets and liabilities that adverse movements in asset values may disclose.
Reversionary bonus	*Bonus* for *with-profits* policies, usually added at yearly intervals during the term of the policy.
Section 68 Order	An Order under section 68 of the *1982 Act*, made by the prudential regulators on the application of, or with the consent of, an insurance company, which directs that certain provisions of that Act would not apply, or would apply with modified effect, to that company.
Solvency	The ability of a company to pay its debts. Under the Insolvency Act 1986, a company is deemed unable to pay its debts if it is proven to the satisfaction of the Court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities. This is sometimes known as absolute solvency, which is not to be confused with *regulatory solvency*.
Surrender value	The amount available if a policyholder were to cash in an insurance policy, where that is possible, before it matures.
Subordinated loan	A debt issued by an insurance company where both the interest and repayment obligations are subsidiary to the insurance company's obligations to its policyholders.
Terminal bonus	The *bonus*, additional to *reversionary bonuses* already declared, that may be paid for *with-profits* policies at *maturity* or if a claim is made.
Total policy fund	The current accumulated value of the total fund (including accumulated *terminal bonuses*) expected to be available to *with-profits* policyholders at *vesting* to purchase a pension. This was shown in personalised annual bonus statements sent to the Society's with-profits policyholders. Until the *vesting* date, the total policy fund continued to grow at a rate allocated annually by the company. Other than in exceptional circumstances, when it could be zero or less, the rate of growth applying to the total policy fund was expected to be greater than the sum of any *guaranteed investment returns* and *reversionary bonus*. To the extent that the total policy fund exceeded the *guaranteed policy fund*, it was not guaranteed.

Unitised with-profits	Contracts where *premiums* are invested in units, either in the *with-profits* fund or in linked funds, or in a mix of both.
Unit-linked	Describes any plan where the value of the *benefits* goes up or down in line with the price of units in a fund.
Valuation	An investigation carried out by the Appointed Actuary under section 18 of the *1982 Act* to place a value upon the long-term liabilities of an insurance company. The resulting provision held by the insurance company for its long-term liabilities is called the *Mathematical Reserves*.
Vesting	The taking of *benefits* under an insurance policy.
With-profits	Life insurance policies which receive their investment income in the form of *bonuses*, paid out of the total income earned by the insurance company on its pooled fund. The value of the saver's fund thus depends on the amount he or she has bought and the amount of bonuses added. Once added, bonuses cannot be taken away, making these policies generally less volatile than linked policies.
Zillmerisation	A modification of the net premium method for valuing a life insurance policy which increases the future premiums valued to take account of acquisition costs incurred.

Notes:

1. Terms italicised are defined elsewhere in this glossary.
2. The definitions in this glossary have been derived from a number of sources, including the glossaries of insurance terms produced by the Association of British Insurers, the International Association of Insurance Supervisors, and the FSA, and other published reports on the Society.

Chapter 1 – Introduction

1 This report sets out the results of my investigation into the prudential regulation of The Equitable Life Assurance Society in the period prior to 1 December 2001. This is the third report that my Office has produced in respect of that regulation.

2 I announced my intention to conduct this investigation – as I noted in the Foreword to this report, the second investigation conducted by my Office – and the reasons for that decision in a report that I laid before Parliament on 19 July 2004, entitled *A Further Investigation of the Prudential Regulation of Equitable Life?* (HC 910). Excerpts from that report are reproduced in Part 4 of this report.

3 That report was published following a consultation exercise I conducted in the aftermath of the publication of the report of an independent inquiry, the Penrose Inquiry, and with the purpose of seeking views from interested parties as to whether I should conduct an investigation in respect of a broader time-period than was covered in the report of my first investigation and with a wider jurisdiction than that which governed the earlier investigation.

4 I derive my powers from the Parliamentary Commissioner Act 1967, as subsequently amended (the 1967 Act). My role is to conduct investigations and to determine complaints referred to me by Members of the House of Commons, which are made by those who claim to have sustained injustice in consequence of maladministration on the part of bodies within my jurisdiction through action by or on behalf of those bodies taken in the exercise of their administrative functions.

5 Where I find that a person aggrieved has sustained injustice in consequence of maladministration, I seek to secure a remedy for that injustice.

6 The terms of reference for the investigation leading to this report were:

> *To determine whether individuals were caused an injustice through maladministration in the period prior to December 2001 on the part of the public bodies responsible for the prudential regulation of the Equitable Life Assurance Society and/or the Government Actuary's Department; and to recommend appropriate redress for any injustice so caused.*

7 Those who have complained to me about the matters covered by this report alleged that the public bodies responsible for the prudential regulation of insurance companies and the Government Actuary's Department, which advised and assisted those regulators, acted with maladministration in failing for considerably longer than a decade properly to exercise their regulatory functions in respect of The Equitable Life Assurance Society.

8 The complainants claim to have sustained financial and/or other injustice as a result of that alleged maladministration. The remedy they seek is full redress for the financial losses that they say they have incurred in consequence of the alleged maladministration; they also seek a remedy for the other injustice they claim to have sustained.

9 In accordance with section 10(1) of the 1967 Act, I have sent a copy of this report to all those Members of the House of Commons who have referred individual complaints to me about the subject matter of this report. In accordance with section 10(2) of the 1967 Act, I have sent a copy of this report to the principal officers of those bodies about whose actions those complaints were made.

10 I am also laying this report before both Houses of Parliament, pursuant to section 10(4) of the 1967 Act, as, for a number of reasons, I consider it to be in the public interest to do so.

11 First, I have received referrals of complaints about the subject matter of this report from Members of the House of Commons acting on behalf of their constituents in respect of 1,018 individuals. 1,480 other people have also contacted me direct to complain about similar matters, many of whom sent a copy of their correspondence to their Member of Parliament or have otherwise involved those Members.

12 The events which form the basis of those complaints have had an effect on many thousands of other individuals both in the United Kingdom and elsewhere. My report therefore affects the interests of a considerable number of people and a large number of Members of Parliament from all political parties and from all parts of the United Kingdom have contacted my Office to express their views.

13 Secondly, the actions I have investigated leading to the production of this report have been (and in some respects continue to be) the subject of a number of inquiries, investigations, and other proceedings – in the domestic courts, within relevant professional bodies, at the European level and before other Ombudsmen.

14 My intention is that my report will provide a clear explanation of the role of the prudential regulators and contain an authoritative account of the acts and omissions of those regulators and their advisers in respect of the relevant events.

15 Thirdly, the issues raised by the complaints that prompted my investigation have raised a considerable amount of interest within Parliament and relate to the performance of regulatory functions which, while the statutory regime relevant to my investigation is no longer in force, go to the heart of some current political debates – about the nature of financial services regulation, about what consumers and taxpayers might reasonably expect from such regulation, and about the relationship between public bodies and citizens in the fields of banking, pensions and life insurance.

16 My report therefore addresses questions of wide social and political importance and its contents might assist Parliament in their further deliberations on these issues.

The subject matter of the report

17 The investigation which led to this report has centred on allegations of regulatory failure on the part of those responsible for the prudential regulation of insurance companies in the period prior to 1 December 2001, as those general responsibilities were discharged in the case of The Equitable Life Assurance Society. In the rest of this report, that mutual life insurance company is referred to as 'Equitable' or 'the Society'– although in some of the direct quotations reproduced in this report, other acronyms commonly used by others have been retained.

Equitable

18 Equitable was founded as the 'Society for Equitable Assurances on Lives and Survivorships' in 1762. In August 1892, it was incorporated in the United Kingdom as a private unlimited company to be known as 'The Equitable Life Assurance Society'. As a mutual life insurance company, Equitable has no shareholders. Instead, it is owned by those who effected its with-profits policies. With-profits policyholders effectively stand in the position of proprietors, sharing in any profits made or losses

incurred in running the business. Equitable is generally accepted to be the oldest surviving mutual life assurance company in the world.

19 On 8 December 2000, Equitable announced that it would stop writing new business with immediate effect. Since then, the Society has undergone a difficult period and has implemented cuts in the policy values of its with-profits policies – or the income derived from its with-profits annuities.

20 The operation of the Society's differential terminal bonus policy in respect of a representative policy for which the default benefit was an annuity paid at a guaranteed rate had become the subject of a judicial decision of the House of Lords on 20 July 2000 in *Equitable Life Assurance Society v Hyman* ([2002] 1 AC 408). That policy, which Equitable had adopted since January 1994, involved the paying of different levels of terminal bonus to policyholders exercising their right to take an annuity at the guaranteed rate than were paid to policyholders not exercising such a right. The House of Lords held that this policy was unlawful.

21 In the aftermath of the House of Lords' decision, the position of Equitable was discussed at a tripartite meeting between the Treasury, the Bank of England, and the FSA held two days prior to the announcement of the Society's closure to new business. At that meeting, Treasury officials explained their view that the problems faced by the Society had been caused by a unique set of circumstances which had contributed to the Society's position being distinct from that of other life insurance companies.

22 The four most important factors identified in that discussion were:

- first, that Equitable had for many years operated a policy of full distribution of any surplus through bonuses to its with-profits policyholders and a policy of not building up a free estate, leaving the Society with a comparatively low level of free assets;
- secondly, that Equitable, being a mutual, had no access to additional, shareholder capital;
- thirdly, that Equitable had offered relatively generous and flexible guarantees on certain types of policy; and
- finally, that the proportion of the Society's business to which those guarantees applied was much higher than was the case for other companies.

23 At the time that Equitable closed to new business, it was thus considered by the prudential regulators that the bonus distribution policy of the Society and also the level and extent of its guaranteed annuity rate policies – which enabled policyholders to secure an annuity with their pension fund at a specified, guaranteed rate as opposed to the then current annuity rates set by the Society or available on the open market – were of central importance to the Society's problems.

24 The announcement by Equitable of its closure to new business had been prompted by the withdrawal of the last potential bidder from the process that had been launched to seek a buyer to acquire the Society following the decision of the House of Lords in the *Hyman* case.

25 In a letter sent by Equitable to all its policyholders on 12 December 2000, those events and the background to them were summarised by the then President of the Society as follows:

As most policyholders will be aware, on 8 December 2000 the Board announced that it had been unable to find a purchaser for the Society and had decided to stop writing new business ... I must stress that the Society remains solvent and will continue to pay benefits and accept premiums under existing policies ...

I am greatly saddened by the need to close the Society ... but the Board decided ... that this was the only realistic option. I apologise most sincerely to you ... that this has come about. The intention of the sale process had been to make good the loss of growth for with-profits policies from 1 January to 31 July 2000 which followed the House of Lords' ruling. In the event, this loss of value is unlikely to be restored, although we remain committed to generating the greatest possible value from the sale of some of the Society's operations and providing the best possible ongoing service.

26 On 19 December 2000, during the first debate in the House of Commons on the closure of Equitable to new business, the sponsor of that adjournment debate, Mr Richard Ottaway MP, said that:

On the role of the regulator, it is the view of many in the industry that the Equitable has been treated differently by successive regulators ... It is clear that something had to give. It was not possible for some policyholders to have guaranteed policies with guaranteed annuities, while other categories of policy holder were not so entitled, without there being some difficulty ...

What was the regulator's view? When it looked at policyholders' contracts, did it think that the directors were adopting a policy that was nowhere mentioned in the contract? If not, why not?

27 Other complaints soon began to be made. Those complaints alleged that failures by those responsible for the prudential regulation of Equitable had caused or contributed to the position in which the Society had found itself when it had closed to new business.

Insurance regulation

28 In the period since 1988, the regulation of insurance companies within the United Kingdom has been subject to different statutory regimes within two distinct time periods. The first period ran from April 1988 to December 2001. In this period, the regulatory regime was effectively split along functional lines and was based on two separate statutes: the Insurance Companies Act 1982 – which concerned primarily the prudential regulation of insurance companies – and the Financial Services Act 1986 – which concerned the regulation of the conduct of investment business, including the marketing activities of life insurance companies.

29 Responsibility for the prudential regulation of insurance companies – which was primarily related to supervision of the solvency of such companies and their ability to meet and continue to meet their liabilities to policyholders and to fulfil the reasonable expectations of those policyholders or of potential policyholders – lay throughout this first period with central Government Departments.

30 During the period prior to 4 January 1998 relevant to this report, the prudential regulator was the Department of Trade and Industry (the DTI) and its predecessors; from 5 January 1998 to 1 December 2001, the prudential regulator was Her Majesty's Treasury (the Treasury). From January 1999 until 1 December 2001 aspects of the day-to-day prudential supervision of insurance companies were contracted out to the Financial Services Authority (the FSA) – which, in this role, acted on behalf of the Treasury.

31 Furthermore, throughout the period relevant to this report legal advice to the prudential regulators was provided by in-house lawyers and, until 26 April 2001, actuarial advice was provided by the Government Actuary's Department (GAD). Thereafter, actuarial advice was provided to the FSA by actuaries directly employed by the FSA, some of whom had previously worked for GAD.

32 Actions taken by all of the bodies with statutory responsibility for prudential regulation during the first period are within my jurisdiction, where those actions are taken in the exercise of administrative functions of such bodies. GAD, however, was not within my jurisdiction until the beginning of this investigation (see paragraphs 18 and 21 of Chapter 3) and was only brought within my investigative reach on a limited basis, to enable me to conduct this investigation.

33 I may only investigate action taken by GAD on or before 26 April 2001 in the giving of advice concerning the exercise of administrative functions under Part II of the Insurance Companies Act 1982 or any other enactment concerned with the regulation of insurance companies.

34 The FSA's actions are only within my jurisdiction in so far as those actions relate to the prudential regulation of insurance companies during the period in which the FSA undertook this regulation on behalf of the Treasury. I have no power to conduct investigations in respect of any other of the actions of either GAD or the FSA.

35 Conduct of business regulation throughout this first period was delegated to a system of industry and practitioner-based, self-regulatory organisations under the supervision of a designated agency. This agency was at first called the Securities and Investments Board but became the FSA. The self-regulatory organisations of which the Society was a member during the period covered by my investigation were, until 1994, the Life Assurance and Unit Trust Regulatory Organisation and, from 1994, the Personal Investment Authority. None of the bodies with statutory responsibility for conduct of business regulation are or were within my jurisdiction.

36 The regime that was operational during this first period and which entailed this functional split between prudential and conduct of business regulation was replaced on 1 December 2001 by the current integrated regulatory regime, governed by the Financial Services and Markets Act 2000.

37 Since then, in this second period, the regulatory regime has combined all aspects of insurance regulation within the remit of one regulator – the FSA, which now regulates the insurance industry in its own right. The FSA, acting in its own right, is not within my jurisdiction and so, consequently, complaints about action taken as part of the regulation of any insurance company on or after 1 December 2001 are not ones that I have the power to consider.

38 I now complete this introduction by explaining the structure of my report.

The structure of the report

The Parts to the report

39 My report is in four Parts (or volumes): this, **Part 1**, describes the background to my investigation, summarises the evidence and representations submitted to me by the parties to the complaints, explains the tests I have applied in determining those complaints within the general and specific contexts of the subject matter of this report, sets out my key findings of fact, and contains my determinations as to whether

maladministration occurred and, if so, whether it has resulted in any unremedied injustice.

40 **Part 2** of the report contains a factual description of the historical development of the regime that was relevant to the prudential regulation of life insurance companies during the period prior to 1 December 2001.

41 **Part 3** of the report contains a detailed chronology of events relating to the prudential regulation of the Society during the relevant period.

42 Finally, **Part 4** of the report contains some key primary documents, reproduced in whole or in part, which I consider are either key to a full understanding of the matters that I have investigated or which help place my determination of the relevant complaints in a wider context.

43 We have also prepared a guide to the main report and summary of findings and recommendations, which is published as Part 5 of this report.

The Chapters in this Part of my report

44 There are fourteen other Chapters in this Part of my report:

Chapter 2 sets the scene for the investigation I have conducted, focusing on the events which form the background to, and the context for, my investigation, and also on the other reviews, inquiries and litigation which have taken place (or which continue to take place) in respect of Equitable.

Chapter 3 explains the involvement of my Office in respect of the events related to Equitable and which led to my decision to conduct this investigation. It also outlines the legal and administrative framework for the investigation and describes the process that I have used to conduct it.

Chapter 4 sets out the general and detailed complaints that have been made to me about the prudential regulation of the Society. It also sets out the initial response to those complaints of the public bodies whose actions were the subject of complaint.

Chapter 5 sets out the basis for my determination of the complaints. It describes my general approach to investigating complaints of injustice sustained as a consequence of maladministration; and sets out both the general principles of good administration and public law and the specific legal and administrative framework of prudential regulation applicable to my consideration of those complaints. It concludes with a summary of the key obligations of the prudential regulators and/or GAD which are relevant to this investigation.

Chapters 6, 7 and 8 set out a summary of the way in which the prudential regulation of the Society was undertaken in three time periods:

- the first period being prior to 20 June 1998;
- the second period being from 20 June 1998 to 8 December 2000, when the Society closed to new business;
- the third period being the post-closure period from 8 December 2000 to 1 December 2001, when my jurisdiction ends.

Chapter 9 contains the preliminary assessments which I have made in respect of disputed questions concerning what standard of regulation it would be appropriate to apply when reviewing the acts and omissions of those undertaking the prudential regulation of the Society, and what powers were available to those regulators.

Chapter 10 sets out the results of my review of the evidence I have obtained and contains my findings of fact.

Chapter 11 sets out my determinations as to whether the acts and omissions of the prudential regulators and/or GAD constitute maladministration.

Chapter 12 sets out my determinations as to whether any such maladministration has led to injustice to those who have complained to me.

Chapter 13 contains my disposal of each complaint within the terms of reference for the investigation, setting out which I have upheld in full, which I have upheld in part, and which I have dismissed.

Chapter 14 considers questions of remedy and contains my recommendations.

Chapter 15 contains my concluding remarks.

Chapter 2 – The background: The Equitable Life Assurance Society

Introduction

1 In this Chapter, I set the scene for the investigation I have conducted, focusing on the events which form the background to, and context for, this report. I also explain which other reviews, inquiries and litigation have taken place (or which continue to take place) in respect of Equitable.

2 This Chapter is structured in the following way:

- in paragraphs 3 to 10, I describe the constitution of the Society;
- in paragraphs 11 to 18, I summarise the nature of the business Equitable conducted during the period covered by this report;
- in paragraphs 19 to 66, I explain the Society's distinctiveness in certain respects within the wider context of the United Kingdom life insurance market at the time;
- in paragraphs 67 to 69, I describe the reputation that the Society had gained at the relevant time;
- in paragraphs 70 to 96, I summarise the events which led to the closure of Equitable to new business on 8 December 2000;
- in paragraphs 97 to 123, I describe the principal events relevant to this report which have occurred following that closure to new business; and
- in paragraphs 124 to 167, I set out the professional and regulatory reviews, inquiries, complaints and litigation which have taken place or been made (or which continue to take place or to be made) in respect of, or relating to, the closure of Equitable to new business.

Equitable

The constitution of the Society

3 I explained in Chapter 1 of this report that Equitable, founded in 1762, is generally believed to be the oldest surviving mutual life insurance company in the world. The Society was registered with its current name as a private unlimited company on 18 August 1892.

4 Equitable's constitution is contained within the Memorandum and Articles of Association, which set out the objectives of the Society and which make provision for who may become a member, the rights and responsibilities of those members, and the Society's governance and organisation.

5 Throughout its history, the Society has been owned by its members. As a mutual life insurance company, its participating policyholders became members of the company and shared in any profits made or losses incurred in running the business of the Society. However, not all of its with-profits policyholders are members of the Society. Only the person who effects a with-profits policy is a member of the Society and, where such a policy is effected by two (or more) people, only the first-named (living) person is a member.

6 The Society is governed by a Board of Directors, which is appointed by the members. Throughout the period covered by this report, the executive directors on the Board were mainly actuaries and, amongst other things, they represented both the Society's finance and actuarial functions. None of the non-executive directors was an actuary (except during the period between 1991 and 1993, when the Society's former Chief Executive, who was an actuary, joined the Board as a non-executive director). During the period relevant to this report, the Society's Chief Executive was always an actuary.

7 The Society has no shareholders, so the scope for conflict between the interests of policyholders and shareholders which can occur in a proprietary life insurance company does not arise.

8 The Society's annual general meetings are open to its members and consider standard items, including the election of directors. Matters not included in that standard agenda are treated as special business. The voting rights of individual members are defined in articles 24(3) and 24(4) of the Society's Articles of Association. On a poll, each member is entitled to one vote for every £1,000 of the sum assured of the with-profits policies that member holds, limited to a maximum of ten votes.

9 The Society's Articles of Association during the period covered by this report made provision for an 'Actuary' to carry out a valuation at least triennially. The Society was the first life insurance company to use the title 'Actuary', having introduced the term in the 18th century.

10 The initial holders of this post (particularly William Morgan) are credited with much of the early development of actuarial science. With the passage of time, the designation 'Actuary' (and later 'General Manager and Actuary') became the Society's title for its Chief Executive – although this is no longer the case.

The nature of the Society's business

11 In the 1950s, Equitable were a relatively small mutual company, selling largely retirement plans – in particular, to university staff under the Federated Superannuation Scheme for Universities. This source of business disappeared in the early 1970s, when the Federated Scheme took the management of its pension business in-house.

12 The Society at that time embarked on a new strategy of active marketing to the upper end of the pensions market, concentrating on high net-worth individuals. It developed new products, a sales force and a branch network.

13 That new strategy was successful, and growth between 1970 and 2000 was substantial. According to the Society's published accounts, at the end of 1970, 1988 and 2000 the total value of funds under management was, respectively, £113 million, £4,163 million and £33,899 million.

14 The Society's business was largely pensions business. Equitable did write some non-pensions business, ranging from endowments to school fees policies, but this was far less financially significant.

15 Equitable sold both individual and group pensions business. Individual products were mainly aimed at the market for high net-worth self-employed individuals, and, in particular, self-employed professionals. The Society also provided pension annuities to individuals on their retirement or to trustees to provide an income when scheme members retired.

16 Group products were sold to trustees of occupational pension schemes and included investment products aimed at small to medium size occupational schemes. Those products were also sold as additional voluntary contribution arrangements for larger schemes, including both the National Health Service and Principal Civil Service pension schemes.

17 While the Society wrote other sorts of pensions business, it was best known for its with-profits products. The option of a broadly-based fund where the Society made the investment decisions and the results were smoothed was attractive to many investors. As a result of this and of the Society's concentration on pensions business, the majority of the business it sold constituted with-profits pensions.

18 Over time, Equitable developed other products to help maintain their position. The Society was one of the first offices to introduce with-profits annuities and income drawdown products. It also allowed combinations of with-profits and unit-linked investments within the same policy.

The distinctiveness of Equitable

19 In addition to being regarded as the oldest mutual life insurer in the world and as important to the early development of actuarial science, the Society was distinctive in other ways related to the nature of its business and its commercial policies.

20 The pension savings products sold by Equitable were generally more flexible than other products available in the market. In particular, under its most popular pension policies the Society did not require policyholders to make regular or minimum premium payments every year.

21 In addition, policyholders did not have to choose a specific retirement age when purchasing a policy. This meant that those who retired 'early' with an Equitable policy typically avoided some of the penalties that could be imposed by other insurers, so that those policyholders were free to retire at any age that was permitted under what were then the Inland Revenue rules relevant to the product.

22 Another way in which it was distinctive was the nature of the guarantees contained within the Society's products. The Society provided a range of guarantees on its with-profits pension products, although those of its policies issued in later years did not contain all of those guarantees. However, unlike some other life insurance companies at the time, the Society did not impose explicit charges for these guarantees via an addition to the premium charged or a deduction from each policy's share of the assets of the with-profits fund.

23 The Society provided three main types of guarantee. Although many life insurance companies provided similar guarantees, Equitable differed in their application of those guarantees. Such guarantees were also provided on an unusually high proportion of the Society's business and a significant proportion of that business contained all three guarantees.

24 The first guarantee provided by the Society was that policyholders would receive full benefits on retirement, without penalty. However, while most other insurance companies generally restricted this guarantee to one particular age, usually selected by the policyholder at the outset, Equitable provided this guarantee at a wide range of ages.

25 The second guarantee provided by the Society was in the form of a guaranteed investment return, which meant that the guaranteed benefits available to policyholders (based on the sum assured) would grow at a minimum rate each year whatever the Society's actual investment performance had been. This guaranteed investment return was not included within new policies sold from 1996 onwards.

26 Equitable differed from most other companies because the level premium policy structure of those other companies normally meant that only future premiums paid at the initial level would benefit from guarantees in the original policy. Most other companies had ceased to offer guaranteed investment returns by 1990, although some continued to offer them into the mid-1990s.

27 However, with the Society, future premium payments in respect of policies which already contained this guarantee (including recurrent single premium policies where policyholders had the right, but not the obligation, to pay further premiums) continued to benefit from this guarantee.

28 The third guarantee provided by the Society was in the form of the guaranteed annuity rates it wrote into some of its policies. Those guaranteed the rate at which the proceeds available at retirement (based on the sum assured plus associated bonuses) would be converted to pension – and thus the minimum amount of pension available at retirement.

29 The Society stopped providing guaranteed annuity rates on new policies from June 1988, although new members of some existing group schemes continued to be provided with policies containing guaranteed annuity rates until the early 1990s.

30 The guaranteed annuity rates provided by the Society were more generous than those provided by most other companies. Those guarantees were also more flexible, as they gave policyholders the option to apply the guarantees over a wide range of ages rather than the more usual practice of applying them at a single age.

31 Under the terms of most of the Society's policies containing those guarantees, including the comparatively high proportion of recurrent single premium policies, benefits purchased by future premiums would also enjoy the same guarantees. In this respect, the Society differed from most other companies who restricted the amount of future premium payments that could benefit from such guarantees.

32 At the time of the changes made by the Society to remove guaranteed annuity rates and, subsequently, to remove guaranteed investment returns from the policies it wrote, no new fund was established by the Society. Thus the assets held in respect of the different classes of policy thereby created were held in one fund.

33 Nor was there a separate bonus series declared or any differentiation in treatment between the various classes of individual pension policyholders in terms of the level of bonuses declared by Equitable, despite the changes in policy terms and the associated guarantees that had occurred.

34 Equitable differed from other life insurance companies in other ways. One example was that, from the 1987 bonus declaration onwards, the Society began to illustrate in annual bonus statements, under the heading of '*Present value of the fund*', the policy value for each policyholder, including the value of terminal (or '*final*') bonus.

35 Those bonus notices explained that the amount of final bonus payable was not guaranteed and that it might vary as financial conditions altered. Those notices also said that, when benefits were ultimately taken, the amount of final bonus could be less than the final bonus illustrated. Other companies typically provided less information than this, or focused only on the guaranteed benefits.

36 Another example of the Society's distinctiveness was its bonus policy introduced from 1989. Equitable stated that this reinforced their philosophy of providing a 'full and fair' return to policyholders. The Society treated its with-profits policyholders as participating in a managed fund[1], which allowed them to benefit from investments in a wide range of assets[2].

37 In the Society's accounts for 1992, its then President said:

[1] This view was set out by two actuaries employed by the Society in a paper, *'With Profits Without Mystery'*, presented to the Institute of Actuaries and to the Faculty of Actuaries in 1989 and 1990. This paper was, much later, to become the most famous exposition of the Society's approach.
[2] See also, for example, Section C of the Society's *With-Profits Guide* as at 1 July 1997.

In the Equitable we pride ourselves on allocating earnings from our investments across all classes and durations of contact in as fair and consistent a manner as possible. The fundamental philosophy is that each generation of policies should receive benefits commensurate with the earnings produced during its lifetime. Beyond the bounds of normal commercial prudence, it would be alien to our culture to hold back benefits from one generation to build reserves for a future generation.

38 Equitable thus did not maintain an estate – that is, assets in excess of the amount needed to meet policyholder benefits, including terminal bonus. Apart from maintaining what was sometimes referred to as a 'revolving estate' to provide some working capital, the Society said that it made a full distribution to its participating policyholders.

39 The Society also considered that all its policyholders should get a fair return, which reflected investment earnings during the period of their membership, whilst avoiding short-term fluctuations in those earnings.

40 Prior to 1989, Equitable aimed to achieve this using a bonus system similar to that of other life insurance companies writing with-profits business, in that the Society declared different levels of terminal bonus for policies maturing at different durations since commencement.

41 For the 1989 bonus declaration, the Society changed its bonus system and introduced the concept of a 'total policy fund' for each policy, which started at the amount of the sum assured and subsequently grew by an amount that represented accumulated bonuses, including terminal bonus.

42 In order to do this, the Society decided to allocate a single growth rate, adjusted for tax, as appropriate, to the total policy fund of all policies, irrespective of policy duration or the guarantees they contained.

43 The total policy fund equalled the policy value illustrated to policyholders each year. Also, each year, the guaranteed funds of each policy (which, at the outset, equalled the sum assured) were increased by the addition of the guaranteed investment return and any declared reversionary bonuses. The amounts of the guaranteed funds were shown in the statements sent to policyholders each year.

44 The rate of growth of the guaranteed funds was intended to be lower than the rate of growth applied to the total policy fund. Thus, under the Society's new system, final bonus represented the amount required to lift the guaranteed benefits up to the total policy fund value.

45 Policyholders were also told in the Society's *Annual Report and Accounts* and, from 1993, in its *With-Profits Guides*, about the investment returns earned on the with-profits fund in the year and, starting with the 1989 *Annual Report and Accounts*, policyholders were also informed of the returns which had been allocated to their total policy funds.

46 A further example of its distinctiveness related to the Society's approach to the adjustment of policy values, equal to the total policy funds, applicable on surrender.

47 Where policy values, including terminal bonus, were in excess of the market value of underlying assets, it was common for life insurance companies to use market value adjusters in order to restrict the benefits paid to policyholders who withdrew from the fund at times other than at maturity, death or retirement. It was also common for such companies to penalise policyholders who were in theoretical breach of contract by surrendering their policy before the contractual retirement or maturity date.

48 In common with other life insurance companies, at certain times Equitable applied market value adjusters to reduce payouts on non-contractual withdrawals from the with-profits fund. The Society's stated aim when applying such adjusters was to protect remaining policyholders. This was achieved by paying surrender values that approximated to the market value of the underlying assets of each policy if this amount were less than the value of its total policy fund.

49 However, unlike other companies, Equitable said that they did not use market value adjusters unduly to penalise surrendering policyholders. For this reason, the approach Equitable adopted was to apply market value adjusters only if significant numbers of policyholders were judged to be seeking to take advantage financially of the with-profits fund.

50 The Society said that this was done to ensure that continuing policyholders were not disadvantaged by withdrawing policyholders being paid more than their fair share, measured by market value, of the underlying assets.

51 The Society's practice in this respect during the 1990s was more generous than that of most other life insurance companies. Before November 1992, most of its surrender values were not adjusted – although some, involving large amounts payable to individual policyholders and all those in respect of group schemes, did suffer such adjustments.

52 From November 1992, adjusters were applied to all surrenders at various levels until such adjusters were withdrawn in March 1997. Adjusters were reintroduced in July 2000 and then applied to all surrenders.

53 Yet another example of the distinctiveness of the Society relates to the fact that it did not pay commission to third parties for the introduction of a potential investor to the Society's sales force and was said by the Society to be a reason for its low expenses.

54 The combination of these distinctive features of the Society's business was not in itself problematic. However, as the external environment changed, the combination of those features eventually would have profound effects.

55 Briefly in late 1993 and early 1994 and continuously from April 1995 onwards, the Society's guaranteed annuity rates became generally more favourable than its then current annuity rates.

56 As a result, the application of a single growth rate to the total policy fund in respect of all policies would have meant that those policyholders whose policies contained guaranteed annuity rates could receive a greater proportion of the surpluses than was, in the Society's view, compatible with its stated approach to 'full and fair' distribution.

57 In order to deal with this situation, the Society introduced what came to be known as the 'differential terminal bonus policy' to enable it to continue to reflect the Society's philosophy of 'full and fair' distribution to all its policyholders in its bonus policy.

58 Under the differential terminal bonus policy, the amount of final bonus payable when a policyholder took benefits under a policy would be dependent on the form in which those benefits were taken – that is, either a guaranteed annuity of a specified type or a current annuity where a wider choice of benefits was available, such as index-linked or joint-life annuities.

59 In particular, if the guaranteed annuity were taken, the level of terminal bonus was reduced from the rate that otherwise would have applied – restricting the amount of the annuity so that its value equalled the value of an annuity available at the then current rate, in respect of which the full amount of terminal bonus was awarded.

60 The operation of the differential terminal bonus policy, however, did not reduce the amount of the resulting annuity to below the amount provided by the application of the guaranteed annuity rate to the amount of the guaranteed fund value.

61 Notes to the Annual Statements provided to policyholders, included from the Statements for the year ending 31 December 1995 and subsequently, gave a brief description of the differential terminal bonus policy[3]. However, at that time no other indication was given to the Society's policyholders of the effects of that policy.

62 Whether the operation of the differential terminal bonus policy was consistent with the understanding that the Society's policyholders had developed of the terms of their policies and the nature of the Society's approach was a question which was central to what those policyholders might reasonably expect from the Society.

63 At all times relevant to this report, it was commonly accepted that the reasonable expectations that the policyholders of a with-profits life insurance company possessed would be influenced by, among other matters, the illustrations, marketing material and other information that had been provided to them.

64 There was therefore a direct link between the Society's method of illustrating benefits and the expectations that its policyholders would have as to what benefits they would receive in normal circumstances.

65 The introduction of the differential terminal bonus policy in this context thus added to the distinctiveness of the Society. While some other companies also adjusted terminal bonuses in a similar way in the type of circumstances which faced the Society from 1995 onwards, those companies tended to illustrate benefits to their policyholders without including terminal bonus in the illustrations and often had separate bonus series for policies with and without annuity rate guarantees.

66 This meant that the expectations of their policyholders may have developed in a different way from those that the Society's policyholders were likely to possess.

The Society's reputation

67 While the Society was distinctive in important ways, some of which were, in combination, to have significant adverse consequences in due course, the Society had a generally excellent reputation until the differential terminal bonus policy began to be questioned and challenged.

[3] For example, for the year ending 31 December 1995, the note said *'the total fund values include amounts of final bonus which are not guaranteed and may vary. In addition, where the policy provides a guarantee of terms on which annuity benefits can be secured, the final bonus then payable will take account of the cost of providing that guarantee. The fund available at retirement may therefore be less than the total shown, but would not be less than the guaranteed value'.* In 1997, some categories of policyholder received only an abbreviated note. No notes were included in the statements for the years ending 31 December 1993 or 31 December 1994.

68 During the 1980s and 1990s, Equitable had built up a reputation for good customer service, provided by skilled and efficient staff. The Society had said that it had invested significant resources in developing its administration systems[4], which were at the time generally considered to be efficient and were, for example, used to administer contracts for other insurers, as well as those systems being sold to third parties.

69 Equitable also told policyholders that the Society's expenses were low compared to other offices due to these efficient systems[5]. In addition, Equitable had developed good management information systems that were said to allow regular and detailed monitoring of expenses and investment policy. Equitable were generally seen as a market leader, albeit one that was, in certain respects, out of step with the rest of the industry.

The events leading up to closure to new business

70 As I have noted in paragraph 57 above, with effect from 1 January 1994 and in a context of reducing interest rates and of improving longevity[6], the Society introduced what became known as its differential terminal bonus policy.

71 That policy was introduced in order to deal with the cost of meeting the guaranteed annuity rates within its older policies, which had become more advantageous to its policyholders and thus more onerous for the Society than the current annuity rates otherwise available.

72 Interest rates continued to fall during the 1990s. The actuarial profession undertook work to review industry practice in the light of the fact that guaranteed annuity rates generally were then, in that low interest rate environment, starting to exceed current annuity rates.

73 In June 1998 and in the light of the profession's work, GAD, with the permission of the prudential regulators, surveyed the approaches of life insurance companies to reserving for annuity guarantees.

74 The analysis undertaken by GAD of the results of that survey found that, while eight companies gave general cause for concern in terms of the approach adopted by those companies to this question, Equitable and one other company were notable exceptions to industry practice and were of particular concern.

75 This was because those two companies did not hold adequate reserves to cover the liabilities which existed in respect of these policies and GAD were concerned about their ability to meet their statutory solvency requirements once they did so reserve.

76 From October 1998 onwards, the Society, the prudential regulators and GAD entered into extensive discussions about the regulatory requirements concerning reserving for annuity guarantees and the consequent need for the Society to establish significant reserves to cover the liabilities which arose from its policies which contained guaranteed annuity rates.

77 In 1999, Equitable entered into a financial reinsurance arrangement with IRECO, a reinsurer based in Dublin, in order to seek to mitigate the impact of the reserving requirements to which the prudential regulators and GAD had now insisted that the Society had always been subject.

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[4] See, for example, the Annual Report and Accounts as at 31 December 1989: *The President's Statement,* pages 3 and 10, and the Annual Report and Accounts as at 31 December 1991: *The President's Statement,* page 3.
[5] See, for example, the Annual Report and Financial Highlights as at 31 December 1997: *The President's Statement to Members*, page 4.
[6] Which affected the annuity rates that were generally available to a policyholder when benefits under a pension policy were taken.

78 That arrangement, which had been 'backdated' to 31 December 1998 and was first relied on in the Society's regulatory returns for 1998, was contingent on the Society maintaining its differential terminal bonus policy.

79 Whilst now reserving as GAD required, the effect of the way that the Society treated the arrangement with IRECO in the calculation of its long term liabilities was to reduce that amount by £809 million as at the end of 1998, and by £1,098 million as at the end of 1999.

80 In the meantime, complaints had begun to be made to Equitable and to the Personal Investment Authority Ombudsman about the Society's operation of the differential terminal bonus policy.

81 On 15 January 1999, in response to those complaints about the legitimacy of their approach, Equitable instituted a legal action against a representative guaranteed annuity rate policyholder, Mr Hyman, to seek confirmation from the Court that the Society's approach was lawful and within the discretion of its Board. The Society funded Mr Hyman's costs. The policy document which was at the centre of those proceedings is reproduced in Part 4 of this report.

82 According to papers lodged with the Court, Mr Hyman had been chosen as the representative defendant because he was the only policyholder from among those who had made formal complaints to the Personal Investment Authority Ombudsman who had already taken retirement benefits.

83 On 9 September 1999, the High Court ruled that the Society was entitled to operate its differential terminal bonus policy, but Mr Hyman was given leave to appeal.

84 On 21 January 2000, the Court of Appeal gave judgment against Equitable by a majority of two to one. The Society was granted leave to appeal to the House of Lords and was permitted by the Court in the interim to continue to operate its differential terminal bonus policy pending that appeal – subject to the assurance that, if the Court of Appeal's decision were to be upheld, Equitable would pay additional sums in respect of any retirement or maturity after the date of the decision of the Court of Appeal.

85 On 20 July 2000, the House of Lords handed down its decision and held that Equitable could not apply different rates of bonus depending on whether or not a policyholder took benefits based on guaranteed annuity rates. The House of Lords also held that the Society could not pay lower bonuses to policyholders with annuity rate guarantees as a class than those paid to the class of policyholder whose policies did not contain such guarantees. The differential terminal bonus policy could no longer be applied.

86 The decision of the House of Lords had a significant and immediate financial impact on the Society. The decision of the House of Lords meant that the Society could not 'ring-fence' groups of existing policyholders from its effects. The increased costs to the Society had to be charged to the entire with-profits fund, and shared among all those holding at that date all types of with-profits policies, whether or not those policies contained an annuity guarantee.

87 In the absence of the operation of the differential terminal bonus policy, the ability to take benefits in guaranteed annuity rate form became significantly more attractive. The Society was now required to apply, without reduction of terminal bonus, the guaranteed annuity rate to the total policy funds of those policyholders whose policies contained such

rates where they elected to take benefits in this form. This meant that it had become more likely that policyholders would so elect.

88 Equitable now had significantly increased liabilities against which they held much reduced assets. This was in part because the financial reinsurance arrangement, for which credit of £809 million and £1,098 million, respectively, had been taken by Equitable within their regulatory returns to the prudential regulators in respect of 1998 and 1999, could no longer be relied upon.

89 As the continuation of that arrangement had been conditional upon Equitable maintaining the differential terminal bonus policy, which the House of Lords had held to be unlawful, the financial reinsurance arrangement now needed to be re-negotiated, which it was subsequently. The Society thereafter relied upon that arrangement again within its 2000 regulatory returns, although the credit taken was reduced to approximately £500 million.

90 The decision of the House of Lords had other effects. In the words of the Society's press release of that day, that decision also would '*increase the Society's statutory reserves and that will diminish the Society's capital strength and reduce its investment freedom*'.

91 In the face of all this, the Society immediately announced that it was seeking a buyer, saying that:

> *Despite the Society's long commitment to mutuality, the Board has concluded that members' interests will be best served by the sale of the business to an organisation capable of providing capital support and therefore ensuring continued investment freedom. The proceeds of* [a] *sale to such a parent will mitigate the reduction in benefits that with profits policyholders not taking* [guaranteed annuity rate] *benefits would otherwise suffer.*

92 On 26 July 2000, Equitable further announced that, in the light of the decision of the House of Lords, the Society had set new final bonus rates. For with-profits policies where benefits were taken in guaranteed annuity form, the Society said that those policies would '*receive higher benefits than would have been available under the Society's previous approach*'. For with-profits policies which did not contain an annuity guarantee, or where the guaranteed annuity was not selected, the Society said:

> *These policies will receive lower growth in the current year than would otherwise have been the case as a result of the need to cover the increased GAR benefits. There will thus be no growth on these policies' funds from 1 January 2000 to 31 July 2000...'* [7].

However, the Society went on to say that a particular aim of the sale of the business was to replace this loss of growth of policy funds.

93 One further result of the House of Lords' decision was that it now appeared that policyholders with policies containing guaranteed annuity rates who had taken benefits between 1 January 1994 and 19 July 2000 had been presented with information about their options which had been incorrect.

[7] Internally, on 27 July 2000 Equitable described the broad effect of these changes as being: '*For the main classes of business, current policy values before 20 July 2000 for contractual benefits were achieved by rolling forward the 31 December 1999 values by a given growth rate. The Board has decided that a reduction in policy values of around 5% is necessary and this will be achieved by giving no growth for the first seven months of this year and resuming the appropriate interim overall rate of return with effect from 1 August 2000*'. In relation to with-profits annuities, Equitable said that: '*such policies cannot be transferred and thus a more gradual approach can be taken to adjusting rates. Therefore a reduction of 1% p.a. will apply in the growth rates for with-profits annuity contracts to avoid too sharp a discontinuity in income levels*'. The Society also changed its terms for non-contractual exits from the with-profits fund by introducing a 20% deduction to final bonus.

94 In response to this problem, in December 2000 the Society launched a Rectification Scheme, with the objective of putting policyholders in the position they would have been in had final bonus rates been set in accordance with the principles set out within the House of Lords' decision at the time at which they had taken benefits.

95 The announcement on 8 December 2000 that Equitable had closed to new business with immediate effect, following the failure of an attempt to effect a sale of the Society's business to another insurer, came as a shock to many of its members and to outside observers.

96 Equitable had been viewed as a well-regarded institution with a venerable and proud tradition. However, the attempt at sale still failed. While many companies had expressed some interest in purchasing the Society, none put in a formal bid after examination of the Society's financial position.

The aftermath of closure to new business

Regulatory response

97 The closure of the Society to new business also attracted a regulatory response. The FSA – the body by then responsible under contract for exercising on behalf of the Treasury and the Personal Investment Authority (one of the conduct of business regulators) various regulatory powers in respect of insurance companies such as Equitable – issued a press notice on 8 December 2000.

98 In this notice, the FSA said that:

> *The Society has worked closely with the... FSA since its decision to put itself up for sale. We have been in particularly close touch since it became apparent in recent days that an offer for the Society might not, in the event, be made. As the management of the Equitable said after the House of Lords judgment, the institution's special circumstances meant that a sale was in the best interests of policyholders, as it would provide the investment flexibility necessary to permit long-term continuation of business as normal. The Society will now need to review its investment strategy and, as is normal in a closed fund, this is likely to lead to a progressive move away from equities to lower risk investments over time.*

99 The press notice continued:

> *The FSA has stressed the importance of the Equitable providing comprehensive and timely information to its policyholders so that they can consider their options fully... The FSA will continue to monitor closely the operations of the Equitable. The Society continues to meet the statutory solvency requirements.*

Sale of parts of the business

100 The Society continued to make efforts to mitigate the impact of the House of Lords' decision on its financial stability and future prospects. On 22 December 2000, it was announced that the Society's wholly-owned subsidiary, the Permanent Insurance Company Limited, was to be sold – which it subsequently was, to Liverpool Victoria Friendly Society.

101 On 5 February 2001, Equitable announced that, through a deal agreed with Halifax Group, the Society had raised capital by reinsuring its non-profit and unit-linked business (including index-linked policies, but excluding annuities) and by selling its sales force, its asset management function, and its customer services division.

102 As a result, additional future payments, conditional on sales performance and on the implementation within a set timescale of a scheme of arrangement under section 425 of the Companies Act 1985 (commonly known as a Compromise Scheme), were to be made to the Society.

103 Despite these sales of parts of its business, the Society continued to face significant financial uncertainty in a context of difficult market conditions, with the stock market falling by 10% during 2000 and by a further 15% during 2001. Those conditions were reflected in a market value adjuster applied to non-contractual exits, which had been set at 10% from when the Society closed to new business, and which was increased on 16 March 2001 to 15%.

104 On 28 February 2001, the new Chairman of the Society said, in an open letter to policyholders that:

> *... the* [with-profits] *fund is intact and solvent and has been strengthened by the Halifax first instalment of £500m. However, the potentially open-ended nature of the* [guaranteed annuity rate] *policies means that the position is unsatisfactory for all policyholders and investment freedom is constrained. A compromise agreement... will allow us to stabilise the* [guaranteed annuity rate] *costs and will trigger a further large payment from the Halifax. The combination of these should restore the investment freedom of the fund.*

Policy value cuts

105 On 16 July 2001, Equitable announced to the Society's policyholders that the Board had decided to reduce final bonuses on all with-profits policies.

106 The total policy funds of each with-profits pension policy were reduced by an amount equal to 16% of their value as at 31 December 2000, with reductions made of 14% in the value of all non-pension with-profits policies. Those cuts reduced previously notified accumulated terminal bonuses but could not reduce benefits on any particular policy below the level of its guaranteed fund. Similar cuts to the benefits to be paid under with-profits annuities were also made at a later date.

107 That decision had been taken, Equitable said, following analysis of the Society's cash flows, premiums, the rates of policies maturing and being surrendered, and the value of investments underlying the fund – and after assessment had been made of the Society's obligations to all its policyholders in the context of the '*fundamental uncertainties*' which Equitable now faced.

108 The press release issued by the Society to accompany this announcement explained that the rationale for these reductions in policy values had been informed by '*the need to ensure fairness between all policyholders*' and that these reductions had been '*vital for the long-term interests of the Society and its policyholders*'. Equitable explained that:

> *The decision was taken, and could not be delayed, because:*
>
> - *Stock markets have fallen heavily over the last 18 months;*
> - *Maturity values now significantly exceed the value of the investments underlying maturing policies;* [and]
> - *As a mature fund, a large number of policyholders are currently retiring and taking their benefits.*

The Compromise Scheme

109 In September 2001, Equitable published proposals for a scheme of arrangement under section 425 of the Companies Act 1985 through which, in the words of the press release which accompanied the publication of the detailed proposals, '*all with-profits policyholders* [would] *give up some rights in exchange for increases in their policy values*'. As already noted, such arrangements are often referred to as Compromise Schemes.

110 Equitable explained that the '*key points*' of the Society's proposals were:

- that they were based on the four principles of *'fairness, clarity, mutuality, and legality';*
- that all policyholders were *'being asked to give up some rights in exchange for greater certainty, more investment freedom, and the possibility of higher investment returns in the future';*
- that the proposals would settle the guaranteed annuity rate issue through the provision to those policyholders who held policies with such guarantees of, on average, '*an increase of 17.5% in their policy values in exchange for giving up their rights*' to the guaranteed rates; and
- that those with-profits policyholders without policies which attracted such guarantees would '*receive an increase of 2.5% in their policy values in exchange for giving up any rights to make claims against the Society*' which arose from the costs of the guarantees.

111 On 20 September 2001 (the day on which the Society published its proposals for consultation on its Compromise Scheme), the FSA made a statement on the proposals, in which it was said that:

> *We firmly believe that a successful compromise would offer the best prospect of bringing stability to the with-profits fund and improving the outlook for worried policyholders. We think that today's proposals offer a sensible basis on which Equitable Life can consult its policyholders...*
>
> *Our concern is to ensure that the interests of all Equitable Life's policyholders are properly taken into account. We are keeping Equitable Life's financial position under continuous review. We have also obtained independent legal advice on the issue of whether Equitable Life may be exposed to potential claims for compensation by non-*[guaranteed annuity rate] *policyholders with a realistic chance of success... Our formal assessment of the final scheme later this year will examine whether, for each relevant group of policyholders, the proposal put to them is a fair exchange for the rights they are being asked to give up. If that test is passed, we will also look to see that the scheme does not give disproportionately greater benefits or disbenefits to some policyholders.*

112 On 1 December 2001, the Society sent to its policyholders the Compromise Scheme proposal documentation (the 'Circular'). The Circular made clear that, although the Society remained solvent at that time, it faced a number of '*serious problems*' that the scheme would help to address. The key benefits to policyholders of the scheme were described in the Circular as being:

- [guaranteed annuity rate – GAR] *policyholders as a group will receive fair value for the loss of their GAR Rights and the waiver of their GAR-Related Claims*;

- *Non-GAR Policyholders as a group will receive fair value for the waiver of their GAR-Related Claims*;

- *the financial strength of the Society will be improved and the Society will have a more flexible investment policy than it would have if the Scheme did not become effective*;

- *all policyholders (including the Society's non-profit annuitants) will have greater certainty going forward in that their contractual benefits will have greater certainty of being paid; and*

- *£250 million will be made available by Halifax to the Society's With-Profits Fund if the Scheme becomes effective on or before 1 March 2002.*[8]

113 Policyholders were advised that the statements and information set out in the Circular superseded the information, statements and opinions contained in the consultation documentation and otherwise made available by or on behalf of the Society in the past. Policyholders were therefore advised to rely only upon the information in the Circular when making their decision as to how to vote.[9]

114 On 10 December 2001, the FSA published their formal assessment of the Society's proposals. This followed correspondence with the Society during the previous month – in which the FSA had signalled that, subject to the resolution of outstanding points, they saw no regulatory obstacles to the successful sanctioning of the Compromise Scheme. That assessment is reproduced in full in Part 4 of this report.

115 The press notice accompanying the FSA's assessment of the Compromise Scheme – which is also reproduced in Part 4 of this report – quoted one of its Managing Directors as saying:

> *The FSA has already said that a successful compromise would, in principle, offer the best prospect of bringing stability to Equitable Life's with-profits fund and so improving the outlook for policyholders. Having taken into account all the relevant considerations, we have concluded that the proposed Compromise now put forward is a fair offer for the rights and claims given up...*
>
> *The FSA is not required to approve the proposed Compromise but it does have powers to take action in order to protect the interests of policyholders. We have concluded that, taken in the round, the Compromise is a fair offer and we saw no reason to intervene to stop the proposals being put to policyholders.*
>
> *The FSA's assessment of the proposed Compromise does not constitute a recommendation by the FSA as to how individuals should vote; our view reflects the merits of the scheme overall. Individual policyholders must of course decide how they themselves vote in the light of their own individual circumstances.*

116 Following the votes of affected policyholders in favour of the Compromise Scheme, on 8 February 2002 the High Court gave its sanction to that Scheme. This bound all those who were members of the Society at that date to its terms.

[8] Page 17 of the Circular.
[9] Page 5 of the Circular.

Further policy value and other cuts

117 Despite the action taken by the Society to stabilise the with-profits fund, to improve the financial strength of that fund, and to provide policyholders with greater certainty that their contractual benefits would continue to be paid, further cuts followed the Compromise Scheme. First, these were in the form of a maturity adjuster. In announcing this, Equitable said that:

> *... with effect from 15 April* [2002]*, the maturity value for a UK pension policyholder choosing to take maturity now will be the indicative policy value calculated allowing for the new bonus announcements, adjusted down by 4%. The maturity value of a policy will not be lower than the guaranteed value of that policy*.

In July 2002, the level of the maturity adjuster was increased to 10%.

118 The extension of similar reductions to with-profits annuities was announced later in 2002, resulting in significant reductions in annuity payments over the following two years. This was the result of the recognition that it would no longer be possible to delay the reductions to final bonus equivalent to those previously made for other groups of policies.

119 A letter sent by the Society on 15 November 2002 to its with-profits annuitants to announce those reductions in their income set out the scope of the various cuts that had been made since the decision of the House of Lords in the following way:

> *Since 20 July 2000, our decisions on bonuses have been particularly affected by the falling value of investments in stocks and shares, the costs of the guaranteed annuity rates... and increases in the money we set aside for potential claims for compensation. Following the House of Lords decision in July 2000, we had to reduce the value of with-profits policies. We did this, other than for with-profits annuities, by reducing the policy value by 5% at that time. We made significant further reductions in July 2001, April 2002, and July 2002. This means, allowing for bonuses, our other with-profits policyholders have suffered an overall reduction of about 20%.*

120 That letter continued by explaining to annuitants that:

> *So far we have largely protected you from these falls. In fact, you and other with-profits annuitants have generally received a positive investment return of about 14% over the same period... It was possible for us to phase the cuts to with-profits annuities in the hope of improved financial conditions. Unfortunately, because conditions have not improved we can no longer keep doing this. This basically means that with-profits annuities, like yours, are now out of line by about 30%.*

121 The Society's letter then set out the action that would be taken by Equitable to remedy this position during the following year – being a reduction in the total value of with-profits annuities '*by up to 20%*', the declaration of a zero rate of return for all such annuities in respect of 2002, and an increase from 1% to 1.5% in the annual adjustment made to the value of each annuity. The letter also said that there would be further reductions in a year's time for most annuities.

Further developments

122 The Society has continued to seek ways of bringing stability to its remaining business. Following approval by the Court, the Society effected the transfer of the bulk of its non-profit annuity business, with reserves of £4.6 billion, to Canada Life – completing this

transfer on 12 February 2007. On 1 June 2007, the Society completed the sale of its subsidiary company, University Life, to Reliance Mutual. The Society announced on 2 January 2008 that the transfer to Prudential of its with-profits annuity book, with reserves of £1.7 billion, had been completed.

123 In the Society's *Annual Report and Summary Financial Statements 2007*, considered at its annual general meeting on 19 May 2008, its Chairman and Chief Executive both said that:

> *2008 is likely to be a key year in deciding the longer term future of the Society. The Society can run its existing policies to maturity or it may be able to transfer them to one or more third parties who can provide the prospect of better outcomes for policyholders. The options should become clear during 2008... The Society is now stable and secure and it can foresee running its business, paying policy benefits as they fall due, for many years. The Society will remain closed to new business and will gradually run down as policies mature. This is known as 'run-off'.*
>
> *In 2008 we are inviting other companies to say what they could do to improve the prospects for policyholders. If we believe that one or more can provide a better option for policyholders than run-off, we will choose the best proposal and recommend it to you. We emphasize that no such change would take place without the approval of members.*

Reviews, inquiries, complaints and litigation

124 Other developments occurred in the aftermath of the Society's closure to new business on 8 December 2000. Since then, a number of reviews and inquiries have been undertaken into the professional and regulatory aspects of the events which led to that closure. Complaints and litigation have also been initiated.

The FSA review of regulation and the Baird Report

125 On 22 December 2000 – two weeks after the closure of the Society to new business and following an announcement that day by the Treasury that such a review would be established – the FSA published the terms of reference for an internal review they would undertake.

126 Those terms of reference included consideration of how the various functions the FSA had exercised on behalf of those given statutory responsibility for the regulation of insurance companies had been discharged in relation to the Society. That review led to the Baird Report (see paragraphs 129 to 132 below).

127 The FSA explained the thinking behind the establishment of the review thus:

> *The* [FSA] *Board believes that it is good discipline to learn the regulatory lessons from episodes such as this while acknowledging the fact that the Equitable remains solvent and has not failed. Under these circumstances, the Board has asked the FSA's executive management to produce a full account of its regulation of Equitable Life for its consideration. It will cover the period from 1 January 1999 until... closure to new business on 8 December 2000. It will also set out the background and events leading up to the FSA assuming formal responsibility for prudential insurance regulation on 1 January 1999.*

128 The terms of reference for this review were to cover:

- *the FSA's discharge of the functions (under the Insurance Companies Act 1982) which it undertakes as delegate for HM Treasury; and*

- *the Personal Investment Authority's... discharge of its functions as a recognised self regulating organisation (under the Financial Services Act 1986).*

and the resulting report would:

- *describe the background and events leading up to the FSA's assumption of responsibility for the prudential regulation of the Equitable Life on 1 January 1999;*

- *describe the course of supervisory work from then until the Society's closure to new business on 8 December 2000;* [and]

- *identify any lessons to be learned.*

129 The Baird Report was published on 17 October 2001 when it was laid before Parliament by Treasury Ministers. The Report concluded that the Society's policy of deliberately maintaining a low free asset position through the full distribution of profits to each generation of policyholders and in writing historic business on a large scale containing very generous guarantees had contributed to the weak financial position of Equitable, which had accordingly developed over many years.

130 The Baird Report found that the specific difficulties which Equitable had faced had crystallised following the decision of the House of Lords, which had rendered unlawful the differential terminal bonus policy which the Society had adopted to manage those difficulties. In paragraph 6.1.4, the Report concluded that:

> *The scale of Equitable Life's potential liability from the unmatched interest rate exposure, which it created when it wrote its* [guaranteed annuity rate] *business, and the scale of the future profits it had already taken into account combined to leave Equitable Life seriously exposed to any further financial shock.*

131 In making its overall assessment of the discharge by the FSA of its regulatory responsibilities under contract during the relevant period, the Baird Report stated, in paragraphs 6.2.4 and 6.2.5, that:

> *... applying hindsight, it is fair to say that, by 1 January 1999, the "die was cast" and we have seen nothing which the FSA could have done thereafter which would have mitigated, in any material way, the impact of the outcome of the Court case as far as existing policyholders were concerned, or made any material beneficial difference to the final outcome so far as Equitable Life was concerned.*
>
> *That said, our assessment does identify a number of things which the FSA could have done better. There were occasions when both the prudential and the conduct of business regulators did not spot issues to be addressed or, having spotted them, did not follow them up... One of the reasons why issues were missed was the poor level of communication and coordination between the two arms of regulation, prudential and conduct of business...*

132 The Baird Report went on to make a number of recommendations in order that lessons might be learned from the Society's experience and that future life insurance regulatory practice might be improved. The FSA have implemented those proposals.

Professional reviews

133 Meanwhile, there had been two further developments related to the professional aspects of the relevant events.

134 First, on 21 December 2000, the actuarial profession had announced that it was setting up an independent committee of inquiry to look at the events surrounding the closure of Equitable to new business and at the implications of those events for that profession. This committee – the Corley Committee – reported subsequently on 28 September 2001, making general recommendations concerning the adequacy of relevant professional guidance.

135 Secondly, on 10 January 2001, the accountancy profession had announced that the part played by the Society's auditors would be subject to enquiry by that profession. Upon reaching the opinion at the conclusion of that enquiry that there were grounds upon which a Joint Disciplinary Tribunal could make an adverse finding concerning the firm in question, a formal complaint was then presented and a Tribunal appointed to determine the complaint.

136 The proceedings had been stayed while those against whom that complaint had been made were involved in other proceedings. Following the conclusion of those other proceedings, the hearing into the complaint took place during 2007 and the findings of the Disciplinary Tribunal Panel are, at the time of writing, awaited.

Parliamentary inquiry: the interim report of the House of Commons Treasury Select Committee

137 On 27 March 2001, before the Baird Report was published, the House of Commons Treasury Select Committee published an interim report. The main conclusions and recommendations of the Committee, as they relate to the subject matter of this report, included the following:

(i) that Equitable's '*risky decision in 1993 not to build up a reserve to cover the cost of Guaranteed Annuity Rate (GAR) liabilities was a crucial turning point*';

(ii) that it was unclear '*why the issue of GAR liabilities and reserving was not considered by the prudential insurance regulator at least by 1993, rather than only in 1998*' and that this should be pursued;

(iii) that the prudential regulators should be asked to '*reconsider whether it was right to accept the reinsurance contract given its terms, and whether it was prudent to allow such a contract to have accounted for half of the Equitable Life's statutory reserves*' set up to meet the cost of annuity guarantees;

(iv) that the Society had '*demonstrated that the information provided to policyholders, through the statutory accounts, and to the regulator, through the regulatory return, differed substantially in their treatment of the GAR liabilities and the consequential reserving that had been undertaken. As a result, policyholders were not able easily to establish the true position of the company…*';

(v) that those regulators '*should … consider whether the assessment made by Equitable Life, and indeed by themselves, of whether the eventual House of Lords ruling could have been predicted, was justified…*'; and

(vi) that it was '*important that the role of the regulator since 1993, when Equitable Life began to operate a policy of terminal bonus differentiation, should be analysed in order for the regulatory lessons to be properly learnt, for policyholders to fully understand the history of the affair and for Parliament to* *undertake its scrutiny of this topic properly and fully…'.*

Conduct of business complaints

138 The effect of the Compromise Scheme was that only those who were no longer members of the Society on 8 February 2002 could proceed with complaints to Equitable and then to the Financial Ombudsman Service (or to the courts) alleging mis-selling on the part of the Society in relation to the guaranteed annuity rate issue.

139 On 23 May 2003, the Financial Ombudsman Service published determinations on three lead cases that required Equitable to compensate for mis-selling certain categories of policyholders whose claims had not been extinguished by the Compromise Scheme. I am told that payment of this compensation has been completed (with the exception of a small number of cases still with the Financial Ombudsman Service or the courts).

Litigation by the Society against its former directors and auditors

140 In April 2002, Equitable commenced formal litigation against certain of their former directors and Appointed Actuaries who held office between 1996 and 2000 and also against their former auditors. The claims made by the Society were based on allegations concerning:

(i) the Society's guaranteed annuity rate policies and its differential terminal bonus policy;

(ii) the risks as to the legality of that policy and the management of those risks;

(iii) the Society's accounting for guaranteed annuity rate policies within its Companies Act accounts; and

(iv) its contingent liability and risk disclosures in relation to the *Hyman* litigation within the Society's Companies Act reports and accounts.

141 The High Court hearing commenced in April 2005. In September 2005, the Society announced that it had agreed with its former auditors that the Society's case against them would be discontinued and that each side would pay its own costs.

142 Over the following two months, the Society announced that it had reached further agreements for the discontinuance of cases against some of the remaining defendants.

143 In December 2005, following service of written closing submissions by all parties and immediately prior to the final court session, the Society announced that it had agreed terms to discontinue the cases against the remaining defendants. There was thus no determination of, or agreement about, the matters at the heart of the case.

The inquiry led by Lord Penrose

144 The Report of the Equitable Life Inquiry, which had been led by Lord Penrose, was published on 8 March 2004. That Report had been commissioned on 31 August 2001 by Treasury Ministers, who announced that they had established this independent inquiry. The terms of reference for that inquiry had been:

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

145 The contents and principal conclusions of the Penrose Report are well known and I do not repeat those here. In summary, in so far as his Report considered matters related to regulatory action within my jurisdiction, Lord Penrose concluded that there were six '*areas of specific concern about the regulatory response to the Society's practices*'.

146 He also concluded that those areas of concern had had a bearing on the solvency of the company as that solvency position had been presented to the public. Those areas of concern are set out in paragraph 166 of chapter 19 of his Report, and related to:

- *the interest rate differential (between the bonus rate projected forward and the rate of return used to discount liabilities back to present values) between 1990 and 1997;*
- *the quasi-zillmer adjustment (through which acquisition costs for recurrent single premium business were annuitised) from the early 1990s;*
- *implicit items for future profits employed in and after 1994;*
- *the subordinated debt;*
- *the* [guaranteed annuity rate] *liability valuation;* and
- *the financial reinsurance treaty.*

147 In paragraph 240 of chapter 19 of his Report, Lord Penrose then set out five '*key findings*' about the regulation of the Society, as part of a wider list of such findings which also related to other aspects of the Equitable situation. The relevant findings were that:

- *Regulation was based on an over-reliance on the appointed actuary, who in the case of the Society was also the chief executive over the critical period from 1991 to 1997, despite a recognition of the potential for conflict of interest inherent in this position*;
- *The regulatory returns and measures of solvency applied by the regulators did not keep pace with developments in the industry, in particular the trend towards unguaranteed and unreserved for terminal bonus. Thus regulatory solvency became an increasingly irrelevant measure of the realistic financial position of the Society*;
- *The significance of policyholders' reasonable expectations under the legislation was understood by the regulators, who had also developed over time a good appreciation of the factors involved. There was, however, no consistent or persistent attempt to establish how* [policyholders' reasonable expectations] *should affect the acknowledged liabilities of the Society*;
- *The regulators also failed to give sufficient consideration to the fact that a number of the various measures used to bolster the Society's solvency position were predicated on the emergence of future surplus. In the case of the reinsurance agreement, it is not clear on what basis the Society was permitted to take the credit against its potential annuity guarantee liability that it did*; and
- *There was a general failure on the part of the regulators and GAD to follow up issues that arose in the course of their regulation of the Society, and to mount effective challenge of the management.*

148 In giving the Government's formal response to the Penrose Report, the then Financial Secretary to the Treasury explained to the House of Commons on the day that the report was published that:

> *Lord Penrose makes it clear that the Society's former management adopted a series of "dubious" practices, many of which it concealed from its own Board, its policyholders, and the regulators. This, he argues, led to the situation in which the Society found itself in July 2001.*

149 The Financial Secretary said that Lord Penrose had come to a '*central finding*', which was that '*principally, the Society was the author of its own misfortunes*'.

Events following the publication of the Penrose Report

150 Since the publication of the Penrose Report, a number of developments have occurred. Those developments include the following two events:

(i) on 15 July 2004, 873 'trapped annuitants' launched a legal action against the Society. During the proceedings, the number of claimants fell and the action has recently been settled by way of a confidential agreement with the 401 annuitants remaining in that action; and

(ii) on 22 March 2005, the Financial Ombudsman Service announced that it would not consider what it referred to as '*Penrose-related complaints*' against the Society – citing jurisdictional obstacles, the existence of other proceedings and investigations on some aspects of the subject matter of the complaints, that some of the complaints would be more suitable for resolution in the courts, the likelihood that no worthwhile outcome would be achieved by an investigation due to the '*earlier substantive conclusions of the regulator on these matters*', and the wider implications for the Society and for the interests of its remaining policyholders of any investigation which might result in an order for compensation to be paid only to some policyholders at the expense of others.

Recent developments

151 Two further significant developments have occurred during the closing stages of my investigation: the first being a Decision made on 30 January 2007 by a Panel of the Disciplinary Tribunal of the actuarial profession, following a hearing of charges brought against certain actuaries who had held senior posts within the Society.

152 The second was the publication on 4 June 2007 of the *Report on the Crisis of the Equitable Life Assurance Society* by a Committee of Inquiry of the European Parliament, established following two petitions made by United Kingdom citizens to that Parliament.

The actuarial professional tribunal

153 In the August 2004 edition of its magazine *The Actuary*, the actuarial profession had published – as the profession's rules required it to do – a summary of the allegations which formed the basis for a referral to a disciplinary tribunal by a professional investigating committee of the cases of four actuaries who had formerly held senior positions at the Society. Those charges concerned their conduct of the affairs of the Society in respect of the part of the period from 1988 to 2000 relevant to each actuary.

154 In March 2006, a Panel of the Disciplinary Tribunal constituted under the profession's 1995 disciplinary scheme ordered that the charges against one of the actuaries should be dismissed with no order for costs, following confirmation by the investigating

committee that it did not intend to offer any evidence in respect of that actuary at any subsequent meeting of the tribunal.

155 After consideration of the defences submitted by two of the other actuaries, charges in relation to the submission of regulatory returns by those actuaries, who also faced other charges, were also withdrawn by the investigating committee prior to the hearing. Those charges were not considered by the panel – which found, in the absence of evidence being submitted, that there was no basis on which they could make an adverse finding in these respects.

156 A panel of the disciplinary tribunal then heard the other charges brought by the investigating committee against the remaining three actuaries at a hearing held during November and December 2006. The relevant standard of proof required was the criminal standard; in other words, the panel had to be satisfied beyond all reasonable doubt before it could find a charge proven.

157 The decisions made at the conclusion of that hearing were published in a written determination on 2 March 2007. The panel found in respect of the first actuary – Mr Roy Ranson, who had held the post of Appointed Actuary of the Society from 1982 to 1997 – that, in the words of the Executive Summary of the determination:

(i) *in implementing a stated philosophy of providing a full and fair return to policyholders, holding no estate apart from a revolving estate providing working capital, and treating policyholders as participating in a managed fund, the actuary had, over a long period of time, consistently failed to apply an appropriate smoothing policy, had failed to provide appropriate information to the Society's board to enable proper consideration to be given to the consequences of his recommendations and had failed to maintain the publicised relationship between the investment reserve and total policy values notified annually to policyholders*;

(ii) *in addition to the points above, the information provided to policyholders created a misleading impression of the Society's financial strength. The Society's board was provided with little information showing the relationship between the totality of the policy values including accrued terminal bonuses as notified to policyholders and the Society's actual asset strength. No evidence was provided to the panel to indicate any proper degree of financial analysis undertaken by the Society during the period under examination*; [and]

(iii) there had been '*a failure to properly distinguish, in spite of the significantly different terms and conditions, between the pension policies issued prior to 1988 and those subsequently issued, both in internal analyses of the financial performance and in communications to policyholders. The panel found this failure created the basis for the subsequent problems of the Society. This failure, compounded by the unresponsiveness of management to signals and questioning of the policy adopted, in the light of changing circumstances, was viewed by the panel as irresponsible. The introduction of the differential terminal bonus policy and its implications under different economic scenarios was not properly addressed either in the board or in the communications to policyholders*'.

158 The panel found that the matters outlined above constituted a breach of the standards of integrity, competence and professional judgement which

other members of the profession and the general public might reasonably expect of a member of the profession and determined that Mr Ranson should be expelled from membership of the Institute of Actuaries.

159 The panel found in respect of the second actuary – Mr Christopher Headdon, who had held the post of Appointed Actuary of the Society from 1997 until early 2001 – that:

(i) a charge that he had failed to take appropriate action, on becoming aware of what appeared to be a breach by Mr Ranson of professional conduct standards and/or professional guidance notes and had caused or contributed to such breaches, should be dismissed;

(ii) a charge that he had failed to provide full information to the Society's board on the financial position of the Society and failed to advise the board accurately on its policyholders' reasonable expectations was found to constitute misconduct to the extent that it was upheld. The part of the complaint that was upheld related to '*a failure to notify and warn the board of the potential consequences for the Society of the valuable guarantees contained in certain policies on which the Society was continuing to accept increments, and of the existence of the differential terminal bonus policy and the likely policyholder reasonable expectations problems arising from the failure to communicate that policy sufficiently to policyholders*'. This was found to constitute misconduct; and

(iii) a charge that he had failed to disclose to the prudential regulators the signing, in April 1999, of a side-letter to a reinsurance agreement, which '*was possibly relevant to the value attributed to such agreement in the regulatory returns*', was found to constitute misconduct.

160 The panel decided that Mr Headdon should be admonished in respect of the two charges on which misconduct was found. Had he held a current practising certificate, which he did not, the panel stated that it would have suspended any such certificate for three years.

161 The panel found in respect of the third actuary – Mr Alan Nash, who had been the Society's Managing Director and Actuary at the time of the court proceedings which had culminated in the House of Lords' judgment – that:

(i) a charge that he had '*failed to ensure that the board was properly informed and advised in circumstances where the aggregate policy value of the Society's policies as reported to policyholders consistently exceeded the value of its assets*' was not proven, partly because '*the excess of maturity payments which had reduced the Society's financial strength was a consequence of decisions predating* [his] *tenure*'; and

(ii) a charge that he had authorised and signed '*a letter to policyholders dated 1 February 2000, upon which policyholders were likely to rely, that allegedly misrepresented the Society's position in the event of its appeal to the House of Lords failing*' was proven and constituted misconduct, because '*the letter, in an effort to provide an unambiguous assurance for the future, went further than was appropriate under the sensitive circumstances*' and, albeit that legal advice had been obtained, he had remained responsible for the content of that letter.

162 The panel admonished Mr Nash.

The European Parliament report

163 On 18 January 2006, the European Parliament announced that it would establish a Committee of Inquiry into the situation at Equitable. The mandate of this Committee was to:

- *investigate alleged contraventions or maladministration in the application of Directive 92/96/EEC, now codified by Directive 2002/83/EC, by the United Kingdom's competent authorities in relation to Equitable Life, notably as regards the regulatory regime and the monitoring of the financial health of insurance undertakings, including their state of solvency, the establishment of adequate technical provisions and the covering of those provisions by matching assets;*

- *assess, in this respect, whether the Commission has properly fulfilled its duty to monitor the correct and timely transposition of Community law and identify whether systematic weaknesses contributed to the situation that has arisen;*

- *assess allegations that the UK regulators consistently failed, over a number of years, and at least since 1989, to protect policy holders by exercising rigorous supervision of accounting and provisioning practices and the financial situation of Equitable Life;*

- *assess the status of claims by non-UK European citizens and the adequacy of remedies available under UK and/or EU legislation for policy-holders from other Member States; and*

- *make any proposals that it deems necessary in this matter.*

164 The report of the Committee was published on 4 June 2007 and was debated and endorsed by a plenary session of the European Parliament on 19 June 2007. The recommendations of the report were adopted by the Parliament with 602 votes in favour, 13 votes against and 64 abstentions.

165 The report made certain recommendations related to the role of the European Commission, to the way in which the United Kingdom had transposed European Directives into domestic law, and to the role of Committees of Inquiry within the institutions of the European Union. Those recommendations are not directly relevant to the subject matter of this report.

166 However, in addition and under the heading '*Remedies*', the report's recommendations included the following two statements:

(i) *... in view of the UK Government's failure to comply with the requirements of the Third Life Directive and given the absence either of accessible legal redress through the courts or of effective alternative means of redress, the committee firmly believes that the UK Government is under an obligation to assume responsibility. The committee therefore strongly recommends that the UK Government devise and implement an appropriate scheme with a view to compensating Equitable Life policyholders within the UK, Ireland, Germany and elsewhere*; [and]

(ii) *... the committee urges the UK Government and all affected parties to accept and implement appropriately any recommendations the UK Parliamentary Ombudsman may make with regard to Equitable Life. The committee recommends that the Irish, German and other host*

Member State authorities actively assist their citizens in implementing those recommendations.

167 At the time of writing, no response has been made by the United Kingdom Government to the relevant recommendations of the report of the Committee of Inquiry or to any other aspects of that report.

Chapter 3 – My investigation

Introduction

1 In this Chapter, I explain the involvement of my Office in respect of the events related to Equitable which led to my decision to undertake this investigation. I then go on to outline the legal and administrative framework for the investigation and to describe the process that I have used to conduct it.

2 This Chapter is structured in the following way:

- in paragraphs 3 to 22, I explain the earlier involvement of my Office in the relevant events – including those which led to my decision to undertake this investigation;
- in paragraphs 23 to 28, I outline the legal and administrative framework which governed the investigation which led to this report;
- in paragraphs 29 to 43, I describe the process used during the preliminary phase of the investigation;
- in paragraphs 44 to 54, I describe the process used to conduct the investigation proper; and
- in paragraphs 55 to 66, I describe the process used to share drafts of this report with the parties to the complaints and other interested parties.

The involvement of my Office

3 The first complaint that my Office received about the prudential regulation of Equitable was received in early January 2001. In his Annual Report for the year 2000-01, published on 27 June 2001, my predecessor set out his decision in relation to the complaints he had received by that date, saying:

> *I decided to postpone a decision on whether there were aspects of* [the regulatory] *handling of the affair which I might usefully investigate until the report of an investigation being undertaken by the Financial Services Authority was available. In doing so, I was mindful of the limitations of the Authority's remit, and of the expectations that Members of Parliament and the public rightly have as regards the independence of the investigating body in matters of this kind.*
>
> *I hoped, however, that the Authority's investigation might serve to indicate those areas, if any, which warranted further scrutiny. I accordingly wrote to all Members setting out my position, and undertook to write again once I had reached my final decision. I expect that to be later in 2001-02.*

4 Following publication of the Baird Report (see paragraphs 129 to 132 of Chapter 2), my predecessor re-assessed the position, as he had indicated to Parliament that he would do, in the light of the conclusions of that internal FSA review. He decided to conduct an investigation into the discharge under contract by the FSA of certain of the functions of the Treasury related to the prudential regulation of Equitable during the period covered by the Baird Report.

5 My predecessor did so on the basis that the shortcomings in regulation identified in the Baird Report constituted *prima facie* evidence of maladministration, which had hitherto been lacking.

6 In relation to other aspects of the Equitable affair, he decided to await the outcome of the Penrose Inquiry (see paragraphs 144 to 149 of Chapter 2) before deciding whether to conduct a wider investigation. Those decisions reflected the normal practice of Ombudsmen that intervention in

respect of complaints is only appropriate once the body whose actions are the subject of complaint has had an opportunity to consider the complaint and to respond to it.

7 When his next Annual Report was published on 2 July 2002, my predecessor reported those events to Parliament in the following way:

> *... there were particular difficulties concerning complaints about the conduct of the prudential regulation of the Equitable Life Assurance Society. I was strongly criticised in Parliament and the media for deferring a decision on whether to investigate some of those complaints until the* [internal inquiry] *set up by the Financial Services Authority had reported, and for deferring a decision on whether to investigate other complaints until the Penrose Inquiry set up by the Government, which will consider a much wider range of issues than my statutory remit allows, had reported. I did not, and do not, agree with the critics. It seems to me plainly inefficient, and potentially unfair, to have two simultaneous but separate investigations covering much the same ground and taking evidence from much the same sources.*
>
> *However, the critics had a point: the situation is not satisfactory. The investigation by my office into the first category of complaints could not begin until December 2001; any investigation into the second category – should such an investigation be considered appropriate – would start a good deal later still. That is objectionable, not only because complainants should not have to wait so long for their case to be considered, but also because it is difficult or impossible to conduct a satisfactory investigation after such a lapse of time.*
>
> *The root cause of the problem, in my view, is the failure of the authorities to establish at the outset a single inquiry with terms of reference covering all aspects of the Equitable Life affair, including issues of possible personal injustice due to maladministration and redress for such injustice if it should be demonstrated.*

8 I became Parliamentary Ombudsman on 4 November 2002. Shortly after taking up office, as a matter of priority I conducted a review of the limited investigation that my predecessor had launched, in the light of representations I had received that I should widen the scope of that investigation.

9 I reported the results of that review to all Members of Parliament in a letter dated 5 December 2002. I explained that it had become clear from a statement made on the Inquiry's website that the Penrose Inquiry – which was looking at all aspects of these events, which I could not do – was prepared to make adverse findings against any of the relevant parties should the evidence justify such findings. That being so, I saw no basis at that time to depart from the decision taken by my predecessor to limit the scope of my Office's investigation – one that was nearing completion – to the time period covered by the Baird Report.

10 The report setting out the results of that investigation was laid before Parliament on 30 June 2003. I reported (in paragraph 9 of Part I of that report) that:

> *I did not find evidence to suggest that FSA acting as prudential regulator had failed in their regulatory responsibilities during the period under investigation. Nor did I find that the decisions which the prudential regulator had taken as to what action (either formal or informal) was required of them in relation to*

Equitable were outside the bounds of reasonableness, given the information they held and the legal and actuarial advice which they received.

11 I reported to Parliament that I therefore could not uphold the complaints which alleged that maladministration had occurred during the period covered by that report and that such maladministration had resulted in injustice to complainants.

12 Following the publication of the Penrose Report on 8 March 2004 – in which no determinations were made as to whether the prudential regulators had failed properly to undertake their responsibilities in accordance with the standards that had prevailed at the relevant time – I wrote to all Members of Parliament on 16 March 2004.

13 I advised them that, in order to inform my decision on whether I should conduct any further investigation into the prudential regulation of Equitable in the light of the evidence set out in that report, I would consult interested parties.

14 That consultation, on whether my Office should carry out a further investigation and, if so, over what period and with regard to which matters, was launched on 22 April 2004 by way of letters to interested parties and by notices in the press.

15 I set out the results of that consultation and of my subsequent decision in a report that was laid before Parliament on 19 July 2004, to which I referred at the beginning of Chapter 1 of this report. As I explained there, excerpts of that report are reproduced in Part 4 of this report.

16 In my 2004 report, I explained that the Penrose Report and the representations I had received during the consultation process had provided me with sufficient *prima facie* evidence that indicated that administrative action or inaction on the part of the bodies responsible for the prudential regulation of Equitable might have played some role in causing the unremedied injustice that individuals claimed to have sustained and about which they had provided me with ample information through the consultation process.

17 Having considered all the evidence before me at the time and having regard to submissions concerning whether a further investigation would be in the public interest or might be able to produce a worthwhile outcome for the parties to the complaints, I decided to conduct a further investigation.

18 The full reasoning for this decision was set out in my July 2004 report to Parliament (relevant extracts of which, as I have said, are reproduced in Part 4 of this report). However, key to my decision was a recognition that the outcome sought by those who had complained to me – a determination as to whether maladministration on the part of the prudential regulators and GAD had occurred and, if so, whether that had caused injustice to them – was something that only I could provide.

19 Considering the practical difficulties that would inevitably arise if I were not able, for jurisdictional reasons, to investigate the actions of GAD in assisting the prudential regulators of Equitable, I asked the Government to make provision for GAD to be brought within my jurisdiction to enable me properly to assess all of the actions of those involved in the prudential regulation of the Society during the relevant period.

20 Following the agreement of the Government to this request and Parliamentary sanction of this proposal, the Parliamentary Commissioner Order 2004 (SI 2004/2670) came into force on 15 November 2004.

21 That Order brought GAD within my jurisdiction, enabling me to investigate any action that related to the giving of advice by GAD on or before 26 April 2001 in respect of the exercise of administrative functions under Part II of the Insurance Companies Act 1982 or any other enactment concerned with the regulation of insurance companies.

22 It was in this context that I launched the investigation which has led to this report. I will now turn to explain the procedure used to conduct the investigation.

The legal and administrative framework for the investigation

23 The 1967 Act places me under certain obligations in respect of the nature of the process by which I conduct investigations – the first being those contained in section 7 of that Act, which states, in section 7(1), that, where I propose:

> *... to conduct an investigation pursuant to a complaint under this Act,* [I] *shall afford to the principal officer of the department or authority concerned, and to any other person who is alleged in the complaint to have taken or authorised the action complained of, an opportunity to comment on any allegations contained in the complaint.*

24 Section 7(2) of the 1967 Act further provides that:

> *Every such investigation shall be conducted in private, but except as aforesaid the procedure for conducting an investigation shall be such as* [I consider] *appropriate in the circumstances of the case; and without prejudice to the generality of the foregoing provision* [I] *may obtain information from such persons and in such manner, and make such inquiries, as* [I think] *fit, and may determine whether any person may be represented, by counsel or solicitor or otherwise, in the investigation.*

25 A further obligation placed on me is contained in section 10 of the 1967 Act. I must send a copy of the final report of any investigation to the Member(s) of Parliament who referred the original complaint(s) and to the principal officers of the body or bodies whose actions were the subject of those complaints.

26 There are no other mandatory requirements imposed on me as to the procedure I must use in the conduct of an investigation. Parliament, through the provisions of the 1967 Act, has thus given me considerable discretion as to procedure; and the Courts have recognised the width of the discretion granted in this respect to Ombudsmen.

27 I must, nonetheless, act fairly and in accordance with principles of natural justice when conducting any investigation and when determining what an appropriate process to conduct any investigation might be. However, the Courts have also recognised that what process is appropriate in any investigation is largely derived from the circumstances of each case.

28 In all investigations conducted by my Office, in the interests of fairness it has always been our practice to provide, prior to the issue and/or publication of a final report, full drafts of those reports to those whose actions have been investigated. It has also been my practice in recent years, for the purposes of the investigation, to share such drafts with complainants (and/or their representatives). Where relevant, I will also for the same reasons provide excerpts from draft reports to affected third parties.

The investigation

July 2004 to March 2005 – the preliminary stage

29 As I am required to do, in December 2004 I asked the principal officers of the public bodies whose actions were subject to complaint for their response to the allegations contained in the complaints as those complaints had been put to me.

30 The formulation of those heads of complaint (with the input of certain policyholder and annuitant action groups) – from a mass of documentary material submitted in support of (at that time) more than 600 referred complaints – constituted part of the preliminary stage of the investigation.

31 The initial response to those heads of complaint, which I received from the principal officers in March 2005, is summarised within Chapter 4 and is reproduced in full in Part 4 of this report.

32 In May 2005, I decided that the scope of my investigation would include those known as the 'internationals', that is, those people who had bought policies from one of the Society's overseas or offshore branches. I came to this conclusion following consideration of the views as to this question that were provided to me by the public bodies whose actions were the subject of the investigation which led to this report and by the Guernsey Financial Services Commission.

33 The preliminary stage of the investigation had a number of other aspects. First, as I explained in a letter to all Members of Parliament issued on 24 November 2004, between August and October 2004 I appointed a team of investigators to conduct the investigation, using the power contained in section 3(2) of the 1967 Act – which enables me to authorise any of my officers to undertake functions on my behalf. That team has, throughout the investigation, exercised such delegated authority on my behalf.

34 Secondly, I appointed both legal and actuarial advisers to assist my investigation team. Legal advisers were appointed in February 2005 and actuarial advisers appointed in May 2005. The advice of both sets of professional advisers has greatly informed (and is integrated into) this report.

35 My legal advisers during the investigation were Tony Child, of Beachcroft LLP, and Anna Forge, of McGrigors LLP, and my actuarial adviser was Tony Leandro, of Barnett Waddingham LLP.

36 In addition, I arranged for the actuarial advice I received to be peer reviewed. I also appointed in August 2005 an academic advisory panel, made up of external professionals with relevant experience. I asked them to advise me on the standard of regulation set out in this report, with a view to ensuring that this standard was consistent with the prevailing standards that were applicable at the time relevant to the actions I have investigated.

37 Thirdly, as has been noted already in paragraphs 19 to 21 above, work was undertaken to bring GAD within my jurisdiction and to gain sanction for the provision by Parliament of additional resources to support the conduct of the investigation. I had a number of meetings with principal officers and others during the preliminary stage of the investigation in connection with both of these developments.

38 Fourthly, during September 2004 my team held preliminary meetings with officials of the public bodies whose actions were the subject of complaint to establish liaison arrangements and to discuss the likely scope of the investigation and the process through which it would be conducted.

39 During October 2004, similar preliminary meetings were held with the policyholder and annuitant action groups. The action groups who have liaised with my staff during the investigation are the Equitable Members' Action Group, Equitable Life Trapped Annuitants, the Equitable Late Contributors' Action Group, the Equitable Members' Help Group; and the Investors' Association.

40 Such meetings have continued throughout the investigation, as have meetings with the Society and with other interested parties.

41 Fifthly, with the assistance of those action groups, 15 individuals who had made complaints about the prudential regulation of Equitable were chosen to act as lead complainants for the purposes of the investigation. Those lead complainants epitomised the position of all the principal groups of the Society's current and former policyholders and annuitants who had complained to me.

42 Section 6(2) of the 1967 Act permits the persons aggrieved to be represented by a personal representative, a family member, or other suitable individual. In this case, the lead complainants authorised members of the action groups referred to above to act as their personal representatives during the course of the investigation.

43 Finally, as part of the preliminary stage of the investigation we sought to gain access to all the relevant evidence necessary for the conduct of the investigation. The different sources of evidence we have reviewed included:

(i) the operational and policy files of the public bodies whose actions were under investigation;

(ii) all the documentary evidence from other sources that was available to Lord Penrose;

(iii) transcripts of evidence given to the Baird and Penrose inquiries (and to my first investigation) by current and former officials and actuaries who had some connection with the prudential regulation of the Society;

(iv) the working documents and emails of those officials and actuaries;

(v) publicly available material (such as actuarial papers and discussions); and

(vi) historical and other material held at the National Archives, the British Library, and the libraries of the DTI, the Institute of Actuaries, and the Institute of Chartered Accountants of England and Wales.

April 2005 to January 2007 – the investigation proper

44 As I explained in paragraph 31 above, in March 2005 I received the response of the principal officers of the public bodies to the allegations contained in the terms of reference for the investigation. As that response, which, as I have said, is reproduced in full in Part 4 of this report, did not resolve the matters which formed the basis for the complaints made to me, I decided to continue my investigation.

45 As part of the investigation, in April 2005 the public bodies were asked to comment on the detailed submissions made by the action groups in support of the complaints set out in the terms of reference for the investigation. Those public bodies provided comments in July 2005.

46 In May 2005, a summary of the initial response of the public bodies to those complaints was issued to the action groups; those groups were invited to comment on that response, which they did in June 2005.

47 Also in May 2005, all the parties to the complaints were issued with a discussion document, on which comments were sought, which outlined my role and the nature of the subject matter that this investigation would cover. That document also, after setting out a summary of the responsibilities of the public bodies as they at that time were understood, explained the tests that I proposed to adopt as being an appropriate standard of regulation.

48 I received comments on that document from the action groups in June 2005 and from the public bodies in both July and November 2005. The discussion document and excerpts from the responses of the public bodies to that document are reproduced in Part 4 of this report.

49 During September 2006, my Office conducted a survey of all those with registered complaints concerning the prudential regulation of Equitable. Throughout the investigation, a substantial number of letters from those with complaints about the prudential regulation of the Society were received and reviewed. We corresponded with the lead complainants throughout the investigation and my investigation team met them in April 2008.

50 Early drafts of Parts 2 and 3 of this report, which contain the work done to chart the historical development of the relevant regulatory regime and the chronology of relevant events, were shared with the public bodies in September 2005, January 2006, and December 2006. We also shared revised drafts of those Parts of this report, which reflected the comments of the public bodies on earlier drafts, with the Society and the action groups in July 2006 and April 2007. The comments and suggestions of all those parties, provided in response to the emerging drafts, were considered.

51 Meetings were also held, in addition to those held with the principal parties to the complaints, with other interested parties, including with the actuarial profession, the Financial Ombudsman Service, the European Parliament Committee of Inquiry, and several Members of Parliament. My staff also travelled to Brussels in September 2005 to assist the Petitions Committee of the European Parliament to understand the nature and scope of my investigation.

52 My investigation team also held regular meetings with my actuarial and legal advisers. Throughout the investigation, my team and advisers have worked collaboratively. A number of roundtable meetings were held at which the professional advice I have been given was reviewed. All my advisers have contributed to the drafting process through such meetings, as well as through the advice that they have provided.

53 I have carried out a thorough and wide ranging investigation into the subject matter of the complaints within the terms of reference for the investigation. I have given careful consideration to all of the evidence, submissions, and other material before me, whether or not that material is referred to within this report.

54 While this report does not refer to everything that I and my investigation team have reviewed, I am satisfied that nothing of significance to my conclusions has been omitted from this report.

Draft reports and review – January 2007 to date

55 At the end of January 2007, I sent to the principal officers of the public bodies a first draft of this Part of my report, which contained my provisional views as to the relevant facts and as to whether maladministration had occurred and, if so, whether it had resulted in any injustice to complainants.

56 At the same time, I also sent those officers further drafts of Parts 2 and 3 of this report, which had been amended in the light of my consideration of the comments which had been made in respect of earlier drafts of those Parts. In March 2007, I made available to the public bodies the full draft of the provisional report of my actuarial adviser.

57 As I explained in a letter of 22 May 2007 to all Members of Parliament, in April 2007 I received substantial joint representations from the public bodies concerning my first draft report. I received at the same time additional representations from three former FSA senior managers.

58 I agreed, in the light of the nature and extent of those representations, to conduct a fundamental review of my first draft report. That review included the seeking of further professional advice from both actuarial and legal advisers and seeking the view of peer reviewers as appropriate.

59 The representations of the public bodies were considered in detail as part of that review, which was also informed by supplementary submissions by the public bodies made in September 2007 at the request of my investigation team. Other work, such as revisiting the original files and other relevant evidence, was also undertaken as part of my review.

60 I communicated the results of that review to the principal officers of the public bodies on 30 November 2007, providing them with an indication of the extent to which I was at that time minded to accept their representations and of the provisional views that I proposed to set out within a revised draft report, which I would send to all the parties to the complaints.

61 That revised draft report, setting out my revised provisional views, was issued in February 2008 to the public bodies, to those representing lead complainants, and to the Society. Representations (or further representations) were invited on that revised draft report.

62 Relevant draft excerpts were also disclosed for the purposes of the investigation to interested parties. Those interested parties included certain former directors of the Society and its former auditors.

63 I received responses to my revised draft report from the public bodies, from those action groups representing the lead complainants, from certain individual members of those groups, from the former Appointed Actuaries of the Society, and from solicitors representing the Society's former auditors.

64 Having considered those responses, which to the extent necessary are reflected within later Chapters of this Part of this report or reproduced in whole or in part within Part 4 of this report, shortly before publication I informed the parties to the complaints as to whether any substantive changes were to be made to my conclusions in the light of my consideration of their representations. I also informed them of the findings that would be made in this report.

65 This report, in which I have reached my final conclusions in the light of my consideration of all the evidence, the submissions I have received, and the other material before me, is the product of all that work.

66 I now turn to set out in detail the complaints which formed the basis for the investigation and the initial response of the public bodies to those complaints.

Chapter 4 – The complaints I have received and the Government's initial response to those complaints

Introduction

1 In this Chapter, I set out the general and detailed complaints that have been made to me about the prudential regulation of the Society; and the initial response to those complaints of the public bodies whose actions were the subject of complaint.

2 This Chapter is structured in the following way:

- in paragraph 3, I set out the number of complaints which have been made to me concerning the prudential regulation of the Society;
- in paragraphs 4 to 7, I set out the general complaint which alleges maladministration on the part of those public bodies whose actions have been the subject of investigation;
- in paragraphs 8 to 32, I set out the 18 heads of complaint alleging specific acts and omissions on the part of those public bodies which it is said constitute maladministration;
- in paragraphs 33 to 51, I summarise the submissions that have been made to me, both by complainants and by those authorised to act on their behalf, in support of those complaints of alleged maladministration;
- in paragraphs 52 and 53, I set out the injustice which it is claimed has resulted from maladministration and the remedy which is sought by complainants in respect of this injustice; and
- in paragraphs 54 to 154, I summarise the initial response to these complaints of the public bodies whose actions were the subject of complaint:

  (i) paragraphs 59 to 61 provide a summary of the response of the public bodies;

  (ii) paragraphs 62 to 75 deal with some general matters;

  (iii) paragraphs 76 to 153 address each specific head of complaint; and

  (iv) paragraph 154 responds to the injustice claimed.

The complaints made to me

3 As noted in paragraph 11 of Chapter 1 of this report, I have received 898 referred complaints in respect of 1,008 people and I have received 1,309 direct representations from a further 1,480 individuals about the prudential regulation of Equitable. Information about the people who have contacted me about the subject matter of this report is set out in Part 4 of this report.

The maladministration alleged

The general complaint

4 As noted in Chapter 1 of my report, the terms of reference for my investigation were:

> *To determine whether individuals were caused an injustice through maladministration in the period prior to December 2001 on the part of the public bodies responsible for the prudential regulation of the Equitable Life Assurance Society and/or the Government Actuary's Department; and to recommend appropriate redress for any injustice so caused.*

5 The terms of reference were agreed with those representing the lead complainants (see paragraphs 41 and 42 of Chapter 3) and, on 14 December 2004,

those terms of reference were distributed to all the parties to the complaints and also published on my Office's website.

6 From all the complaints I have received, three broad areas of complaint emerge from the many submissions we had read and considered. Those concern complaints about, first, the general organisation of the system of prudential regulation; secondly, about the way that this system had been applied generally towards Equitable; and, thirdly, about the specific handling by the prudential regulators and GAD of various aspects of the detail of the Society's business during the relevant period.

7 The general complaint made was that:

> *... the public bodies responsible for the prudential regulation of insurance companies (successively the Department of Trade and Industry, Her Majesty's Treasury and the Financial Services Authority...) and the Government Actuary's Department (GAD) failed for considerably longer than a decade properly to exercise their regulatory functions in respect of the Equitable Life Assurance Society and were therefore guilty of maladministration.*

The detailed heads of complaint

8 Eighteen detailed complaints were made – although, as will be seen, some of those heads of complaint contained more than one allegation. Those heads of complaint were labelled complaint A to complaint R.

9 **Complaint A** was that the prudential regulators had not been sufficiently resourced, and had not all possessed the necessary skills, to contribute effectively to the overall regulatory process and to exercise responsibly their discretionary powers as intended by Parliament and by the European Union. It was alleged that administrative decisions as to resourcing, priorities and methods had contributed to a position in which the prudential regulators had not properly undertaken their functions in respect of Equitable.

10 **Complaint B** was that the prudential regulators had failed to liaise and to co-operate effectively with those responsible for the regulation of the conduct of business by insurance companies. In particular, it was alleged that the prudential regulators had failed to ensure that proper assessments had been made of the Society's individual practices and its communications with policyholders, and of the expectations that those practices and communications had generated, in the light of the information that was, or should have been, known to the prudential regulators.

11 **Complaint C** was that the prudential regulators had not operated the regulatory regime as it was intended to be implemented by Parliament and in conformity with EC Directives. It was alleged that those regulators instead had chosen to regulate Equitable with a 'light touch' – a concept not evident from or provided for under the Insurance Companies Act 1982 and the European Third Life Directive, nor one consistent with these statutory provisions.

12 It was further alleged that the approach to the prudential regulation of Equitable had been exceptionally and unjustifiably lenient when compared to that adopted with other companies, with inadequate investigative site visits and lack of liaison with conduct of business regulators. Much more rigorous standards of supervision and better co-operation with conduct of business regulators had been adopted for smaller and unit-linked companies, it was alleged. That, it was said, demonstrated that the prudential regulators had applied a two-tier standard of regulation.

13 **Complaint D** was that the prudential regulators and GAD had allowed successive Chief Executives or Managing Directors of the Society simultaneously to hold the post of Appointed Actuary, despite recognising the potential for a conflict of interest. This, it was alleged, had not been compatible with the basis of the regulatory regime.

14 **Complaint E** was that the prudential regulators and GAD had failed to keep pace with developments in the pensions and life insurance industry and to assess and adapt their methods to reflect those developments. This, it was alleged, had been particularly critical in a situation in which narrow, technical interpretations of regulatory solvency were becoming an increasingly irrelevant measure of any insurer's realistic financial position as the industry moved more and more towards non-guaranteed bonus declarations.

15 **Complaint F** was that GAD had recommended Equitable as a pension plan or additional voluntary contribution scheme provider in its advice to the administrators of the Principal Civil Service Pension Scheme and to other public sector pension schemes. This, it was alleged, had led to a lack of proper separation of its responsibilities and to a clear conflict of interest between GAD's role in providing advice to government bodies in relation to public sector pensions and in assisting the prudential regulators of the Society. This conflict of interest, it was said, had compromised the proper discharge of GAD's regulatory functions.

16 **Complaint G** was that, from the mid-1980s until 1997, the prudential regulators had failed to evaluate the potential effect of guaranteed annuity rates on the solvency of Equitable in a context where current annuity rates were falling steadily, in line with the Bank of England's base rate, to below contracted guaranteed annuity rates.

17 It was alleged that the prudential regulators had learned explicitly in November 1993 of the degree of Equitable's exposure to risks associated both with the guaranteed annuity rate issue and with the Society's lack of prudent reserves. It was said that the regulators' failure to take action then or to impose reserving until 1999 had played a direct part in the closure of Equitable to new business and to subsequent cuts in policy and annuity values. The prudential regulators had not prepared a study on the extent of guaranteed annuity rates in the industry until 1997: which, it was said, was a decade too late.

18 **Complaint H** was that, from about 1990 onwards, the prudential regulators and GAD had failed to give sufficient consideration to the fact that some of the measures used to bolster Equitable's solvency position were predicated on the emergence of a future surplus. It was alleged that, as a consequence, those regulators and GAD had not properly assessed the overall impact and adequacy of those measures. It was further alleged that the prudential regulators had also allowed Equitable to mis-use the term 'surplus' and had failed to consider the use of that word in the context of policyholders' reasonable expectations.

19 **Complaint I** was that, over this same period, the prudential regulators had allowed Equitable to publish financial results and projections that were misleading in that they had not reflected the Society's true position. In particular, Equitable had been allowed habitually to report growth rates alongside bonus rates, which had given the impression of a prudent margin for error, whereas the true position was that:

- assets had been consistently less than policy values so that higher rates of growth were needed to cover any given rate of bonus; and

- as part of the growth had been needed to cover expenses and the contractual liability for conventional annuities, the growth available to meet with-profits bonuses had always been materially less than the rate quoted in Equitable's literature, which had never been made clear.

20 **Complaint J** was that, during this same period, the prudential regulators and GAD had failed to act when Equitable had adopted what Lord Penrose described as practices of '*dubious actuarial merit*'. Those practices, it was alleged, had included valuing future liabilities at an inappropriate rate of interest between 1990 and 1996; treating selling costs as an asset; making no provision for guaranteed annuity rates until much too late; valuing a financial reinsurance policy (which proved to be of no value) at over £800 million; allowing credit for 'aspirational' (i.e. effectively unrealisable) assets; responding too slowly to widely evidenced changes to mortality expectations; and the issuing of a subordinated debt valued at £346 million, which was not counted as a liability.

21 **Complaint K** was that on several specific occasions, as set out in the Penrose Report, the prudential regulators and GAD had ignored or failed to act on information that might have led to formal or informal regulatory action against Equitable, thus also failing to alert new investors to the risks of investing. It was alleged that those occasions included when the Society's Board papers were sent to GAD by the appointed actuary on 11 June 1991, and when information was provided to GAD on 10 September 1992 which showed that, for the years 1989 to 1991, the aggregate policy values had very significantly exceeded the value of the underlying assets.

22 **Complaint L** was that, over a period of many years, the prudential regulators and GAD had permitted Equitable to operate an unsound business model, of which those regulators and GAD had been aware. It was said that the Society had made public its policy of reliance on 'goodwill' in a 1989 actuarial paper *With Profits Without Mystery*[1], but the prudential regulators had never addressed the issue or challenged the Society about it or about the consequences of the model.

23 Instead, it was alleged, the prudential regulators and GAD had allowed Equitable to operate their model, which had entailed declaring bonuses in excess of admissible assets, while at the same time operating without a significant estate and with a smoothing fund persistently in deficit. It was said that this had been a major contributory factor to the Society's development of what Lord Penrose had quantified as a £3,000 million asset deficit at the time of closure to new business and to the losses incurred by all those who held policies on 16 July 2001.

24 **Complaint M** was that the prudential regulators had failed to ensure any satisfactory correlation between the total of declared policy values and the Society's admissible assets in a context where Equitable, uniquely in the industry, had declared total policy values that had included terminal bonuses and had, without exception, always paid all claims (both contractual and non-contractual) in accordance with those declarations.

25 **Complaint N** was that Ministers and officials had decided that regulatory activities in relation to safeguarding policyholders' reasonable expectations were to be based solely on the regulatory returns, but had failed to put in place adequate procedures and Regulations to enable this to be achieved. It was alleged that this failure had been particularly critical in respect of Equitable, which had had unique practices which elicited policyholders' reasonable expectations.

[1] Presented to the Institute of Actuaries on 20 March 1989 (see Journal of the Institute of Actuaries 116 (1989): 301-345) and to the Faculty of Actuaries on 19 February 1990 (see Transactions of the Faculty of Actuaries 42 (1990-1991): 139-186).

26 **Complaint O** was that the prudential regulators and GAD had allegedly failed over many years properly to monitor and assess the Society's asset position and its practices in the light of policyholders' reasonable expectations. Those regulators and GAD, it was said, had not properly determined policyholders' reasonable expectations or acted to protect them as intended by Parliament and to the standards set by European Directives.

27 **Complaint P** was that, during the course of the litigation which had led to the House of Lords' decision in the *Hyman* case, the prudential regulators had allegedly failed in their duty to all policyholders in respect of policyholders' reasonable expectations and had postponed consideration of issues related to assets and reasonable expectations, both for guaranteed annuity rate and non-guaranteed annuity rate policyholders, until after the decision of the House of Lords (on 20 July 2000).

28 In addition, it was said that the prudential regulators had totally failed to assess properly either the impact or the scope of the *Hyman* decision and to evaluate the range of scenarios for Equitable following it. Those regulators, it was alleged, had failed to take appropriate action to mitigate the adverse affect of the decision on the majority, non-guaranteed annuity rate policyholders, and on new investors into the same with-profits fund.

29 The judgement of the prudential regulators that there had been a 99.9% probability that the Society would be sold demonstrated that, despite the extensive information that those regulators had possessed, they had failed to understand the parlous state of Equitable, which had been apparent to all prospective bidders.

30 **Complaint Q** was that, in March 2001, the prudential regulators had permitted Equitable to declare a bonus for 2000 and an interim bonus for 2001 that were both inappropriate and unjustifiable given the then state of the Society's finances, thus raising misleading expectations about the true state of Equitable just prior to significant across-the-board cuts that were imposed only four months later. Instead, it was alleged that the Society's asset deficit of 13% at year-end 2000 in a closed fund should have precipitated regulatory intervention at that time.

31 **Complaint R** was that, in July 2001, by permitting policy value adjustments worth more than £4,000 million in the form of an inequitable uniform percentage cut across all with-profits policies, rather than the fairer alternative of reducing policy values by cutting only non-guaranteed bonuses, the prudential regulators had allegedly failed to protect policyholders' reasonable expectations.

32 It was further alleged that the prudential regulators had also refused to comment meaningfully on this to policyholders while discouraging independent financial advisers from giving proper advice to policyholders.

Submissions made by complainants in support of those complaints

33 In support of those complaints, I received many hundreds of letters from complainants and from those making direct representations to my investigation team. In addition, certain policyholder action groups (see paragraph 39 of Chapter 3) submitted a vast amount of evidence in support of the complaints outlined above.

34 It is not practicable to set out here every argument, submission or piece of evidence that has been submitted to us since the investigation which led

to this report began, nor to describe the contents of all the documents that were sent to me in support of these complaints. However, we have read each letter sent to us and have considered whether the contents of all the communications we have received warrant inclusion in the report or follow-up through some other means.

35 I will now do two things: first, I will set out in their own words some of the general and specific points made to me by those who have complained to me. These describe, in a representative fashion, what those people have told me have been the effects on them of the events at Equitable and set out their feelings about what has happened. Secondly, I will summarise the key submissions made to me by policyholder action groups on the heads of complaint set out above.

What individual complainants told me

36 The lead complainants provided a considerable amount of information about the effect of the events at Equitable on them. Comments they made included:

(i) that '*the effects of actual and anticipated losses have caused me to sell a large house and move to a smaller property and to general cut-backs on expenditure, holidays, motoring, eating out, and assisting my children*';

(ii) that '*while I was looking forward to a comfortable retirement, this has now been shattered. It is a worry and is constantly on one's mind. When I wake up during the night this is the first thing that enters my mind*'; and

(iii) that '*I have lost confidence and trust in all pension producers and the government's watchdog. After working hard all my life and putting together what I thought were adequate plans for my retirement many years in advance, I feel I have been let down*'.

37 The knock-on effects and worry and distress caused by the financial uncertainty that complainants have suffered were also, they argued, compounded by actual financial losses of varying degree and with differential impact sustained by complainants. The largest sum that a complainant estimates that they have lost amounts to three-quarters of a million pounds; while the smallest amount of loss claimed is less than six hundred pounds.

38 Complainants generally claimed that the prudential regulators were to blame for the situation, although many also expressed anger at the Society's management. They said, for example:

(i) *This saga has undermined my confidence in the regulatory apparatus administered at taxpayers' expense to supervise the U.K. financial system and protect its users. I am also totally disillusioned with the conduct of government*;

(ii) *I feel emotionally affected, angry, as if I have been robbed. I feel the regulatory system has let me down. I was prepared for investment risk but not systemic risk which I felt was covered by the regulator. I will never trust an insurance company again and have advised my children against trusting one*;

(iii) *I have lost confidence in the ability and competence of long-term financial planners and regulators*; and

(iv) *Not only have I been affected financially but I feel badly let down by the regulatory bodies who should have ensured that investors interests are protected. The Government encourages us to save for the future and yet fails to regulate by the appointed bodies.*

39 Many complainants expressed more than disappointment in the role played by the prudential regulators and their advisers – arguing that the actions or inaction of those bodies had been the primary cause of the situation. One told me:

> *I submit that the Treasury/FSA failed to consider, or were culpably negligent in considering the effects on new or continuing investors, of the severe lack of reserves... and failing to require disclosure, or sufficient provision for this at least by the beginning of 1998.*
>
> *The company was allowed to advertise and tout for further business on the basis of "leadership in the UK pensions market" and was awarded by Standard and Poor their prestigious AA (Excellent) rating on the basis of the content of their accounts and returns.*
>
> *I relied on the above and the fact that the company gave no commission and boasted of their low costs and charges. I also believed I had the full protection intended by regulation in making my choice of company.*

40 Another complainant said:

> *The DTI did not impose effective control over the Society. The consequence of this allowed the Equitable to declare bonuses not covered by the assets of the Society from 1989 to 2000. As a further consequence of this, the Equitable retained its AAA rating and thousands of innocent members carried on pouring millions of pounds into a sinking ship. If there had been the slightest inkling that there was anything wrong, I would have changed to another insurance company to provide an annuity for my retirement.*

41 Other complainants also placed the blame for the injustice they claimed to have sustained at the door of the prudential regulators. Such submissions included those from:

(i) a man in his 80s, who told me that he had '*bought an Annuity in 1994. Prior to doing so, and prompted by another company's salesman, I had suggested to Equitable that their financial position might not be secure. I was given a Standard and Poor analysis, which gave an AA+ rating and must therefore have been based on incomplete information given to them. Annual reports were equally misleading. GAD must have known the true situation and they and DTI should not have allowed this to happen. As a result, my pension was reduced last year by £3,000 pa and we have had to sell our house and buy a much cheaper one. Further reductions are still being made*';

(ii) a man in his 70s, who told me that '*before placing my contracts with the Equitable I undertook considerable market research and took particular note of past performance, expense ratios and Standard and Poor's ratings relating to financial strength. The Equitable Life also assured me that information required on regular returns made to the Department of Trade and Industry, the then regulator, had been provided and that the DTI's requirements had been fully met*';

(iii) a man in his 60s, who told me that '*the regulatory bodies – the FSA, the Department of Trade and Industry, the Government Actuary's Department and Her Majesty's Treasury – failed in their duty to rigorously monitor the activities of Equitable Life. The information which was garnered was not made available to potential investors. It is my contention that the regulators failed in their* *duties to safeguard the interests of actual and potential investors and alert them to the financial weakness of Equitable Life thus depriving them of making informed choices; ergo compensation is due*'; and

(iv) a woman in her 60s, who told me that '*what has really upset me is that I did not purchase a time share or something like a pyramid scheme for "women empowering women". I purchased a pension scheme run by a supposedly respectable insurance company. I researched this company in the Financial Times, Standard and Poor's, Money Management, and the Sunday broadsheets, which all gave the company glowing reports. Now to get this money back I will have to go back to work for years*'.

The key submissions made in support of their complaints by those representing complainants

42 In addition to the many individual submissions I have received, certain action groups who were authorised to represent the lead complainants and who, more generally, represented those current or former Equitable policyholders and annuitants who had complained to me in support of the complaints.

43 In February 2005, the Equitable Members' Action Group (EMAG) made a lengthy submission to me, in which it set out its views on each of the heads of complaint covered by the investigation[2].

44 I consider that EMAG's submission, while not covering every submission that has been made to me by or on behalf of complainants, sets out broadly the key arguments put forward in support of their complaints. The following excerpt from the concluding section of that submission is worth quoting at length.

45 EMAG said that:

Our understanding is that the regulatory system was set up with reliance on a regulatory return by the insurance company, scrutiny of that return and reliance on the professional independence of the Appointed Actuary to inform the Regulators of failings in prudent management and above all concerns about Policyholders' Reasonable Expectations. It was to be a system based upon "freedom with disclosure". This strikes us as fair enough BUT:

1. *With developments in the industry the shift from guaranteed to non-guaranteed bonuses should have been noticed as actually happening as... GAD had predicted and the information sought in the regulatory returns suitably adapted to the new circumstances.*

2. *The scrutinies should have been carried out with punctiliousness and care. On occasions they were not carried out at all or only very inadequately.*

3. *Allowing the Chief Executive of Equitable to be the Appointed Actuary for many years completely destroyed his professional function.*

4. *There was no proper disclosure about the realistic financial state of Equitable to the public in the Companies Act accounts. The regulatory returns provided no additional information which would have been of any use to a member of the public. The idea of "freedom with disclosure" was therefore completely undermined.*

[2] The full submission is available on their website: www.emag.org.uk

46 EMAG continued:

> *We submit that there has been serious maladministration and that that maladministration continues. We further submit that such maladministration led to a number of consequences resulting in financial losses to the policyholders who invested in the Society.*
>
> *It is common ground that Equitable's problems were deep-seated going back to the start of providing guaranteed annuity rate policies and losses of their reserves in the early 1970s...*
>
> *The non-availability of files has made it difficult to track the behaviour of the Regulators in the 1980s but there is real evidence of failure from the late 1980s onwards. The failure to scrutinise the 1987 and 1988 regulatory returns came at a crucial time says Lord Penrose. Equitable was already over-bonusing by then.*
>
> [A GAD] *paper in 1988 had warned of the dangers to policyholders' reasonable expectations if companies were allowed to shift from guaranteed to non-guaranteed bonuses. Equitable was doing just that effectively shifting their business out of the purview, as practised, of the Regulators. It is, at that point, that the Regulators should have started to act to bring Equitable back into their effective oversight. For no good reason they failed to do this.*
>
> *From then on as a result of the Society having used up all its reserves the position of solvency for the purposes of covering guaranteed bonuses became more and more problematical with very doubtful devices being allowed to be used to cover the position.*

47 Turning to the role of the prudential regulators, EMAG continued:

> *This together with the shift described above should have impelled the regulators to strong action to protect policyholders. Their failure to do so allowed Equitable to misrepresent their financial strength and to suck in huge numbers of new policyholders into what was becoming a Ponzi scheme where capital is sucked in to cover current revenue deficits.*
>
> *The Regulators not only failed to inquire more deeply into the financial affairs of Equitable but they ignored the evidence that was presented to them: With Profits Without Mystery, the board papers given to* [GAD] *and* [the Appointed Actuary's] *message about over-bonusing over the three years 1989 to 1991.*
>
> *The Regulators cut themselves off from a source of information vital to their policy by allowing the roles of Chief Executive and Appointed Actuary to be combined for most of the 1990s. This was an inexplicable mistake.*
>
> *If the Regulators had bothered to take an overall view of the Company they would have seen that many were joining the company as a result of false pretences. They could have taken steps to control and limit the bonuses being announced so that a truer picture of the Company was presented to the public.*

Equitable would not have pulled in all this new money and would have remained a much smaller but healthier company instead of becoming a cancerous growth on the pensions industry. The guaranteed annuity rate problem would have remained unsolved but at least the cost of the problem would have fallen on the guaranteed annuity rate policyholders and been alleviated by hedging and a proper ring-fencing scheme. It is ironic that with fewer non-guaranteed annuity rate policyholders the need to solve the guaranteed annuity rate problem would have been much more acute and in need of resolution if the non-guaranteed annuity rate total pension funds were not to be removed. The guaranteed annuity rate problem could have been simply resolved in 1988 by the Regulators insisting on a separate fund being set up.

Whether or not the Regulators had controlled the allocation of bonuses they could at least have ensured that Conduct of Business conducted an inquiry into bonus notices and other promotional literature when it would have been seen that serious misrepresentations were being made.

There was also the question of the "technically efficient" but deceitful products such as the [with-profits] *annuities and the Managed Pension where no effective action has or is being taken.*

48 Summarising the more detailed submissions made elsewhere in their paper, EMAG noted:

We have described the period of the Hyman litigation and the pitiful absence of decent legal advice. We have mentioned how the FSA failed to intervene to protect the non-guaranteed annuity rate [policyholders] *who then represented 75% of the membership of the company. We have commented on the total failure to do anything after the Court of Appeal judgment. Finally there was the decision to allow Equitable to continue to trade in the hope of finding a buyer allowing even more policyholders to be pulled in. The failure of the Regulators to make any attempt to protect or compensate these late joiners has come in for particular criticism by Lord Penrose.*

Since the FSA has taken over regulation from HM Treasury, it is difficult not to see that "protection of policyholders" has been ditched in favour of protection of the insurance industry and the public purse. There are many, many policyholders who have lost a substantial part of their savings.

49 EMAG concluded by arguing that:

Policyholders have lost large sums of money as a result of the maladministration by the Regulators to the extent that it is questionable whether they might not have been better served by no regulation at all.

50 I also received further submissions from or on behalf of the other action groups. Those submissions include:

(i) *Equitable Life: Penrose and Beyond: Anatomy of a Fraud* – written by Dr Michael Nassim and submitted to me on behalf of both Equitable Life Trapped Annuitants and the Equitable Late Contributors' Action Group (as well as other papers written by Dr Nassim);

(ii) a submission by the Equitable Late Contributors' Action Group related to events that occurred after the Society's closure to new business; and

(iii) evidence, also given by the Investors' Association to the European Parliament Committee of Inquiry, written by Mr Michael Josephs.

51 The fact that I have not quoted here from these or any other documents does not denote that I have had no regard to their contents. I have had regard to all the evidence submitted to me from whatever source.

The injustice claimed

52 All those who have complained to me claimed to have sustained financial and other injustice as a result of alleged maladministration by those responsible for the prudential regulation of Equitable. Speaking on behalf of all those who complained to me, the lead complainants stated that:

> *The complainants invested in Equitable Life on the basis of its published literature (in some cases supplemented by the claims of its salesmen) on the understanding that it was a properly financed company which was effectively regulated by the Government.*
>
> *They did not know that the Society habitually declared and paid bonuses in excess of its earnings and did not provide properly for its liabilities, all of which was known to the regulators but with which the regulators failed to deal effectively.*
>
> *As a direct consequence of regulatory failure each complainant lost 16% (or 14% for life policies) of their policy values on 16 July 2001 and in some cases they lost more in market value adjustments and other costs and penalties upon subsequent departure. Had the regulators effectively undertaken their responsibilities, the crisis at Equitable Life would have been prevented by earlier intervention and appropriate remedial action.*

The remedy sought

53 The complainants sought full redress for the financial losses they claimed to have incurred in consequence of the maladministration they alleged and for the other injustice they claimed to have sustained.

The initial response of the public bodies

54 As I have explained in paragraph 23 of Chapter 3 of this report, I am required by section 7(1) of the Parliamentary Commissioner Act 1967 to afford to the principal officer of the department or authority concerned and to any other person who is alleged in the complaint to have taken or authorised the relevant action an opportunity to comment on any allegations contained in any complaint pursuant to which I propose to conduct an investigation.

55 On 9 December 2004, I afforded the principal officers of four public bodies – the Treasury, the FSA, GAD and the DTI (which is now the Department for Business, Enterprise and Regulatory Reform) – such an opportunity. I received a joint response on 3 March 2005 from three public bodies – the Treasury, the FSA and GAD.

56 The DTI confirmed that, as statutory responsibility for the prudential regulation of insurance companies had passed in 1998 from that department to the Treasury, it wished to make no separate submissions to my investigation from those made by the Treasury. It was explained that this was in line with the normal conventions concerning the transfer of government functions and Ministerial responsibility.

57 The joint response took the form of two documents. The first document set out the view of the public bodies whose actions were the subject of complaint as to the key aspects of the regime that pertained to the prudential regulation of Equitable during the period covered by my investigation. That document is reproduced in full as an annex to Part 2 of this report.

58 The second document contained detailed responses to the general and specific complaints contained in the published terms of reference for the investigation. That document is reproduced in full within Part 4 of my report.

Summary of response

59 I will now summarise the initial response of the public bodies to the heads of complaint set out above as those responses were set out in the second document submitted by the public bodies. I will also summarise the response of the public bodies on questions of injustice.

60 In summary, the initial joint response of the Treasury, the FSA and GAD to the complaints alleging maladministration was that:

(i) there had been no failure on the part of any of the prudential regulators or GAD properly to exercise their functions in respect of Equitable. At all times those regulators and GAD had acted reasonably and properly, in the context of and having regard to the regulatory regime as it had been at the relevant time;

(ii) the nature and scope of that regime had been determined by legislation and by regulatory policies which informed and were adopted under the applicable legislation. At all times, the policies adopted had been proper ones and had been the result of choices which Parliament and Ministers had been fully entitled to make; and

(iii) none of the complaints made by the complainants disclosed reasonable grounds for concluding that any of the public bodies responsible for the prudential regulation of Equitable or GAD had been guilty of maladministration.

61 Before responding to each of the specific complaints set out in the terms of reference for my investigation, the public bodies made some general observations about two matters: first, about the degree to which the contents of the Penrose Report were relevant to my investigation and, secondly, about the nature of the relevant regulatory context.

Two general observations made by the public bodies

The Penrose Report

62 The public bodies contended that almost all of the specific complaints that were the focus of my investigation had been derived from the Penrose Report. It was the view of the public bodies that the contents of the Penrose Report could not be used to support a case of maladministration, for two reasons. The first reason given was that the observations and criticisms made by Lord Penrose had been made with the benefit of hindsight, which had been permitted by the terms of reference of his inquiry.

63 By contrast, the joint response noted that, in carrying out my investigation, I had to consider the relevant events and actions solely in the light of the circumstances and knowledge of those involved at the relevant time. The public bodies said that this constituted a critical difference between the nature of the exercise which Lord Penrose had carried out and that of my investigation.

64 The public bodies also contended that the criticisms which had been made in the Penrose Report of particular decisions and actions that it was alleged had been taken, or omitted to have been taken, by the prudential regulators and GAD in exercising their functions were in fact few.

65 The public bodies noted that I would wish to form my own view of whether those criticisms were both well founded and relevant to this investigation. Whether those criticisms were accepted or not, the Treasury, the FSA and GAD took the view that they were dependent on the use of hindsight and that, if hindsight were disregarded, there was no reasonable basis for a finding of fault.

66 The public bodies contended that the second reason why the Penrose Report could not be used to support a case of maladministration was that, although that Report had (with the benefit of hindsight) been on occasion critical of the performance of the prudential regulators and GAD, its criticisms had been essentially directed at the regulatory regime which was in force at the relevant time rather than at particular decisions and actions taken, or not taken, in operating that regime.

67 The public bodies argued that the gist of those criticisms was not that the prudential regulators and GAD had failed properly to discharge their functions under the regime as it stood; but rather that the regulatory regime as it had stood was, in the view of Lord Penrose, unsatisfactory in various respects and required to be changed.

68 The public bodies contended that it was evident from his Report that the regulatory approach advocated by Lord Penrose would have required a much greater degree of intervention and intrusion by the prudential regulators than had obtained, or had been seen as politically desirable or appropriate, at the relevant time.

69 The public bodies also submitted that criticism of the regulatory regime as it had stood was not material for the purposes of my investigation. In judging whether maladministration has occurred, it was said that my investigation would not be concerned with whether the regulatory regime that had existed was the optimum one, or with the merits or demerits of the policies adopted.

70 Instead, the issue would be whether, given the regime that existed, and the policy choices made, there had been a culpable failure on the part of the prudential regulators or GAD to apply the provisions and policy of the regime.

The regulatory context

71 The public bodies then turned to the regulatory regime and told me that, in a situation where policyholders' interests are alleged to have been harmed or put at risk, it was unsurprising that some policyholders would believe that they had been 'let down' by the prudential regulators.

72 The joint response explained, however, that no system of prudential regulation could prevent, nor should it be designed to prevent, all financial difficulties that might be experienced by insurance companies operating in a competitive market economy.

73 Prudential regulation of insurance companies instead required a balance to be struck between protecting policyholders against the risk that a company would act imprudently on the one hand and, on the other, allowing the maximum freedom to the company and its management to pursue their chosen commercial strategy in the way they considered best.

74 The public bodies contended that the way in which that balance was to be struck was a matter of policy for Parliament in enacting the applicable legislation, and, within the statutory framework laid down by Parliament, for the Government of the day to decide, reflecting values and priorities as set by Ministers.

75 They told me that it followed that any assessment of whether the prudential regulators and GAD had properly exercised their functions could only be made by reference to the statutory framework of powers and duties which governed the prudential regulation of insurance companies during the period covered by the investigation and to the policy context in which prudential regulation took place – especially in their view as regards the degree of intrusiveness seen as appropriate and the level of public resources allocated to such regulation.

The initial response of the public bodies to the detailed heads of complaints

***Complaint A** – the prudential regulators had not been sufficiently resourced, and had not all possessed the necessary skills, to contribute effectively to the overall regulatory process and to responsibly exercise their discretionary powers as intended by Parliament and by the European Union.*

76 The public bodies submitted that the two allegations – that the prudential regulators were not sufficiently resourced and that they lacked the necessary skills – were both wholly unjustified. It was said that resources were finite and decisions as to their allocation had been policy decisions; Ministers had taken a reasonable view at the time relevant to my investigation that the balance of resources that were deployed was correct.

77 From the 1980s to 2001, the cost of prudential regulation (and the number of staff employed by the DTI and GAD in undertaking it) increased significantly in real terms, against a prevailing climate of pressure on costs and of deregulation. While it could always be argued that it would have been desirable to allocate more resources, there was no objective basis for concluding that the decisions taken at the time on resourcing prudential regulation were improper.

78 In relation to skills, the public bodies said that an early policy decision had been taken to outsource to GAD the actuarial expertise needed by the prudential regulators, a decision confirmed by reviews in 1978 and 1983. That was not an improper delegation of prudential regulation. The public bodies noted that Lord Penrose in his report had recognised that GAD had had access to developing thought in the profession. Steps had also been taken (such as secondments or longer postings) to improve the skills and resources that were available within the DTI and then the Treasury.

79 In summary, the public bodies contended that decisions as to resourcing, priorities and methods were not administrative decisions but were discretionary decisions which involved policy objectives and that there were no grounds for suggesting that those decisions had been improperly taken.

***Complaint B** – that the prudential regulators had failed to liaise and to co-operate effectively with those responsible for the regulation of the conduct of business by insurance companies.*

80 The public bodies contended that this complaint did not specify any concrete instance in which there had supposedly been a failure of liaison or co-operation by the prudential regulators with the conduct of business regulators. Nor, it was said, did

complainants specify any particular steps which the prudential regulators should have taken at any particular time but did not take.

81 The public bodies said that the relevant regime had not required extensive co-ordination as the two regulators addressed separate issues within their own areas of policy and focus.

82 The view of the public bodies was that there had been no failure of liaison between the two sets of regulators. They noted that Lord Penrose had recognised that there had been routine exchange of information in the 1980s and that interaction on a more formal footing had begun from 1992 onwards. During the period in which the FSA had had day-to-day responsibility for both prudential and conduct of business regulation, the public bodies said that arrangements had been put in place to encourage liaison between both sets of regulators.

83 The public bodies noted that, while Lord Penrose had said (with hindsight) that there had been insufficient liaison, he had given no specific examples other than in the autumn of 1999, which the public bodies took to refer to communications between the two regulators in September 1999 over bonus notices. In the view of the public bodies, however, that episode did not reveal any failure of liaison but rather a potential gap in the regulatory framework which pertained at that time. That gap was not as a result of any improper decision by the prudential regulators, but reflected the then prevailing system of regulation and the way the prudential and conduct of business regulators had been required to operate prior to their full merger within the FSA.

Complaint C *– that the prudential regulators had not operated the regulatory regime as it was intended to be implemented by Parliament and in conformity with European Directives. Those regulators instead had chosen to regulate Equitable with a 'light touch' – a concept not evident from or provided for under the Insurance Companies Act 1982 and the European Third Life Directive, nor one consistent with those statutory provisions.*

84 The public bodies submitted that neither allegation under this head of complaint – that the prudential regulators had operated a 'light touch' contrary to the provisions of United Kingdom statutes and European Directives and that, compared to other companies, the approach of those regulators towards Equitable had been exceptionally and unjustifiably lenient – was well founded.

85 In relation to 'light touch', the position of the public bodies was that the regime applied (whose guiding principle had been 'freedom with publicity') was precisely that which informed and was enabled by the relevant statutory provisions; in addition, it was their position that the relevant domestic legislation at all times had complied with European Directives.

86 In relation to the allegation of a 'double standard' applied to the prudential regulation of Equitable, the public bodies wholly rejected this. They noted that the regime had targeted resources through a priority rating system. In most years, Equitable had been assigned a rating of 3[3], indicating that there had been sufficient concerns to warrant early attention or other reasons to require scrutiny early in the cycle. These ratings had been assigned on the basis of objective criteria, taking account of key indicators (including coverage for the required solvency margin).

87 In the 1990s, Equitable's required minimum solvency margin had been reasonably well covered, as had been reflected in their ratings, which were in line with those given to other companies with similar

[3] See Appendix E to Part 2 of my report for a description of GAD's priority ratings.

levels of cover. Supervision had not been limited to scrutiny of the returns alone, but had included site visits (which relied on co-operation and were not 'investigative'), which had been introduced in 1991 on a three-year cycle. Equitable had been visited in 1992, 1994 and 1996, within the three-year cycle.

88 The public bodies stated that the priority ratings given to the Society and the frequency of visits to it showed that Equitable had been treated no differently from other companies. If anything, the public bodies argued, the intensity of exchanges between GAD and the prudential regulators, and between those regulators and Equitable, had been higher than for other companies of a comparable priority level during the 1990s.

Complaint D *– that the prudential regulators and GAD had allowed successive Chief Executives or Managing Directors of the Society simultaneously to hold the post of Appointed Actuary, despite recognising the potential for conflict of interest. This had not been compatible with the basis of the regulatory regime.*

89 The public bodies denied that there had been successive Chief Executives or Managing Directors of the Society who had simultaneously held the post of Appointed Actuary; this had only applied to one person from 1991 to 1997, they said.

90 Nevertheless, those bodies said, the prudential regulators had regarded the dual role as undesirable and had sought to discourage it; but it had not been contrary to established industry norms and other companies also had been in that position at the relevant time.

91 The public bodies submitted that there had been arguments both for and against somebody holding that 'dual role'. In the case of a mutual insurance company, there could have been no conflict between shareholders and policyholders and so there had been less potential for a conflict of interest in the Society's case.

92 The Insurance Companies Act 1982 had not expressly prohibited the dual role and so the complaint that the prudential regulators 'allowed' this was, in the view of the public bodies, misplaced. It was said that those regulators could have objected to the appointment of a Chief Executive on the ground that he or she was not a 'fit and proper' person. This, however, had been taken to mean grounds such as dishonest conduct. The public bodies said that the person concerned had been amply qualified to be the Society's Chief Executive.

93 In addition, the public bodies contended that there had existed specific circumstances in the case of Equitable, in that there had been no-one to take over from the incumbent as Appointed Actuary when he became Chief Executive.

94 The public bodies submitted that the prudential regulators had expressed concern but had had to accept that they could not impose a condition that the incumbent should end his dual role after 12 months; nor, it was said, could those regulators bring the dual role to an end. The prudential regulators and GAD had continued to express concern (from 1992 to 1996), but the incumbent's response had been that he would give up one of the roles if a conflict arose, that it was still a temporary measure, and that there was no suitable replacement.

95 In addition, the public bodies contended that it was not clear what advantage to the complainants there would have been had the dual role been avoided, or what changed in Equitable's thinking or actions when the dual role ended in 1997.

Complaint E *– that the prudential regulators and GAD had failed to keep pace with developments in the pensions and life insurance industry and to assess and adapt their methods to reflect those developments.*

96 The public bodies' response to this head of complaint was that it was wrong to suggest that the regime remained static or that the prudential regulators had not taken steps to adapt to developments in the industry. There had been a series of initiatives from 1974 onwards.

97 Those initiatives had included successive legislative changes from 1974-2001 affecting the valuation of assets and liabilities, the applicable Regulations and the regulatory returns; moves to require the Appointed Actuary to specify certain facts in the returns; site visits from 1991; and the addition of the requirement for sound and prudent management in 1994.

98 Those initiatives had also included a Service Level Agreement between GAD and the DTI in 1995, replaced by a further such agreement in 1998; annual reports on the industry prepared by GAD from 1995; GAD surveys of bonus distributions (1993) and in respect of guaranteed annuity rates (1998) and three working parties set up through the Joint Actuarial Working Party in the 1990s – on policyholders' reasonable expectations, on the net premium method of valuation and on the impact of guaranteed annuity rates. Changes in mandatory guidance issued by the actuarial profession to Appointed Actuaries and additional guidance by GAD through 'Dear Appointed Actuary' letters had also been issued.

99 In these ways, the public bodies said, the regime had been kept up-to-date and the level of regulation increased, despite a then prevalent policy of deregulation.

100 With regard to regulatory solvency, the public bodies submitted that this had been the crucial yardstick by which the balance between policyholder protection and freedom to compete had been struck. The public bodies stated that the prudential regulators could not be criticised for applying and scrutinising regulatory returns by reference to the prescribed solvency criteria.

101 The public bodies contended that the complainants' real grievance appeared to be that, as the industry had moved increasingly towards non-guaranteed terminal bonuses, the prudential regulators should have required Equitable to reserve for these. But, in the view of the public bodies, those regulators could not have done so.

102 The Third Life Directive had given Member States discretion over whether or not to require the setting aside of reserves for bonuses. The United Kingdom Government had decided not to require this. The alternative approach that had instead been agreed was that an implicit allowance for terminal bonus should be made through a deliberately prudent and cautious approach to the valuation of assets and liabilities, which would create implicit margins for future bonuses. That was achieved in particular by requiring conservative valuation assumptions (including not taking credit for future capital appreciation on equity investments) and using a net premium method of valuation.

103 The public bodies submitted that it was not open to the prudential regulators to impose reserving by the back door method of policyholders' reasonable expectations. Had those regulators done so, it would have gone against the policy decision of the Government and would have been an attempt to use its powers of intervention impermissibly in preventing a company from disposing of its assets even though the test for regulatory solvency had been met.

104 The public bodies also said that it was not clear from where policyholders had derived a reasonable expectation that Equitable would set aside reserves for terminal bonuses, given the lack of a statutory requirement to do so and given the Society's well-publicised policy of full distribution. The public bodies submitted that, had Equitable set aside reserves, it would arguably have gone against the reasonable expectations of with-profits policyholders that there would be full distribution.

Complaint F *– that GAD had recommended Equitable as a pension plan or additional voluntary contribution scheme provider in its advice to the administrators of the Principal Civil Service Pension Scheme and to other public sector pension schemes. This had led to a lack of proper separation of its responsibilities and to a clear conflict of interest between GAD's role in providing advice to government bodies in relation to public sector pensions and in assisting the prudential regulators of the Society. This conflict of interest had compromised the proper discharge of GAD's regulatory functions.*

105 The public bodies submitted that it was wrong to suggest that the facts demonstrated any lack of proper separation of GAD's responsibilities or a conflict of interest in GAD's roles. GAD had provided advice at the time that Equitable had been selected to provide additional voluntary contributions for the civil service scheme (in 1988) and then had carried out three paper reviews (in 1992, 1993 and 1995) of this provision but this role had then been outsourced.

106 The public bodies said that GAD's role of giving advice had not conflicted with its role assisting the prudential regulators. The two functions had been kept separate by what they referred to as a 'Chinese wall' and there had been no exchange of confidential information. There had been no professionally improper conduct and, in their view, the complaint was without substance.

Complaint G *– that, from the mid-1980s until 1997, the prudential regulators had failed to evaluate the potential effect of guaranteed annuity rates on the solvency of Equitable in a context where current annuity rates were falling steadily, in line with the Bank of England's base rate, to below contracted guaranteed annuity rates.*

107 The public bodies' response to this head of complaint was that the applicable Regulations had required guaranteed annuity rates to be valued on prudent assumptions – depending on the extent they would be 'in the money' if mortality and interest rate assumptions were borne out and with regard to a prudent assumed take-up rate. Otherwise, guaranteed annuity rates represented only a contingent liability and were something the Appointed Actuary was expected to take into account when analysing the company's overall financial condition.

108 The public bodies noted that guaranteed annuity rates had begun to exceed current annuity rates briefly in 1993 (and then continuously from 1995). Equitable had decided to award a lower terminal bonus to a policyholder who took benefits with a guaranteed annuity rate and on this basis took the view that there was no need to set up a reserve. However, the public bodies argued that it had been the responsibility of the Appointed Actuary to disclose the company's liabilities and to justify how they had been reserved for; it was contended that the prudential regulators had relied on the Society's Appointed Actuary to do this and had been entitled so to do.

109 The public bodies noted that the Society's returns had not disclosed its exposure to guaranteed annuity rates or the approach it had adopted of awarding differential terminal bonuses in anything approaching a satisfactory way. The public bodies contended that the prudential regulators could not have been expected to identify the problem from

the information provided or (given the time and resources available and nature of the regulatory regime) to have sought the information needed. Contrary to the Society's claim that it had disclosed its differential terminal bonus policy since 1993, the public bodies noted that Lord Penrose had found that the Society's returns had failed to identify the growing obligations, with his report referring to obscure, opaque and uncommunicative information.

110 In relation to the November 1993 meeting, the public bodies stated that there had been no clear disclosure of Equitable's policy or their exposure to guaranteed annuity rates. The note of that meeting had referred to the Society remarking that the allocation of a final bonus could be conditional on the waiving of the guarantee. But, it was said, the Appointed Actuary had said that in the context of the resilience reserve – i.e. that the guaranteed annuity rates may bite in the reduced interest rate scenario but not in the base valuation. The public bodies submitted that the Appointed Actuary had not been saying that, while a base valuation reserve was needed, this was not being held due to the differential terminal bonus policy. That this was the position had only emerged in 1998.

111 In relation to the study of the extent of guaranteed annuity rates in the industry, the public bodies said that it had not been until the late 1990s that guaranteed annuity rates had become of significant value to policyholders. At GAD's suggestion, a professional working party had been set up in January 1997. Its terms of reference had recognised that there was no accepted practice for reserving for the guarantees.

112 The working party's report had been published in spring 1998. It had found considerable variations in reserving practice and did not provide definitive recommendations as to the right approach. GAD had been represented on the working party but could not provide the prudential regulators with confidential information provided by (or concerning) companies. So GAD had initiated its own survey in June 1998, to tie in with the submission of 1997 returns by the end of June 1998. The public bodies said that this had been an appropriate follow-up to the professional working party report and there was no reasonable basis to suggest this should have been done a decade earlier.

113 The public bodies said that the Society's exposure to guaranteed annuity rates had become apparent with Equitable's response to GAD's survey, in July 1998. This had showed that Equitable had not reserved for guaranteed annuity rates, had significantly higher exposure than others, and had not separated that business from non-guaranteed annuity rate business. For other companies, guaranteed annuity rate business had been on a smaller scale, or had been kept separate from other business, or the company had had an estate or was reserving on a proper basis.

114 The public bodies contended that the prudential regulators and GAD had reacted swiftly and firmly to information provided to them in July 1998. In November 1998, GAD had sent the Treasury a report identifying Equitable as particularly vulnerable. The prudential regulators had taken steps (which had begun in September 1998) to ensure that the Society made proper provision for those liabilities. Equitable had maintained their position that it would be excessively prudent for them to reserve on the basis that there would be a 100% take-up rate. The Society had threatened judicial review, sought the assistance of the then Economic Secretary to the Treasury, and continued the debate until the House of Lords' judgment in July 2000.

115 The public bodies submitted that the Society's difficulties after the decision of the House of Lords in *Hyman* had arisen due to the cost of honouring the guaranteed annuity rates on the non-guaranteed part of maturity values. That cost, it was said, had been determined by the prevailing investment conditions and not by the reduced interest rate scenario in the resilience test. The cost was separate from the cost of honouring guaranteed annuity rates on the guaranteed part of maturity values, which had already been reserved for at the insistence of the prudential regulators (subject to the renegotiation of the reinsurance treaty).

116 The public bodies contended that those events demonstrated no fault on the part of the prudential regulators or GAD, who had acted promptly and firmly: it was one thing to say, with the benefit of hindsight, that Equitable should have been quizzed about its approach at an earlier stage. The public bodies said, however, that the Society's returns for 1993 to 1996 had not disclosed that Equitable were not reserving for the liabilities associated with guaranteed annuity rates, or that the extent of the relevant policies was significant; nor had those returns disclosed the reserving method, the rate of guarantee, or the volume of business.

117 The public bodies submitted that it was not the case that the Society's failure to reserve had played a direct part in Equitable's closure to new business and the subsequent cuts in policy values. It was said that Equitable had been required to reserve for guaranteed annuity rates and the outcome of the litigation had not changed their gross reserving requirements. After the House of Lords' judgment, Equitable had sought a buyer to fund the guaranteed annuity rate costs. For various reasons, not all related to the financial state of Equitable, the sale had failed and policy values had had to be cut. The public bodies argued that there was no clear, let alone direct, link between the cut in policy values and the guaranteed annuity rate issue.

118 The public bodies contended that this had been a complex chain of events and that it was not clear what role, if any, the Society's delayed introduction of full reserving had played. It was said that earlier additional reserves would most likely have been at the expense of showing a weaker statutory solvency position or of slimming down margins elsewhere in the valuation basis, so it was not clear that additional reserving would have forced Equitable to change their bonus policy.

119 The public bodies stated that the July 2001 cuts had been largely due to negative rates of investment returns earned by Equitable in 2000 and 2001, against a background of falls in equity markets and their policy of no estate, which meant that, in adverse investment conditions, policy values might have had to be cut.

Complaint H *– that, from about 1990 onwards, the prudential regulators and GAD had failed to give sufficient consideration to the fact that some of the measures used to bolster Equitable's solvency position were predicated on the emergence of a future surplus. As a consequence, the prudential regulators and GAD had not properly assessed the overall impact and adequacy of those measures.*

120 The public bodies stated that the measures used to bolster Equitable's solvency margin criticised in this head of complaint were assumed to relate to the use of future profits implicit items (those complaints which related to the subordinated loan and reinsurance are dealt with under Complaint J below).

121 The public bodies contended that United Kingdom and European legislation had allowed value to be placed on projected future surplus for demonstrating cover for the regulatory required solvency margin. For an insurance company to be permitted to include a future profits implicit item, an Order under section 68 of the Insurance

Companies Act 1982 had been required. The value of the item was limited by law.

122 The United Kingdom's approach, as reflected in guidance issued by the prudential regulators in 1984, had been more cautious, it was said, than the European regime – in requiring the amount applied for to be less than the present value of profits expected to arise on in-force business. The Appointed Actuary had been required to certify this. Guidance had made clear that the Appointed Actuary's assessment had to be based on cautious assumptions.

123 The public bodies submitted that the role of the prudential regulators, acting with the advice and assistance of GAD, had been to determine whether a section 68 Order could be justified under relevant Regulations and guidance. It was said that the prudential regulators had been entitled to place weight on the certificate from the Appointed Actuary. If the calculations provided were justifiable, a refusal to grant the Order would have been highly unusual. The 1984 guidance had allowed, but had not required, the prudential regulators to request details of the assumptions used in the Appointed Actuary's certificate.

124 The public bodies contended that it would not have been proportionate for this to have been done unless there had been evidence from the returns (particularly the 'matching rectangle' in Form 57 of the returns) to suggest that the application might not have been adequately supported. This, it was said, had never been the case with Equitable. In addition, even where a section 68 Order was granted, what credit should be taken for it in the returns had been a matter for the professional judgement of the Appointed Actuary.

125 The public bodies submitted that there was no evidence that the prudential regulators had ever wrongly granted a section 68 Order. The public bodies noted that Lord Penrose in his report had accepted that the Order made in September 2000 (and by implication each earlier Order) had been properly granted and in accordance with the Regulations.

126 The public bodies argued that the allegation that the prudential regulators had failed to assess the impact of these Orders was also not justified. Equitable had applied for and used less (generally substantially less) than they had been entitled to use. The Society had not been the first company to use such an item; the increase in its use from 1995 to 2000 had also not been out of line with the increase in the aggregate amount for the industry.

Complaint I *– that, from 1990 onwards, the prudential regulators had allowed Equitable to publish financial results and projections that were misleading in that they had not reflected the Society's true position.*

127 The public bodies' position in relation to this head of complaint was that the accuracy of the material in Equitable's literature had not been a matter for the prudential regulators. The way Equitable had reported growth reflected their policy of a guaranteed reversionary bonus and non-guaranteed terminal bonus. It had not been for those regulators to prescribe the approach to be followed, provided that the Society complied with its statutory obligations.

128 The public bodies contended that the calculations contained in the Penrose Report, which suggested that the Society's assets had been consistently less than policy values, had not been seen by the prudential regulators at the time and it was not clear how those or similar calculations by complainants ensured consistency of assets and liabilities.

129 The public bodies submitted that the comparison of policy values and asset shares was a complex actuarial exercise where different professional opinions were possible, depending on the methodology and assumptions employed. Thus, in their view, there was little scope for a finding of maladministration unless the specific professional opinion relied on was demonstrably unreasonable or was contrary to the then prevailing regulatory regime.

130 The public bodies maintained that no instances had been given of Equitable being allowed to disclose results or projections that were contrary to the Regulations. The only relevance for the prudential regulators of the literature supplied to customers was in relation to policyholders' reasonable expectations, which are covered below in the response to complaints N and O below.

Complaint J *– that, during the period under investigation, the prudential regulators and GAD had failed to act when Equitable had adopted what Lord Penrose described as practices of 'dubious actuarial merit'.*

131 The public bodies noted that the seven practices identified in this head of complaint included five of the six practices discussed by Lord Penrose in chapter 19 of his report. He had expressed concern, in paragraph 166 of that chapter, about the prudential regulators' response to these practices, but had acknowledged that most of Equitable's steps had been within the limits allowed for in the Regulations and in guidance. The public bodies said that such practices had been a matter for the professional judgement of the Appointed Actuary, acting within the limits allowed by the Regulations. The public bodies accepted, however, that not all of Equitable's practices had been permissible but said that, when this had come to the prudential regulators' attention, those regulators had taken appropriate action.

132 The full initial response of the public bodies to these allegations is set out within Part 4 of this report. That response rejected the basis of all the specific allegations made under this head of complaint.

Complaint K *– that... the prudential regulators and GAD had ignored or failed to act on information that might have led to formal or informal regulatory action against Equitable, thus also failing to alert new investors to the risks of investing. Those occasions included when the Society's Board papers were sent to GAD by the Appointed Actuary on 11 June 1991, and when information was provided to GAD on 10 September 1992 which showed that, for the years 1989 to 1991, the aggregate policy values had very significantly exceeded the value of the underlying assets.*

133 The public bodies said that they did not accept that the Board papers provided to GAD in 1991 had contained critical information or had revealed extreme steps. Those bodies said that the adjustment made to the Society's valuation basis had been well within the limits permissible under the applicable Regulations; the GAD actuary had seen no problem and neither had GAD in its correspondence with Equitable in November 1991. In addition, in their view the GAD actuary's actions in not passing the papers to the DTI had been entirely professional and understandable. The public bodies submitted that any criticism of the actuary's actions could only be made with hindsight.

134 The public bodies said that they also did not accept that the information provided to GAD on 10 September 1992 should have led to formal regulatory action. Those bodies said that GAD had raised the issue at a meeting on 15 September 1992 and had passed the letter to the prudential regulators. Equitable had acknowledged on 17 September 1992 that the implications for

bonuses had to be considered carefully. There had been no need for specific comment on the figures, which in any event had showed that the excess of policy values over assets was falling.

135 The public bodies noted that GAD's scrutiny of the 1991 returns had raised concerns about the weakening of the valuation base. The prudential regulators had, in November 1992, acknowledged that this painted a worrying picture. Those regulators had asked GAD to seek a fuller analysis.

136 In response, in March 1993, GAD had said that Equitable could survive a short term fall in the markets. GAD asked Equitable for an indication of the end 1992 position and, when Equitable had indicated that that position had much improved, those concerns '*ebbed away*'. Within the scrutiny of the 1992 returns, GAD had commented on this improvement and had anticipated a further improvement in the 1993 returns, which in turn happened.

137 The public bodies argued that it was not necessarily unacceptable for policy values to exceed the value of assets. Equitable's view had been that the normal range was plus or minus 10% but that there could be circumstances when the relationship was outside this range.

138 There had been no reason, it was said, for the prudential regulators to doubt the Society's view, particularly when the lack of an estate had made smoothing at times of very unfavourable market conditions more difficult. The Society's lack of an estate had been well known and the public bodies said that it was difficult to argue that the Society's approach had been inconsistent with policyholders' reasonable expectations.

139 The public bodies also maintained that it had not been a matter for the prudential regulators to alert potential policyholders to the risks of purchasing policies from a particular company.

Complaint L *– that, over a period of many years, the prudential regulators and GAD had permitted Equitable to operate an unsound business model, of which those regulators and GAD had been aware.*

140 The public bodies stated that this complaint was founded on a false premise. In their view, it had not been for the prudential regulators to judge the soundness of a company's business model.

141 To have done so, it was said, would have substantially interfered in the normal course of competition in the market, would have exceeded those regulators' legal powers, and would have run contrary to the policy of 'freedom with publicity'.

142 The public bodies accepted that the Society's business model had meant that it was inherently weaker in balance sheet solvency terms than companies with shareholders or an estate. The Society's model had had commercial risks. But, the public bodies submitted, that model had been no secret and the risks ought to have been appreciated by policyholders and their advisers when they were taking investment decisions.

143 The public bodies categorically rejected the suggestion that the prudential regulators should have sought to prevent or dissuade Equitable from following their chosen model. It was said that, provided the applicable Regulations had been followed, those regulators had had no power to intervene.

Complaint M *– that the prudential regulators had failed to ensure any satisfactory correlation between the total of declared policy values and the Society's admissible assets in a context where Equitable, uniquely in the industry, had declared total policy values that had included terminal bonuses and had, without exception, always paid all claims (both contractual and non-contractual) in accordance with those declarations.*

144 The public bodies stated that this complaint added little to the other complaints. It was said that, in essence, Equitable had met their statutory solvency requirements, the Regulations did not require reserving for terminal bonus, realistic solvency had been a matter for the Board and the Appointed Actuary, Equitable's business model had been legitimate, and there was nothing to suggest that the prudential regulators had failed, at any time, to ensure that Equitable met the obligations imposed on them by the regulatory regime.

145 In addition, while it was accepted that policyholders' reasonable expectations had been a relevant issue, this was an area in which the role of the Appointed Actuary had been even more important than in other areas. In the view of the public bodies, it was not, and could not sensibly have been, a part of the role of the prudential regulators to monitor and make their own independent assessment of what, at any given time, were the reasonable expectations of the various classes of policyholders of the many life insurance companies.

Complaints N and O *– the protection of policyholders' reasonable expectations.*

146 The public bodies submitted that the concept of policyholders' reasonable expectations had been introduced in 1973 partly to ensure the interests of policyholders were protected as against those of shareholders. The public bodies contended that this concept had not been seen as a means of scrutinising the expectations of different cohorts of policyholders within a mutual company.

147 It was said that the powers of intervention granted to the prudential regulators were only to be exercised where it was obvious that the reasonable expectations of policyholders were not going to be met. Those powers were not to be used to ensure value for money. The Government of the day had also decided that policyholders' reasonable expectations would be safeguarded solely by reference to the regulatory returns and that to take a different regulatory approach would have trespassed on management decisions. This, it was said, was a policy decision that the Government had been entitled to take.

148 The public bodies argued that the Insurance Companies Act 1982 had made clear that the powers of intervention on the grounds of the protection of policyholders' reasonable expectations were extremely limited.

149 It was asserted that section 37(6) of the 1982 Act made clear that this was merely a residual power and that section 45(2) only permitted the prudential regulators to restrict the disposal of assets for the purposes of policyholders' reasonable expectations when regulatory solvency had been breached or when a company had been closed to new business. It was also said that the applicable Regulations had placed the primary responsibility for monitoring policyholders' reasonable expectations on the Appointed Actuary.

Complaint P *– preparation for, and follow-up to, the House of Lords' judgment*

150 The public bodies argued that my first investigation had already fully considered all the issues in this head of complaint and that that investigation had '*rightly concluded*' that there had been no fault by the prudential regulators. That remained the case in the view of the public bodies. The subsequent inclusion within my jurisdiction of GAD made no difference to those findings. GAD had advised the FSA, who had advised the Treasury. In the view of the public bodies, this complaint was not about the advice given by GAD but about the decisions which had been taken by the FSA and the Treasury.

Complaints Q and R *– events in the period following the closure to new business*

151 The public bodies contended that these complaints related to post closure events, which were not the focus of this investigation. In relation to the 2000 bonus declaration, it was said that there had been no such bonus. However, if the complaint referred to the addition of a notional interim bonus, that had not been something that Equitable had been required to report to the prudential regulators. But those regulators did keep a close watch over what Equitable were doing during this time and had taken the view that the Society was acting reasonably.

152 The public bodies submitted that, by the summer of 2001, it had been clear that the Society's practices were no longer sustainable. Equitable had decided that the expectations of policyholders needed to be addressed and that a financial adjustment was needed for those leaving. That, it was said, had been the background to the policy cuts.

153 The public bodies contended that, provided such a decision had been reasonable, it had been for Equitable to decide the approach to these cuts, not a matter for the prudential regulators. Those regulators had considered the issues and had discussed them with Equitable at the relevant times. The prudential regulators had at all times sought to keep policyholders informed of the situation.

Injustice

154 Having addressed the allegations that maladministration had occurred, the public bodies then addressed the injustice claimed by complainants. For all the reasons set out in their full initial response to the complaints (which is set out within Part 4 of this report and is only summarised in this Chapter), the public bodies whose actions were the subject of complaint told me that they believed:

- that it was wrong to say, as complainants did, that the July 2001 policy value cuts had been in any material respect a consequence of '*sustained over-allocation and sustained over-distribution on claims*', as Lord Penrose had concluded;

- that, on the contrary, analysis undertaken by the Society had demonstrated that more than 14% of the 16% cut in policy values made in July 2001 had been in fact attributable to:

  (i) adverse investment conditions prevailing between 1 January 2000 and mid-July 2001;

  (ii) adjustments made to the valuation of the Society's liabilities (on a realistic basis) by the new Appointed Actuary; and

(iii) a decision (taken by the new Board on the advice of the new Appointed Actuary) to create, as at 31 July 2001, an excess in the with-profits fund of available assets over aggregate with-profit policy values of £600 million as a prudential measure given the uncertain outlook for the future;

- that, even to the very modest extent to which the 16% cut in policy values did relate to events before the end of 1999, it was not correct to say that those policyholders as at 31 July 2001 who had also been policyholders throughout the period covered by the analysis contained within the Penrose Report were any worse off;
- that the Society's policy value cuts had not been out of line with those imposed by other life insurance companies at about the same time. Complainants could not demonstrate with any degree of certainty that sums invested elsewhere than with Equitable would have fared any better; and
- that, accordingly, there was no basis for the alleged injustice.

Conclusion

155 Having received a response from the public bodies whose actions were the subject of complaint to the allegations of maladministration made by complainants and to the claims of injustice that those complainants said resulted from such maladministration, and not being satisfied that those responses had resolved the complaints or had provided an explanation of the relevant facts that cleared up the issues, I decided to continue my investigation.

156 The next Chapter sets out the basis for my determination of the complaints contained within the terms of reference for that investigation.

Chapter 5 – The basis for my determination of the complaints

Introduction

1 In this Chapter, I do four things:

- I first describe, in paragraphs 2 to 7 below, the general approach that I adopt when determining complaints that a citizen has sustained injustice as a result of maladministration. This approach is based on establishing a clear understanding of the standards, both those of general application (the general standard) and those which are specific to the circumstances of a case (the specific standard), which applied at the time that the events complained about occurred. The general standard and the specific standard together comprise the overall standard.
- I then set out, in paragraphs 8 to 16 below, the general standard relevant to the investigation, as derived from established principles of good administration and from public law principles.
- I then set out, in paragraphs 17 to 108 below, the specific standard relevant to the investigation, i.e. the specific legal and administrative framework of prudential regulation and the specific duties imposed upon, and the powers available to, the prudential regulators within that framework during the relevant period.
- I then summarise, in paragraphs 109 to 114 below, the key legal and administrative obligations that the prudential regulators and/or GAD had at the relevant time, which are relevant to my consideration of the manner in which those regulators and/or GAD discharged those obligations.

My general approach and the overall standard

2 In simple terms, when determining complaints which have as their basis a claim that injustice has been sustained in consequence of alleged maladministration, I generally begin by comparing what actually happened with what should have happened.

3 So in addition to establishing the facts that are relevant to a complaint, I also need to establish a clear understanding of the standards, both of general application and which are specific to the circumstances of the case, which applied at the time that the events complained about occurred and which governed the discharge of administrative functions by those whose actions are subject to complaint. I call this establishing the overall standard.

4 The overall standard has two components: the general standard which is derived from general principles of good administration and of public law; and the specific standard which is derived from the specific legal and administrative framework relevant to the events in question.

5 Having established the overall standard, I then assess the facts in accordance with that standard.

6 In particular, I assess whether or not an act or omission on the part of the body complained about (in this case the prudential regulators and/or GAD) constituted a departure from the applicable standard. If so, I then assess whether that act or omission was so unreasonable, in the particular circumstances when regard is had to the specific legal or administrative context of the case, as to constitute maladministration; and/or whether any such act or omission otherwise fell so far short of acceptable standards of good administration as to constitute maladministration.

7 The general and specific standards applicable to this investigation are set out below in paragraphs 8 to 16 and 17 to 108, respectively; together they comprise the overall standard. The facts as I have found them to be are set out in Part 3 of this report, which contains a detailed chronology of the relevant events. Those events are summarised in Chapters 6, 7, and 8 of this report. My assessment of those facts against the overall standard is set out in Chapters 10 and 11.

The general standard: principles of good administration and public law

General principles of good administration

8 Since my Office was established in 1967, it has developed and applied certain principles of good administration in determining complaints of maladministration. In March 2007, I published those established principles in codified form, in a document entitled *Principles of Good Administration*.

9 The document[1] organises the established principles of good administration, which are based on 40 years' experience of investigating complaints and are thus derived from the practical processes of our casework, into six principles. Those principles are:

- Getting it right;
- Being customer focused;
- Being open and accountable;
- Acting fairly and proportionately;
- Putting things right; and
- Seeking continuous improvement.

10 I have taken into account those principles of good administration in my consideration of the complaints which led to this report. I have identified that the principles of 'getting it right' and 'being open and accountable' are of particular relevance in relation to the complaints which formed the basis for this investigation. For that reason, I set out below in greater detail some of what *Principles of Good Administration* says under those headings.

11 **Getting it right** means (amongst other things):

- Acting in accordance with the law and with due regard for the rights of those concerned.
- Acting in accordance with the public body's policy and guidance (published or internal).
- Taking proper account of established good practice.
- Taking reasonable decisions, based on all relevant considerations.

12 **Being open and accountable** means (amongst other things):

- Being open and clear about policies and procedures and ensuring that information, and any advice provided, is clear, accurate and complete.
- Stating the criteria for decision making and giving reasons for decisions.
- Keeping proper and appropriate records.

[1] Available at http://www.ombudsman.org.uk/improving_services/good_administration/index.html

General principles of public law

13 The first principle of good administration, 'getting it right' means, as indicated above, acting in accordance with the law. In addition to working within the specific legal framework applicable to insurance business, those responsible for the prudential regulation of insurance companies were required, as are all public bodies, to act in accordance with general principles of public law.

14 In summary, public law may be described as the law that governs the exercise by public bodies and officers of the powers and duties conferred on those authorities. It is a collection of general principles which control the exercise of powers and the carrying out of duties by public authorities.

15 The aim of those principles is to ensure that public authorities carry out their duties in accordance with the law and to keep the exercise by those bodies and officers of their powers and duties within their legal bounds.

16 The principles of public law particularly relevant to my investigation are that:

(i) Public bodies must carry out their legal duties in accordance with the law.

Every public authority must comply with any duties imposed upon it by statute in accordance with any requirements specified in that statute. Those on whom duties are imposed may not choose not to perform or permit themselves to be prevented from performing such duties.

Any public authority which carries out an action must be able to demonstrate that it has statutory authority to do so and that it has exercised that authority in the right and proper manner that Parliament, when conferring that authority, is presumed to have intended. A public authority must have regard to, and act in accordance with, all relevant law, including the law of the European Community.

(ii) Where public bodies have a power granted to them they must properly consider whether to exercise that power.

The exercise of a legal power is discretionary, but a public authority must give proper consideration to the use of its powers at the point when it reasonably considers that grounds for the exercise of those powers have or may have arisen. The authority cannot fetter or constrain its ability to give proper consideration to the exercise of its powers.

(iii) When public bodies exercise a power they must act fairly and reasonably and in accordance with any conditions imposed by law.

Legislation conferring power on public authorities frequently imposes conditions about procedures to be followed before the power may be exercised. Any such conditions must be complied with. In addition, statutory powers must be exercised in a right and proper way and in accordance with the presumed intention of Parliament when it conferred those powers. Those powers must be exercised in good faith, reasonably, for a proper purpose, and with procedural propriety.

The specific standard: the framework of prudential regulation

17 I now turn to set out the principal provisions of the regime relevant to the prudential regulation of insurance companies derived from legislation.

Before doing so, I will explain briefly what the principal influences were on the development of that regime and the legislative purpose underlying that regime.

The influences on the regulatory regime

18 The development of the regime relevant to the prudential regulation of life insurance companies which pertained at the time covered by my investigation is explained in more detail in Part 2 of this report. The development of that regime had four principal influences:

- the traditional approach within the United Kingdom to insurance regulation, which was underpinned by the concept of 'freedom with publicity';

- the central place of the actuarial profession within the architecture of life insurance regulation, which was primarily given effect through the role of the Appointed Actuary;

- the reaction to insurance company failures and the need for consumer protection, which led to the introduction of the concept of the protection of the reasonable expectations of existing and potential policyholders; and

- the United Kingdom's membership of the European Economic Community and the development of a Single Market for insurance within Europe, which led to the introduction of the concept of the fulfilment of the criteria of 'sound and prudent management'.

The United Kingdom approach to regulation and 'freedom with publicity'

19 The first influence was the central importance within the developing system of insurance regulation in the United Kingdom of the concept of 'freedom with publicity'. In a paper prepared in February 1976 by the Insurance Division of the Department of Trade, entitled *Brief History of Insurance Supervisory Legislation in Great Britain*, it was stated that:

> *The main purpose of insurance supervisory legislation is to protect policyholders through measures aimed at preventing insolvencies of insurance companies. Its introduction in this country more than a century ago could therefore be regarded as one of the earliest forms of consumer protection. The basis of the British system has been "freedom with publicity" – freedom for the insurers to fix their own premium rates, policy conditions, investment policies etc. in return for publicity about their financial condition to enable solvency to be monitored.*

Actuaries and life insurance and the role of the Appointed Actuary

20 The second influence was the central place of the actuarial profession within life insurance regulation in the United Kingdom and the creation in 1973 of the statutory role of the Appointed Actuary as part of that system of regulation.

21 In its February 1991 brochure, *The role of the Appointed Actuary in the United Kingdom*, the actuarial profession explained that:

> *Actuaries in the United Kingdom, as in most countries, fulfil a very broad range of roles in the financial management of life insurance companies. In the United Kingdom, however, one actuarial position is set apart by legislation and practice. The actuary who holds this position is known as the Appointed Actuary...* [who plays a] *special role... in a life company's affairs.*

22 In an earlier paper to the Institute of Actuaries in November 1988 on the role of the Appointed Actuary, the then Government Actuary had explained what that special role entailed:

> *... the Appointed Actuary is in a special position in that he is appointed and remunerated by the company, and thus forms part of the management team responsible to the Directors, and at the same time he has responsibilities and obligations to the DTI by reason of his statutory duties, which arise from the Department's supervisory functions aimed at the protection of policyholders.*

Insurance company failures and policyholders' reasonable expectations

23 The third influence was the reaction to a number of high-profile instances in the 1960s and 1970s in which insurance companies collapsed leaving their policyholders without insurance cover. Perhaps the most notorious example of such a failure was Vehicle & General.

24 The domestic statutory regime for prudential regulation at the time relevant to my investigation was contained in the Insurance Companies Act 1982. That regime had its roots in – and consolidated – legislation enacted in the 1970s, after those collapses, which had aimed to strengthen the protection provided by insurance regulation. When this new legislation had been introduced in 1973, its objective was stated by the then Minister to be:

> *Not primarily to penalise post facto dishonest or incompetent managements, but to protect policyholders by taking or requiring suitable corrective action in time to avert the consequences of imprudent or misguided policies...* [the intention was to] *strike a proper balance between, on the one hand, allowing the industry so much freedom that it can be exploited by rogues, and on the other hand, creating for the industry such shackles that it cannot give efficient, competitive and forward looking service to consumers here and abroad* (*Hansard*, House of Commons, 21 May 1973).

25 That legislation – the Insurance Companies (Amendment) Act 1973 – had introduced the concept of 'policyholders' reasonable expectations' (a concept which also included the reasonable expectations of potential policyholders) as a central component of the protection that was to be delivered by that regulatory regime. This concept became known as 'PRE' – I will refer to it, where appropriate, in this way in the rest of this report.

The European dimension and sound and prudent management

26 The fourth influence was the United Kingdom's membership of the European Economic Community and the development of a Single Market for life insurance by moves to co-ordinate the laws, regulations and administrative provisions in Member States in relation to the financial supervision of insurance companies.

27 Key to the completion of the Single Market in so far as the financial supervision of insurance companies was concerned was the concept of 'sound and prudent management' which concerned the way in which insurance companies conducted their business and were governed.

28 In 1992, the European Third Life Directive had established this concept. Article 15.3 of that Directive provided that '*the competent authorities of the home Member State shall require every assurance undertaking to have sound administrative and accounting procedures and adequate internal control mechanisms*'.

The cornerstones of prudential regulation

29 The prudential regulation of life insurance companies was undertaken within the context of those four principal influences – the traditional United Kingdom approach to insurance regulation, the pivotal role of the actuarial profession, the reaction to insurance company failure, and the development of a Single Market for insurance within Europe.

30 The regulatory regime which developed over time to deliver prudential regulation and which pertained at the time covered by this report thus had four cornerstones. Those four cornerstones were:

- 'freedom with publicity';
- the central place of the Appointed Actuary within the regulatory regime;
- the protection of the 'reasonable expectations' of both policyholders and potential policyholders; and
- the criteria of 'sound and prudent management'.

31 Those cornerstones laid the foundations on which were built:

- the way in which regulation was undertaken – in which information provided through the regulatory returns and the role played by the Appointed Actuary in ensuring that this information was so provided were given a central place; and
- the powers, duties, and means conferred on the prudential regulators – which gave prominence to the protection of PRE and ensuring the fulfilment of the statutory criteria of sound and prudent management.

The aim of prudential regulation

32 The stated aim of the system of prudential regulation was to protect the interests of policyholders and potential policyholders. Securing that aim was to be done in such a way as to balance the need to take such action as was necessary to protect those interests, without interfering in the business of insurance companies to such an extent as would stifle competition and prevent innovation, thus harming consumer interests.

The statutory framework

33 The statutory framework which governed that system of regulation, and within which the prudential regulators (acting with the advice and assistance of GAD) were given powers for the purpose of protecting the interests of policyholders and potential policyholders, had four chief component parts:

- European Directives concerning life assurance;
- the Insurance Companies Act 1982;
- secondary legislation made under the Insurance Companies Act 1982; and
- certain other domestic statutory provisions related to the activity of insurance companies.

34 The duties imposed and the powers conferred under this framework were generally to be performed, or were exercisable, by Ministers, although in line with the Carltona principle2, the day-to-day exercise of those powers was carried out by officials working under delegated authority.

[2] It is a principle of constitutional law that a decision made on a Minister's behalf by an official is that of the Minister. This is known as the Carltona principle after the case of *Carltona Ltd v. Commissioners of Works* [1943] 2 All ER 560. Except where the express delegation of authority is required by a particular statute, the official's authority flows from a general rule of law and not from formal delegation.

Table 5a shows the Ministers responsible for prudential regulation during the period covered by this report.

DTI Ministers responsible for the prudential regulation of insurance companies from June 1983 to January 1998

Period	Secretary of State	Junior Minister
16/06/1983-16/10/1983	Cecil Parkinson	Alex Fletcher
16/10/1983-02/09/1985	Norman Tebbit	Alex Fletcher
02/09/1985-26/01/1986	Leon Brittan	Michael Howard
26/01/1986-13/06/1987	Paul Channon	Michael Howard
13/06/1987-26/07/1989	Lord Young of Graffham	Francis Maude
26/07/1989-27/07/1990	Nicholas Ridley	John Redwood
27/07/1990-15/04/1992	Peter Lilley	John Redwood
15/04/1992-21/11/1994	Michael Heseltine	Neil Hamilton
21/11/1994-12/07/1995	Michael Heseltine	Jonathan Evans
12/07/1995-24/07/1996	Ian Lang	Jonathan Evans
24/07/1996-06/05/1997	Ian Lang	John Taylor
06/05/1997-05/01/1998	Margaret Beckett	Nigel Griffiths

Treasury Ministers responsible for the prudential regulation of insurance companies from January 1998 to December 2001

Period	Chancellor	Chief Secretary	Junior Minister
06/01/1998-27/07/1998	Gordon Brown	Alistair Darling	Helen Liddell
28/07/1998-22/11/1998	Gordon Brown	Stephen Byers	Patricia Hewitt
23/11/1998-27/07/1999	Gordon Brown	Alan Milburn	Patricia Hewitt
28/07/1999-10/10/1999	Gordon Brown	Alan Milburn	Melanie Johnson
11/10/1999-10/06/2001	Gordon Brown	Andrew Smith	Melanie Johnson
11/06/2001-01/12/2001	Gordon Brown	Andrew Smith	Ruth Kelly

European law

35 The three life insurance Directives together form the principal European legislation relevant to this investigation. Those Directives aimed to create a single market in the insurance sector and to coordinate the laws, regulations and administrative provisions concerning direct life assurance within Member States. The First Life Directive was made on 5 March 1979 and is described more fully in paragraphs 220 to 233 of Part 2 of this report; the prime aim of that Directive was to ensure freedom of establishment throughout the Community – that is, that life insurance companies which were authorised in one Member State were permitted to establish branches within other Member States.

36 The Second Life Directive was made on 8 November 1990 and is described in more detail in paragraphs 407 to 411 of Part 2 of this report; the prime aim of that Directive was to ensure freedom to provide services throughout the Community – that is, that life insurance companies authorised in one Member State were permitted to market their products in other Member States without the need for authorisation in those other countries.

37 The Third Life Directive was made on 10 November 1992 and is described in more detail in paragraphs 485 to 508 of Part 2 of this report. The prime aim of this Directive was to complete the Single Market in life insurance throughout the Community.

38 All three Directives contained provisions which aimed to co-ordinate the systems of financial supervision of life insurance companies within Member States. The key provisions of those Directives, as they affect the issues under consideration in this report, are:

(i) that all insurance companies were required to be subject to official authorisation which had to be obtained from the competent supervisory authority prior to a company being permitted to operate[3];

(ii) that all authorised insurance companies had to maintain specified reserves and margins of solvency that were to be calculated in accordance with prescribed principles[4]; and

(iii) that an authorised insurance company could have its authorisation withdrawn by the supervisory authority if the company no longer met the conditions necessary for authorisation, if the company breached its solvency requirements and was unable within a specified time to take the measures it had been required to take to restore a sound financial position, or if the company failed seriously in its obligations under the applicable Regulations within the relevant Member State[5].

39 An important provision for the prudential regulation of insurance companies was that contained in Article 16 of the First Life Directive. This provided that:

> *The supervisory authority of the member state in whose territory the head office of the undertaking is situated must verify the state of solvency of the undertaking with respect to its entire business. The supervisory authorities of the other member states shall provide the former with all the information necessary to enable such verification to be effected.*

[3] Article 6 of the First Life Directive.
[4] Articles 17 to 20 of the First Life Directive.
[5] Article 26 of the First Life Directive.

40 That obligation was replaced pursuant to an amendment contained in the Third Life Directive which, so far as is relevant, amended the relevant Article[6] to provide that:

> *... financial supervision shall include verification, with respect to the assurance undertaking's entire business, of its state of solvency, the establishment of technical provisions, including mathematical provisions, and of the assets covering them, in accordance with the rules laid down or practices followed in the home Member State pursuant to the provisions adopted at Community level. The competent authorities of the home Member State shall require every assurance undertaking to have sound administrative and accounting procedures and adequate internal control mechanisms.*

41 The European Directives were implemented in the United Kingdom through domestic legislation, the principal components of which are described below. However, those Directives continued to have direct effect and to impose certain direct duties on Member States.

42 The duties placed on the United Kingdom by those European Directives are, in my view, central to any interpretation of the functions that those responsible for the prudential regulation of life insurance companies were to discharge. It is an established legal principle that, where a statutory provision is necessary in order to comply with a European Directive, that provision is to be construed by reference to the wording and purpose of that Directive, even if that Directive post-dates the relevant domestic legislation.

43 If, as is the case with the subject matter of this report, the extent of the obligations imposed on those public authorities with responsibility for discharging the United Kingdom's duties with respect to financial supervision of insurance companies is a matter of dispute, regard should be had to the terms of the relevant European Directives. In this context, European Directives having direct effect take precedence over domestic legislation.

44 I consider that the most important duties relevant to the subject matter of this report are those imposed by the provisions of the three life insurance Directives, which required the United Kingdom:

(i) to take all steps necessary to ensure that its supervisory authorities had the powers and means necessary for the financial supervision of the activities of those life insurance companies established within their territory, including activities engaged in outside that territory[7].

(ii) to ensure that its supervisory authorities[8]:

  (1) were able to make detailed enquiries about an insurance company's situation and the whole of its business, including by gathering information or requiring the submission of documents concerning life insurance business or by carrying out on-the-spot investigations at the company's premises;

  (2) were able to take any measures that were appropriate and necessary to ensure that the activities of the insurance company remained in conformity with the laws, regulations and administrative provisions with which the company had to comply; and

6 Following other restructuring of the Directive, this was now Article 15.
7 Article 23 of the First Life Directive, as inserted by the Second Life Directive.
8 Article 23 of the First Life Directive, as inserted by the Second Life Directive.

(3) were able to act to prevent or remedy any irregularities prejudicial to the interests of policyholders.

(iii) to ensure that each life insurance company within the United Kingdom maintained an adequate solvency margin in respect of its entire business[9].

(iv) to ensure that, as part of their financial supervision, its supervisory authorities were required[10]:

(1) to verify a life insurance company's state of solvency, with respect to its entire business;

(2) to verify the establishment of technical provisions and of the assets covering them, in accordance with the rules laid down or practices followed in the United Kingdom pursuant to the provisions adopted at Community level; and

(3) to require every company to have sound administrative and accounting procedures and adequate internal control mechanisms.

(v) to ensure that each life insurance company[11]:

(1) established sufficient technical reserves, including mathematical reserves (in line with stated principles); and

(2) had assets equivalent to the underwriting liabilities assumed in all the countries where it carried on its activities.

(vi) to collaborate closely with other Member States in supervising the financial position of authorised insurance companies[12].

(vii) to ensure that each life insurance company produced an annual account of its financial situation and solvency and rendered periodically the returns and statistical documents necessary for the purposes of supervision[13].

Domestic law – primary legislation – the Insurance Companies Act 1982

45 In the United Kingdom, the duties imposed by those three European Directives were transposed into domestic law through what became the Insurance Companies Act 1982 and through subsequent amendments to that Act.

46 The system of prudential regulation of insurance companies created by this statutory framework focused on four regulatory areas of activity. These were:

- the control by the prudential regulators of entry into the insurance market through the dual processes of the authorisation of companies to conduct business and the approval, using 'fit and proper' powers, by those regulators of persons who held a controlling interest or undertook certain specified and significant management roles within a company;

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9 Article 18 of the First Life Directive.
10 Article 15 of the First Life Directive, as inserted by the Third Life Directive.
11 Article 17 of the First Life Directive. This was modified and expanded by the Third Life Directive – see Part 2 of this report.
12 Article 15 of the First Life Directive, prior to amendment by the Third Life Directive – the latter contained similar provisions for collaboration which reflected the different responsibilities between 'home' and 'host' States enshrined within that Directive.
13 Article 23 of the First Life Directive.

- the monitoring by the prudential regulators of the financial condition of companies through the process of the submission and scrutiny of annual regulatory returns, which contained prescribed information about the activity and financial strength of the company;

- the possession by the prudential regulators of powers of intervention that could be used in specified circumstances to direct a company to take certain forms of action or to refrain from certain action; and

- the ability of the prudential regulators to petition the court to wind up a company in certain circumstances.

47 The detailed provisions of the 1982 Act are described in paragraphs 282 to 340 of Part 2 of this report; the provisions of predecessor legislation are described in paragraphs 22 to 45 and 78 to 160 of Part 2 of this report. The key provisions of the 1982 Act, as they affect the issues under consideration in this report, are:

(i) that a life insurance company could only carry on insurance business if it had received prior authorisation to do so from the prudential regulators[14];

(ii) that each life insurance company had to appoint an actuary – who became known as the Appointed Actuary – who was required to hold prescribed qualifications and whose identity had to be notified to the prudential regulators within fourteen days of appointment[15];

(iii) that the company was required to 'cause' its Appointed Actuary to make an annual investigation of the company's financial position and the company was then required to cause an abstract of the Actuary's report to be made in a prescribed form[16];

(iv) that such an investigation had to include a valuation of the liabilities of the company attributable to its life assurance business and a determination of any excess over those liabilities of its assets representing the fund or funds maintained by the company in respect of that business[17];

(v) that, for the purposes of that investigation, the value of any assets and the amount of any liabilities were to be determined in accordance with valuation regulations made by the Secretary of State (or, in later years, by the Treasury)[18];

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[14] Section 2 of the 1982 Act.

[15] Section 19 of the 1982 Act. Each Appointed Actuary was normally invited on first appointment to meet the Government Actuary in person to discuss the role of the Appointed Actuary in the regulation of insurance companies. From the transfer in April 2001 of the responsibility for providing actuarial advice to the prudential regulator to actuaries working in-house at the FSA, those interviews were generally conducted by the head of the FSA's actuarial function.

[16] Section 18(1) of the 1982 Act.

[17] Section 18(2) of the 1982 Act.

[18] Section 18(4) of the 1982 Act.

[19] Section 32 of the 1982 Act.

(vi) that each company was required to hold assets which exceeded their liabilities by at least a prescribed margin. That requirement – known as meeting the required margin of solvency – had to be maintained throughout every year although, in general, it was only required to be demonstrated to the prudential regulators at each year-end[19]. However, from 1996, the Directors of a company had to certify that the company had met the required minimum margin of solvency throughout the year[20]; and

(vii) that each company was required to submit to the prudential regulators, in a prescribed format and normally within six months after the close of the period to which the documents related:

- a copy of its annual accounts and balance sheet;
- the abstract of the Appointed Actuary's report (which was not audited) and any statement of its long term business;
- its annual statement of business, prepared under section 20 of the 1982 Act; and
- any auditor's report on the accounts[21].

48 The above documents, more commonly known as the regulatory returns, were deposited by the prudential regulators with Companies House and were made available for public inspection – and each company was also required to make available a copy of the returns on request to any policyholder or, where relevant, shareholder[22].

49 The prudential regulators were subject to express statutory duties by virtue of section 22(5) of the 1982 Act. That section provided that the prudential regulators:

> *... shall consider the documents...* [i.e. the regulatory returns], *and if any such document appears to* [the prudential regulators] *to be inaccurate or incomplete in any respect,* [the prudential regulators] *shall communicate with the company with a view to the correction of any such inaccuracies and the supply of deficiencies.*

50 Thus, the prudential regulators were under duties:

(i) to consider the regulatory returns and associated documents that insurance companies were required to submit on an annual basis to those regulators; and

(ii) to communicate with an insurance company with a view to the correction of any inaccuracy or the supply of any deficiency where those regulators considered that the relevant returns were inaccurate or incomplete in any respect.

51 In addition to those duties, the 1982 Act gave to the prudential regulators certain powers of intervention, which included:

(i) powers to withdraw authorisation from a company to conduct new business if it appeared that the company was not fulfilling its statutory obligations under the 1982 Act or if it no longer met the criteria necessary for the authorisation of companies to carry out insurance business[23] – and, with effect from July 1994, an additional power to suspend authorisation in urgent cases was introduced[24];

[20] Paragraph 2 of Schedule 6 to the 1996 Regulations.
[21] Section 22 of the 1982 Act.
[22] Sections 23 and 65 of the 1982 Act.
[23] Section 11 of the 1982 Act.
[24] Section 12A of the 1982 Act.

(ii) powers, in the event that a company failed to meet its required margin of solvency, to require the company to submit a plan for the restoration of a sound financial position and to require the company to propose modifications to that plan if it was inadequate. The company was then required to give effect to any plan accepted by the prudential regulators as adequate[25];

(iii) powers, if a company's margin of solvency fell below the 'guarantee fund' of one third of the required margin of solvency (or below £400,000 if that sum were the greater), to require the submission of a short-term financial scheme and to require the company to propose modifications to that scheme if it was inadequate. The company was then required to give effect to any plan accepted by the prudential regulators as adequate[26]; and

(iv) powers to intervene in the affairs of a company in specified circumstances in the form of:

- a requirement for the company not to make, or to realise, certain investments[27];
- a requirement for the company to maintain certain assets within the United Kingdom and to require that all or part of those assets be placed in the custody of an independent trustee[28];
- a requirement for the company to limit its aggregate premium income, either gross or net of reinsurance[29];
- a requirement for the company to arrange for its Appointed Actuary to investigate all or part of the affairs of the company at a time other than the annual investigation and to deposit an abstract of the Actuary's report with the prudential regulators (which was then sent to the Registrar of Companies and was open to public inspection)[30];
- a requirement for the company to accelerate the deposit of its regulatory returns with those regulators[31];
- a requirement for the company to produce specified information or documents, verified in any way specified by those regulators[32]; and
- a residual power to take such other action as appeared to be appropriate for the purpose of protecting policyholders or potential policyholders against the risk that the company might be unable to meet its liabilities or to fulfil the reasonable expectations of policyholders or potential policyholders[33].

52 The power under section 45 of the 1982 Act was 'residual' in the sense that it was only to be used in the event that protecting policyholders (or potential policyholders) from the risk that their reasonable expectations might not be fulfilled could not be appropriately achieved by the exercise of the prudential regulators' other powers[34].

25 Section 32 of the 1982 Act.
26 Section 33 of the 1982 Act.
27 Section 38 of the 1982 Act.
28 Sections 39 and 40 of the 1982 Act (exercisable on restricted grounds specified in section 37(3) of the 1982 Act).
29 Section 41 of the 1982 Act.
30 Sections 42 and 65 of the 1982 Act.
31 Section 43 of the 1982 Act.
32 Section 44 of the 1982 Act.
33 Section 45 of the 1982 Act.
34 Section 37(6) of the 1982 Act.

53 Furthermore, the power in section 45 of the 1982 Act could not be used in such a way as to restrict a company's freedom to dispose of its assets unless authorisation to conduct new business had first been withdrawn from the company (or suspended); or unless the prudential regulators believed that the company did not meet the required minimum margin of solvency; or unless the regulatory returns by the company showed that the company's liabilities had been determined otherwise than in accordance with the valuation regulations or, if no such regulations applied, in accordance with generally accepted accounting practices[35].

54 From 1 July 1994, as a result of the commencement of domestic Regulations implementing the provisions of the Third Life Directive, additional powers were conferred on the prudential regulators:

(i) those regulators were empowered to appoint an independent, competent person to conduct an investigation with a view to ascertaining whether the criteria of sound and prudent management were fulfilled or whether those criteria would be fulfilled if the application from a person seeking to become a controller of the company were approved[36];

(ii) those regulators were empowered to apply to the court to seek an order restraining an insurance company from disposing of its assets where it appeared that grounds existed on which the prudential regulators were empowered to require a company not to do so[37]; and

(iii) the prudential regulators were empowered to use the residual power in section 45 of the 1982 Act to take such action as appeared to them appropriate for the additional purpose of ensuring that the criteria of sound and prudent management were fulfilled with respect to a particular company[38].

55 The criteria of sound and prudent management were listed in the new Schedule 2A to the 1982 Act. Those criteria included:

(i) that the business of the company should be carried on with integrity, due care and the professional skills appropriate to the nature and scale of its activities[39];

(ii) that each director, controller, manager or main agent of the company should be a fit and proper person to hold that position[40];

(iii) that the company should be directed and managed by a sufficient number of persons who were fit and proper persons to hold the positions they hold[41]; and

(iv) that the company should conduct its business in a sound and prudent manner[42].

56 A company was not to be regarded as conducting its business in a sound and prudent manner in the following, among other, circumstances:

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35 Section 45(2) of the 1982 Act. Prior to July 1994, the exception relating to solvency referred only to the minimum margin under section 33 of the 1982 Act – see further paragraph 307 of Part 2 of this report. Similar limitations applied to the exercise of powers of intervention which involved imposing restrictions on a company's freedom to dispose of its assets (under sections 39, 40, and 40A of the 1982 Act) by virtue of section 37(3) of that Act.

36 Section 43A(1) of the 1982 Act.

37 Section 40A of the 1982 Act (exercisable only on the restricted grounds specified in section 37(3) of the 1982 Act).

38 Section 45(1)(b) of the 1982 Act.

39 Paragraph 1 of Schedule 2A to the 1982 Act.

40 Paragraph 2 of Schedule 2A to the 1982 Act.

41 Paragraph 4 of Schedule 2A to the 1982 Act.

42 Paragraph 5 of Schedule 2A to the 1982 Act.

(i) unless the company maintained adequate accounting and other records of its business and maintained adequate systems of control of its business and records (and those arrangements were not to be considered adequate unless they were such as to enable the business to be prudently managed)[43];

(ii) if the company failed to conduct its business with due regard to the interests of policyholders and potential policyholders[44];

(iii) if the company failed to satisfy any obligation to which it was subject under the 1982 Act[45]; or

(iv) if the company failed to supervise the activities of any subsidiary undertaking with due care and diligence and without detriment to the company's business[46].

57 The powers of intervention conferred on the prudential regulators were exercisable on the grounds specified in the 1982 Act, which included:

(i) where those regulators considered that intervention was desirable for protecting policyholders or potential policyholders against the risk that the company might be unable to meet its liabilities[47];

(ii) in the case of long-term business, where those regulators considered that intervention was desirable for protecting policyholders or potential policyholders against the risk that the company might be unable to fulfil their reasonable expectations[48];

(iii) (with effect from 1 July 1994) where it appeared to those regulators that any of the criteria of sound and prudent management of an insurance company was not or might not be fulfilled by the company (or had not or might not have been fulfilled in the past)[49];

(iv) if it appeared to the regulators that the company had failed to satisfy an obligation to which it was subject by virtue of the 1982 Act or predecessor legislation[50];

(v) if it appeared to the regulators that the company had furnished misleading or inaccurate information to those regulators under or for the purposes of the 1982 Act or of predecessor legislation[51];

(vi) if those regulators were not satisfied that adequate arrangements were in force or would be made for the reinsurance by the company of any risks that the prudential regulators considered should be reinsured[52];

(vii) if there were grounds on which, were the company a new company, those regulators would have been prohibited from granting it authorisation to carry on insurance business[53]; or

43 Paragraph 6(1) of Schedule 2A to the 1982 Act.
44 Paragraph 7 of Schedule 2A to the 1982 Act.
45 Paragraph 8 of Schedule 2A to the 1982 Act.
46 Paragraph 9 of Schedule 2A to the 1982 Act.
47 Section 37(2)(a) of the 1982 Act.
48 Section 37(2)(a) of the 1982 Act.
49 Section 37(2)(aa) of the 1982 Act.
50 Section 37(2)(b) of the 1982 Act.
51 Section 37(2)(c) of the 1982 Act.
52 Section 37(2)(d) of the 1982 Act.
53 Section 37(2)(e) of the 1982 Act.

(viii) if it appeared to those regulators that the company had substantially departed from any business proposal or financial forecast submitted at the time of its authorisation[54].

58 The power to require a company to produce documents to the prudential regulators at specified times or intervals was also exercisable on the ground that those regulators considered the exercise of that power to be desirable in the general interests of persons who were or who might have become policyholders[55].

59 The powers of intervention conferred on the prudential regulators to impose requirements on an insurance company regarding:

(i) the making or realisation of investments; or

(ii) the limitation of premium income; or

(iii) the actuarial investigation of all or part of its affairs; or

(iv) the furnishing of information; or

(v) the residual power to take other action necessary for the protection of PRE or to ensure that the criteria of sound and prudent management were being fulfilled

were also exercisable *whether or not any of the grounds for the exercise of the prudential regulators' powers of intervention existed* – if the relevant power was exercised before the expiration of the period of five years beginning with the date on which a new controller of the company became such a controller, although any requirement imposed on the company by virtue of this provision could not continue in force after the expiration of ten years from the relevant date[56].

60 The prudential regulators were also given the power to disapply or to modify the application to a particular company of certain provisions governing the prudential regulation of insurance companies, where that company applied for or consented to the modification or disapplication of such provisions[57]. Those regulators were also given the power to alter the financial year of an insurance company, either by extending or shortening that financial year[58].

61 In addition to being granted powers to control entry into the insurance market through the dual processes of the authorisation of companies and the approval of certain controllers and senior managers of such companies using 'fit and proper' powers (see paragraph 46 above), additional powers were conferred on the prudential regulators with effect from 1 July 1994 in respect of existing controllers or senior managers of authorised companies.

62 From 1 July 1994, those regulators also had the power to object to a controller or senior manager of a company continuing to hold such a position where it appeared that the criteria of sound and prudent management were not fulfilled or may not in the future be fulfilled by reason of the ability of that person to influence the company[59]. The prudential regulators were required to give written notice that they were considering the use of this power. However, they were not obliged to disclose

[54] Section 37(2)(f) of the 1982 Act.
[55] Sections 37(4) and 44(2)-(4) of the 1982 Act.
[56] Section 37(5) of the 1982 Act.
[57] Section 68 of the 1982 Act.
[58] Section 69 of the 1982 Act.
[59] Section 61B and paragraph 4(1) of Schedule 2D to the 1982 Act.

to the person concerned or to the company any particulars of the ground on which they were considering the service of a notice of objection beyond specifying which of the criteria of sound and prudent management was being relied on.

63 Those affected by such a proposal had to be afforded an opportunity to make representations to the prudential regulators and any such representations were to be taken into account before any notice of objection was served by those regulators. Where a notice of objection had been served on a company in respect of a managing director or chief executive, the company was required to remove the person from their post forthwith[60].

64 The prudential regulators were also given the power to petition the court for the winding-up of an insurance company in accordance with insolvency legislation – on the grounds that the company was unable to pay its debts, or that the company had failed to satisfy an obligation to which it was subject under the 1982 Act or under an obligation arising in another country related to the provisions of the European Directives, or that the company had failed to keep or to provide such accounting records as enabled those regulators to ascertain the financial position of the company[61].

65 When exercising any power of intervention, the prudential regulators were required to state the ground on which they were exercising that power – although, in the circumstances described in paragraph 59 above, those regulators were only required to state that they were exercising the relevant power[62].

Domestic law – secondary legislation under the Insurance Companies Act 1982

66 Much of the detail of the relevant regime was left by the provisions of the relevant primary legislation to be fleshed out in secondary legislation. The Regulations most relevant to the prudential regulation of insurance companies during the period covered by this report were:

(i) the valuation of assets and determination of liability regulations – contained in various Insurance Companies Regulations. These contained the rules (which were amended over time) concerning the methods and assumptions which insurance companies were required to apply in valuing their assets and determining their liabilities for the purpose of the requirements of the 1982 Act;

(ii) the regulations which prescribed the form and content of the returns – contained in various Insurance Companies (Accounts and Statements) Regulations. These prescribed over time, in varying degrees of detail, the form in which the regulatory returns were to be submitted to the prudential regulators and the information to be given in those returns (and placed in the public domain) – these Regulations contained general requirements for valuations to be undertaken in accordance with the valuation regulations referred to in (i) above and that the annual accounts required by section 17 of the 1982 Act should '*fairly state the information*' on the basis required by the Regulations; and

[60] Section 61B and paragraphs 4(2) to 4(6) of Schedule 2D to the 1982 Act.
[61] Section 54 of the 1982 Act.
[62] Section 37(7) of the 1982 Act.

(iii) the Insurance Companies (Third Life Directive) Regulations 1994, which amended the 1982 Act to give effect to the provisions of the European Third Life Directive, particularly relating to the codification of the criteria of sound and prudent management, outlined in paragraphs 55 and 56 above.

67 There were two principal sets of regulations governing the valuation of assets and the determination of liabilities made during the relevant period: those made in 1981 and those made in 1994 – although various amendments were made to them over the years[63]. The provisions of the 1981 Regulations are described in paragraphs 248 to 281 of Part 2 of this report. The provisions of the 1994 Regulations are described in paragraphs 628 to 684 of Part 2 of this report.

68 There were three principal sets of accounts and statements regulations made during the period covered by this investigation: those made in 1980, in 1983 and in 1996 – although minor amendments were made to them in other years. The provisions of the 1980 Regulations are described in paragraphs 235 to 239 of Part 2 of this report[64]. The 1983 Regulations are referred to in paragraphs 341 to 343 of Part 2 of this report. The provisions of the 1996 Regulations as complemented by the provisions of the Deregulation (Insurance Companies Act 1982) Order 1996 and as subsequently amended are described in paragraphs 774 to 812 of Part 2 of this report, where the revised requirements placed on insurance companies to provide certain information through the regulatory returns are outlined.

69 Thus, during the time relevant to the subject matter of this report, there were primarily:

(i) two periods in which different regulations governed the methods and assumptions to be used by insurance companies and their Appointed Actuaries when calculating a company's assets, liabilities, solvency position when completing the returns and providing information about other aspects of that company's business – the first ran from the submission of the 1988 returns to the submission of the 1993 returns, with the second running from the submission of the 1994 returns to the submission of the 2000 returns; and

(ii) two periods in which the format and content of the regulatory returns were to be produced under different regulations – the first ran from the submission of the 1988 returns[65] to the submission of the 1995 returns, with the second running from the submission of the 1996 returns to the submission of the 2000 returns[66].

70 It is not necessary here to set out every provision that those Regulations contained in respect of the valuation of assets and the determination of liabilities or in respect of the format of the returns. The relevant provisions of these Regulations will be set out in my assessment, within later Chapters of this report, of the way in which the Society was regulated.

[63] See, for example, paragraphs 412 to 416 of Part 2 of this report for further detail about some of these amendments.
[64] Those Regulations primarily amended earlier ones made in 1968, see also paragraphs 238 and 239 of Part 2 of this report.
[65] The first returns submitted during the period under consideration in this report.
[66] The last returns submitted during the period under consideration in this report.

Domestic law – other relevant legislation

71 Other legislation had an indirect impact on the prudential regulation of insurance companies – or otherwise came into play in certain circumstances. The most important of these were the Policyholder Protection Act 1975, the Insurance Companies (Winding-Up) Rules 1985, and the Insurance (Fees) Act 1985.

72 The Policyholder Protection Act 1975 put in place a system for the payment of compensation to policyholders in the event that an insurance company became insolvent or was otherwise unable to meet its liabilities. The provisions of that Act are described in more detail in paragraphs 207 to 214 of Part 2 of this report.

73 The Insurance Companies (Winding-Up) Rules 1985 set out the preconditions for and the process through which insurance companies were to be wound up by the court – and how the court would calculate the liabilities of the company to its policyholders and other creditors.

74 The Insurance (Fees) Act 1985 inserted a new section 94A in the 1982 Act under which Regulations were made from time to time, with a view to securing (so far as practicable) that the costs of the prudential regulation of insurance companies would be recouped by the Secretary of State (and, later, by the Treasury) through the levy of annual fees on each company, based on a sliding scale that had regard to the size of each company's premium income.

The administrative framework – those playing a role in the system

The role of the prudential regulators

75 The statutory framework therefore gave the prudential regulators the central role in the system of prudential regulation, which involved those regulators in:

- the authorisation of insurance companies – and the suspension or withdrawal of such authorisation – and the approval of proposed managing directors, chief executives and controllers of such companies;

- the receipt and appraisal of accounts, balance sheets, abstracts and statements submitted by insurance companies and the monitoring of insurance companies using those documents, in order to verify their solvency and otherwise to secure compliance by insurance companies with the requirements of the applicable law; and

- the consideration of whether to exercise powers of intervention in respect of an insurance company or to exercise powers to petition the court for the winding-up of such a company, on the basis of specified statutory grounds, and the use of such powers where such grounds existed and their exercise was appropriate to promote the purposes of the 1982 Act in the public interest.

The role of GAD

76 In the period prior to 26 April 2001, the prudential regulators were assisted in the discharge of their statutory functions by GAD, under the terms of service level agreements (SLAs) that were agreed between them in 1984, in 1995 and in 1998. Those agreements are reproduced in full in Part 4 of this report. From 26 April 2001 onwards, actuarial advice to the prudential regulators was provided by actuaries working for the FSA, who also conducted the scrutiny of the regulatory returns.

77 Under the 1984 SLA, the primary objectives of the detailed examination of the returns which GAD undertook on behalf of the prudential regulators were[67]:

- to form a view about the solvency position of the company in respect of its long-term business and to determine whether, at the valuation date of the returns, the company had and whether, in the foreseeable future, it seemed likely to continue to have, the margin of solvency required in respect of that business;
- to determine if the returns, with respect to long-term business, complied with relevant statutory requirements (and with any undertakings given by the company); and
- to determine, as far as possible from the returns, whether the company appeared to have complied with other statutory requirements (or any other undertakings) relating to its long-term business.

78 GAD prepared a scrutiny report which was provided to the prudential regulators and which was required to include[68]:

- a general description of developments in the year which might have affected the company or its long-term business;
- a general commentary on the present and future financial position (including any major weaknesses in the valuation basis adopted by the Appointed Actuary);
- any differences between any quarterly returns and the annual returns (which was not relevant to Equitable, as the Society was never required to submit quarterly returns);
- any deviations from a business plan that had been submitted by a company (which was also not relevant to Equitable, as the Society was already authorised at the time of the enactment of the 1982 Act and was thus never required to submit a business plan as part of the process of new authorisation);
- details of breaches, or possible breaches, of statutory requirements or undertakings;
- details of significant errors or omissions in the returns or other significant instances of non-compliance, explaining whether the problem had been rectified and, if not, whether or not GAD was raising the issue with the company;
- details of any qualifications of any of the certificates; and
- details (and copies) of correspondence between GAD and the company or its Appointed Actuary.

[67] As set out in paragraph 33 of the 1984 SLA.
[68] See paragraph 38 of the 1984 SLA.

79 The 1984 SLA was updated in March 1995. Under the revised agreement, the primary role of the Insurance Division of the DTI, which was responsible for the regulation of insurance companies, was set out[69] as being:

> *... to regulate the insurance industry effectively (within the duties and powers set out in the Act) so that policyholders can have confidence in the ability of UK insurers to meet their liabilities and fulfil policyholders' reasonable expectations.*

80 One of the prime functions of GAD[70] was to '*advise* [the prudential regulators] *in the fulfilment of these aims*'. The 1995 SLA stated that the DTI's Insurance Division had sole responsibility for all executive decisions taken in the exercise of the Secretary of State's powers under the 1982 Act and that GAD '*recognise*[d]' that its functions were advisory (and that it had no responsibility for the exercise of those powers).

81 In its role in the scrutiny programme, GAD was to provide a report to the prudential regulators to identify any company which[71]:

- was not complying with statutory requirements;
- was not meeting regulatory solvency requirements or was in any danger of failing to meet them in the near future; and
- appeared not to be fulfilling PRE.

82 The scrutiny report to the prudential regulators from GAD, in the format specified in Appendix A of the 1995 SLA, was to include[72]:

- a basis for action if any of those fundamental requirements were not being met, or if trends in the reports suggested problems might be encountered when seeking to meet those requirements in the near future; and
- a basis for informed longer term discussion with any company on problems which might arise if trends in key performance indicators continued.

83 Key indicators were said to include cover for solvency, actuarial issues (for example, changes in the valuation basis or matching position), types of new business, expenses, lapses, asset exposures and investment strategies, impact on bonuses and any significant other developments during the year.

84 In October 1998, the SLA was again updated. The revisions mainly reflected the fact that statutory regulatory responsibility had moved from the DTI to the Treasury – and that GAD was now providing advice to the new prudential regulators.

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[69] In paragraph 1 of the 1995 SLA.
[70] As set out in paragraph 2 of the 1995 SLA.
[71] See paragraph A8 of the 1995 SLA.
[72] See paragraph A9 of the 1995 SLA.

The mechanisms of scrutiny – the means by which GAD discharged its responsibilities to the prudential regulators under the SLAs

85 In providing advice to the prudential regulators of authorised insurance companies in order to enable those regulators both to verify the financial position of such companies and properly to consider whether grounds existed for the use of any of the regulators' intervention powers or of their power to petition the court for the winding-up of the company, GAD used a number of mechanisms.

86 Chief amongst those mechanisms was the annual scrutiny of the regulatory returns which an insurance company was required to submit to the prudential regulators on an annual basis. That process had two separate stages – the initial scrutiny and the detailed scrutiny. The initial scrutiny of the returns of a particular company was itself carried out in two steps. The first step, the A1 initial scrutiny, was designed to ensure that all the parts of the returns had been completed and properly signed. The second step, the A2 initial scrutiny, was carried out through an initial review based largely on some standard arithmetical checks. GAD had a standard 'tick-list' for these checks, which was completed in manuscript.

87 The A2 tick-list also contained sections where comments could be made, including one headed 'aspects that look worrying'. Based primarily on the solvency position shown on Form 9 of the returns, a priority rating was allocated and recorded on the tick-list. That priority rating governed whether or not a particular company's returns were to be subject to a detailed scrutiny and, if they were, the higher the priority rating the more quickly the detailed scrutiny was to be carried out. The Society's returns were subject to detailed scrutiny in all years covered by this report apart from those submitted in respect of 1988 and 1989.

88 Once the returns had been reviewed by GAD, it was normal for GAD to raise questions directly with the company about any *actuarial* issues. The SLAs allowed this, although they also provided that any particular *regulatory* issue was to be dealt with between the prudential regulators and the company. GAD was required to identify any significant errors or omissions in the returns when reporting to those regulators. This contact between GAD and a company was an important part of the scrutiny process. Through such contact, GAD gained a better understanding of the company, was able to advise the prudential regulators whether the returns needed clarification or whether further information from the company was needed and was able to advise those regulators what the important issues regarding the company were, as GAD were required to do. In addition to its scrutiny of the returns, GAD was also provided with copies of other correspondence between the prudential regulators and the company. In this way, GAD was kept informed of developing issues during the year.

89 However, while the scrutiny of the annual regulatory returns submitted by insurance companies was the prime focus of the mechanisms used by the prudential regulators and GAD to assist them to undertake their responsibilities, that was not the only mechanism open to them. A further part of the information-gathering process was company visits, which were introduced in the early 1990s and which became a regular part of the regulatory process. Those visits covered industry and company-specific topics and allowed the prudential regulators and GAD to assess the actuarial management of the company in face-to-face meetings.

90 GAD also undertook a number of industry-wide analyses to enable them to scrutinise the returns of insurance companies in a wider context, to highlight any practices which were out of line with industry practice, and to spot any developing trends. GAD also initiated and/or participated in professional working parties on specific actuarial issues of concern or interest. This work also included the preparation of internal GAD standards in relation to mortality assumptions and analysis of the investment performance of a typical fund. Much of this analysis was reported within an annual report on the industry, which was confidential to GAD and to the prudential regulators but which was referred to by GAD scrutinising actuaries as part of their consideration of the regulatory returns.

The role of others in the system – the insurance company and its Directors

91 A number of other actors had key roles within the system of prudential regulation that pertained at the time covered by this report. The terms of the 1982 Act imposed obligations on life insurance companies to ensure that their Appointed Actuaries took certain steps, which are summarised in paragraphs 95 to 98 below. The applicable law also placed the following obligations on insurance companies:

(i) to maintain at all times a prescribed solvency margin of assets in excess of their liabilities, prudently assessed;

(ii) when calculating their solvency margin, to make proper provision for all liabilities on prudent assumptions which included appropriate margins for adverse deviation of the relevant factors;

(iii) when calculating their solvency margin, to value their assets in accordance with the asset valuation regulations and to maintain a proper spread of such assets; and

(iv) when determining the amount of their liabilities for the purpose of these calculations, to follow prescribed valuation rules set out in the valuation regulations or – where departures from those rules were permitted – to use valuation methods which produced at least equally prudent results.

92 These were the principal obligations to which insurance companies were subject pursuant to the 1982 Act and to secondary legislation made under it. Where a company failed to satisfy any such obligation, this gave grounds for the prudential regulators to exercise their powers of intervention.

93 In addition, as a failure by insurance companies to conduct their business having regard to the interests and reasonable expectations both of their policyholders and potential policyholders and as a failure to act in accordance with the criteria of sound and prudent management both constituted grounds for intervention action by the prudential regulators, insurance companies were under implicit obligations to act in a way which did not provide grounds for the exercise of those powers of intervention.

94 Specific responsibilities were also imposed on the members of a life insurance company's Board of Directors. Those responsibilities included ensuring that the Companies Acts accounts of the company gave a true and fair view of the affairs of the company, that the regulatory returns prepared for the purposes of insurance legislation were prepared in accordance with that legislation, and that the company fulfilled the criteria of sound and prudent management (as set out in Schedule 2A to the 1982 Act). The Directors also had to sign a certificate in relation to the regulatory returns regarding such matters as whether those returns had been produced in accordance with the applicable Regulations, the adequacy of accounting

records and appropriate systems of control, the maintenance of the margin of solvency throughout the year in question, and whether a list of published guidance had been complied with.

The role of others in the system – Appointed Actuaries

95 Appointed Actuaries also had express requirements and implicit obligations by virtue of the relevant subordinate legislation. The statutory requirements were complemented by professional guidance to actuaries (both mandatory and recommended in terms of professional standards) issued by the Faculty and Institute of Actuaries to their members.

96 The actions which the Appointed Actuary was required to undertake by the legislation or in order to comply with the professional guidance to actuaries were considerable. Those actions included carrying out at the instigation of the company, once in every twelve months, an investigation of the company's financial condition in respect of its long term business, undertaking a valuation of the liabilities and determining any excess of assets over liabilities, and separately identifying any excess relating to the with-profits part of the fund.

97 The Appointed Actuary was also to be required by the company to prepare an abstract of the valuation report (for the annual returns) when the annual investigation was undertaken, or when another investigation was made with a view to the distribution of profits or when the results of the investigation were to be made public. The Appointed Actuary would also undertake a special actuarial investigation when the company was required by the prudential regulators to arrange for such an investigation to be undertaken.

98 Other matters in respect of which the Appointed Actuary had responsibilities pursuant to professional guidance included ensuring, so far as was within his or her authority, that the company was operated on sound financial lines and with regard to PRE and also taking all reasonable steps to ensure, at all times, that he or she was satisfied that in any investigation the long-term fund would be sufficient and the company would be able to satisfy any obligation to which it was subject by virtue of the 1982 Act. The Appointed Actuary was also required to advise the company of his or her interpretation of PRE, advising on the implications for PRE of any likely significant changes which might affect the company and ensuring that incoming policyholders were not misled as to their expectations.

The role of others in the system – the actuarial profession

99 The Faculty of Actuaries and the Institute of Actuaries also played a part in the prudential regulation of insurance companies, although that role was given only limited acknowledgement in the relevant subordinate legislation[73]. Acting under their Royal Charters, these professional bodies, among their other functions, set professional standards and provided guidance to actuaries; liaised with GAD and were formally and informally consulted by GAD over such matters as methods of valuation; initiated research and set up working parties on actuarial issues and proposed new Regulations and guidance; set professional qualification standards (which eventually culminated in the issue of practising certificates); and were responsible for professional discipline.

[73] The Accounts and Statements Regulations required that an actuary should be a Fellow of the Institute of Actuaries or of the Faculty of Actuaries and, in later years, the actuary's certificate given in connection with the regulatory returns was required to include a statement regarding compliance with certain of the professional guidance issued by the profession.

The role of others in the system – the auditors of an insurance company

100 The auditors of insurance companies had only a limited role to play in the system of prudential regulation. Such auditors had no role in considering the Appointed Actuary's valuation report or the certificates and forms that those Actuaries were required to submit as part of the returns. Those were matters for the professional judgement of the Actuary concerned. Auditors were, however, generally responsible for:

(i) auditing the company's accounts and related documents in the manner prescribed in the Companies Acts;

(ii) reporting to members of the company on the annual accounts laid before a general meeting, stating whether the annual accounts had been prepared in accordance with the Companies Act 1985 (and certain international accounting standards on consolidated accounts, if applicable) and, from 1995, stating whether the accounts gave a 'true and fair view', in accordance with the relevant financial framework, of the state of affairs of the company (in the case of a balance sheet) and its operating profit and loss (in the case of a profit and loss account);

(iii) auditing the company's balance sheet, profit and loss account and revenue account (required to be prepared under section 17 of the 1982 Act) and every statement, analysis, report or certificate annexed thereto which was referred to in certain of the Regulations (but, as noted above, not including the abstract of the actuary's valuation report, the forms required to be submitted by Schedule 4 to the Regulations, or the certificate given by the Appointed Actuary);

(iv) giving a report containing statements (in addition to the comparable statements required under companies legislation) of the opinion of the auditors on such matters as whether specified forms and information in the annual returns had been properly prepared in accordance with the applicable Regulations and whether or not it was unreasonable for the directors to have made the statements contained in their certificates; and

(v) communicating to the Secretary of State information which the auditors had reasonable cause to believe might be of material significance for determining whether any of the Secretary of State's powers of intervention should be exercised.

The administrative framework – relevant policy and guidance

101 In order to seek to ensure that the statutory framework for the prudential regulation of insurance companies operated effectively and that all those who had a role to play within that system understood their obligations and responsibilities properly, guidance was issued to explain the nature of the system, to set out how those operating it should conduct themselves, and to set minimum standards to which it was expected that the relevant actors within the system would conform.

102 There were five types of general guidance applicable to the system of the prudential regulation of insurance companies.

103 First, there was internal guidance developed by the prudential regulators to assist them to apply consistently the provisions of the relevant statutory framework. During the period covered by this report, the principal form of such guidance was the DTI's Policy Guidance Notes, which were

issued in September 1991. The most relevant of this guidance is reproduced in Part 4 of this report.

104 Secondly, there was internal guidance developed by GAD to assist those actuaries responsible for conducting the scrutiny of the annual regulatory returns to undertake that scrutiny. During the period covered by this report, the two principal forms of such guidance were GAD's Insurance Supervisory Work Guidance Manual and their scrutiny proformas, which set out key questions to be covered in the scrutiny reports of a company's annual returns and which gave a structure to such reports. Both of those sets of guidance are reproduced in Part 4 of this report.

105 Thirdly, there was external guidance developed by the prudential regulators and issued to assist insurance companies to comply with the requirements of the relevant and applicable statutory framework. During the period covered by this report, there were two principal forms of such guidance: the Prudential Guidance Notes issued by the prudential regulators to assist companies in, among other matters, completing and submitting their regulatory returns, and the '*Dear Director*' (or '*Dear Managing Director*') letters sent by those regulators to companies from time to time on issues of topical or general concern. The most relevant of this guidance is reproduced in Part 4 of this report.

106 Fourthly, there was external guidance developed by GAD and issued to assist the Appointed Actuaries within insurance companies to understand the general requirements that GAD expected from such actuaries when applying the relevant Regulations and professional standards. During the period covered by this report, the principal forms of such guidance were the '*Dear Appointed Actuary*' letters issued by the Government Actuary. The most relevant of these letters are reproduced in Part 4 of this report.

107 Finally, the actuarial profession issued guidance in the form of both mandatory and recommended professional standards, to which Appointed Actuaries (and other actuaries) were required or expected to conform in the discharge of their responsibilities. This guidance is publicly available on the profession's website.

108 It is not practicable to summarise here all of that policy, procedural, explanatory and professional guidance, some of which, as I have said, is set out in full or in part within Part 4 of this report. Where relevant, aspects of such guidance are set out within later Chapters of this report.

Summary of the key obligations of the prudential regulators and/or GAD which are relevant to this investigation

109 In later Chapters of this report, I set out my findings of fact and my determinations as to whether the acts and omissions of the prudential regulators and/or GAD which are disclosed in those findings constitute maladministration on the part of either the prudential regulators, or GAD, or both.

110 I have set out in paragraphs 2 to 7 above the approach that I generally adopt when making such determinations. I establish first the facts and the overall standard, and I then go on to assess the facts against that overall standard.

111 In particular, I assess whether or not an act or omission on the part of the body complained about (in this case the prudential regulators and/or GAD) constituted a departure from the applicable standard. If so, I then assess whether that act or

omission was so unreasonable, in the particular circumstances, when regard is had to the specific legal or administrative context of the case, as to constitute maladministration; and/or whether any such act or omission otherwise fell so far short of acceptable standards of good administration as to constitute maladministration.

112 Central to this approach is the identification of the general and specific legal and administrative obligations which I consider the prudential regulators and/or GAD had at the relevant time; and my consideration of the manner in which those regulators and/or GAD discharged those obligations.

113 This Chapter, supported by the relevant detail in Part 2 of this report, provides an overview of the general and specific legal and administrative obligations which I consider the prudential regulators and/or GAD had at the relevant time.

114 From that overview, I have identified the following key legal and administrative obligations that the prudential regulators and/or GAD had at the relevant time, which I use in my consideration of the manner in which those regulators and/or GAD discharged those obligations:

(i) The prudential regulators were under a specific statutory duty, imposed by the 1982 Act and the Regulations made under that Act, to consider whether the regulatory returns were complete and accurate (in the sense of them being compliant with the applicable Regulations).

In complying with this duty, I would expect the prudential regulators (acting with the advice and assistance of GAD) to have considered the regulatory returns submitted by insurance companies and, if those returns appeared to be inaccurate or incomplete in any respect, to have communicated with the company with a view to the correction of any such inaccuracies and the supply of deficiencies.

(ii) The prudential regulators were under a specific statutory duty, imposed by the 1982 Act and the Regulations made under that Act, to ensure that an insurance company valued its assets and determined its liabilities in accordance with the requirements that were imposed on it by the applicable Regulations.

In complying with this duty, I would expect the prudential regulators (acting with the advice and assistance of GAD) to have considered whether the way in which an insurance company valued its assets and determined its liabilities that was set out within the regulatory returns had been undertaken in accordance with the requirements of the 1982 Act and the Regulations made under that Act and, if it appeared that the company had used a valuation basis that was not compliant with these requirements, to have considered whether to take action to seek to remedy the position.

(iii) The prudential regulators were under a general public law duty to give proper consideration to the use of their powers of intervention where the circumstances had or may have arisen which gave grounds for the use of such powers.

In complying with this duty, I would expect the prudential regulators (acting with the advice and assistance of GAD) to have considered the use of their powers in the light of any information that they possessed – whether from the content of the regulatory returns, from contact with an insurance company, or from other sources – which gave rise to questions about the solvency position of that company, or about whether it was acting in line with the interests of its policyholders or in accordance with the reasonable expectations of those policyholders, or potential policyholders, or about whether it was acting soundly or prudently.

(iv) The prudential regulators were under a general public law duty to exercise their statutory powers in a right and proper way, in accordance with the presumed intention of the legislature which conferred those powers, in good faith, reasonably, for a proper purpose, and with procedural propriety.

In complying with this duty, I would expect the prudential regulators (acting with the advice and assistance of GAD) to have dealt appropriately with any regulatory issues which arose in relation to any insurance company other than through the scrutiny process and to have acted in such a manner as to ensure the effective operation of the regulatory regime as Parliament had established it – informed as that regime was by the concepts of 'freedom with publicity', the protection of the reasonable expectations of policyholders and potential policyholders, and the fulfilment of the criteria of sound and prudent management.

(v) Both the prudential regulators and GAD were under an obligation generally to act in accordance with established principles of good administration.

In complying with this obligation, I would expect the prudential regulators and/or GAD:

- to have acted in accordance with their general and specific legal duties and powers;
- to have acted in accordance with their own published and internal policy and guidance;
- to have taken proper account of established good practice, including professional practice;
- to have taken reasonable decisions based on all relevant considerations, leaving out of account irrelevant considerations and balancing those considerations appropriately;
- to have kept proper and appropriate records as evidence of their activities, including a record of the reasons for their decisions; and
- to have provided information, where it was appropriate to provide information, which was clear, accurate, complete and not misleading.

Conclusion

115 In this Chapter, I have set out my general approach to determining complaints of maladministration against public bodies; and I have provided an overview of the general and specific legal and administrative obligations which I consider the prudential regulators and/or GAD had at the relevant time – the overall standard against which I assess the facts in this case.

116 Finally, I have extracted from that overview a summary of the key legal and administrative obligations that the prudential regulators and/or GAD had at the relevant time, which I use in my consideration of the manner in which those regulators and/or GAD discharged those obligations.

117 In Chapters 6, 7, and 8 which follow, I set out a summary of the way in which the prudential regulation of the Society was undertaken during the period from when the regulatory returns for 1988 were submitted to the end of my jurisdiction on 1 December 2001.

Chapter 6 – The prudential regulation of Equitable in the period prior to 20 June 1998

Introduction

1 In this Chapter and in the two Chapters which follow it, I set out how the prudential regulation of the Society was undertaken during the period from when the Society's regulatory returns for 1988 were submitted to the prudential regulators until the end of my jurisdiction on 1 December 2001 – with the coming into force of the current regulatory regime, which replaced that which existed during the period relevant to this report.

2 Given the history of events which unfold during the period covered by my report, this account is structured in three time-periods which are covered in these three separate Chapters. This is in recognition that, within the regulatory regime that was applicable at the relevant time, the way in which the prudential regulation of a life insurance company was undertaken, including the degree of intensity of the scrutiny given to such a company's affairs, would reflect the circumstances of that company as those circumstances were known to the prudential regulators and/or GAD at the time.

3 Where a life insurance company showed no signs of being in financial difficulty or where the prudential regulators and GAD considered that there were no such signs, the way in which that company's affairs would have been scrutinised followed the routine pattern of supervision, with the focus being on the regulatory returns.

4 However, where the prudential regulators and GAD had been provided with information which raised significant doubts about the financial condition of such a company or about its ability to meet its liabilities or about its compliance with the obligations imposed on the company, the supervision of such a company would have been undertaken with heightened intensity.

5 That might include more regular liaison between the prudential regulators and/or GAD and the company, as well as more detailed consideration by those regulators of the specific issues and problems which the company faced and the options open to it to resolve those problems.

6 Moreover, where such a company had been closed to new business, the issues faced both by that company and by the prudential regulators and GAD were of a different nature to those facing companies which were still writing new business. The regulatory approach accordingly changed.

7 Crisis management or the supervision of a company that is already deeply in financial trouble and where the effects of such trouble have already been triggered throws up very different questions from those which arise in a situation in which the issue has yet to develop or crystallise – and where prudential regulation might still have a role to play in preventing its occurrence or mitigating its impact.

8 As I have explained in paragraphs 85 to 88 of Chapter 5, during the period covered by this report, the prudential regulation of insurance companies such as Equitable was primarily undertaken through two mechanisms.

9 The first mechanism was the submission of regulatory returns. Each company was required each year to submit to the prudential regulators returns, containing detailed information in a prescribed format about the business and financial strength of the company. Once checked by those regulators for completeness, the returns were placed by the prudential regulators in the public domain at Companies House – and were required to be provided by the company to any policyholder on request. One purpose of the publicity given to those returns was to enable an independent assessment of the financial strength of the

company to be undertaken by policyholders, potential policyholders, or by those advising such individuals.

10 The second mechanism was the scrutiny of those returns to enable the prudential regulators to verify the financial position of the company. GAD, who assisted those regulators in the discharge of their responsibilities and who gave them advice, undertook the scrutiny of the returns. The aim of that scrutiny was to ensure that the company had complied with the statutory and other obligations imposed on it. This included taking all reasonable steps to verify the financial position of the company and to check that the company was both able to meet its liabilities and to fulfil the reasonable expectations of its policyholders and/or potential policyholders.

11 However, as I have also explained in paragraphs 89 and 90 of Chapter 5 of this report the prudential regulators and GAD obtained information about these matters other than through their scrutiny of the regulatory returns, not least through visits to, and meetings with, insurance companies – and through the information provided to them by such companies on an *ad hoc* basis. GAD also undertook industry-wide analysis, which informed their scrutiny of the returns.

12 The information which the prudential regulators and GAD possessed – whether by way of disclosure within the regulatory returns, whether arising from the scrutiny process undertaken in respect of those returns, or whether provided through other means – was the principal basis on which those regulators would undertake their statutory functions.

13 I have explained in Chapter 5 that, where the circumstances for the performance of any of the duties imposed on the prudential regulators or for the use of any of their discretionary powers may have or had arisen, those regulators were required to consider what, if any, action was necessary in respect of a particular company and to record the reasons for their considered decision.

14 This Chapter begins my account of how the prudential regulators and GAD undertook those responsibilities. That account is continued in Chapters 7 and 8 of this report. What follows in these three Chapters is by necessity only a summary of how the prudential regulation of the Society was undertaken. Part 3 of this report contains an extensive and detailed chronology of events, to which the reader is referred if they wish to obtain a more detailed knowledge of the history of the prudential regulation of the Society during the relevant period.

15 My account of the first period in the prudential regulation of the Society covered by this report is set out in this Chapter. That period covers events from the submission in late June 1989 of the regulatory returns for 1988 until late June 1998.

16 During this period, the Society was not considered by the prudential regulators or GAD to show any signs of serious problems and its supervision was thus conducted in the normal way, with the focus of such supervision being on scrutiny of the regulatory returns and on consideration of any other information which came into the possession of the prudential regulators or GAD.

17 My account of the second period is set out in Chapter 7 of this report. That period covers events from 20 June 1998 – approximately at the time of the Society's submission both of its response to an industry-wide survey about the exposure of life insurance companies to guaranteed annuity rates and of its 1997 regulatory returns – until 8 December 2000, when the Society closed to new business.

18 As information about some of the problems which were in time to engulf the Society had been provided to the prudential regulators and GAD both in that survey response and within those regulatory returns (and as further information about those problems began to emerge), during this period those regulators and GAD were closely involved in discussions with Equitable about the significant problems that it was now known that the Society faced.

19 My account of the third period is set out in Chapter 8 of this report and deals with events occurring in the period from the Society's closure to new business until the end of my jurisdiction over the relevant actions on 1 December 2001.

20 Throughout this third period, Equitable was not writing new business and the supervision of the Society reflected that fact. A large amount of supervisory activity was undertaken within this period on a wide range of matters, covering the whole spectrum of the issues facing Equitable in the context of the Society being a closed fund.

The structure of this Chapter

21 The rest of this Chapter is structured in the following way:

- in paragraphs 22 to 25, I summarise the events relevant to the scrutiny of the Society's 1988 regulatory returns;
- in paragraphs 26 to 42, I summarise the events relevant to the scrutiny of the Society's 1989 returns;
- in paragraphs 43 to 56, I summarise the events relevant to the scrutiny of the Society's 1990 returns;
- in paragraphs 57 to 82, I summarise the events relevant to the scrutiny of the Society's 1991 returns;
- in paragraphs 83 to 118, I summarise the events relevant to the scrutiny of the Society's 1992 returns;
- in paragraphs 119 to 131, I summarise the events relevant to the scrutiny of the Society's 1993 returns;
- in paragraphs 132 to 158, I summarise the events relevant to the scrutiny of the Society's 1994 returns;
- in paragraphs 159 to 170, I summarise the events relevant to the scrutiny of the Society's 1995 returns; and
- in paragraphs 171 to 212, I conclude this Chapter with a summary of the events relevant to the scrutiny of the Society's 1996 returns.

The period prior to 20 June 1998

Events relevant to the 1988 returns

22 The Society submitted its 1988 regulatory returns to the prudential regulators on 29 June 1989. A detailed description of the content of those returns is contained within the chronology entry for that date within Part 3 of this report. GAD completed the A1 initial scrutiny check on the returns on 24 July 1989 and completed the A2 initial scrutiny check on 11 September 1989. No concerns about the Society's position as disclosed in those returns were raised in either initial check and no detailed scrutiny was undertaken of those returns.

23 On 19 February 1990, the Society's Appointed Actuary and another actuary who worked for Equitable presented their paper, *With Profits Without Mystery*, to a sessional meeting of the Faculty of Actuaries. This paper set out the authors' account of the business model that Equitable operated. The discussion generated lively debate as to the appropriateness of the approach that the Society was adopting. That paper had also earlier been presented to the Institute of Actuaries, on 20 March 1989.

24 A DTI Minister attended a lunch engagement at Equitable's offices on 23 May 1990. Briefing provided for the visit by DTI officials in advance of that engagement included the statement that the *'Society appears to be sound, and has expanded steadily, with the underlying trend of expenses being satisfactory. Its strong solvency position makes it low priority in the companies supervised by Insurance Division. Consequently, contact with the Society is infrequent, and there appear to be no important issues'.*

25 There were no further events relevant to the 1988 returns.

Events relevant to the 1989 returns

26 The Society submitted its regulatory returns in respect of the 1989 year end to the prudential regulators on 29 June 1990. A detailed description of the content of those returns is contained within the chronology entry for that date within Part 3 of this report. GAD completed the A1 initial scrutiny check on the returns on 6 July 1990 and completed the A2 initial scrutiny check on 10 July 1990. No concerns about the Society's position as disclosed in those returns were raised in either initial check.

27 On 14 November 1990, DTI and GAD officials met the Appointed Actuary of the Society and another actuary employed by Equitable, as the first in a recently initiated round of such meetings with insurance companies. A detailed description of the content of the note of that meeting, prepared by GAD, is contained within the chronology entry for that date within Part 3 of this report.

28 The meeting discussed the financial position of Equitable and ways of improving their reported financial position. Equitable informed the DTI and GAD that they were considering not paying any reversionary bonus for 1990, although the Society indicated that it would pay an interim bonus in respect of policies maturing in 1991. GAD's note of the meeting records:

> *When he informed me of the current position, i.e. that free assets were £55m assuming the same valuation basis as last year,* [the Appointed Actuary] *asked me whether I had any qualms about the position of Equitable. I had to say that I did. He asked why? I replied that I had not looked at the figures in detail although I knew it was possible to weaken the valuation basis. However, the society had to comply with the valuation regulations and my main concern was whether it would be able to do this if the market fell any further (or even remained at its present level). What about next year, for example?* [The Appointed Actuary] *said he took my point and he thought that if the market fell by a further 20% they would have problems and he would have to consider what action should be taken. He implied that at such a point he would have to consider reducing the level of new business taken on.*

29 GAD's note concluded with two comments. The first was to note that the Appointed Actuary had stated that *'the Society is solvent. However, as he is considering not paying a reversionary bonus this year (while at the same time paying terminal*

bonuses) he must be feeling very uneasy about the current position of the Society'. The second was to record that GAD would be *'carrying out a detailed scrutiny of the 1989 returns in order to get a better feel for the position of the society, and in particular for what margins there are in its current valuation basis and in the alternative net premium basis'.*

30 On receipt of GAD's note of the meeting, on 22 November 1990, a DTI official commented on the note *'if the Equitable is not going to declare a bonus we need to warn the Minister before it becomes public. Will there be publicity? What about Equitable's advertising? Does it need to be changed?'*

31 GAD wrote to the Society on 4 December 1990, as part of their detailed scrutiny of the 1989 returns. The questions raised with Equitable included whether there were any surrender/transfer guarantees relating to their pension business fund contracts and *'... what investment return is required to support (i) the current reversionary bonus rates and (ii) the current reversionary and terminal bonuses'.*

32 The day after GAD had written to Equitable, GAD provided the DTI with a short note which explained that GAD had completed their detailed scrutiny of the 1989 returns. That note included the statement that *'if the property values remain depressed and the equity market does not show any bullish tendencies in the* [1990s] *and beyond, we think that the Society may have problems in maintaining the current bonus rates on its with-profit life and pensions contracts'.* GAD explained that they had written to the Society and enclosed a copy of their letter. However, GAD also informed the DTI that they considered that *'we do not anticipate that the replies will affect our view of the solvency position'.*

33 Equitable replied to GAD's letter on 17 December 1990. In response to GAD's question about the existence of surrender and transfer guarantees, the Society stated that *'our pensions contracts generally carry guarantees of the amount that will be paid in the event of actual retirement (whether on the originally stated pension date or otherwise) or death. There are, however, no guarantees on withdrawal in other circumstances, e.g. transfer to another pension provider. It is our aim to pay full value in those circumstances also but there are no guarantees in the matter'.*

34 In response to GAD's question about what investment return was required to support the current reversionary bonus rates and to support current reversionary and terminal bonus rates, the Society explained, in relation to the former, that the declared bonuses rates, announced at 31 December 1989, required annual earnings of 11¼% for pensions business and around 8% net for life business. In relation to the latter, the Society did not answer the question directly, and instead explained that, due to the way in which the Society operated their business, *'the question of what rate of growth is needed to support "current reversionary and final bonuses" is not ... meaningful in our case'.*

35 On 19 December 1990, GAD wrote to the Society to thank it for the information provided in the above letter, which they described as *'most helpful'* and to inform the Society that GAD had *'no further queries on your 1989 returns'.*

36 On the same day, GAD sent two notes to the DTI. A detailed description of the content of those notes is contained within the chronology entry for that date within Part 3 of this report. The first note began by stating that:

There is one point which we think you may need to consider following our meeting with Equitable. If, as seems possible, the society decides not to declare reversionary bonuses this year you would need to consider whether or not there is a risk that the society may be unable to fulfil the reasonable expectations of present and future policyholders.

37 After explaining their understanding of the position, GAD stated that:

> *... on balance, we do not think that the society's possible course of action, in itself, leads to a risk that the society may be unable to fulfil the reasonable expectations of such policyholders. If the society had another bad year (or this year's performance is worse than anticipated) and the company was unable to establish sufficient mathematical reserves on current guaranteed levels of benefits (including past reversionary bonuses) within the resources of the company, that would be a different matter.*

38 GAD concluded by stating that *'at present we do not have enough information about the society to be more specific and indeed, unless the society makes more signals, we do not suggest that further information should be sought. The society is our longest established life company and is well respected in the market'.*

39 The second note recorded the fact that GAD had spoken to the Society's Chief Executive on the telephone to discuss certain concerns that GAD had about the financial position of Equitable. The note explained that the background to this discussion had been, in part, related to concerns that the DTI had expressed about the Society's current advertising. It was said that:

> *This was in the context that, if the Equitable were unable to pay a reversionary bonus this year, policyholders who had taken out policies on the basis of recent advertisements (which highlighted the returns achieved by the Equitable over the past 10 years), might have justification for wondering whether their reasonable expectations would be, or were being, met. You would like the Equitable to examine their advertising to ensure no such complaint could be justified.*

40 The note continued by recording that the Society's Chief Executive had told GAD that he considered that Equitable was now *'pretty unlikely to be in a position of not being able to declare a bonus this year given the optimistic assessment of investment returns achievable by the company next year'* and that *'there was clearly a risk in this strategy, but there is a risk in all bonus declarations taken in similar circumstances'.*

41 GAD concluded their note by informing the DTI that it now seemed likely that a bonus would be declared, by agreeing that there was *'clearly some risk'* in this strategy, and by recording the view of GAD that *'if the Equitable goes ahead with a bonus distribution this year and the market subsequently falls considerably, we will need to hold some urgent talks with the company's actuary, as we would, of course, with other companies that take similar decisions and who are in a similar financial position to (or an even less strong position than) the Equitable'.*

42 On 20 December 1990, the day after the above notes were sent, Equitable applied for a section 68 Order which would permit them to include a future profits implicit item of £250 million within their 1990 returns. The DTI granted this, after taking GAD's advice, on 11 January 1991.

Events relevant to the 1990 returns

43 On 27 June 1991, the Society had submitted its regulatory returns in respect of the 1990 year end to the prudential regulators. A detailed description of the content of those returns is contained within the chronology entry for that date within Part 3 of this report. GAD completed the A1 initial scrutiny check on the returns on 24 July 1991 and completed the A2 initial scrutiny check on 29 July 1991. No concerns about the Society's position as disclosed in those returns were raised as part of the A1 initial check. As part of the A2 initial check, GAD had noted two points, being '*deteriorating cover for the* [required minimum margin]' and '*loss of working capital for future expansion*'.

44 On 11 June 1991, shortly prior to the submission of the returns, the Society's Appointed Actuary had sent certain Board papers to GAD, saying:

> *The papers are of course confidential and offered as a good will gesture to promote greater understanding and I should prefer restricted circulation in your department.*

Those Board papers are published in full in Part 4 of this report and a detailed description of the content of them is contained within the chronology entry for that date within Part 3 of this report. Amongst the other information which the papers contained, the Board papers gave a great deal of detailed information about the financial condition of Equitable, about the approach that the Appointed Actuary took to managing the reported solvency position of the Society, and the relationship between that solvency position and bonus declarations.

45 On 12 September 1991, as part of more general internal commentary concerning guarantees on with-profits bonds, GAD had commented that:

> *Generally we are aware that a number of companies are now issuing this type of contract. These include for example Equitable Life and others which apparently held reserves below the face value of the units at the end of last year. This practice can only be justified if they currently apply market value adjustments on surrenders, and can reasonably hope to earn a positive rate of return (in addition to future bonus declarations that may be "reasonably expected") over the period to death or "maturity" of the policy. Furthermore, we have to be satisfied that they can still set up adequate reserves under changing investment conditions, including a 25% fall in the value of equities and a 3% variation in yields on fixed interest securities.*

46 On 19 November 1991, GAD wrote to Equitable concerning their returns. In addition to asking for information to be supplied about various miscellaneous issues, GAD asked the Society to justify against the relevant provisions of the 1982 Act and the applicable Regulations the method by which the Appointed Actuary had completed the returns in respect of the use of sub-funds, without providing individual portions of the returns for each sub-fund. GAD also asked about the guarantees on the Society's with-profits bond.

47 GAD also asked Equitable what the cost had been of the change in the Society's main valuation basis as at the 1990 year end, when compared with the equivalent basis used at the previous valuation. GAD also noted that:

> *... you refer to the resilience test which you have carried out in connection with the valuation using the net premium method. I note your comments and that you would not need to have recourse to assets shown at line 51 of Form 14 of the Returns. There is however a substantial difference in the mathematical reserves shown at*

line 11 of Form 14, and the amount of the reserves arrived at using the net premium method of valuation. I would therefore like to know the amount of the mismatching [i.e. the resilience] *reserve which you would have needed to set up had you used the net premium method in arriving at the amount shown in line 11 of Form 14.*

48 GAD also asked Equitable to provide their estimate of the figures, including the likely amount of the available assets, which would be shown within the 1991 returns.

49 On 20 November 1991, GAD provided the DTI with a detailed scrutiny note. After noting that Equitable had experienced falls in the market values of equities and other assets, GAD noted that, as a result:

> *... the actuary has decided to weaken the valuation basis of the with-profits business. The rates of interest he has used are within the limits laid down in the regulations and could be supported by the yields shown* [in the returns] *although the margin is small. We are asking a few questions about the valuation basis and we will comment in detail after the replies from the Society.*

50 GAD also explained that:

> *The cover for the required minimum margin is reduced from 477% (1989) to 177%* [for] *this year. The main reason for this is the fall in value of the assets (referred to ... above). Part of the fall has been covered by a release of £214m from the mathematical reserves arising from the weakening in the valuation basis. Other reasons for the reduction in cover for the* [required minimum margin of solvency] *are (a) growth of new business and (b) maintenance of unchanged bonus rates on with profit policies.*

51 Equitable replied on 22 November 1991 to GAD's letter of 19 November 1991. The Society explained that, if it had shown mathematical reserves for the resilience reserve, calculated using the net premium method of valuation, the Society would have needed to set up an additional resilience reserve of £450 million.

52 Equitable also explained that, if the reserves shown in the main valuation had been calculated as at the 1990 year end, using the basis used for publication at the previous valuation, their reserves would have been £557 million higher. Equitable also explained that they would:

> *... need to publish a substantially stronger valuation at the end of 1991, either by explicit strengthening of the basis or the inclusion of an explicit* [resilience] *reserve, than at 31 December 1990 reflecting the reduction in yields during the year. My current view is that it is unlikely that the* [solvency] *position at the end of 1991 will be any stronger than at 31 December 1990, although the underlying liability valuation will, of course, be substantially stronger.*

53 On 16 December 1991, Equitable were granted a section 68 Order by the DTI for a future profits implicit item of £300 million for possible use in their 1991 returns.

54 On 31 January 1992, GAD wrote to the Society in response to its letter of 22 November 1991. GAD continued to seek further information about the with-profits bond but made no comment on either the information provided by Equitable concerning the resilience reserves, about the impact of the change in the valuation basis adopted in 1990, or the comments made by Equitable about the likely solvency position in the 1991 returns. GAD wrote to the DTI on the same day to set out what had been done as part of the detailed scrutiny.

55 Equitable replied to GAD on 13 February 1992. The Society explained that the guarantee of 'full value' payment on the with-profits bond applied only at certain specific dates set out in the policy document and that the valuation basis took account of those dates.

56 However, although Equitable's current practice was to pay out *'full value'* on early surrender, *'... we do not guarantee this. I do not see that the reserving basis for the bonds needs to take any particular account of this practice'*. The Society also stated in relation to its with-profits bonds that: *'If our surrender experience deteriorates or if financial conditions worsened significantly, we should certainly impose surrender penalties'*. GAD informed the DTI on 24 February 1992 that the detailed scrutiny was completed.

Events relevant to the 1991 returns

57 Prior to submission of their 1991 returns, Equitable wrote to GAD on 12 May 1992 and informed GAD that the solvency position at 31 December 1991 showed that the cover for the Society's required minimum margin was likely to be 1.17. This would signal a drop in solvency cover from 1.77 the previous year (and from 4.77 the year before that).

58 An internal GAD minute, dated 14 May 1992, contained analysis of Equitable's letter. A detailed description both of the content of the Society's letter and of the GAD minute is contained within the chronology entries for these dates in Part 3 of this report. GAD's analysis and notes made separately as part of an assessment of the Society's position included observations:

(i) that the margins in the valuation basis were *'very thin'* in 1990, *'with an average interest rate used of 7.12%'*;

(ii) that the strengthening of the valuation basis in 1991 had increased reserves by £150 million, whereas the weakening in 1990 had reduced reserves by £557 million;

(iii) that Equitable had over £100 million of single premium with profits bonds in force, which had been valued on an acceptable basis, *'although the reserves held were less than current surrender values (not guaranteed). This led to some release of premiums into surplus'*;

(iv) that it had been expected, with the increase in market values, that the Society's position would have seen an increase in excess assets available in 1991 but that, surprisingly, there had been instead a reduction in the value of those assets;

(v) that the Society's free asset ratio was low and that, when the 1991 returns were published, financial advisers would question the strength of Equitable;

(vi) that the Society had used up its investment reserves (i.e. its free assets) quickly in paying *'very good bonuses'*; and

(vii) that Equitable's recurrent single premium business (i.e. its principal line of business) would be *'exposed to cancellation as soon as there is adverse publicity about the strength of Equitable'*.

59 The DTI were copied into GAD's note. On their copy, the DTI official responsible for the supervision of Equitable noted that GAD *'thinks they have been paying too much in bonuses'*.

60 The DTI and GAD met Equitable on 19 May 1992, as part of a planned series of company visits. Prior to the meeting, on 14 May 1992, the DTI prepared briefing, which included the observation that there had been a:

> *... considerable reduction in excess assets between 1989 and 1991 ...* [the] *Society has experienced falls in the market value of equities and other assets, and the actuary has decided to weaken valuation basis of* [with-profits] *business. Reduction in cover for* [required minimum margin of solvency] *is due to fall in value of assets, growth in new business, and maintenance of unchanged bonus rates on* [with-profits] *policies. GAD meeting with Equitable on 14.11.90 noted that they were considering not paying any reversionary bonuses for 1990. In the event a bonus was declared for 1990 at same rate as for 1989.*

61 A detailed description of this briefing and of the note of the meeting prepared by the DTI is contained within the chronology entry for these dates within Part 3 of this report. The latter records that the Society disclosed the existence of its policies with a guaranteed investment return, that GAD had observed that the solvency position of the Society was *'arguable'*, and that GAD had noted that they *'would be concerned about Equitable's performance if there were dramatic falls in the market'*. After the meeting, Equitable provided GAD with some further information on 28 May 1992.

62 On 29 June 1992, the Society submitted its regulatory returns in respect of the 1991 year end to the prudential regulators. A detailed description of the content of those returns is contained within the chronology entry for that date within Part 3 of this report.

63 GAD completed the A1 initial scrutiny check on the returns on 3 August 1992 and completed the A2 initial scrutiny check on 10 August 1992. No concerns about the Society's position as disclosed in those returns were raised in the A1 initial check. In the A2 initial check, GAD noted that the valuation interest rate of 10% for immediate annuities was *'very high'*. GAD also identified three aspects that *'look worrying'*: a low free asset ratio, the amount of other management expenses, and *'transfer from* [investment reserve]'.

64 On 30 July 1992, GAD had described, in general internal briefing, the Society as being one of the *'companies on whom we have been keeping a close watch for a number of years'* and that Equitable remained a company *'which cause serious concern'*.

65 Other briefing, prepared by the DTI on 19 August 1992, observed that the Society's *'solvency margin, whilst well covered, has reduced in recent years mainly due to falls in the market value of equities'*. This was subsequently corrected, following GAD informing the DTI that *'since 1990 ... the solvency margin position has worsened, and is a cause for some concern ... Equitable Life will be one of the first companies we will be talking to in our imminent discussions with appointed actuaries'*.

66 At this time, GAD expressed some more general concerns in their discussions with the DTI about the then current weakness in investment and foreign exchange markets and the possible effect on the free asset ratios of life insurance companies. GAD explained that they had sought meetings with the Appointed Actuaries of a number of insurance companies to discuss their company's current and projected financial position. Prompted by concern about Equitable's worsening solvency position, GAD had included the Society in this exercise.

67 GAD and the DTI met Equitable on 15 September 1992. Before, at, and after the meeting Equitable provided additional information about their past and projected performance. This information is summarised within the entries in Part 3 of this report for 10 September 1992, 15 September 1992, and 17 September 1992.

68 The Society stated that it remained confident that it would be able to meet the regulatory solvency requirements at the end of 1992 and 1993, although Equitable at the same time cautioned that the implications for bonuses would need to be considered carefully. In their note of the meeting, Equitable recorded that, at the meeting, GAD had asked about:

> *... the extent to which the Society's minimum statutory reserving basis might be weakened by removing "unnecessary" margins.*

In response, on 17 September 1992 the Society pointed to a number of measures which it might use to protect its position, including weakening the valuation basis *'on account of zillmerisation'* and using a future profits implicit item.

69 Following the meeting and in the light of the additional information provided by Equitable, GAD observed in an internal note, copied to the DTI, that the Society had implied that too stringent liability valuation regulations were forcing it to invest in fixed interest securities rather than in equities, which the Society considered a better long term investment. GAD concluded:

> *Our view is that the society has over-distributed in the last few years, compared with the return on investments. This has eroded the level of free assets available in the society, which are needed to provide for market changes in the value of assets.*

On 29 October 1992, GAD provided the DTI with their scrutiny report on the 1991 returns. GAD explained that they had compared the average valuation rate of interest used by Equitable with the average rate of interest earned on the corresponding allocated assets (using the highest yielding assets first). GAD noted that there appeared to be little or no margin in the interest rates used and that this was an issue they were taking up with Equitable.

70 GAD highlighted the fact that Equitable's earnings on assets had fallen well short of what was required to meet bonuses paid in 1989 and 1991. As a result, Equitable had transferred funds from their investment reserves and had weakened the valuation basis. GAD also noted that the Society still had over 60% of its non-linked assets invested in equities and property.

71 GAD also attached a copy of their letter to Equitable, taking up a number of matters from the 1991 returns. In this, they asked Equitable to:

- explain how their with-profits immediate annuity contract worked;
- explain why the proportion of reserves not matched by assets in the same currency had risen from 0% to 7.7% in one year;
- clarify the paragraph in their returns which dealt with the calculation of the final bonus for a group of policies, including recurrent single premium deferred annuities, and to provide an example of how this worked in practice *'including the effect of both reversionary and final bonuses'*;

[1] A matching rectangle is a table showing the assets hypothecated, or notionally allocated, to liabilities. It thus allows the regulators to establish if the valuation rate of interest for any liability is supported by the yield on the notionally allocated assets. A specimen is annexed to Part 2 of this report.

- provide a *'matching rectangle showing what assets you would hypothecate to the net premium mathematical reserves*[1]'; and

- explain the amount of the valuation strain in respect of additional business written in 1991.

On the last point, GAD stated:

> *... we wish to know (i) the reserves set up at the end of 1991 (ii) the total cost of any bonuses allocated during 1991 and provided for in the 1991 returns (iii) the cost of any claims paid in 1991 (iv) the total premiums received in 1991 and (v) the total related expenses incurred in 1991.*

72 By way of annotations made on their copy of GAD's report and letter, the DTI's Head of Life Insurance commented:

> *This paints a worrying picture. Over-distribution by a company with a (deliberately) small coverage of its* [required minimum margin] *and a (continuing) policy of high equity exposure. I think we should ask GAD for a fuller assessment of the position and of the options available to the company in the event of a significant further downturn in the market (unless we have this already, in which case I should like to see it).*

The Head of Life Insurance also suggested that GAD should ask Equitable how long they could continue with their present bonuses in the event of a zero investment yield.

73 On 6 November 1992, in response to GAD's letter, Equitable:

- provided details of their with-profits immediate annuity contract, including an example of how annuity payments were determined by bonus rates. These showed that the annuity calculation implicitly guaranteed growth of 3.5%, which was taken into account in the calculation of the guaranteed annuity payment. Equitable also explained that, for with-profits annuity contracts, policyholders were allowed to select at the outset an assumed future reversionary bonus of up to 5.5% (in addition to the 3.5% guarantee) – the higher the level of assumed future bonuses the higher the initial annuity payment. But, if in future the actual level of bonuses fell short of the assumption, the annuity payment also would fall;

- explained that the proportion of reserves not matched by assets in the same currency had been overstated – the correct figure should have been 2.9% (or zero on a net premium basis);

- explained that each with-profits policy had a 'total claim value' based on the accumulated value of the premiums paid, increased as appropriate by annual bonus declarations – and that the amount by which the total claim value exceeded the value of the guaranteed benefits (including reversionary bonuses) determined the final bonus element;

- provided matching rectangles – but these did not show assets allocated to liabilities calculated at a particular valuation rate of interest; and

- explained that information on the valuation strain generated by business written in 1991 was not readily available and would take a great deal of time and effort to produce. Instead, Equitable provided an analysis of the financial impact of new business, which did not include 'regular' recurrent single premium renewals, in 1991. The Society stated that the new business did not produce a valuation strain. This, it was said, was *due mainly to the fact that 'the valuation bases for recurrent single premium business released monies at outset in a similar way to the release produced by a zillmer adjustment'.*

74 In reply, GAD told Equitable that their response would be considered in detail shortly. However, the Society's letter was given no further consideration at that time. It appears that this was because its receipt coincided with a change in the GAD actuary responsible for scrutinising the Society's returns.

75 On 3 March 1993, GAD advised the DTI that Equitable's replies to their questions on the 1991 returns:

> *... seem satisfactory. The operation of the bonus system (as described in the responses to Questions 1) and 3) seems complex, and even more difficult for policyholders to understand than that of most companies, but there is nothing inherently unsound about it.*

76 The DTI had passed to GAD in January 1993 the queries that they had raised. In their advice to the DTI, GAD highlighted a number of unusual features about the Society. Those features included that Equitable had a very high proportion of with-profits business and, even more unusually, that 80%-85% of their with-profits business was in the form of single or recurrent single premiums, with the annual premiums in force being very modest in relation to the size of the company. GAD stated this could be:

> *... both a strength and a weakness. A strength because it has only to secure the benefits bought by premiums already paid, and needs less by way of protection for the future premiums to be received under the contracts. A weakness because it will have less by way of "free reserves" and is therefore more vulnerable to changes in asset values.*

77 GAD also noted Equitable's use of a bonus reserve valuation in their main valuation. GAD stated that the Society's high proportion of single or recurrent single premium business made this more appropriate than the net premium approach. GAD observed that the results in the main valuation would be similar to those that would be disclosed on the appendix basis.

78 GAD noted from reports of earlier meetings that, in setting bonus rates, Equitable had considerable regard to gilt yields. GAD commented that this was not entirely consistent with the bonus system or the asset mix but that it no doubt explained what, in retrospect, had been an over-distribution by the Society in 1990. GAD added:

> *It seems possible from the* [required minimum margin] *cover ratios that the over-distribution followed a period of some <u>under</u>distribution; but without going back into previous history in detail I could not be sure.*

79 GAD noted that, in the event of a downturn in the market, the option of reducing bonuses would be less of a protection for Equitable than would be the case for other companies, as terminal bonus did not represent such a high proportion of their total payouts. GAD concluded:

> *Overall, I suspect that Equitable could survive a <u>short-term</u> fall in market levels, even a substantial one, as well as most companies. Their portfolio, however, must leave room for concern, were there to be a prolonged period of depressed share values. Their recent shift towards fixed interest securities will ease the difficulties, although they would argue at the expense of the expected ultimate benefit to policyholders.*

80 Also on 3 March 1993, GAD wrote to Equitable, in response to the Society's letter of 6 November 1992. GAD explained '[t]*here seems little point in asking further questions on the matters relating to the 1991 Returns'*. GAD asked, instead, for the Society's initial assessment as to what its position would be at the end of the year, including the position regarding the cover for the required minimum margin, the actual rate of return on the fund in 1992, and details of the 1992 bonus distribution.

81 GAD explained that, in due course, they would also be seeking details of how the Society's assets were allocated to liabilities, as well as the yield on the assets so allocated and an analysis of new business.

82 Equitable provided their initial assessment of the end of 1992 position on 9 March 1993. The Society described an improved position and, on 11 March 1993, GAD advised the DTI that they regarded the scrutiny of the 1991 returns as *'fully completed'*.

Events relevant to the 1992 returns

83 In June 1993, the Institute of Actuaries held one of its regular one-day conferences on current issues in life assurance, attended by nearly 200 actuaries. One topic for discussion was the disclosure and reporting of terminal bonus costs.

84 The conference heard that disclosure of some information would help avoid creating unreasonable policyholder expectations and would demonstrate that policyholders were being treated fairly. However, the actuarial profession's Valuation Regulations Working Party favoured private disclosure (for example through a report by the Appointed Actuary to the Board or through a new 'financial condition report'[2] to the DTI) rather than public disclosure (for example through the annual returns or a with-profits guide).

85 Contributors to the discussion also favoured private rather than public disclosure. A spokesperson for GAD:

> *... made it clear that this body would like to see some private disclosure. The Government Actuary's Department will be seeking further information on surplus distribution, given the inadequacy of the information provided in Schedule 4 of the DTI returns. It is particularly interested in marketing material and the methodology used in determining bonus distributions. The information will be collected through a survey of larger offices or by other means, such as company visits*[3].

86 On 5 July 1993, the Society's Appointed Actuary complained to the Government Actuary (following a press report that GAD were to launch an investigation into the way life companies distributed bonuses to their policyholders). He argued that Equitable had a very open bonus system and so the consequences of such a survey were likely to be to their advantage. However, he expressed concern that the intended survey was announced first in the press rather than direct to companies, that it might further weaken confidence in the industry, and that it might be a precursor of tighter regulation – for example of bonus rates.

87 On 7 July 1993, the Government Actuary replied and explained to the Appointed Actuary that the survey had been announced at the recent conference on current issues in life assurance and that there had been no intention to weaken confidence in the industry or to introduce tighter regulation. He added:

> *In one sense there is nothing new in this, since GAD and the DTI have always taken a close interest in policyholders' reasonable expectations. Indeed, this has been the central issue in many Section 49 Transfers* [i.e. transfers

[2] A report on the actions available to the company for dealing with particular circumstances, traditionally prepared by the Appointed Actuary for the Board.
[3] Quoted in the *Journal of the Institute of Actuaries,* Volume 120, pp. 481 – 482.

of the whole or part of a company's long term business], in the setting up of sub-funds, in changes to the proportion of surplus going to shareholders and in a number of other areas. We have been signalling for some time that asset share calculations would be one of the aspects on which we would seek to focus during the next round of company visits. On top of this there have been particular pressures on companies because of falling investment returns and some evidence that proprietary companies are under more than usual pressure to demonstrate value to shareholders. These and other factors pointed to the need to focus on this area and for DTI to be seen to be doing something positive to indicate that it has policyholders' reasonable expectations very much in mind.

88 On 9 July 1993, the DTI wrote to all life insurance companies in the United Kingdom writing with-profits business and explained:

The Department has an ongoing responsibility to keep itself informed of developments within the life insurance industry, and a particular responsibility to protect policyholders' reasonable expectations. In this context we wish to gain a clearer picture of current industry practice in respect of bonus methodology.

We have therefore asked the Government Actuary's Department to conduct a survey of leading UK offices which write with-profits business, in order to obtain more detailed information about companies' bonus philosophies, and the actuarial techniques used in assessing bonus payments.

89 The DTI enclosed a letter which had been sent at the same time by GAD to Appointed Actuaries, giving more detail on the background to the survey. In their letter, GAD explained that actuaries had introduced new methodologies for assessing bonuses, including the technique known as 'asset shares'.

90 However, GAD recognised that there was no clearly accepted definition of how such asset shares were calculated, nor was there information in the regulatory returns about how the appropriate rates of bonus could be assessed. The survey had been designed, GAD said, to obtain this information.

91 Attached to GAD's letter was a questionnaire, which sought detailed information in response to 11 questions. GAD explained that the survey was divided into two broad headings:

(i) the content of current marketing literature, combined with information on the principles of distribution in the constitution of the company and (ii) the company's actual methodology in respect of the determination of appropriate levels of final or terminal bonus payable on with-profit policies.

92 On 20 July 1993, Equitable wrote to GAD enclosing their completed questionnaire for the with-profits survey. The Society was the first to respond. Within the Society's responses to part (i) of GAD's survey (about marketing literature and the principles of distribution), Equitable stated that their Articles of Association gave:

... the Society's Directors absolute discretion as to bonus allocations[4]. Beyond that, there is no statement of bonus philosophy in the Society's constitution. The main statement of the Society's long-standing philosophy on bonus distribution in marketing literature is contained in ... the With Profits Guide.

[4] Article 65 of Equitable's Articles of Association stated that the amount of any bonus which may be declared or paid and the amount to which any policyholder may become entitled *'shall be matters within the absolute discretion of the Directors, whose decision thereon shall be final and conclusive'*.

Equitable further explained that their With-Profits Guides gave no specific information on the period and magnitude of smoothing or the likely frequency of changes to final bonus rates. The Society said that general comments in the Guides could be expected to lead policyholders to expect relatively infrequent changes to the latter.

93 Equitable provided the detailed information sought in part (ii) of GAD's survey (about actual methodology for determining final or terminal bonuses). The Society explained in particular:

- that, for surrenders, *'the full policy value (including final bonus) is normally adjusted to ensure that the surrender value paid does not exceed the underlying asset share. The level of adjustment required is monitored monthly'*;
- that, when determining the annual expense level attributed to with-profits contracts for recurrent single premium business, *'allowance is made for an implicit fund charge of ½% p.a. That is, the gross rate of accumulation ... is taken to be ½% p.a. higher for conventional contracts, such as endowment assurances, than for recurrent single premium contracts'*;
- that, in assessing appropriate final or terminal bonuses, the Society made no allowance for a charge for the guarantee provided in respect of benefits payable on maturity or for a contribution to an 'estate';
- that Equitable did not discriminate between different contracts in their smoothing process;
- that the smoothing of final or terminal bonuses *'is determined by the relationship between the accumulation rates determined each year and actual investment earnings. That smoothing is also reflected in the comparison of the aggregate total policy values with actual asset values. In normal circumstances the Directors look to apply a 3 to 5 year averaging cycle but expect to apply that more flexibly in more unusual circumstances'*; and
- that, when valuing their assets for the above comparison, *'allowance is made for the accumulated new business strains which will be recouped from future premium loadings'*.

94 Equitable added:

> *Part of the Society's stated philosophy is to achieve a reasonable degree of stability in proceeds with gradual, rather than sudden, changes in proceeds. The approach to smoothing needs to reflect that philosophy, particularly in volatile investment conditions.*

95 Equitable submitted their 1992 returns on 29 June 1993. GAD completed their A1 Initial Scrutiny check on 30 June 1993. GAD noted that the cover for the required minimum margin was 2.36. They identified no concerns. GAD completed their A2 Initial Scrutiny check on 5 July.

96 GAD lowered the Society's priority rating from 2 to 3 and identified the valuation basis for unit-linked business as a worrying aspect, although it was also noted that this was not a major part of the Society's business. GAD noted that the proportion of assets invested in fixed interest securities had risen from 26% to 38%. GAD identified no items to notify to the DTI, to be taken up immediately with Equitable.

97 Following receipt of the 1992 returns but prior to GAD's detailed scrutiny both GAD and the DTI considered other information about Equitable. On 30 November 1993, GAD and the DTI met Equitable to follow up the meeting in September 1992, at which they had discussed the effect of market

conditions on the Society's solvency position. Prior to the meeting, GAD had signalled that they wished to discuss Equitable's current and projected financial position, their bonus and investment policy and their resilience reserves.

98 On 25 November 1993, Equitable had provided a number of papers, including a report by Standard & Poor's giving Equitable a *'very good rating'*[5] and papers considered by the Society's Board in October and November. The entry for that date in Part 3 of this report includes a detailed description of the information that those papers contained.

99 At the meeting, Equitable indicated that they expected their position at the end of 1993 to be significantly stronger than had been the case at the end of 1992. The Society also expected to eliminate the recent excess of payouts over asset shares and that future bonuses would depend primarily on earned returns. In response, GAD noted that Equitable *'... appeared to be moving to a lower proportion of the total bonus payout being guaranteed (i.e. declared as distinct from terminal)'*[6].

100 The issue of guarantees arose at the meeting in other ways. The DTI noted that Equitable had *'no guarantees that bite'*. In the course of discussion about the resilience test, GAD noted the following comments by the Society's Appointed Actuary and Chief Executive:

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

Equitable added that they were sure that allowance for the resilience reserve had been made within the appendix valuation but agreed that they would check and confirm whether this was so[8].

101 Prior to the meeting, GAD had informed Equitable that they might wish to clarify some points from Equitable's response to the bonus survey. I have seen no evidence that GAD raised any issues concerning this response at the meeting.

102 Meanwhile, in the autumn of 1993, the DTI had analysed which life insurance companies had shown a significant deterioration in their 1992 solvency cover, compared with 1991.

103 As a result of that exercise, the DTI identified sixteen companies which they *'... should be paying special attention to in the remainder of 1993 and 1994'*. Although it was said that Equitable had shown a *'marked improvement'* in terms of solvency, the Society was listed as being one of these companies[9]. The DTI also noted that Equitable had been one of 11 included in GAD's *'free asset ratio list'*, prepared on 16 August 1993, as raising concerns.

[5] Standard & Poor's are an international company providing credit ratings and other financial services. Their reports were paid for by the companies concerned.
[6] When scrutinising Equitable's 1991 returns, the GAD actuary had noted that the option of reducing bonuses was less of a protection for Equitable, as terminal bonus did not represent a high proportion of their total payouts.
[7] Shortly after the meeting, in December 1993, the Appointed Actuary presented a report to Equitable's Board, which set out amendments to Equitable's Statement of Bonuses, including the insertion of wording describing a differential terminal bonus policy for policies with guaranteed annuity rates. The amendment was agreed.
[8] Equitable did not provide any further information on this point until GAD raised the issue in March 1994.
[9] Equitable's cover had fallen from 4.77 at the end of 1989 to 1.67 at the end of 1991.

104 The DTI arranged a meeting to be held on 6 January 1994 to discuss those 16 companies. By way of a note headed *'1992 returns – "Problem Companies"'*, the DTI line supervisor with responsibility for Equitable was asked to attend. On 5 January 1994, the line supervisor explained that he could not attend. The line supervisor pointed out that GAD had held a *'mainly actuarial'* meeting with the Society, also attended by the DTI (i.e. the meeting on 30 November 1993). He continued:

> *At the time* [this] *list was drawn up, both* [Equitable and another named company for which he was responsible] *seemed rather marginal candidates for inclusion, a view confirmed by recent contacts. They are both well-managed and reasonably successful; neither appears to be anywhere near the slippery slope at present. I believe they need no special attention before submission of the 1993 returns.*

105 No-one was asked to attend in his place. I have been unable to establish what happened at the meeting.

106 On 24 March 1994, GAD considered Equitable's 1992 returns in detail and drew attention in their detailed scrutiny notes to their advice to the DTI of March 1993 and the note of the meeting on 30 November 1993, both of which GAD said *'should be noted in particular'*. GAD also explained that, according to the Society's letter of 9 March 1993, the Society had strengthened its valuation basis by about £100 million.

107 GAD stated that there was *'nothing to note'* from the Society's reply to the with-profits survey. I have seen no other evidence to suggest that the information in the bonus survey informed the scrutiny of the 1992 returns[10].

108 On 28 March 1994, GAD provided the DTI with their *'detailed'* two page scrutiny report on the returns. GAD highlighted the Society's improved cover for the required minimum margin (2.36 compared with 1.67 at the end of 1991) and noted the Society's practice of using a bonus reserve valuation in the body of its returns and publishing a net premium valuation as an appendix.

109 GAD also pointed out that, under the net premium valuation, Equitable's cover was 3.9 and referred to past concerns which GAD had had that Equitable had over-distributed. However, GAD now felt able to provide reassurance to the DTI:

> *More recently matters seem to have been brought under better control. The situation as at 31 December 1992 is more satisfactory than the previous year, and as you will know from recent reports (eg the notes of the meeting held on 30 November last) we expect the position as at the end of 1993 to have*

[10]In December 1993, GAD produced a question by question summary of the responses to the survey. This was largely factual and did not refer to companies by name. GAD did not include any further analysis of the responses or seek to draw any general conclusions. I have seen no other evidence regarding whether and, if so, how Equitable's response to the bonus survey, or the responses from other companies, were assessed with regard to policyholders' reasonable expectations or any other considerations, at that time or subsequently. In March 1995, Equitable wrote to GAD to state that they had seen a press report from which it appeared that GAD had decided to take no action as a result of the survey. Equitable complained that it had been discourteous of GAD to disseminate the results of the survey in such a way. In April 1995, GAD replied. GAD stated that they had explained to the journalist in question that *'... the grounds for intervention available to the Secretary of State are prescribed in the* [Insurance Companies Act] *1982, as amended, and if higher bonuses are awarded than have been earned, this is principally a matter of commercial judgement provided the reasonable expectations of the other policyholders are not affected.'* GAD denied that they were disseminating the results of the survey through the press and added: *'In fact, during the conversation I told* [the journalist] *that it was decided not to publish the results of the survey due to the difficulty of not laying ourselves open to the charge that one could identify particular companies' practices.'*

improved still further. Reversionary and terminal bonus rates were reduced at the end of 1992 and it has just been confirmed that reversionary bonuses have been reduced again from the end of 1993.

110 Also on 28 March 1994, GAD wrote to Equitable to ask them to provide copies of their recent bonus announcement and of their most recent With-Profits Guide. GAD requested that these documents should be supplied routinely in the future. GAD also asked Equitable:

- *In the Appendix (where the net premium results are set out) you mention in para. 5(a) on page 98 that resilience reserves could be set up without recourse to the Form 14 line 51 assets. However you do not give an indication of the amount of any resilience reserve which would be required on the* <u>*net premium*</u> *basis and which is not covered by the net premium liabilities. Could you please advise this amount as at 31 December 1992, and ensure that the corresponding figure is disclosed in future returns;*
- to provide the figure for the growth rate of non-unit reserves, if a rate of return of 2% rather than 3% were used;
- to explain why, for certain linked business, Equitable had reduced their reserves in respect of tax on unrealised capital gains;
- *... the rate of 9% used to value the non-profit immediate annuities seems on the high side. Could you please supply more details of the assets that are deemed to be backing these liabilities, and their yields, having regard to Regulation 59(2) and (6)(a);* and
- to provide a preliminary estimate of the Society's position at the end of 1993, including an indication of the extent to which the valuation basis had been strengthened.

111 In response, on 7 April 1994 Equitable sent to GAD a copy of their 'Bonuses' booklet, which set out their most recent bonus rates. The Society undertook to supply its With-Profits Guide when that had been updated and to add GAD's details to the Society's press release distribution list. In addition, the Society's Appointed Actuary, in response to the specific issues that GAD had raised on 28 March 1994:

- informed GAD that the figure for the resilience reserves required in the statutory minimum valuation was £462 million. The Appointed Actuary said that he was not prepared to publish the figure in future returns as he considered it to be confidential. The Appointed Actuary added:

  > *GAD have previously indicated that they feel the Society provides much fuller information than the norm in this area*[11]*. To require even more from us seems unreasonable;*

- explained that there would be no increase in the non-unit reserves, if a return of 2% rather than 3% had been used;
- explained that Equitable had net unrealised losses in their linked funds and accordingly the capital gains tax reserve was negative;

[11] I have seen no evidence to support that statement. I have been told by the Society's former Appointed Actuaries that it is their recollection that: *'it was GAD's consistent view that, by publishing an appendix valuation which was intended to be close to the statutory minimum, ELAS revealed much more about the strength of its main valuation than was the norm whereby offices just published one net premium valuation on a basis stronger than the statutory minimum'.* Those former Appointed Actuaries also pointed out to me that GAD had not challenged the comment at the time.

- explained that, in the Appointed Actuary's view, the valuation of the assets backing the non-profit liabilities in the Society's gross premium valuation was a matter for his professional judgement. He further explained that, within this group, there were different categories of annuities and that Equitable considered that the valuation rate used was suitable, as some assets actually yielded a higher rate; and

- provided an estimate of the position at the end of 1993, showing a strengthening in reserves of £1,076 million and cover for the required minimum margin of 3.75.

112 Handwritten comments on this letter show that, after some discussion, GAD were satisfied that, with the addition of the resilience reserves, the Society's published valuation was *'(just) OK'*[12]. GAD expressed surprise that non-unit reserves would not increase if a return of 2% rather than 3% had been used, but suggested that GAD should *'let this pass'*.

113 On 19 April 1994, GAD sent the DTI copies of their correspondence with Equitable. GAD explained that they were generally satisfied with the Society's responses and noted that, once the resilience reserves were taken into account, there was little difference between the Society's main and appendix valuations, although the latter valuation was weaker than that used by most with-profits offices.

114 GAD noted that the Board papers that had been supplied showed that the Society's bonus rates had been reduced by less than was justified by their usual approach of relating declared rates to prevailing interest rate levels, primarily on account of the good performance of assets during 1993. GAD also explained that they were asking Equitable some additional questions.

115 GAD also enclosed a copy of their letter to Equitable, in which they had pursued two points. The first point was whether the Society's approach to unrealised tax losses was prudent. The second point was whether the valuation interest rate used for non-profit immediate annuities could be supported by the assets deemed to have been backing those liabilities. GAD explained:

> *You will appreciate, I am sure, that our primary concern is with the net premium valuation published in the Appendix to Schedule 4, rather than with the office basis. This question was posed in the context of the net premium assumption (where 9% was also used), and I am sorry if that was not clear. Could you please now provide the information that we are seeking; the yields shown in Forms 45 and 46 do not, after allowing for the 7½% margin, seem to support the 9% assumption.*

116 In response, on 25 April 1994 Equitable provided a justification of their approach to the treatment of unrealised capital losses. The Society also explained that the *average* valuation rate of interest used had been 6.5%, which was less than the *average* yield of 7.0%.

117 Equitable explained that it was their view that, while the applicable Regulations permitted the allocation of assets to specific liabilities, those Regulations did not require this. Equitable reiterated that the valuation of the assets was a matter for the professional judgement of the Appointed Actuary. GAD decided not to pursue either point further.

118 On 7 June 1994, GAD copied this correspondence to the DTI and explained that GAD had *'no further questions for the actuary, and this scrutiny* [of the 1992 returns] *is regarded as complete'*.

[12] The apparent margin of £476 million, between Equitable's published valuation (£8,557 million) and their statutory minimum valuation (£8,081 million), fell to just £14 million when the resilience reserve of £462 million was added.

Events relevant to the 1993 returns

119 Equitable submitted their returns for 1993 on 27 June 1994. GAD completed their initial scrutiny in a different order than had been the case for earlier years, completing the A2 Initial Scrutiny check first on 7 July 1994. GAD gave Equitable a priority rating of 3 (unchanged from the previous year). GAD again identified the valuation basis for unit-linked business as a matter of (small) concern.

120 GAD noted that the Society had not set up any provision to meet potential exposure for pension mis-selling but commented that such a problem was unlikely to be significant. GAD identified no items to notify to the DTI, to be taken up immediately with Equitable. GAD completed their A1 Initial Scrutiny check on 15 July 1994. GAD noted that the cover for the required minimum margin was 3.75.

121 On 24 October 1994, GAD prepared three pages of *'detailed scrutiny notes'* on the 1993 returns. As part of these, GAD noted *'New rules reducing final bonuses'*, citing the page in the returns which set out the Society's differential terminal bonus policy. GAD commented that the valuation rates of interest looked too high and needed to be justified by a matching rectangle.

GAD also queried Equitable's mortality assumptions for annuities.

122 On 15 November 1994, GAD provided the DTI with a 14 page scrutiny report on the 1993 returns. The report followed a new standardised format adopted by GAD, comprising thirteen specific sections[13]. In their report, GAD drew attention to a number of matters. In particular:

- GAD noted that particular care was needed when reviewing the appendix (net premium) valuation, as the figure for the resilience reserves necessary under that valuation had been omitted from the returns;

- GAD explained that the valuation bases used for Equitable's main (gross premium) valuation were primarily a tool to support the method of determining bonus distributions and commented that they were not particularly relevant to the prudential supervision of the Society. GAD observed that the adequacy of the Society's valuation *'is demonstrated by publishing a net premium valuation on the minimum basis necessary to meet the regulations'*. GAD noted that this appendix valuation had a number of apparent weaknesses, including that the valuation rates of interest appeared somewhat high. GAD explained that they had little concern about the Society's solvency, given its cover for the required minimum margin. However, GAD said that, if Equitable's reserves were too thin as a result (that is, if the Society were using valuation rates of interest that were too high):

  > *... it may lead to inappropriate conclusions being drawn by policyholders and prospective policyholders as to the financial strength of the Society*[14]. We are therefore seeking confirmation of the prudence of certain of the assumptions; and

- GAD noted that some mortality tables appeared on the optimistic side and further information as to their justification was required.

[13] GAD had established a Scrutiny Strategy Working Party in 1994, and it appears that it was as a result of this that the Service Level Agreement (SLA) between the DTI and GAD came to be revised in 1995. The revised SLA included a new detailed format for scrutiny reports and it appears that GAD's report on the 1993 returns anticipated its adoption.

[14] By this, GAD meant that policyholders could conclude that Equitable's position was *stronger* than was in fact the case.

123 GAD explained that they would seek further information from the Society on each of the above points. GAD also observed that Equitable carried no reserves for pension mis-selling, due to the Society's selling methods *'which are based upon largely approaches from prospective policyholders'*, but that it remained to be seen if this was correct.

124 Also on 15 November 1994, GAD wrote to Equitable. GAD asked the Society to disclose the amount of the resilience reserve required in the appendix valuation, to provide a matching rectangle, to demonstrate the notional allocation of assets to liabilities, and to explain why Equitable had chosen the particular mortality tables they had used.

125 In response, on 22 November 1994 Equitable:

- explained that the figure for the resilience reserves required in the appendix valuation was £236 million[15];

- provided a rudimentary matching rectangle which did not allocate assets to specific liabilities. Equitable stated that the average yield of the assets was 5.32% and that, after the required reduction of 7.5%, those assets supported the average valuation rate of interest of 4.78%.

  Against this, GAD noted *'Seems OK, but the averaging should only be assets'*; and

- provided details of the mortality experience Equitable were using for annuity contracts and acknowledged that some slight strengthening might be appropriate for the valuation at 31 December 1994.

126 On 23 November 1994, GAD copied the Society's reply to the DTI and commented:

> *In view of the nature of the net premium valuation for this company, which is published to demonstrate the adequacy of the published main bonus reserve valuation, and the undoubted adequacy of the reserves in aggregate, we are satisfied with the reply received.*

GAD concluded:

> *We regard this scrutiny as complete.*

127 Nevertheless, on the same day GAD pursued with Equitable their treatment of valuation rates of interest. GAD explained that the applicable Regulations did not permit the averaging of valuation interest rates, and that each interest rate used had to be supported by the yield on the assets matching the corresponding reserve. GAD also suggested to the Society that, for the 1994 valuation, its assets should be allocated to each category of contracts for which a different interest rate was used.

128 On 30 November 1994, Equitable replied and disputed GAD's interpretation of the relevant Regulations. Following another exchange of correspondence, on 7 December 1994 Equitable undertook to give the matter further consideration in relation to the 1994 returns. The Society explained that it did not wish to prolong the correspondence unduly as *'it relates only to our "appendix" demonstrations of compliance with the regulations'*. The Appointed Actuary also stated that he had provided a similar presentation on a number of occasions in the past without being questioned. GAD did not pursue the point further.

129 On 9 December 1994, shortly after the conclusion of the scrutiny of the 1993 returns, GAD and the DTI

[15] The apparent margin of £323 million, between Equitable's published valuation (£11,450 million) and their statutory minimum valuation (£11,130 million), fell to just £81 million when the resilience reserve of £236 million was added.

met Equitable. The meeting was the second with Equitable arranged as part of GAD's rolling programme of visits to life companies[16].

130 In preparing for the meeting, the DTI had noted GAD's comments, contained within their scrutiny report on the 1993 returns, about the prudence of the Society's assumptions in its valuation. The DTI also queried whether GAD had pursued these matters following the scrutiny but also commented:

> *The point which concerns me ... a little is that, as from the 1994 returns, it is not sufficient for the actuarial liabilities to be estimated prudently. Each of the assumptions which goes into the actuarial calculation has itself to be prudent. Equitable need to be alive to this.*

131 At the meeting on 9 December 1994, Equitable provided a number of reports and papers including details of their recent rating from Standard & Poor's of 'AA'[17]. The entry for that date within Part 3 of this report contains a fuller description of the information provided by the Society. In discussion on their bonus philosophy, Equitable commented:

> *... it was expected they would "overshoot" in 94 – they were not worried – but DTI may be!*

In response, GAD commented:

> *... that it looked like over-distribution, compared with market values.*

Equitable also commented that they were not concerned at how small their free assets got. The Society had, so far, chosen not to show an implicit item in its regulatory returns, as to do so *'would make them look weak'* – but, if the free asset ratio became negative, Equitable said that they would use a future profits implicit item and would not declare a bonus if they were unable to do so.

The Appointed Actuary asserted that a well managed office would not become insolvent in such circumstances and that a vigorous expanding office might have a low free asset ratio. It does not appear from the DTI's note of the meeting that this statement was challenged. There is nothing in the note of the meeting to suggest that there was any discussion of the DTI's concerns, which they had expressed prior to the meeting, about the need to ensure the prudence of each of the assumptions within the Society's valuation.

Events relevant to the 1994 returns

132 Following the meeting with Equitable in December 1994, the DTI reminded them that the Society had not yet submitted an application for a future profits implicit item for use in its 1994 returns. On 15 December 1994, Equitable sought a section 68 Order for an implicit item of £500 million. The calculations submitted in support of this application suggested that Equitable were entitled to seek an Order up to the value of £2,140 million.

133 In their review of the application in order to advise the DTI as to whether to grant the Order, GAD expressed concern at the way that Equitable had omitted from the calculations some exceptional losses even though they were not matched by exceptional profits. However, having reworked the calculations to eliminate the exceptional items, GAD concluded that a maximum implicit item of £1,590 million was still justified.

134 On GAD's recommendation, the DTI granted the Order, for possible use in Equitable's 1994 returns. When doing so, the DTI reminded Equitable that

[16] The first such meeting had been held in May 1992.
[17] See footnote 5, earlier in this Chapter.

exceptional losses should only be omitted if they were matched by exceptional profits.

135 On 4 January 1995, in response, Equitable stated that they *had* excluded exceptional losses only to the extent that they were matched by exceptional profits. The Society sought some more general advice from the DTI about how to treat profits and losses arising from changes in the valuation basis. This advice was not provided at that time.

136 On 23 March 1995, Equitable pressed the DTI for a response, explaining that they were now thinking of using the implicit item in their 1994 returns. The DTI sought advice from GAD and passed this on to Equitable.

137 On 27 March 1995, Equitable replied and acknowledged that they had not carried out past calculations in accordance with this advice, but stated that this had had *'... no material effect on the applications for a future profits implicit item submitted by the Society in previous years'*.

138 When considering this matter, the DTI noted that one GAD actuary took the view that *'the calculation of the implicit item was essentially flawed, and he didn't fuss too much about* [very] *technical details'*.

139 Meanwhile, Equitable raised a second query about the use of implicit items, pointing out that, in the Society's 1993 returns, the required resilience reserves were considerably below the available future profits implicit item. Equitable asked if, on this basis, it would be acceptable for the Appointed Actuary to conclude that no explicit reserve was required. GAD advised that this approach was not acceptable.

140 On 23 March 1995, Equitable told the DTI that their excess over the required minimum margin as at 31 December 1994 would be about £400 million, which would *'present a marginally stronger position than at the end of 1991'*. Equitable did not say what this figure represented in terms of cover for the required minimum margin.

141 On 13 April 1995, the DTI asked the Society again for an update on its liability for compensation payments for pensions mis-selling, which had first been requested in October 1994 but to which request the Society had not replied. Following this reminder, Equitable stated that it was not possible to quantify their liability, even crudely, but that the Appointed Actuary still believed that the Society's exposure was relatively small, adding:

> *We are therefore making no explicit provision against this contingency in the accounts although I have "over estimated" the technical liabilities by £50m as a very full implicit provision. Our auditors have given a "true and fair" certificate on our accounts in the new Insurance Accounts Directive in the full knowledge of our approach.*

142 I have seen that, at this time, the conduct of business regulators were still in correspondence with Equitable about their sales of pension policies. I have seen no evidence that the DTI checked the position with those regulators. During April 1995, discussions were also taking place within the DTI about the possible nomination of the Society's Chief Executive and Appointed Actuary for recognition in the New Year honours list for 1996. The factors cited in support of a nomination included that Equitable had no known pensions sales malpractice and had avoided the bad image afflicting the industry generally as a result of poor selling methods.

143 Equitable submitted their returns for 1994 on 30 June 1995. GAD completed their A1 Initial Scrutiny check on 24 July 1995. The design of the check form had changed and there was no longer an entry showing the cover for the required minimum margin. GAD identified no concerns.

144 GAD completed their A2 Initial Scrutiny check on 25 July 1995. GAD gave Equitable a priority rating of 3 (unchanged from the previous two years). GAD noted, again, that Equitable had not set up any reserves to meet their potential exposure for pension mis-selling and that there should be a *'check into mis-selling'*. GAD also noted that Equitable's mortality rates were reasonable *'but thin'*.

145 GAD identified mismatching as a worrying aspect and highlighted as other issues derivatives, ethical fund general investments, and reserves for contingent liabilities to tax on unrealised capital gains. GAD identified no items to notify to the DTI, to be taken up immediately with Equitable.

146 GAD took no further action on the 1994 returns until 8 December 1995, when GAD asked Equitable about their *'significant'* use of derivatives. In his reply of 14 December 1995, the Appointed Actuary pointed out that such derivatives accounted for only 0.1% of the Society's assets and denied that this was significant.

147 On 23 January 1996, GAD provided the DTI with a 20 page scrutiny report on the 1994 returns. The report followed the format used for the 1993 returns. In their report, GAD drew attention to a number of matters. GAD noted, *inter alia*:

- that GAD had derived much useful information from Equitable's With-Profits Guide of May 1994 and that they were requesting a later edition. (GAD had previously asked Equitable to send such documents routinely and Equitable had agreed.)

- that Equitable took advantage of their main valuation to *'hide'* their resilience reserve. GAD explained that at least a substantial part of the difference between the main and the appendix valuation was accounted for by the resilience reserve which was not disclosed. GAD said they would ask for this *'yet again'*.

- that, following the visit to Equitable in December 1994, it was known that the Society's Appointed Actuary had decided that its interests were best served by using a weak valuation basis, in order to show as strong a free asset position as possible (albeit that this had fallen in 1994). GAD stated:

> *This means that the valuation basis is selected at the limits of the regulations. This requires us to exercise particular vigilance in ensuring that users of the returns are not misled.*

GAD set out in tabular form the valuation rates of interest used by Equitable and compared these with the asset yields (although Equitable did not allocate specific yields to specific liabilities). GAD concluded that this gave rise to some doubt as to the sufficiency of the higher yielding assets and noted that, in the main valuation, cover for the required minimum margin was 2.36.

- that, for general annuities, Equitable used a mortality table showing death rates well in excess of recent industry experience.

- that one of the strengths in the Society's valuation was its assumption that recurrent single premium business would pay no more premiums, although this was *'arguably only in line with the best practice'*. GAD pointed out that, if the business were treated as regular premium business, the margins in future premiums might allow lower reserves and that it was likely *'that some credit is being taken implicitly for this in the expense reserves'*.

- that Equitable had had a few *'PIA and compliance problems'* but that GAD understood that these were not significant. GAD stated:

> *Although the Equitable take a highly esoteric line on a number of issues, and are inclined to argue their case rather longer than most, they have a culture which would not permit the continuation of a compliance breach.*

GAD explained that they were raising with Equitable areas of concern, the most pre-eminent of which were the Society's valuation rates of interest and mortality bases. GAD said that they were pressing Equitable on the latter point *'quite vigorously'*.

148 Also on 23 January 1996, GAD wrote to Equitable. GAD sought the latest version of Equitable's With-Profits Guide, asked that the amount of the resilience reserve required in the main valuation and a matching rectangle were both provided, the latter in order to demonstrate the notional allocation of assets to liabilities.

149 GAD asked the Society to provide this information in the new format that would be required for the 1996 returns. In addition, GAD asked Equitable to justify their mortality assumptions for annuitants and to explain how allowances had been made for future improvements in mortality rates, as well as for adverse deviations.

150 In response, on 21 February 1996 Equitable supplied their latest With-Profits Guide. The Appointed Actuary explained that the figure for the resilience reserves required in the main valuation was £171 million[18]. He provided matching rectangles. Because Equitable amalgamated liabilities, the Appointed Actuary explained that this information had been provided only *'approximately'* in the requested format.

151 The figures, as presented by Equitable, showed that the valuation rates of interest used were supported by the allocated assets. However, the notional matching was to reserves which excluded any resilience reserves. Equitable explained that their mortality experience was some 106% of the a(90) table, rated down one year.

152 The Appointed Actuary said that he felt that using this table was appropriate. However, as Equitable had experienced a modest improvement in mortality and that their 1994 experience was close to 100% of a(90)-1 year[19], the Appointed Actuary said that he would deduct a further year in future returns.

153 On receipt, GAD considered the information that Equitable had provided and noted that the figure for the resilience reserve was *'OK'*. GAD accepted the Appointed Actuary's wish not to publish the figure and simply asked him again to supply this information at the same time that future returns were submitted.

154 GAD also noted that the information provided by the Society as to the hypothecation of assets to liabilities was:

> *Supplied approximately in the requested format except that, surprise surprise, the resilience reserve is omitted. OK apart from the missing resilience line. It is probably pushing it a bit to complain and I intend to turn a blind eye.*

[18] The apparent margin of £301 million, between Equitable's published valuation (£12,380 million) and their statutory minimum valuation (£12,080 million), fell to £130 million when the resilience reserve of £171 million was added.
[19] See the glossary of terms for an explanation of this term.

GAD raised no objection to the Society's amalgamation of its liabilities, with the proviso that the valuation rate of interest used had to be the highest for the group. GAD concluded that Equitable's explanation of their mortality tables was 'OK for now'.

155 GAD wrote to the Society on 5 March 1996 and offered some advice to Equitable on the mortality tables that might be appropriate. Equitable replied on 3 April 1996, objecting to what they saw as GAD's intrusion into matters which the Society saw as being the preserve of its Appointed Actuary.

156 Following clarification by GAD of their remarks in a further letter, on 15 April 1996 Equitable stated that they shared GAD's concerns about the need to manage the risk of future improvements in mortality on an annuity portfolio. The Appointed Actuary added:

> *That was one of the reasons why we introduced our with profits annuity some years ago. Any unexpected improvement for that class could, of course be reflected in the bonus rate granted. You may be interested to know that around two thirds of our current immediate annuity new business is with profits.*

157 Meanwhile, on 5 March 1996 GAD sent the DTI an update on their scrutiny report. Taking account of the figure for the resilience reserves that had been provided by the Society, GAD assessed that, in the appendix valuation, the Society's cover for the required minimum margin was 2.65 and its free asset ratio was 4.1% (compared with 2.36 and 3.1%, respectively, in the main valuation).

158 GAD concluded:

> *We are now satisfied with the valuation basis. The net premium cover for the required minimum margin is greater than that for the published basis, and a priority of 4 could have been justified[20]. The scrutiny is now complete.*

Events relevant to the 1995 returns

159 Equitable submitted their returns for 1995 on 28 June 1996. GAD completed their A1 Initial Scrutiny check on 8 July 1996. GAD identified no concerns. GAD completed their A2 Initial Scrutiny check on 18 July 1996 and lowered Equitable's priority rating from 3 to 4.

160 GAD noted, among other things, that the reserve held by the Society for additional liabilities arising due to mortality strains caused by AIDS was contained within the reserve for future bonus in the main valuation, that unit costs had not been updated, that Equitable had used a future profits implicit item of £264 million, and that the Society's cover for the required minimum margin was 2.89.

161 GAD noted, again, that Equitable had not set up any provision to meet potential exposure for pension mis-selling but that the Society had indicated in April 1995 that technical liabilities had been *'overstated'* by £50 million. GAD identified no worrying aspects and no items to notify to the DTI, to be taken up immediately with Equitable. At the end of July 1996, Equitable sent GAD a copy of their latest With-Profits Guide.

162 GAD's initial target date for completing the detailed scrutiny of the Society's returns had been December 1996. However, this was brought forward to October 1996, apparently because of an impending visit to Equitable.

[20] That is, a lower priority.

163 On 1 November 1996, GAD provided the DTI with their 16 page scrutiny report on the 1995 returns. The report followed the format used since the 1993 returns. In their report, GAD drew attention to a number of matters. GAD noted, *inter alia*:

- that the Appointed Actuary:

> *... indicates that the resilience reserve required in relation to his net premium valuation would be covered by the difference between the bonus reserve gross premium valuation liability and the net premium valuation liability.*
>
> *This difference is revealed as £436m, and we have no reason to doubt its adequacy – although managing the distribution and consequent growth in guaranteed liabilities in respect of the very substantial (over £8.6bn) portfolio of unitised with profit type business is a potential problem to be monitored.*

GAD also observed that they were unconvinced of the value of Equitable's main valuation and would be happier to see a *'clearer exposition'* of Equitable's ability to react to possible falls in the value of their assets, particularly given their *'exceptionally large exposure to unitised with profit type liabilities'*. However, GAD did not indicate that they would seek an actual figure for the resilience reserve from Equitable.

- GAD noted that Equitable's main valuation:

> *... includes only an allowance for modest levels of future bonuses, with the result that the disclosed liability is actually very similar to that that would be derived from an acceptable net premium valuation with due allowance for resilience reserves. Thus, the picture shown above may reasonably be compared directly with other offices who prepare Returns on standard net premium valuation bases. Without the implicit future profits item, cover for the* [required minimum margin] *would be by a factor of 2.44. This is satisfactory.*

- that Equitable had revised their valuation rates of interests to reflect falling interest rates and rising asset values. GAD set out in tabular form the valuation rates of interest used by Equitable and compared these with the asset yields (although they did not allocate specific yields to specific liabilities). GAD concluded that the assumptions made by the Society were acceptable.

- that Equitable had revised their mortality assumptions for general annuities, following the discussion of their 1994 returns. GAD considered it desirable to keep pressing Equitable *'quite vigorously'* on this point as longevity improved.

- that, again, one of the strengths in the Society's valuation was the assumption that its recurrent single premium business would pay no more premiums, although this was *'arguably only in line with the best practice'*. GAD pointed out that, if the business were treated as regular premium business, the margins in future premiums might allow lower reserves and that it was likely *'that some credit is being taken implicitly for this in the expense reserves'*.

- that the Society's failure to set up a specific reserve for tax on capital gains of £37.4 million was *'dubious – relying on other margins in the valuation basis'*.

- that, although Equitable:

  ... might be expected to be beyond reproach, we understand that an over-estimation of pension liabilities of £50m has been incorporated into its reserves as a provision against possible costs arising from pensions mis-selling. No other [compliance] *problems are known.*

- that it would be helpful to learn what scenario-testing Equitable undertook.

164 GAD stated that they had not raised any points directly with Equitable. However, it was noted that GAD, with the DTI, were due to meet Equitable at the third of GAD's rolling programme of visits to life companies[21].

165 In their 1 November 1996 scrutiny report, GAD also suggested that, at the meeting, it would be *'interesting'* to discuss Equitable's continued fall in expenses, the reasons for their increased investment in non-insurance companies[22] and the sustainability of their present contract structures, the scenario tests they performed in relation to falls in assets values, and how they would react to *'sustained unfavourable market movements'*. On 5 November 1996, the DTI wrote to the Society to put these matters on the agenda.

166 The meeting took place on 8 November 1996. At the meeting, Equitable explained that their expenses had fallen partly in relative terms as a consequence of the high expenses which had been incurred in previous years because of their investment in information technology software. The Society offered some reassurance about its investment in non-insurance companies, explaining that it had majority holdings in some companies for investment purposes.

167 Equitable confirmed that they did not reserve for terminal bonuses, as these were whatever was left after the declared reversionary bonuses and thus *'instantaneous'*. Equitable acknowledged that their main valuation was not really any stronger than the appendix valuation. GAD expressed concern about the Society's bonus statements and warned that Equitable needed to ensure that customers were not misled.

168 Equitable, looking ahead, indicated that they might apply for a section 68 Order for a subordinated loan. The DTI had also signalled a wish to discuss the Society's liability for pensions mis-selling. The Appointed Actuary explained that, although £50 million had been included in the Society's technical reserves, it was his view that only £10 to £15 million would be needed.

169 Equitable also reported that a conduct of business team had visited them for a week earlier in the year. The Appointed Actuary told the meeting that he:

> *... thought* [the conduct of business regulators] *had misunderstood the issues, and* [he] *had sent them away! It was hoped that all cases would be settled by Autumn* [1997].

170 I have seen no evidence that the DTI checked the position after the meeting with the conduct of business regulators. Nor have I seen any other correspondence between the prudential regulators and Equitable about the 1995 returns or about any of the issues which had been discussed at the meeting on 8 November 1996. I have also seen no note from GAD to the DTI or to Equitable formally concluding their scrutiny of the 1995 returns.

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[21] The previous two meetings had been held in May 1992 and December 1994.

[22] GAD noted that the level of investment had increased from £52 million to £94 million. The latter figure represented 0.62% of Equitable's non-linked assets.

Events relevant to the 1996 returns

171 Equitable submitted their returns for 1996 on 30 June 1997. GAD completed their A1 Initial Scrutiny check on 18 July 1997. GAD identified no concerns. GAD completed their A2 Initial Scrutiny check on 7 August 1997. The check was more detailed than in the past. GAD raised Equitable's priority rating from 4 to 3. GAD highlighted a number of matters, including:

- that Equitable, as a major with-profits office, *'was unlikely to be insolvent but it may be building higher expectations than could be met'*;
- that the valuation basis appeared weak and that the valuation rates of interest used for certain with-profits business did not appear to make proper provision for policyholders' reasonable expectations;
- that the Society's matching rectangle might need review;
- that Equitable's description of discretionary adjustments relating to surrender values made during the reporting period was not satisfactory; and
- that it was not clear if Equitable had set up any identifiable pensions mis-selling reserves.

172 Under *'Aspects that look worrying'*, GAD noted that the Society had declared high reversionary bonuses for its substantial unitised with-profits business. Moreover, it was noted that Equitable held reduced reserves and could be relying too much on the potential application of market value adjusters.

173 Under *'Other Notes'*, GAD stated that reviews were required of the Society's mortality assumptions for their pensions and annuity business, their assumptions for unit growth rates for their unit-linked business, and their unitised with-profits reserves in the resilience scenario. GAD identified no items to notify to the DTI, to be taken up immediately with Equitable.

174 On 1 August 1997, the position whereby one person had held both the posts of Appointed Actuary and Chief Executive came to an end. On 8 August 1997, prompted by this change, GAD provided briefing about Equitable to the Government Actuary.

175 That briefing stated that, as a mutual, the Society made a *'strong play'* of not building an excessive estate which led to it declaring high non-guaranteed terminal bonuses on its substantial accumulating with-profits contracts. The briefing expressed doubts about the ability of Equitable to apply a market value adjustment in all the circumstances covered by the resilience test (which was what their valuation assumed). The briefing noted that Equitable had insisted that their bonus system gave them the necessary flexibility.

176 Before the 1996 returns were submitted, another issue – namely whether the Society should be permitted, as a mutual, to issue subordinated loan capital with the consent of the prudential regulators but not to recognise such capital as a liability – arose for consideration.

177 At the meeting with GAD and the DTI on 8 November 1996, Equitable had advised the DTI and GAD that they might apply for a section 68 Order for a subordinated loan. This matter had first been raised in 1993. At that time, GAD had made a number of observations, including the importance of subordinating the rights of depositors to those of policyholders. GAD had then commented:

> *As the rate of interest would presumably need to be fairly high, perhaps above the market*

rate, how would the issue of such deposits benefit the security and, more importantly, the reasonable expectations of members generally?

On GAD's advice, the DTI had put this query to the Society and had sought other information about this proposal. There is no record of a reply from Equitable to this query.

178 Following the meeting in November 1996, Equitable noted, internally, that the DTI appeared to be *'relaxed'* about the issue of the subordinated loan.

179 On 27 November 1996, the Society asked the DTI to indicate in principle if they would agree to the necessary application for a section 68 Order, in order to allow the Society to count the loan towards their required solvency margin. Equitable presented the proposal as a means of raising finance and providing benefits to policyholders.[23]

180 The DTI sought GAD's views. As in 1993, GAD was cautious about this proposal. In their reply to the DTI on 14 February 1997, GAD said that they were *'uncomfortable'* with the idea that Equitable could market the subordinated loan products, treat the proceeds as free capital, and not hold reserves to cover the repayment liability.

181 GAD also pointed out that the loan could only count for up to 25% of Equitable's required minimum margin and warned the DTI that they would need to be satisfied that early redemptions could not suddenly threaten cover for the required minimum margin of solvency.

182 On 14 March 1997, Equitable signalled their hope that it would not be necessary to set up a subsidiary company and also their wish to pursue the proposal swiftly. On 24 March 1997, GAD told the DTI that they understood it to be that department's view that it would not be possible to satisfactorily issue subordinated debt from within a company's long term fund.

183 GAD also said that a proper degree of subordination could best be achieved if the debt were issued through a subsidiary company. There followed further exchanges between the DTI, GAD and Equitable.

184 GAD remained unconvinced about the proposal. In further advice to the DTI, given on 29 April 1997, GAD questioned in what way it would be possible for the loan to be treated as not being a liability on the long term fund and how Equitable could make interest payments and eventual capital repayment, if they held no assets outside the long term fund. Equitable's proposal initially involved loans potentially of the value of £325 million.

185 GAD pointed out:

It should be appreciated by the DTI that the potential sums involved in these proposed issues are substantial ... and this amount of gearing could cause problems to the Society unless the terms are reasonable and proper subordination to policyholder rights is achieved.

186 The DTI's legal advisers shared the view that a subordinated loan taken out by a mutual was likely to constitute a liability on the long term fund. But, in advice given on 9 May 1997, those advisers noted that the DTI had already issued section 68 concessions to mutuals:

[23] However, I have seen that, in a report to Equitable's Board in January 1997, the Appointed Actuary had justified the pursuit of a subordinated loan by reference to Equitable's relatively weak solvency position, the tightening of the valuation regulations and the way they were interpreted, and the increased scope for GAD to challenge his choice of bases. This report was not seen by the prudential regulators or GAD at that time.

... despite the apparent lacking of the safeguard that would be in place in a proprietary company.

The legal advisers suggested that the DTI should not change what had become their policy, namely to agree a section 68 Order, subject to the proposal being reasonable – particularly in relation to adequate subordination. They also drew attention to Prudential Guidance Note 1994/1 on hybrid capital, which had set out the need to establish a proper degree of subordination[24]. But they also considered that it was not necessary for there to be a subsidiary company to achieve this and that the terms of Equitable's proposal already demonstrated the necessary subordination.

187 Equitable continued to share the view that it should not be necessary to set up a subsidiary company. Discussions continued on this basis, although GAD remained *'uncomfortable'* about the proposal, citing the advice in Prudential Guidance Note 1994/1. In the event, on 3 July 1997, Equitable changed their approach. The Society announced that it now proposed a subordinated loan of £350 million and that:

In line with market practice, the issuer will be a wholly owned subsidiary of the Society and the issue will be guaranteed by the Society.

188 Having considered the issue again, on 25 July 1997 GAD told the DTI that they were satisfied that the revised proposal was acceptable and in line with precedent. The outstanding details were settled and, on 20 August 1997, the DTI issued the necessary section 68 Order to allow Equitable to count the loan towards their required solvency margin.

189 While the scrutiny of the 1996 returns was underway, other issues arose. On 26 September 1997, the Government Actuary met with Equitable's new Appointed Actuary.

190 On 30 September 1997, the DTI had again asked Equitable and other companies for details of their provision for potential liabilities arising from pensions mis-selling. On 24 October 1997, Equitable replied and explained that their estimated liability was £85 million compared with £50 million as at the end of 1996.

191 The Appointed Actuary stated that one reason for this increase was that a number of cases had been brought back into their review following discussions with the conduct of business regulators. He anticipated showing the provision more explicitly in the Society's 1997 returns[25]. I have seen no evidence that the DTI checked the position with the conduct of business regulators in the light of this information.

192 On 17 November 1997, the administrators of the NHS pension scheme wrote to the DTI. Those administrators explained that they were reviewing the NHS's arrangements for enabling members of their occupational pension scheme to make additional voluntary contributions (AVCs).

193 The administrators said that they were considering appointing Equitable as their AVC provider and needed further information in order to advise the Secretary of State for Health, as the sponsoring employer, whether to do so. The administrators asked the DTI if there had been any points of contention with Equitable within the last three years or whether there were any material facts of which the Secretary of State should be aware before a decision was made.

[24] See paragraphs 715 to 723 of Part 2 of this report.
[25] In May 1998, Equitable explained that their estimated liability was now £75 million.

194 The DTI sought the views of their lawyers and also other internal advice. In seeking the view of officials, the DTI line supervisor responsible for Equitable said:

> *To my knowledge there are no outstanding supervisory "points of contention" with Equitable Life (and would we say anything if there were?) ... Personal pensions mis-selling — Equitable appears to be getting on well with this — as at 30/9/97 compensation offers of £11m had been made. Total provision at 30/9/97 is £85m, including non-priority cases. New Chief Executive from 1/7/97 and separate Appointed Actuary. Previously* [the Chief Executive] *was also the* [Appointed Actuary]. *Issue of £350m subordinated loan capital August 1997. Future profits implicit item agreed for 1997 returns of £700m.*

195 The DTI line supervisor also noted that, as at 31 December 1996, Equitable's cover for the required minimum margin had been 2.53. Against this, an official noted that, without the future profits implicit item, the cover would be 2.07.

196 It was agreed that the DTI should reply to the NHS scheme administrators, confirming Equitable's solvency position and indicating that the DTI were not aware of any matters that should be brought to the Secretary of State's attention. On 26 November 1997, the DTI did so and informed the administrators of the NHS pension scheme that, on the basis of Equitable's 1996 returns, and in the absence of interim information, they would say that the company was financially sound. The DTI added that there were *'no outstanding issues of a material nature pertaining to DTI's regulation of the Equitable Life Assurance Society ...'*.

197 The wording in the letter was based on one sent in respect of another company, although the DTI recorded that they had omitted a reference from the precedent letter to strong solvency cover of more than 6.00 because, in the Society's case, *'their solvency cover* [without] *the implicit item is* [2.07], *which isn't that hot'*.

198 On 16 December 1997, GAD provided the DTI with their 19 page scrutiny report on the 1996 returns. The report followed the format used since the 1993 returns. In their report, GAD drew attention to a number of matters. GAD noted, *inter alia*:

- that Equitable had a *'modest free estate'*.
- that there was one hidden strength in the valuation basis relating to the Society's treatment of recurrent single premium contracts, where it was assumed that no further premiums would be received. GAD note that this was in line with best practice.
- that it was thought that the resilience reserve should be a grossed up figure of £668 million, rather than the £501 million reported.
- that the Society's main valuation did not appear to be any stronger than its appendix valuation.
- that the Society's mortality bases were *'reasonably conservative'*, and Equitable had insisted in the returns that they contained sufficient allowance for future improvements.
- that, as reversionary bonuses included credit for asset appreciation (that is, as yet unrealised gains), future bonuses appeared vulnerable to a sustained stock market downturn and that it would seem desirable for policyholders to be given greater warning of this.

- that Equitable reserved the right to penalise early surrenders, including guaranteed benefits under unitised contracts, and that it might be desirable to give this greater prominence in their literature.

- that the Society's failure to set up a specific reserve for the contingent liability to tax on unrealised capital gains of £47.7 million was, as had been the case in 1995, *'dubious – relying on other margins in the valuation basis'*.

- that, while Equitable had included in the main valuation a reserve of £50 million for the potential liability from pensions mis-selling, it was not clear if a similar provision had been established in the appendix valuation.

- that Equitable *'informs its holders of accumulating with profit contracts of the amount of their accumulating final bonus (although clearly stating that it is not guaranteed), but only holds reserves for a discounted sum compared with the current guaranteed value'*.

GAD explained to DTI that:

> *Because of the large proportion of business written on a participating basis and the high level of annual emerging surplus, there are not considered to be any actual potential solvency problems for the Society, but it does seem that, in the event of a marked fall in asset values, the Society might find itself in a position where it had to cut back severely the level of payout to members.*
>
> *It would seem desirable for the Society to hold back more of its emerging surplus by declaring lower guaranteed bonuses – although it could still attempt to pay out generous final bonuses to members (preferably without raising expectations too much in advance with its declarations of "non-guaranteed final bonuses").*

GAD said that they were taking up a number of points with Equitable, including the provision made for resilience, possible tax on capital gains, and pensions mis-selling.

199 Also on 16 December 1997, GAD pursued five specific issues with Equitable:

- GAD pointed out that Equitable did not state which assets were backing the required resilience reserve. GAD queried if the figure indicated in the report on the appendix valuation (£501 million) should be grossed up.

- GAD queried whether it was acceptable for Equitable to assert that other margins were available to cover the contingent liability to tax on unrealised capital gains and invited Equitable to advise what other margins were considered to be available.

- GAD noted the provision for £50 million for pensions mis-selling in the main valuation and asked where the corresponding provision was in the appendix valuation.

- GAD noted that Equitable stated that terminal bonus additions were implicitly covered by the amount of excess admissible assets held over the mathematical reserves — shown in the 1996 returns as being about £1,400 million (including the required minimum margin). GAD added:

  > *However, since your reserves already value <u>current guaranteed</u> benefit values at a combined discount of some £1.3bn, it seems likely that the total current*

"asset shares" (including the final bonuses indicated to members) exceed total current admissible assets. Is this a correct deduction? Please provide a figure for the accumulated asset shares for all in-force accumulating with-profit contracts at end 1996.

- GAD asked if the reserves for any accumulating with-profits policies were less than the basic surrender values (i.e. excluding terminal bonus) available on the valuation date and, if so, what was the total of those differences.

200 In their initial scrutiny report on 7 August 1997, GAD had noted that Equitable did not appear to have made proper provision for policyholders' reasonable expectations in the valuation rates of interest used for with-profits business. GAD did not refer to this issue in their detailed scrutiny report nor did they pursue it with the Society.

201 On 13 January 1998, Equitable replied to each of GAD's five queries. They explained:

- that the resilience reserve required in the appendix basis *was* the grossed-up value.
- that substantial margins were available in the expense reserves that could be used to cover the contingent liability to tax on unrealised capital gains. The Appointed Actuary suggested that, as the tax would essentially relate to gains that Equitable would distribute as terminal bonus, it was not necessary to reserve for it.
- that a provision for pensions mis-selling was held in the appendix valuation, on a similar basis to that held in the main valuation.
- that they were unclear what GAD meant by their question, explaining that: *'The face value of benefits is the current value of guaranteed benefits if a contractual event (e.g. death) occurred at the valuation date. In most cases there is no contractual right to receive the current accumulated benefit at the valuation date'*. Equitable went on to say that GAD were *'correct in deducing that at 31.12.96 the total face value of policies including accrued final bonus was in excess of the value of the assets attributable to the with profits business. Those assets will include items like the accumulated new business strains and so are higher than a pure share of the Form 9 admissible assets'*. For accumulating with-profits business, the total smoothed asset shares at 31 December 1996 were some £14,700 million.
- that surrender values were not guaranteed for Equitable's accumulating with-profits business. The Society said that the valuation *'took account of the range of ages at which benefits could be taken at full value, including on retirement, which explains why the discounted value of benefits was 95% of their face value when the typical outstanding period to the selected pension date would lead one to expect a much more substantial degree of discounting'*. Equitable did not answer GAD's question as to whether reserves were less than the surrender values for any policies as at 31 December 1996.

202 On 16 January 1998, GAD wrote again to Equitable:

- GAD stated that it would be easier for them to follow the resilience reserve calculation if this reserve were included in the matching rectangle. GAD asked Equitable to reconcile the change in asset and liability values in the resilience scenario disclosed in the main valuation and the change disclosed in the appendix valuation (as the figures were different).

- GAD stated that they were not convinced that it was appropriate to use margins within the expense reserves to cover the contingent liability to tax on unrealised capital gains. Neither did GAD accept Equitable's view that they did not need to reserve for this liability. GAD asked Equitable to reconsider this matter for the 1997 returns.

- GAD noted that the reserve for pensions mis-selling was included in the reserves for personal pensions business in the appendix valuation. GAD asked Equitable to disclose this reserve separately in future returns.

- GAD accepted that the amount of the current face value of guaranteed benefits was not immediately payable at the valuation date. However, GAD noted that the total asset share for accumulating with-profits business of £14,700 million exceeded the reserves in the appendix basis by £3,800 million. This, they said, clearly exceeded the amount of free assets shown in the returns. GAD stated that, whilst this did not necessarily cause concern, the lack of a free estate highlighted the importance of not building up policyholders' expectations too far.

- GAD again asked Equitable to confirm whether the policy reserves in the appendix valuation for any accumulating with-profits policies were less than the basic surrender values (i.e. excluding final bonus) available on the valuation date.

On the same day, GAD provided the Treasury[26] with copies of their post scrutiny correspondence with Equitable.

203 On 4 February 1998, the Society responded to GAD's further queries. The Appointed Actuary:

- explained that the differing amounts quoted for the change in asset and liability values were accounted for by the differing treatment of index-linked business.

- noted GAD's comments and undertook to reconsider the matter for the 1997 returns.

- explained that the Society's approach in the 1996 returns reflected the difficulty of quantifying the amount of the possible liability. He stated that, as Equitable now had more data, he would be *'showing an explicit reserve in the 1997 returns'*.

- suggested that the figures given by GAD in their letter of 16 January might have somewhat misrepresented the position, as GAD had compared the excess of policy values over the appendix net premium reserves with the available assets shown in Form 9 of the returns, which were determined by reference to the reserves established under the main (gross premium) valuation.[27]

- explained that the Society took great care to emphasise that the final bonus element of the current policy value was not guaranteed in any way. He suggested that declared bonuses were being kept imprudently high by some offices, particularly on with-profits bonds *'partly due to a failure of* [those] *offices to communicate the developing terminal bonus position adequately to their clients'*.

[26] Responsibility for prudential regulation had passed from DTI to the Treasury on 5 January 1998.
[27] GAD subsequently pointed out, on 27 February 1998, that the available assets, calculated by reference to the appendix valuation reserves (including the resilience reserves), were in fact very little different from those shown in the main valuation.

- again did not answer GAD's question regarding whether the policy reserves in the appendix valuation were less than basic surrender values.

204 On 27 February 1998, GAD wrote once more to Equitable to seek a response to the last point. GAD stated:

> *It is clearly in the best interests of the whole industry for all participants to be wary of either granting over-generous guaranteed bonuses or of building up any false expectations in relation to final bonuses. The manner in which Equitable operates as a mutual – giving the best possible returns to each generation of policyholders, with the consequent lack of any substantial unutilised free estate, does mean that you do not have much of a cushion to enable you to protect holders of such contracts from the natural effects of future falls in the market value of assets. We remain confident that your company is fully aware of this.*

On the same day, GAD advised the Treasury that there were no compliance points in relation to the 1996 returns to follow up. GAD confirmed that:

> *... even though our correspondence is not yet concluded about their accumulating with-profit business we are basically satisfied with the prudence of their reserving bases as adopted for the 1996 returns.*
>
> *The position revealed is very tight, since Equitable operates on the basis that, as a mutual, it should endeavour to give full value to each generation of policyholders. It therefore does not accumulate any meaningful free estate. Hence our desire to ensure that it does not build up any false expectations for its policyholders, because it would be hard for it to establish reserves for any greater liabilities than those it currently recognises.*

GAD concluded that the Treasury could regard the scrutiny of the 1996 returns as complete.

205 On 12 March 1998, the Society's Appointed Actuary wrote to GAD to explain that he now understood the question about whether any reserves for accumulating with-profits policies were less than basic surrender values.

206 He stated that the Society could not *'state categorically that the non-contractual surrenders we were actually paying on 31 December 1996 were, in all cases, lower than the mathematical reserves held'*. The Appointed Actuary added that he was not clear as to the relevance of the point raised by GAD, as:

> *The surrender values being paid were only "available" because we were prepared to pay them on the low incidence of early non-contractual terminations being experienced. If we had been experiencing a significant volume of surrenders we should have exercised our right to reduce further the values paid – possibly to below the level of the mathematical reserves in all cases – in order to protect the fund.*

207 In the light of this further exchange, GAD invited Equitable to a meeting to discuss the issue. GAD explained that:

> *The whole area of the appropriate bonus methodology to be used for accumulating with-profits business, the expectations built up for policy holders and the establishment of proper reserves has become more difficult as a greater proportion of investment returns is being derived from asset appreciation – which could prove to be ephemeral.*

208 On 28 May 1998, GAD met Equitable. GAD made no formal record of the meeting but noted the following:

> *Non* [guaranteed] *element could be negative.*
>
> *Particular problems with Bonds rather than pensions* [business].
>
> *Has company done specific market research on policyholder understandings? Analysed telephone queries.*
>
> *Further discussion to take place on reserves. – Equitable.*
>
> *Discussed PRE surrender test.*

209 According to the Society's note of the meeting, the discussion had been fairly unstructured and GAD had gone through a *'ragbag of not particularly well thought through concerns'* that they had. However, GAD's main points had seemed to be that *'Declared bonus rates are still too high'*, that offices had been incautious in distributing recent high capital returns and that it would be difficult to change terminal bonuses without *'severely damaging policyholders' perceptions of them'*.

210 Equitable also recorded that, at the meeting, they had strongly refuted GAD's concern that the Society was more exposed to these risks than most other life insurance companies, as a result of its 'full distribution' approach to bonuses and anecdotal evidence that policyholders believed their full fund value to be guaranteed. The Society's note recorded that GAD had stated that GAD were *'considerably more reassured about our approach than they had been at the start'*.

211 Following the meeting, GAD explained in a letter to Equitable on 8 June 1998 that:

> *I think that there is little more to be said or done at this stage in relation to the reserving bases that are appropriate for accumulating with-profits business but it is clear that we are agree*d *that great restraint should be exercised in relation to the setting of guaranteed bonus levels at a time when a large part of investment returns is being derived from capital gains.*

212 On 8 June 1998, GAD provided an update to the Treasury on the position. GAD confirmed that, in the light of those discussions, GAD *'did not conclude that any particular strengthening of their reserves was needed in relation to accumulating with-profits business, although I remain somewhat concerned that not all holders of such contracts (with this and other offices) appreciate what could happen at future bonus declarations if we saw a sudden downturn in the market values of assets. The whole industry is relying on a soft landing, so that reductions can be achieved gradually and without trauma'*.

213 Events were soon to take a different turn for the prudential regulation of the Society. In the next Chapter, I turn to summarise those events.

Chapter 7 – The prudential regulation of Equitable in the period between 20 June 1998 and 8 December 2000

Introduction

1 In this Chapter, I summarise the way in which the prudential regulation of the Society was undertaken during the period from 20 June 1998 until the Society closed to new business on 8 December 2000.

2 As was explained in Chapter 6 of this report, this covers a period where the supervision of the Society was undertaken with heightened intensity as a result of information provided by it to the prudential regulators and GAD concerning serious financial difficulties which Equitable faced. This Chapter is structured in the following way:

- in paragraphs 3 to 12, I explain how the Society's annuity guarantees problem became known to the prudential regulators and GAD;
- in paragraphs 13 to 60, I explain how those regulators and GAD reacted to the Society's guaranteed annuity issue and how, in particular, they dealt with three questions that arose for consideration, relating to:
  - (i) the Society's practice as to reserving for the annuity guarantees, which I cover in paragraphs 17 to 41;
  - (ii) what the Society had told its policyholders, which I cover in paragraphs 42 to 52; and
  - (iii) what the Society had told the prudential regulators and GAD, which I cover in paragraphs 53 to 60;
- in paragraphs 61 to 75, I set out the events relevant to the consideration given by the prudential regulators and GAD to the Society's financial position in the immediate aftermath of their awareness of the annuity guarantees problem;
- in paragraphs 76 to 172, I summarise, on a month-by-month basis, the events which occurred during the period starting from the preparations for the handover on 1 January 1999 of regulatory functions from the Treasury to the FSA and ending with the decision of the House of Lords in the *Hyman* case, which was handed down on 20 July 2000; and
- in paragraphs 173 to 231, I summarise the events which occurred during the period between the *Hyman* judgment and the Society's decision to close to new business on 8 December 2000.

The Society's GAR problem

The intimation of the problem

3 On 20 June 1998, GAD wrote to all life insurance companies enclosing a questionnaire seeking information on the annuity guarantees they had written, their methods of reserving for such guarantees, and related issues.

4 GAD's survey followed a similar exercise (which they had instigated) undertaken by the actuarial profession who, in January 1997, had set up an Annuity Guarantees Working Party to consider the issue of annuity guarantees and how companies should reserve for them in the context of low interest rates and improved mortality, which made such guarantees more valuable. As part of their enquiries, the profession's Working Party had surveyed offices that had written business containing guaranteed annuity rates.

5 On 1 November 1997, the Working Party published its report and approximately one month later, at the profession's annual Life Convention held from 30 November 1997 to 2 December 1997, that Working Party presented their findings to the industry.

6 Their report, which dealt with companies on an anonymous basis, identified three approaches to reserving for contracts containing annuity guarantees that had been used by companies, none of which were found to be entirely satisfactory. One of the approaches identified involved covering the guarantees by adjustments to terminal bonus. The Working Party considered that this *'could be viewed as unsound because no explicit provision is made for an explicit guarantee'*.

7 One of the members of the Working Party had been an actuary from GAD, who was party to the results of their work. However, it has been said that the Working Party had collected the information which underpinned their conclusions on a confidential basis and GAD considered that it could not use this information for other purposes, including in providing assistance and advice to the prudential regulators.

8 On 10 February 1998 at an internal directorate meeting, GAD discussed the annuity guarantee issue and the fact that the findings of the profession's Working Party demonstrated that a problem existed and that 75% of companies were not reserving properly[1]. The minutes of that meeting record that GAD had decided to conduct its own survey into the issue.

9 On 18 June 1998, GAD informed the Treasury that they intended to conduct a survey of companies about annuity guarantees. GAD explained that *'a number of* [companies which had sold policies containing guaranteed annuity rates] *may now be significantly exposed to additional liabilities in respect of these guarantees'*. On 19 June 1998, the Treasury gave their agreement for GAD to conduct the survey. GAD sent out the survey questionnaires on the following day.

10 On 29 July 1998, Equitable submitted their completed questionnaire to GAD. In this, the Society explained:

- that Equitable had sold policies between 1956 and 1988 which carried a guaranteed annuity rate (which also applied to future premiums);
- that Equitable did not reserve for those guarantees (against this, GAD wrote '?');
- that Equitable made no general allowance for the guarantees, when establishing maturity values, and took no significant account of the guarantees when determining investment policy and matching guidelines;
- that, for any policy for which the annuity guarantee was 'biting' (that is, where such a guarantee had become more advantageous than an alternative option), Equitable reduced the amount of terminal bonus to pay for the cost of the guarantee; and
- that Equitable did not advise policyholders of any available options to receive a guaranteed annuity when they reached retirement (against this, GAD also wrote '?').

Equitable added as a final comment:

> *The cost of annuity guarantees has more than adequately been covered by the terminal bonus cushion to date for all but a few small policies, as described ... above. As the business to which annuity guarantees apply ages, the increasing terminal bonus cushion will make it increasingly unlikely that guarantees will actually bite.*

[1] It appears that GAD did not inform the Treasury at this time that they were aware that such a problem existed.

GAD sidelined this comment and wrote: *'Is this acceptable?'*.

11 This constituted disclosure of the GAR issue – that is, that the Society had extensive exposure in its older business to such guarantees and that it had made no explicit provision for the liabilities arising from those guarantees.

12 That disclosure gave to the prudential regulators and to GAD a clear indication that the Society's reported financial position might not have been prudent and that its liabilities might have been understated. Those issues still had to be resolved. An enhanced level of scrutiny and supervision was now to be given to the Society.

Regulatory treatment of the GAR issue

13 On 1 September 1998, GAD wrote to the Treasury concerning the monitoring of the behaviour of companies towards policyholders whose policies contained a valuable guarantee. GAD advised that the Treasury had a duty to ensure that insurance companies did not try to avoid meeting their obligations, as this would be a breach of policyholders' reasonable expectations. GAD suggested that the Treasury had a number of options, those being:

- to advise all companies that avoiding their obligations would constitute unacceptable behaviour;
- to ask all companies to report on the procedures that were in place to ensure that guaranteed rates would be applied in maturity option quotations, and that the existence of options was made known (although GAD queried this internally as being perhaps *'a step too far'*);
- to use any policyholder complaint or one made by an independent financial adviser as a trigger for a visit to review a company's procedures in these respects;
- to carry out an investigation under section 43A of the 1982 Act[2] should there be any subsequent failures; and
- to take further action, including a review of cases and consideration of 'fit and proper' action[3], if a substantial problem were identified.

14 On 3 September 1998, the Treasury's Head of Life Insurance welcomed GAD's note as a clarification of the issues. At the same time, in the light of press attention being given both to annuity guarantees and to Equitable, and prior to the Treasury contracting out their prudential regulatory functions to the FSA[4], he advised the relevant FSA Managing Director of the action that the prudential regulators and their advisers had taken on annuity guarantees.

15 The Treasury explained that, *'when it became clear that a number of companies had issued policies with these guarantees'*, GAD, on the Treasury's behalf, had written to all companies seeking information about such guarantees and how those companies had reserved for them.

[2] This empowered the prudential regulators to appoint one or more competent persons to make an investigation into, and report to those regulators on, (a) whether the criteria of sound and prudent management were fulfilled with respect to an insurance company, or (b) whether those criteria would be so fulfilled if a person notified to the prudential regulators as intending to become a controller of such a company were to become such a controller.
[3] That is, action under section 37(2)(aa) of Insurance Companies Act 1982.
[4] See paragraphs 914 to 918 of Part 2 of this report.

16 On 15 September 1998, GAD advised the Treasury to explore further the issue of meeting the costs of providing guaranteed annuity rates by reducing terminal bonus. There followed, over the next three months, detailed correspondence between the Treasury and the Society about the latter's approach. Officials from the Treasury and GAD also met Equitable four times. In the course of these exchanges, three questions emerged:

(i) Did Equitable need to reserve for the annuity guarantees within the policies that they had sold – and, if so, at what level?

(ii) What had Equitable told their policyholders about their practice?

(iii) What had Equitable told the prudential regulators?

Reserving for annuity guarantees

17 The first question which arose in the discussions between the Society and the prudential regulators and GAD concerned the approach which Equitable took to the establishment of the reserves required in respect of those policies which contained guaranteed annuity rates. Throughout those discussions, the Society defended its approach robustly.

18 On 29 September 1998, the Society explained that it had introduced the differential terminal bonus policy in order to be fair to all policyholders (in that this resulted in benefits of broadly equivalent value, irrespective of whether or not a guaranteed annuity was taken). Equitable stated that this had been their policy since the end of 1993.

19 Equitable, in their response to GAD's questionnaire, had implied that the Society had not reserved in its 1997 returns for the annuity guarantees because, where the guaranteed rate was 'biting' (i.e. the guaranteed rate was higher than any available current annuity rate), Equitable were protected by the cushion of the differential terminal bonus policy. In the subsequent exchanges with the Treasury and GAD, Equitable informed those regulators and GAD that the position had changed.

20 On 2 October 1998, at a meeting with the Treasury and GAD, Equitable's Chief Executive stated that:

> *... no provision had been made for GAOs as at 31 December 1997 since it had only been recently that the guarantees were biting on the guaranteed fund. The Equitable does not as a matter of course reserve for GAOs that exist on policies; the recent practice has only been to reserve once the guarantees bite.*[5]

21 Equitable further explained that, even where the guarantees were more advantageous than the open market option, there had been a low take-up of the guaranteed options.

[5] Equitable's former Appointed Actuary in post at that time has told me that there was no change to the Society's reserving practice over this period. He said: *'The Society's approach was that reserving could reflect actual and expected policyholder behaviour, in terms of the proportion of policy benefits that could reasonably be expected to be taken in guaranteed annuity form. Up to and including the end of 1997, financial conditions were such that that proportion was effectively nil because, as stated in the survey response, conditions were such that the DTBP could be expected to result in GAR benefits of no higher value than the "cash based" alternative in all but a trivial proportion of cases. The sharp fall in interest rates in 1998 had changed that position so that, by the time of the meetings, the GAR was "biting" in the sense that, even with a zero final bonus, the GAR benefits were more valuable than the alternative. In those changed conditions, it was now reasonable to expect some level of take-up of guaranteed benefits. The Society had accepted that that change of conditions meant further reserves were needed at the end of 1998 – the debate was around the level of those further reserves (the Society suggested that assuming a take-up rate of GAR benefits of 25-35% would be appropriate)'.*

22 On 30 October 1998, Equitable stated that, in the first nine months of 1998, only 3% of retirement annuity benefits had been taken in the form of a conventional non-profit annuity. Equitable also stated that '[all] *retirement cases are checked to determine whether, if a conventional non-profits annuity is required, the guaranteed annuity rate will produce a higher level of income*'[6] than a conventional non-profit annuity at the current rate. This, they said, had been so in around 30% of cases.

23 Equitable said that they had advised the policyholders concerned but none had taken up the guaranteed option[7]. The Society concluded that, in a worst case scenario of 100% take up of those guaranteed options which produced a higher income, the reserving requirement amounted to some £170 million and that their 1998 experience suggested that £50 million would be the more likely cost.

24 For their part, GAD took the view from the outset that guarantees had to be reserved for, whether or not they were more advantageous. On 3 November 1998, GAD observed that the Society's analysis at the end of October 1998:

> *... does not take account of the key point that the existence of a guaranteed annuity rate increases the level of cash that needs to be paid in substitution for that annuity (as otherwise policyholders would not agree to take the cash sum in place of the guaranteed annuity).*

GAD advised the Treasury that:

> *... appropriate mathematical reserves need to be established for the full value of these guaranteed benefits and the associated obligations to policyholders in accordance with Part IX of* [the Insurance Companies Regulations 1994]*, including in particular Regulation 64. It is not acceptable in this context to regard these guarantees as covered by a "first charge" against a final bonus for which no provision is made.*

GAD stated that, on this basis, a reserve of £170 million was quite inappropriate and advised the Treasury to ask Equitable how they proposed establishing the reserve that was required. GAD also suggested that, if the Society were unable to meet this obligation, intervention using the powers available to the prudential regulators might be warranted. GAD added that *'we believe that policyholders would expect Equitable to maintain adequate mathematical reserves to cover their obligations'.*

25 The Treasury conveyed those views in writing to the Society on 5 November 1998 and also at a meeting on 13 November 1998. On 24 November 1998 in response, Equitable estimated that, using the Treasury's approach, the reserving requirement at the end of 1997 would have been approximately £675 million. Equitable estimated the equivalent figure for the end of 1998 could be between £955 million and £1,360 million. An annotation made by GAD on the Society's letter suggested that GAD considered that the figure might actually be as high as £1,650 million.

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[6] Equitable's former Appointed Actuary has told me that: *'Cases were not routinely checked at the time of the survey response because by then interest rates had not fallen to a level which was likely to lead to more valuable benefits in GAR form. Checking of all retirements was introduced a little later in 1998 following further falls in interest rates and, once introduced, applied to 100% of cases.'*

[7] Equitable made no reference here to the role of the differential terminal bonus policy, which was designed to ensure that there was, in fact, no difference in the benefits produced if a policyholder elected to take a guaranteed annuity. Equitable's Counsel subsequently recorded in the factual background of his Opinion on the reserving implications of annuity guarantees that the differential terminal bonus policy had *'substantially influenced'* the low take-up of an annuity at the guaranteed rate specified in the policy.

26 The Society continued to dispute strongly the requirement that it should reserve on the basis of 100% take up of guaranteed annuity options. On 24 November 1998, Equitable suggested that there was some misunderstanding of the precise policy benefits in question which the exchanges with the Treasury and GAD had not resolved.

27 The Society accordingly provided three examples of how the differential terminal bonus policy was applied, in order to demonstrate *'why the vast majority of policyholders selected the cash fund* [that is, the open market] *form of benefit'* rather than the guaranteed annuity. Equitable claimed that their approach to reserving fulfilled the requirements of the applicable Regulations. The Society warned that the consequences for it of adopting GAD's approach to reserving were *'potentially extremely serious'*.

28 Equitable then set out five options available to them in those circumstances:

(i) *Passing* [that is, not making] *the bonus declaration, either for all business or for the classes incorporating guaranteed annuity rates.*

(ii) *Raising capital either through further subordinated debt (limited scope at present) or financial reassurance.*

(iii) *Trying to obtain some sort of protection based on derivatives.*

(iv) *Publishing a* [statement of solvency] *where the required minimum margin is only just covered.*

(v) *Making a sizeable switch from equities to fixed interest or cash.*

The Society went on to explain:

> *Of the above (ii) is now probably rather difficult to put in place by 31 December* [1998] *and there must be doubts as to how effective (iii) could be. Approaches (i) – (iv) carry very significant* [public relations] *risks – possibly of a scale which would threaten the continued independence of the Office. Approach (v) will damage the future prospects of policyholders for a number of years.*

29 GAD remained of the clear view that Equitable had to reserve in full. At the meeting on 3 December 1998, the Society's Chief Executive stated that *'the reserving basis required was excessively prudent and bore no resemblance to commercial reality and policyholders would be damaged by this (through a change to a more conservative investment policy, passing bonuses or through there being a run on the office)'*.

30 The Chief Executive was told by the Treasury's Head of Life Insurance that he could not see any scope for granting Equitable any concession, as the reserving requirements derived from European Directives. Equitable's Chief Executive was also told that the only avenue of appeal would be to seek judicial review of the Treasury's decision. The Chief Executive said that the Society *'might well have to take up this option'*.

31 In response to the suggestion from GAD's Chief Actuary C that financial reinsurance could be used to offset their reserving requirements, Equitable's Appointed Actuary confirmed that he had considered that that was '[an] *option for protecting the balance sheet'*. However, the Appointed Actuary pointed out that it was unlikely that any reinsurance agreement could be put in place by 31 December 1998.

32 The Treasury said that, in those circumstances, it might be possible for the prudential regulators to grant Equitable a concession so that the effect of any such agreement was pre-dated to cover the 1998 year-end position.

33 The Appointed Actuary expressed his concern that *'from a professional point of view ... he was being forced to adopt a reserving approach that was "wildly prudent"'*. He said that he might have to consult the actuarial profession on that matter.

34 In response to this, GAD's Chief Actuary C said that he did not think there was a professional issue to consider as, in his view, '[there] *was ... a distinction between the legal position as required by Regulation 64 and* [for example] *the resilience reserve, where there was more scope for professional judgement and interpretation'*.

35 On 8 December 1998, GAD advised the Treasury that:

> *... it could be reasonable to assume that less than 100% of policyholders elected to take the guaranteed annuity provided that the reserve held in respect of those policyholders who are assumed to take an alternative annuity benefit is based on a realistic value of that alternative.*

GAD noted that the Society's approach had been one identified by the actuarial profession's Annuity Guarantees Working Party as potentially *'unsound'*[8]. After some doubt, legal advice provided within the Treasury supported the view that Equitable had to reserve on a 100% basis[9]. The Treasury reiterated this position to Equitable.

36 On 15 December 1998, the Treasury advised the FSA as part of the discussions held with them in advance of the FSA taking on the day-to-day regulation of insurance companies, that in their view:

> *Equitable is effectively having to "guarantee" to pay terminal bonuses at a level which means that the cash option is worth as much as the annuity option in order to be able to assume policyholders continue to take the cash option. If terminal bonus is effectively guaranteed we consider the company needs to reserve for it (it has effectively become a "guaranteed benefit").*

37 On 18 December 1998, Equitable supplied to the Treasury a copy of Counsel's opinion they had received which supported their stance. Counsel had advised that, had Equitable reserved on the basis now suggested, the Society would have been unable to pay bonuses in previous years.

38 Counsel also advised that, had the prudential regulators taken a consistent line on the issue from 1994, it would have been possible for the Society to have absorbed any need to establish reserves gradually. But, as a result of the Treasury seeking to impose their interpretation of the Regulations for the first time at the end of 1998, Counsel said that it appeared that the prudential regulators were now requiring the Society to establish a 'one-off' reserve of approximately £1,500 million.

39 In the course of these discussions, Equitable disclosed that policyholders could apply the guaranteed annuity rate to money they transferred in from other schemes, prior to retirement.

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8 See paragraphs 854 to 872 of Part 2 of this report.

9 Some time later, on 3 August 2001, the FSA *'look again'* at the requirements of the applicable Regulations and came to the view that it was not clear that reserving on the basis of a 100% take up rate was required by those Regulations and concluded that a lower level of reserving would be permissible, if that was prudent.

40 On 22 December 1998, the Treasury and GAD met Equitable once more. There was no agreement on the issue of reserving. The Treasury offered to consider any case Equitable put forward for the phasing in of reserves. But the Treasury warned that they would take regulatory action if the Society's returns disclosed that the reserves established by Equitable were inappropriate, or if the Society's actions imperilled its solvency cover. The Treasury also agreed to consider and respond to Counsel's opinion which the Society had shared with them.

41 On 11 January 1999, the FSA advised Equitable that that opinion did not cause them to change the views which had been expressed by the Treasury. The FSA stated that, in their view, the company's discretion not to pay additional bonuses was *'substantially fettered'* and that *'prudence would require the actuary to hold a reserve which is within a few percentage points of the reserve required for the guaranteed benefit'*.

What had Equitable told their policyholders?

42 The second question which arose during the discussions between the Society and the prudential regulators and GAD concerned what information had been given to its policyholders about the guaranteed annuity rates contained within the policies that Equitable wrote and about their differential terminal bonus policy. Again, the Society robustly defended its position.

43 In doing so, on 29 September 1998 Equitable told those regulators and GAD that the Society had described its approach to bonuses *'in the most general terms in marketing literature'*. However, Equitable also said that, when writing to policyholders, they had made it very clear that terminal bonus was allotted only at retirement, that the amount could vary, and that it was not guaranteed. Equitable explained that a note indicating the possibility of a different terminal bonus had been added to the 1995, 1996 and 1997 policyholder annual statements[10].

44 For their part, GAD advised the Treasury to establish if Equitable had marketing literature or other evidence to support their approach, as the Treasury needed *'to be satisfied that the reasonable expectations of policyholders are being met'*.

45 On 21 September 1998, the Treasury had asked Equitable for copies of marketing literature and policy documents, which were then supplied. The Treasury's initial view was that the Society's approach was in accordance with the contracts sold and that Equitable were endeavouring to fulfil the reasonable expectations of their policyholders.

46 On 6 November 1998, the Treasury noted that the prudential regulators still needed to take a view on whether Equitable were acting with due regard to the interests of their policyholders and more generally in accordance with those policyholders' reasonable expectations.

47 On 12 November 1998, GAD set out a number of *'fundamental questions'* – including whether Equitable had made their differential terminal bonus policy sufficiently clear to policyholders (GAD said that they doubted that the available evidence demonstrated that policyholders' reasonable expectations had been adequately modified) and whether the introduction of the policy was itself contrary to policyholders' reasonable expectations. GAD identified a need to review Equitable's documentation *'to assess the reasonableness of their approach on* [guaranteed annuity options] *in terms of PRE'*.

[10] No such note had been added to the 1993 or 1994 statements. Furthermore, it appears that not all the 1997 statements contained such a note due to clerical errors.

48 GAD and the Treasury both considered that they required further documentation from the Society (as the Treasury were concerned that Equitable might have *'cherry picked'* those supplied so far). At the meeting with Equitable on 13 November 1998, GAD and the Treasury therefore asked for an additional selection of documents *'to get a feel for what impression had been given to policyholders over the years'.*

49 At a meeting on 3 December 1998, the Treasury sought more documentation, relating to the previous 40 years. The Treasury explained that the description of Equitable's contracts and bonus policy in the documentation supplied so far *'did not appear to be fully in line with the approach adopted by the company'.*

50 On 23 November 1998 and 17 December 1998, the Society supplied the further information sought by GAD and the Treasury. That information included copies of the literature which had been sent to GAR policyholders over the lifetime of the contract. Equitable also supplied a copy of a leaflet recently provided to policyholders considering retirement, explaining the guaranteed annuity rates issue and the operation of the differential terminal bonus policy.

51 While those exchanges were taking place, the Treasury considered whether to provide guidance to the insurance industry. On 18 December 1998, the Treasury issued to Managing Directors of all United Kingdom life companies guidance on *'Guaranteed Annuity Option Costs and Policyholders' Reasonable Expectations'*. That guidance acknowledged the possibility that the terminal bonus added at the maturity of a contract with a guaranteed annuity might be somewhat lower than the terminal bonus for contracts without such options or guarantees or where benefits were taken in other forms. The Treasury added that:

> *... the appropriateness of any adjustments to bonus allocations for participating policyholders would need to be assessed by each office in the context of the reasonable expectations of policyholders. This assessment will be influenced by their policy documents and any representation made through marketing literature, bonus statements or elsewhere.*

52 Also on 18 December 1998, Equitable announced their intention of taking a test case to the High Court, in order to seek confirmation that they had acted within their powers in adopting the differential terminal bonus policy. On 26 January 1999, the FSA, which was now exercising the prudential regulatory functions contracted out by the Treasury, took the view that the issue of policyholders' reasonable expectations should be put on hold, pending the outcome of that Court case. As a result, there was no further analysis at that time of the information supplied.

What had Equitable told the regulators?

53 The third question which arose in the discussions between the Society and the prudential regulators and GAD related to whether Equitable had properly disclosed the position with regard to guaranteed annuity rates to those regulators. Again, the Society defended its position and maintained that Equitable had disclosed their differential terminal bonus policy in the 1993 returns and in each subsequent year.

54 At the meeting on 3 December 1998, Equitable argued that GAD should have been aware from those returns that the Society was writing business which contained guaranteed annuity rates. By not questioning that disclosure, the Society said that GAD had since 1993 *'tacitly accepted'* Equitable's approach to reserving.

55 On 22 December 1998, the Society noted that Counsel had expressed the view that Equitable, in their returns from 1993 to 1997, had *'consistently'* notified the prudential regulators of their differential terminal bonus policy, and that those regulators had been well aware that there existed policies containing guaranteed annuity rates within the Society's business[11].

56 For their part, on 16 November 1998 GAD noted that the differential terminal bonus policy had been *'mentioned'* in the 1993 returns but disputed that Equitable had disclosed their reserving basis in those returns or that GAD had acquiesced in the Society's approach.

57 On 8 December 1998, GAD argued that the references in the 1997 returns had been *'brief'* and '[as] *the Actuary signed a certificate which confirmed that the liabilities had been determined in accordance with the regulations we had no reason to challenge that Actuary's basis'*[12].

58 GAD developed this point on 4 January 1999, accepting:

> *... with hindsight that we might have addressed the issue rather earlier by asking some pointed questions about their guaranteed annuities. However, the presentation of their valuation methodology in their returns was somewhat obscure, and required the reader to pick up comments in three quite separate parts of the return and draw certain inferences from them. There was nothing said to indicate that the level or extent of these guaranteed annuities were regarded as significant.*
>
> *For example, the wording in paragraph 5 refers to no explicit provision being made in current conditions for the "other" guarantees in paragraph 3, without clarifying exactly which guarantees have or have not been included, or saying whether allowance had been made implicitly for guarantees within the methodology adopted or within the other valuation assumptions.*

59 GAD expressed *'some sympathy'* with Counsel's argument that, had the prudential regulators taken a consistent line on the issue of reserving from 1994, it would have been possible for the Society to absorb the need to make reserves gradually. However, GAD noted that *'most of the increase in the £1.5bn provision has arisen in 1997 and 1998 ...'*.

60 The FSA shared GAD's views on the information which had been given within the regulatory returns. On 11 January 1999, in commenting on Counsel's opinion, the FSA rejected the suggestion that the information in those returns could be seen as constituting notice to the DTI or to the Treasury of the Society's reserving practice. The FSA argued:

> *... the statements in the returns are brief in the extreme and do not disclose the reserving method, the rate of guarantee or the volume of business affected. (In fact, as an aside, we have some concerns about Equitable's compliance with paragraphs 4(1)* [which required full description of benefits for accumulating with-profits policies] *and 6(1)* [which set out the principles and methods to be adopted in the valuation] *of Schedule 4 to the Insurance Companies (Accounts and Statements) Regulations 1996 which we hope will be put to rest in the 1998 return).*

[11] See the entry for 18 December 1998 within Part 3 of this report.
[12] However, the Society had not suggested that it was only in its 1997 returns that this approach had been stated.

Regulatory consideration of the Society's financial position

61 On 26 June 1998, the Society had submitted its regulatory returns for 1997. A detailed description of the content of those returns is contained within the chronology entry for that date within Part 3 of this report. GAD completed their A1 Initial Scrutiny check on 17 July 1998. They identified no concerns. GAD completed their A2 Initial Scrutiny check on 20 August 1998. That check followed the more detailed format first used for the 1996 returns. GAD lowered Equitable's priority rating from 3 to 4 and highlighted a number of matters, including:

- that the interest rates used by Equitable were *'just about'* supported by the risk adjusted yields on the matching assets;
- that the Society's overall interest basis was *'adequate'* and that the valuation basis was *'adequate'* to *'weak'*;
- that Equitable had an *'Enormous Growing Liability for terminal bonus on* [unitised with-profits] *business* [which] *is not reserved for, so that FORM 9 margin overstates strength!'*;
- that the absolute level of cover for the required minimum margin was *'adequate'*. However, GAD referred to their comment about the Society's liability for terminal bonus (see directly above) and to the fact that Equitable had raised capital of £350 million through the issue of the subordinated loan;
- that the Society's level of sales was very high and that it held a negligible estate; and
- that Equitable were known to have material exposure to annuity guarantees and that the Society *'Adjusts terminal bonuses – so no value to policyholders! No additional reserves considered necessary'*.

62 Under *'Aspects that look worrying'*, GAD queried whether Equitable's position on annuity guarantees was satisfactory. Under *'Other notes'*, GAD initially noted that Equitable appeared to have failed to disclose provision for pensions mis-selling but GAD appear later to be satisfied that provision had been made within the Society's returns.

63 GAD also stated that a review of annuitant mortality assumptions was required and that the issue of the subordinated loan appeared to be the sole reason for the increase in available assets over the year. GAD identified no items to notify to the prudential regulators, to be taken up immediately with Equitable.

64 There was no detailed scrutiny of the 1997 returns at this time. Comment on the 1997 returns was included in the detailed scrutiny of the 1998 returns, on which GAD reported in May 1999. This was despite the fact that consideration of certain issues arising from GAD's Reserving for Annuity Guarantees survey had raised questions about Equitable's 1997 returns, their on-going solvency position, and, as would be seen in due course, about the options open to the prudential regulators.

65 On 22 October 1998, the Treasury provided an update to the Tripartite Standing Committee (a Committee of senior officials from the Treasury, the FSA and the Bank of England) on the effect of current market conditions on UK life insurers. They referred to a paper, submitted to a previous meeting of the Committee, which listed eight *'fairly well known offices that we are monitoring particularly carefully'*. Equitable was one of those companies.

66 In an annex to that paper, the Treasury gave details for each company, stating that Equitable *'are not well placed to weather difficult investment conditions'*. This was said to be because of a lack of estate and exposure to liabilities associated with the guaranteed annuity rates within a significant number of policies.

67 Figures attached to the update paper recorded that Equitable's free reserves (excluding any item for future profits) were £1,752 million – and that the Society's solvency margin requirement at 31 December 1997 was £845 million. The Treasury estimated that the current additional cost of the Society's annuity guarantees was between £1,000 million and £2,500 million, the large range reflecting *'uncertainty about the nature of their guarantees'*. The Treasury estimated that the Society's current free reserves were estimated to be between (a negative figure of) £750 million and (a positive figure of) £700 million, and that Equitable faced a further £5 million in costs as a result of personal pensions mis-selling[13].

68 On 27 October 1998, GAD produced a preliminary report on the annuity guarantees survey. The report stated that a number of companies held substantial reserves for those guarantees and that Equitable were one of two notable exceptions. The report noted that the Society seemed to be *'particularly vulnerable because the relevant business is approaching 30% of their total'*.

69 GAD identified Equitable as one of twelve offices with potential solvency margin problems and one of five that could be *'technically insolvent'*. GAD stated *'we shall certainly need to raise the issue of annuity guarantees with each of these offices as part of the scrutiny process for their returns'*. GAD also identified Equitable as one of seven offices which had not told policyholders about the existence of a guaranteed annuity option, and one of eight that were considering whether they should reduce the final bonus payment to policyholders with guarantees, to reflect part or all of the cost.

70 On 5 November 1998, the Treasury noted that their principal concern was the Society's ability to reserve adequately for those guarantees. The Treasury concluded that the information received to date had been unconvincing and raised *'serious questions about the company's solvency'*[14].

71 At the meeting on 13 November 1998, Equitable's Appointed Actuary stated that he was convinced that the Society was still solvent. On 16 November 1998, the Treasury sought an estimate of Equitable's free assets and solvency cover.

72 On 24 November 1998, Equitable explained that, as at 30 October 1998, and before taking account of any implicit items or any liabilities associated with guaranteed annuity rates, the Society had available assets of £2,090 million to cover the required minimum margin of £926 million. Equitable provided figures which showed that, having established reserves for the full cost of those annuity guarantees, the Society had available assets of £300 million, which, with the release of margins contained within the valuation basis of £100 million and a future profits implicit item of £850 million, could be increased to £1,250 million.

73 On 26 November 1998, GAD provided the Treasury with a *'2nd Update on the Effect of Current Market Conditions on UK Life Insurers'*, to be provided to the Tripartite Standing Committee. In that update, GAD stated that Equitable were only *'just solvent'*, if it were assumed that 100% of policyholders exercised their guaranteed annuity options. GAD's update continued:

13 Under the Treasury's lowest estimate for the cost of meeting the annuity guarantees, they calculated that Equitable had £700 million to cover the required minimum margin of £845 million. Under the Treasury's highest estimate for the cost of those guarantees, the Treasury calculated that Equitable would have been insolvent for regulatory purposes by £750 million. However, the Treasury noted that those figures did not account for certain measures which might have been taken. Such measures included any future profits that might have been permissible if an appropriate concession were granted or any margins within the valuation basis which might have been available to be released. (For the full notes accompanying the Treasury's figures, see the entry for 22 October 1998 in Part 3 of this report.)

14 In December 2000, after the decision of the House of Lords in the *Hyman* case, this note was leaked to a national newspaper. Commenting on the last point in the note, the FSA's Line Manager E wrote: *'We were subsequently satisfied that* [Equitable] *was solvent and it remains solvent today'*.

While this is reassuring it should be realised that publication of such a low solvency position is likely to severely undermine the company's reputation in the market and could threaten its survival as an independent entity.

74 On 1 December 1998, GAD advised the Treasury that Equitable *'would just have sufficient cover for their required margin of solvency'*, but that this was *'before any declaration of bonus'*.

75 On 11 December 1998, the Treasury gave consideration as to whether the applicable Regulations gave them the power to require the Society to resubmit its 1997 returns, with proper reserving for the liabilities associated with guaranteed annuity rates. The initial legal view was that the Regulations did not allow this. GAD disputed this and, on 15 December 1998, GAD expressed surprise that the Treasury believed:

... that there is no power in the Act or any Regulations which would enable [the Treasury] *to require a company to "reissue" or amend accounts when it has breached* [Regulation] *64 of the Insurance Companies Regulations 1994. In our opinion there are grounds to require reproduction of the abstract of the actuary's report and resubmission of the returns...*

The handover to the FSA and events up to the decision of the House of Lords

December 1998

76 On 15 December 1998, the Treasury met the FSA to brief them about Equitable. The Treasury described the Society as *'just solvent'* if it reserved fully for the liabilities arising from policies which contained guaranteed annuity rates.

77 However, the Treasury also noted that the Society's free assets figure had made no allowance for the declaration of any bonus and that Equitable appeared to have insufficient assets to declare a bonus in 1999.

78 The Treasury also noted that, if Equitable reserved fully for guaranteed annuity rates, the Society would be close to breaching the requirement that only five-sixths of the required minimum margin could be covered by implicit items. In such circumstances, the Treasury noted, a relatively small fall in equities or gilt yields could wipe out the company's explicit free assets.

79 The Treasury set out for the FSA a *'Strategy for Regulatory action'*, which formed the basis for a further meeting with the Society in December 1998, and which would be used to:

- *Clarify that* [the Treasury are] *not minded to take action against the company for its failure to reserve fully for* [guaranteed annuity options] *in its 1997 returns. (This would be consistent with* [the] *approach taken with other companies)*;

- *Formally put the company on notice that the reserving approach that the company is proposing (assuming this remains to reserve for 25-35% of the* [guaranteed annuity rate liabilities]) *is not acceptable in* [the Treasury]*'s view;*

- *Indicate that in the context of settling its year end position it is for Equitable to decide the reserving approach that it intends to adopt in its 1998 returns since it is for the company to comply with the Regulations. But make the company aware that if in FSA's view the returns submitted at the end of June are not compliant, FSA will take action;*

- *Seek an undertaking from the company that it will not declare any further bonuses without prior discussion with* [the Treasury]. *If necessary use the lever/threat of intervention action on the grounds of sound and prudent management to obtain agreement from the company.*

80 The Treasury stated that intervention action would be likely to take the form of closing the Society to new business and that this could happen immediately, if Equitable did not agree to refrain from declaring further bonuses without prior discussion with the Treasury. The Treasury noted that, if Equitable did agree:

> *... intervention action would only become necessary when the company indicated its intention to declare a bonus which would have the effect of making the company breach its* [required minimum margin] *if the* [guaranteed annuity options] *were fully reserved for. (The company usually declares bonuses in February.) If agreement is obtained and no bonus is declared the need for intervention action/prosecution would probably not arise until July when the annual returns were submitted and it was clear from those returns that the* [liabilities associated with guaranteed annuity rates] *had not been adequately reserved for.*

The Treasury warned that the Society could be expected to seek judicial review of any intervention action on reserving for guaranteed annuity options[15].

81 The FSA asked the Treasury about the potential impact of a policyholder challenge to the Society's differential terminal bonus policy. The Treasury stated that the Society's financial position would not be made worse, assuming that it had reserved on a 100% basis. The only additional costs to it would arise from compensation payments to policyholders who had already retired and who had been adversely affected by the operation of that policy.

82 According to the Treasury's note of the meeting, the FSA also asked why no action had been taken on Equitable's 1997 returns, when those returns showed no reserves for the liabilities associated with guaranteed annuity rates. In response, the Treasury *'explained that the approach taken by the company had not been clear from the return'.*

83 On 18 December 1998, GAD, on seeing the note of the meeting, disputed the assertion that no action had been taken on those returns. GAD pointed out that the current discussions on guaranteed annuity rates had followed directly from questions which GAD had raised on the reserving basis within those returns. GAD also noted:

> *It should be remembered by* [the Treasury] *that GAD invited* [Equitable] *to a meeting on 28th May this year (following consideration of their 1996 returns), at which we discussed the reserving bases appropriate to accumulating with-profits business, attempted to clarify certain PRE aspects of the bonus notices being issued by Equitable and urged great restraint in the granting of guaranteed bonuses.*

[15] When the Treasury and GAD met Equitable on 22 December 1998, the Society had been warned that regulatory action was a possibility.

January 1999

84 On 4 January 1999, GAD advised the FSA that:

> *We need to set out in writing to Equitable that we are not satisfied with the level of mathematical reserves (ie zero) established for annuity guarantees in their 1997 returns. (Otherwise, they would have a good case next year in saying that we accepted these returns in full knowledge, through detailed correspondence and discussion, of their reserving methodology and assumptions).*

85 GAD produced a list, detailing the additional information that they would like to receive from Equitable. GAD said that this would enable them to form a better understanding of the Society's current financial position.

86 On 7 January 1999, the FSA's Director of Insurance put to the FSA's Chairman an options paper, suggesting the courses of action open to the FSA in relation to companies whose 1997 returns had been submitted on an imprudent or unacceptable basis.

87 The Director advised the Chairman that:

> *... there are significant doubts about whether the legislation empowers us to require companies to correct their returns where we consider them to have been prepared on an inappropriate basis ...*

Given those doubts, the Director recommended to the Chairman that the FSA should require accelerated returns from those companies which had submitted *'misleading'* returns for 1997. The FSA's Chairman later agreed to this recommended approach.

88 On 13 January 1999, the FSA wrote to all insurance companies to express their concern that the regulatory returns of some companies might have presented *'a materially misleading impression of companies' financial positions as at the end of 1997'*. The FSA stated that:

> *Where there was a material effect on the overall financial position shown in the 1997 returns, and where the company has not subsequently taken commensurate action to strengthen its financial position, it is the FSA's view that it would be appropriate for such companies to submit their 1998 returns early – and in any case not later than 31 March – so that the FSA and potential policyholders and their advisers can form a proper view of these companies' financial position.*

89 On the same day, the Government Actuary issued guidance to all Appointed Actuaries, reminding them of the need to make proper provision for guaranteed annuity rate liabilities on prudent assumptions.

90 On 15 January 1999, in response to complaints from some of their policyholders about the legitimacy of their differential terminal bonus policy, Equitable initiated legal proceedings against a representative guaranteed annuity rate policyholder, Mr Hyman, so that the arguments for and against their differential terminal bonus policy could be put before – and be resolved by – the courts.

91 On 18 January 1999, the FSA asked Equitable for more information about their mathematical reserves and aggregate asset shares as at the 1998 year-end. On 21 January 1999, Equitable's Chief Executive told the FSA that the Society planned to declare a 5% annual reversionary bonus (down from 6.5% for 1997).

92 The Chief Executive said that the Society had *'entered into a financial reinsurance arrangement with effect from 31 December 1998'*, at a cost of £150,000 each year. It was said that this arrangement would provide support to Equitable when those holding more than 25% by value of the guaranteed annuity rate business maturing in that year selected to take benefits applying a guaranteed annuity rate.

93 On 22 January 1999, FSA noted that Equitable were one of four companies giving cause for concern, and that it was questionable whether the Society would be able to declare a bonus that year. Based on the GAD estimate, it was also noted that the Society, without reinsurance, was only just covering the required minimum margin at the end of October 1998, with £1,150 million available assets to cover a regulatory solvency margin of just under £1,000 million.

94 The FSA noted that, should the court case go against the Society, *'its financial position would become even more precarious (there would be a potential liability to enhance past settled claims) and it would have to reduce the level of terminal bonus paid to its other policyholders – thus upsetting its status in the market'*.

95 On 26 January 1999, Equitable provided the information that the FSA had requested on 18 January 1999. The Society's Appointed Actuary informed the FSA that the *'aggregate smoothed asset share was 103% of the value of the actual assets attributable to the with profits business'*. The FSA responded by asking for further information, including sight of any bonus recommendations made to the Board during the previous year.

96 On the same day, the FSA decided that it would not continue earlier efforts to reach a view on policyholders' reasonable expectations until after the conclusion of the court case as, although that case would not preclude the FSA from taking a view on whether the Society's policy had been consistent with policyholders' reasonable expectations and as to the possible need for intervention, the Court's judgment on whether or not such expectations had been met would be sure to influence the FSA's view on those matters.

97 On 27 January 1999, GAD raised a number of concerns with the FSA about Equitable's proposed reinsurance arrangement, including the fact that the draft reinsurance agreement could be cancelled retroactively, if the Society changed its practice on guaranteed annuity rates (which GAD presumed included Equitable losing their court case).

98 At a meeting between Equitable, GAD and the FSA the next day to discuss the matter, the Society was asked to seek various revisions of the draft agreement from the reinsurer. The FSA also questioned at that meeting whether the Society was satisfied that the proposed reinsurer was sufficiently strong to be able to fulfil the obligations under that treaty *'(i.e. to cover a potential £1bn+ liability)'*. The FSA recorded that the Society's response to their questioning indicated that:

> *Equitable Life appeared to be relying on the company's AAA rating for comfort as to the reinsurer's financial strength. The Actuary was reminded that it was his responsibility to be satisfied with the security of the reinsurance for which he was* [taking] *credit in his valuation.*

99 How the reinsurance treaty could be presented in the returns was also discussed at that meeting. The Society's Appointed Actuary said that he was keen not to have to show a reserve for the annuity guarantees of more than £1,000 million, as he thought that the press would wrongly interpret such a figure as representing the real cost to Equitable. The Appointed Actuary also said that instead he would like to show the reserve net of reinsurance – while including a statement that *'the reserve had been established at the 25% level because reinsurance provided protection for liabilities in excess of that level'*.

100 The response from the FSA and GAD to this suggestion was that:

> *GAD were concerned that this was not consistent with the Directive requirements which required insurers to calculate their gross liabilities and then deduct the liabilities covered by reinsurance. It was also potentially inconsistent with the guidance issued by the* [Government Actuary] *and endorsed by FSA. It was emphasised that FSA's main concern was that the reserving basis should be clear from the annual returns. FSA would explore the implications of the presentation Equitable Life were seeking to adopt before expressing a definitive view on the issue.*

The FSA's note of the meeting also records the comment that:

> *... having reviewed the structure of the relevant forms, it is clear that any presentation which did not show separately the gross liability and reinsurance cover would be artificial and hence potentially misleading. In view of the significance of the reinsurance treaty to the company's solvency position it was important that the level of dependence on the reinsurance was clear to readers of the returns.*

101 On 29 January 1999, GAD commented on the Board papers that the Society had forwarded in respect of its proposed bonus declaration. GAD said that, while the financial position shown was likely to appear reasonably satisfactory, Equitable *'would be potentially close to regulatory action under Section 33* [of the 1982 Act – that is, for failure to maintain the required minimum margin of solvency] *if their proposed reinsurance is not completed satisfactorily'*.

102 GAD noted that, while it would be difficult for the FSA to object formally to what Equitable were proposing, the prudential regulators would need to monitor the Society's position carefully.

103 GAD commented that both GAD and the FSA should voice their concerns to Equitable about the Society's vulnerability and ask Equitable to produce some contingency plans to show how they would react to adverse investment conditions. GAD also pointed out that the Society continued to issue annual notices to policyholders showing a high level of projected benefits, thereby generating further expectations.

February 1999

104 On 1 February 1999, the FSA wrote to Equitable on the lines suggested by GAD, underlining the fact that, in the absence of a robust reinsurance agreement, it would not be prudent to declare any bonus for 1998. The FSA advised the Society that, even with a reinsurance treaty in place:

> *... we consider it necessary for the company to consider carefully the scope for declaring a bonus because of the uncertainties surrounding the financial implications of the court case in relation to the company's payment practice in respect of contracts carrying guaranteed annuity options. In*

particular it would appear necessary for Equitable Life to consider the prudence of declaring a bonus in the light of the risk of losing the court case and the potential costs that might be incurred as a result. We also consider it necessary for the company to take account of the risk, even after the terms of the reinsurance treaty have been revised as discussed with GAD, of the treaty being cancelled by the insurer ...

The FSA concluded that, were the reinsurance agreement to be revised to resolve GAD's concerns, the FSA would not be minded to object to the Society's proposed bonus declaration. Two weeks later, the Society sent the FSA a copy of the revised draft reinsurance terms, which led to both the FSA and GAD raising further matters regarding those draft terms.

105 On 22 February 1999, GAD confirmed to Equitable that the principle whereby the reinsurance arrangement offset the guaranteed annuity rate liabilities, as set out in the terms of the agreement, was acceptable to GAD. This was, however, subject to the resolution of GAD's outstanding queries and sight of a final version of the agreement.

106 On 24 February 1999, however, the FSA raised a concern of a different nature with the Society, that being:

... we think that the returns might have given potential policyholders a misleading impression as to Equitable Life's financial position at the end of 1997. You indicate that there would have been a net decrease in the coverage of the required minimum margin from 2.5 to 2 times after allowing for the use of margins which existed in the valuation basis and taking account of a much larger future profits implicit item. We consider that such a decrease is material and that some account must be taken for the greater reliance on implicit items that would have been necessary (and apparent in the returns) if a further reduction in the solvency margin coverage was to be avoided.

Equitable were asked to agree by 3 March 1999 to submit their 1998 returns by 31 March 1999 or face possible regulatory action.[16]

March 1999

107 Equitable were not specifically mentioned at the first quarterly liaison meeting between the Treasury and the FSA on 10 March 1999. The following week, the relevant FSA Managing Director informed the FSA Board about the Society's particular difficulties.

108 On 19 March 1999, the FSA summarised in an internal note the position of the six companies identified as being potentially at risk from guaranteed annuity rates and whose statutory solvency could be threatened, if economic conditions were to deteriorate further. Of those six companies, it was said that Equitable were viewed as giving rise to the greatest concern, as their financial position had been very severely affected.

109 The FSA recorded that, despite action which had been taken to restore the Society's solvency margin to a more acceptable level, the FSA remained *'concerned about the financial viability of the company in the longer term'*, and they set out their particular concerns. The FSA also noted that the position might worsen if Equitable lost the *Hyman* case and incurred significant compensation costs as a result.

[16]The public bodies told me that the FSA had taken the same action in respect of several other life assurance companies which had not reserved appropriately for guaranteed annuity rate policies.

110 The Society submitted its 1998 regulatory returns on 30 March 1999, as the FSA had requested. A detailed description of the content of those returns is contained within the chronology entry for that date within Part 3 of this report. On the same day, the Society applied for a section 68 Order for the use of a future profits implicit item of £1,000 million within the Society's returns for 31 December 1999. Equitable had included a future profits implicit item of £850 million within their 1998 returns.

April 1999

111 On 8 April 1999, GAD completed the A2 Initial Scutiny check. GAD's scrutinising actuary's observations during that check included that:

(1) *We still need to be satisfied that* [the reinsurance] *treaty with* [IRECO] *works in the way intended — REQUEST COPY OF TREATY as finally agreed.*

(2) *Loss of the Court case on treatment of* [Guaranteed] *Annuities would put position in doubt – would need to cut all bonuses.*

112 On 9 April 1999, GAD reported to the FSA the results of their initial scrutiny of the Society's 1998 returns, saying that the Society's financial position appeared satisfactory, but that GAD had not yet seen a copy of the finalised reinsurance treaty. GAD asked the FSA to request it urgently, which the FSA did.

113 On 20 April 1999, Equitable told the FSA that the reinsurance treaty had not yet been concluded, and the Society sent a copy of the term sheet which would form its basis. That term sheet showed that the reinsurance treaty remained contingent on no change being made to the Society's then current guaranteed annuity rate bonus practice, either by choice or as a result of legal action; and that, if the withheld claims balance exceeded £100 million, negotiations would take place to find a mutually acceptable restructuring of the agreement.

114 The Society also enclosed a copy of a paper prepared by the Appointed Actuary for its Board on measures to protect the Society's statutory solvency position. One issue that the paper discussed, but could offer no solution to, was how the Society might use policy conditions to restrict the growth in its guaranteed annuity rate business. The paper concluded with a list of measures which, it was said, it seemed sensible to pursue.

115 Commenting on those measures on 27 April 1999, GAD said that they seemed *'fairly plausible'*, but could ultimately reduce the Society's investment returns. GAD said that they were also content with the level to which any future repayment premiums under the reinsurance treaty had been subordinated to policyholders' rights.

116 Meanwhile, on 30 April 1999 Equitable had written to the then Economic Secretary of the Treasury, complaining about the level to which the Society was being required by the FSA and GAD to reserve for guaranteed annuity rates. She replied on 14 June 1999, defending the position which had been taken by the prudential regulators, saying that:

> *... companies have to err on the side of underestimating the value of their assets' future income and overestimating their liabilities. In this way it is ensured companies have some spare capacity to withstand adverse economic circumstances. The determination of how conservative the assumptions should be has been derived from past experience and is embodied in guidance to appointed actuaries.*

May 1999

117 On 4 May 1999, Equitable provided a further paper on the Society's projected solvency position. That paper showed three different scenarios, each based on different assumptions as to developments in the investment markets.

118 All three scenarios showed the Society remaining solvent and the position steadily improving. Equitable had attempted to project the impact of losing the court case, although it was said that this had been difficult to do, as there were a number of varying components. In the Society's view, however, the key solvency consideration, if an unfavourable outcome occurred, was the replacement or modification of the reinsurance arrangement, which was being actively pursued.

119 On 20 May 1999, GAD provided the FSA with a detailed scrutiny report on the Society's 1997 and 1998 regulatory returns; this gave Equitable a priority rating of 2 (raised from 3 in respect of their 1996 returns). A detailed description of that report is contained within the chronology entry for that date within Part 3 of this report.

120 GAD highlighted a number of problem areas, but concluded that, because of the way that the Society operated, *'provided the currently high level of annual emerging surplus continues, the Society should be able to work its way out of its current solvency margin problems'*. The Society, in GAD's view, needed to hold back more emerging surplus by declaring lower guaranteed bonuses; and to give policyholders greater warning about the possible implications for bonuses of a substantial market setback.

121 The following day, GAD suggested to the FSA that the Society should be asked to consider further possible scenarios – and to confirm the basis of some of those calculations.

June 1999

122 In the meantime, both the FSA and Equitable had been considering the possible outcome scenarios in respect of the Society's court case and the resulting implications of those scenarios. On 21 June 1999, the Society informed the FSA that its lawyers had identified six possible scenarios, which were:

1) *Complete success.*

2) *Success but with some adverse comment in* [the] *judgement.*

3) *Directors have discretion but have incorrectly executed it on technical grounds (for example, the wording of the formal statement of bonuses is inadequate in some way).*

4) *Directors have discretion but have not given sufficient weight to or considered the right PRE.*

5) *Ruling that ELAS approach invalid and that final bonus rates on cash and annuity benefits must be equal but that Board still have discretion to set rates at a level they deem appropriate. Even if the Society appeals, the judgement stands until that appeal is heard.*

6) *Ruling that ELAS approach invalid and that final bonus rates on cash and annuity benefits must be equal due to PRE it must be at the cash levels. Appeal certain but judgement will stand until that appeal is heard.*

Equitable said that they considered all of them except for scenarios 1 and 2 to be highly unlikely. Nevertheless, Equitable confirmed that they had been discussing with IRECO possible amendments to the reinsurance agreement, and had been discussing other possible arrangements with other reinsurers. The next day, the FSA and GAD reviewed the court papers which had been provided by the Society.

123 On 24 June 1999, the FSA asked the conduct of business regulators if they had any jurisdiction over the bonus notices issued to policyholders, and whether those regulators could require Equitable to change those notices. The FSA sent the conduct of business regulators copies of the 1996 and 1997 notices, which the FSA said were possibly misleading, and said that they would forward the 1998 notice to those regulators the following week.

124 On 25 June 1999, prompted by concerns expressed by GAD on the likely consequences if the court referred the issue of policyholders' reasonable expectations to the prudential regulators, the FSA prepared a paper on the action that they might need to take if the court did not give a clear view on how policyholders' reasonable expectations might be viewed.

125 The FSA noted that they saw no point in reaching a view ahead of the court judgment, but also said that they would do some more work on the issue, so as to be ready to give a view shortly afterwards.

126 The FSA added that the Society's bonus notices, which seemed to give policyholders unrealistically high expectations of the pay-outs they could expect, were currently the main evidence in support of the argument that the Society's approach had not been consistent with the reasonable expectations of its policyholders.

127 The FSA stated that:

> *Even in the context of non-GAO policies the notices appear liable to lead policyholders to have potentially unrealistically high expectations of their total payouts because of the prominence given to the total accumulated benefits figure which includes undeclared terminal bonus. The format of bonus notices is something we have raised with Equitable previously (before the GAO issue arose) but we never made any progress in obtaining changes.*

128 On 29 June 1999, Equitable met GAD and the FSA to discuss further information that the Society had provided and also developments in relation to the court case. Equitable said that their lawyers considered it very likely that the Society would win the court action but with some adverse comment. Equitable also said that those lawyers considered the worst case scenario (wherein bonus rates for both the cash fund option and annuities had to be equalised at the highest cash level) to be '*inconceivable*'[17].

129 The FSA pointed out that, even if Equitable won, the FSA would still need to consider whether the Society's bonus policy had been consistent with policyholders' reasonable expectations; the FSA also said that they had concerns about the information contained within the Society's bonus notices, but that the FSA had not yet reached a view as to whether that information had been misleading.

[17] At interview with the FSA's Baird Inquiry, Chief Counsel A said that she had provided oral advice to the regulators and GAD on the likely outcome of *Hyman* following a meeting with Equitable. The Baird Report stated that it was believed that this advice was provided after this meeting. In response to the view put forward by Equitable at the meeting (that the outcome of the case was likely to be positive for them), Chief Counsel A cautioned that: '*You can never predict judicial outcomes ... If Equitable get the wrong panel or the wrong judge, they could find themselves on the receiving end of a change in judicial approach. The Court ... might not like what the Equitable has done and might be influenced for that reason. Don't jump to conclusions on this.*' (See the entry for 29 June 1999 within Part 3 of this report.)

130 The Society insisted that its practice of paying out as much as possible in bonuses and in not building up any hidden estate offered the best value to policyholders, as well as being a useful deterrent against predators. Equitable said that they had been approached by a number of suitors, but that Equitable had always replied that the Society was committed to mutuality.

131 The impact of each presumed potential court ruling on the reinsurance treaty was also discussed at that meeting. Equitable's Chief Executive told the FSA and GAD that he believed that the reinsurance treaty would remain in place if the court ruling fell within scenarios 1 to 4. He also informed the FSA and GAD that:

> *As a contingency against losing the case the company had been in discussion with reinsurers about increasing the scope of reinsurance cover.* [A named reinsurance company] *had been prepared to offer a form of surplus relief reinsurance and even offered to take over the company's existing reinsurance with* [IRECO]. *However at the eleventh hour* [the company's] *Head Office backed off from the proposal claiming "capacity problems".*
>
> *Following this the company had decided to wait until the outcome of the Court case before talking to other reinsurers, they did not want to tout around the reinsurance market at such a sensitive time.* [Equitable's Chief Executive] *believed that there was room to extend the scope of the existing reinsurance contract if Equitable were to lose the case and that premium rates would be practical and consistent with the existing treaty ...*

July and August 1999

132 The High Court hearing began on 5 July 1999, and on the same day the FSA Managing Director with responsibility for Equitable was sent a note (which was also copied to the conduct of business regulators) about that legal action and about the implications both for Equitable and the FSA, in terms of any follow-up action which might be required.

133 The FSA's note set out the implications of three possible outcomes: Equitable winning, winning in part, and losing the case. In the last scenario, the FSA noted that the reinsurance arrangement would then be invalid, although the Society had established that there would then be scope for replacing it; should that not be possible, the FSA noted that Equitable would only just cover the required minimum solvency margin after taking full account of the future profits implicit item available to the Society. The FSA also noted that Equitable would need to consider drastic measures, which might precipitate a take-over bid or a reduction in new business.

134 The note continued by stating that the FSA would then need to determine the Society's solvency position and, if the required minimum margin were breached, to exercise intervention powers to require the production of a plan for the restoration of a sound financial position.

135 Even if the solvency margin were not breached, the note said that the FSA would require steps to be taken to strengthen the position in the short to medium term. It was noted that there would also be the question, if there were a significant risk that Equitable would be unable to meet their liabilities to policyholders, as to whether to close the company to new business or to suspend their authorisation.

September and October 1999

136 On 9 September 1999, the High Court ruled that Equitable had been entitled to operate their differential terminal bonus policy. However, the claimant was given leave to appeal. GAD told the FSA that they could see nothing in the judgment which was inconsistent with the guidance that had been issued by the prudential regulators on that subject, although GAD suggested that the FSA might need to consider intervening in respect of those policyholders whose expectations might not have been met.

137 The FSA's legal advisers also pointed out various issues arising for the FSA, which related to policyholders' reasonable expectations. However, those advisers noted that the FSA had decided to defer a decision on taking such action until the appeal had been concluded.

138 On 15 September 1999, the FSA's prudential regulation division suggested to the FSA's conduct of business division that both divisions needed together to consider the matter from the perspective of all the FSA constituent bodies, but should not decide on any action until the Court of Appeal's decision was known.

139 If the High Court judgment were overturned, the FSA noted that it would be possible that intervention action would be warranted under the 1982 Act, and that they wanted to avoid any action which might constrain or prejudice such action. The FSA noted that they should consider the matter further in the light of analysis that they had agreed should be undertaken while the appeal was still pending.

140 On 20 September 1999, the FSA contacted Equitable to arrange a company visit. The FSA said that they were:

> *... very conscious that although we have had a considerable amount of contact over the past year, this has necessarily been heavily focussed on the guaranteed annuities issue. I think that while this issue is somewhat in abeyance, and given that it is nearly 3 years since we last visited you, now would be an opportune moment for a visit to discuss the Society's overall position and future plans.*

The FSA expected that the visit would last a day, would involve both the FSA and GAD, and would cover the following areas:

1. *Overview of corporate management structure of Equitable Group.*

2. *General market outlook and business strategy.*

3. *Marketing approach including product development and distribution.*

4. *Role of the Appointed Actuary.*

5. *Systems and Controls.*

6. *Investment Policy and Asset Management.*

141 On 23 September 1999, the FSA's conduct of business division responsible for regulating Personal Investment Authority member firms (such as the Society) wrote to their prudential regulation colleagues within the FSA about the Society's bonus notices which had been referred to them.

142 The conduct of business regulators said that they did not consider the Society's bonus notice to be poorly presented or inaccurate and that they did not therefore intend to take any regulatory action. The conduct of business regulators went on to say that, historically, they had not regarded post-sales literature as being within their remit and would,

therefore, have had to have serious concerns about a document before taking action against a company.

143 On 24 September 1999, GAD advised the FSA that the Society's application of 30 March 1999 for a future profits implicit item of £1,000 million was acceptable. GAD confirmed that the calculations which had been provided by the Society's Appointed Actuary were *'in line with the guidance and that the* [figure for the maximum amount of future profits that could be claimed] *of £2,960m appears to be a fair estimate of 50% of "Estimated Future Profits"'.*

144 GAD also noted that the sum applied for was about one third of the sum for which the Society could have applied, and was substantially less than it had been allowed in the previous year. However, GAD said that Equitable should first be asked to confirm certain details and should be asked to provide a copy of the reinsurance agreement as that had been finally signed (which Equitable subsequently provided and GAD confirmed as acceptable[18]).

145 The FSA subsequently[19] recommended to its Insurance Supervisory Committee that the application should be granted. The FSA informed the Committee that, while there remained some debate at the margins between Equitable and GAD about the appropriate reserves for guaranteed annuity rates, the FSA were generally satisfied that Equitable had adequately reserved for their exposure to those rates, as that had *'been largely offset'* through reinsurance. The Committee approved the application and the Treasury issued the Order on 9 November 1999.

146 In the meantime, on 14 October 1999 Equitable sent the FSA a copy of the final signed version of the reinsurance treaty. On 22 October 1999, GAD advised the FSA that the treaty:

> *... is totally in accord with the Draft Term Sheet that was examined in detail in April. (It is my understanding that the construction of the reinsurance agreement as set out in the draft term sheet was considered to be acceptable at that time).*

November and December 1999

147 On 17 November 1999, the FSA prepared a risk assessment of Equitable, as part of piloting a new approach to company assessment. That assessment suggested that Equitable should be viewed as a high financial risk for a number of reasons.

148 The assessment noted that, while Equitable had not been alone in being caught out by the guaranteed annuity rate issue, the FSA's view was that the Society had not woken up to that issue quickly enough, and communication to policyholders of the Society's change in policy in relation to bonuses was decidedly unclear and had left Equitable open to criticism.

149 The assessment observed that Equitable had *'gone too far in distributing surplus to policyholders to the extent that the company is dangerously under capitalised and exposed to a market downturn'*. However, it was noted that Equitable had taken heed of concerns about the level of reversionary bonuses and had made some effort to reduce them. It was also noted that the Society's reserving basis was *'acceptable (but not particularly strong)'*. The overall assessment prepared as part of the FSA's co-ordinated supervisory programme confirmed Equitable as medium to high risk.

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[18] See the entries for 14 and 22 October 1999 within Part 3 of this report.
[19] See the entry for 3 November 1999 within Part 3 of this report.

150 On 6 December 1999, the FSA and GAD carried out a company visit to Equitable. The areas discussed included: the Society's corporate structure; its business plan; and its intentions with regard to bonuses.

151 On 20 December 1999, the FSA informed Equitable that the FSA had introduced a system of 'enhanced lead supervision'. The FSA explained that, under those arrangements, a lead supervisor would be nominated for each company (which, in its case, would be the prudential line supervisor for the Society) and that that lead supervisor would be responsible for maintaining an overall assessment of the Society and for producing a co-ordinated supervisory plan, with the aim of avoiding any regulatory *'overlap and underlap'*.

January 2000

152 On 21 January 2000, the Court of Appeal gave judgment against Equitable by a majority of two to one. One of the majority judges, however, went on to say, at the end of his judgment and in an observation which did not form part of his reasoned decision, that it would be legitimate, in his view, for the Society effectively to 'ring-fence' funds relating to different types of policyholder, which could result in those policyholders with guaranteed annuity rates not doing much better in cash terms.

153 The Society was granted leave to appeal to the House of Lords and was permitted by the Court in the interim to continue its differential terminal bonus policy pending the appeal, so long as Equitable gave an assurance that, if the Court of Appeal's decision were to be upheld, the Society would pay additional sums in respect of any policy maturing after the Court of Appeal's judgment by way of rectification.

154 On the same day, GAD told the FSA that the judgment meant that most of the advice in the guidance note issued by the Treasury on 18 December 1998 remained valid. GAD suggested that the extra costs to Equitable might be fairly marginal, but that the Society should be asked to confirm that the judgment did not affect its reinsurance agreement.

155 The FSA told their conduct of business colleagues that the judgment gave no cause for panic. The FSA, while noting that the adverse publicity was likely to dent the Society's sales, told those colleagues that the Society's reserving requirement would not be affected by the judgment – and so Equitable's financial position for regulatory purposes would be largely unaltered.

156 On 28 January 2000, the FSA prepared a note setting out the implications for the insurance industry if the House of Lords were to uphold the Court of Appeal's judgment. The FSA said that, although the Society would need to revise its bonus policy for future years, the new approach need not lead to any significant additional costs for it.

157 On 31 January 2000, an FSA legal adviser circulated a summary of the judgment, commenting that each of the four judges who had at that stage considered the case (the High Court judge and the three Court of Appeal judges) had arrived at their respective conclusions for different reasons.

158 The FSA legal adviser said that, in that context, it was not possible to predict what the decision of the House of Lords would be, and any attempt to do so, or to determine the implications of the Court of Appeal's decision, would therefore be of little benefit. Over the subsequent months, discussions continued internally about the wider implications more generally of the judgment for policyholders' reasonable expectations.

February to May 2000

159 On 1 February 2000, Equitable had written to policyholders, assuring them that there would be no significant costs for the Society if the House of Lords were to uphold the Court of Appeal's decision.

160 On 22 March 2000, Equitable published their Companies Act report and accounts for 1999[20] and declared a bonus of 5%. In that report and accounts, the Society explained that any additional costs resulting from the guaranteed annuity rate issue would fall generally on the with-profits fund. Equitable reported that:

> *We have projected that the cost of these additional benefits is unlikely to exceed £50 million in total over the coming years, and the experience in 1998 and 1999 was well within our expectations. However, for accounting purposes we have established a provision of £200 million in our balance sheet, to provide an allowance for more extreme future changes in financial conditions and mortality experience which could lead to more policyholders taking benefits in the guaranteed annuity form.*

Equitable also set out the background to the *Hyman* litigation and the progress up to that date, saying that the Society expected the House of Lords' hearing to be in June 2000 and that the judgment would follow shortly thereafter.

161 On 30 March 2000, Equitable applied for a section 68 Order to raise the limit on the amount of shareholdings in a particular company that could be taken into account within the Society's 1999 returns. On 10 April 2000, the FSA's Insurance Supervisory Committee confirmed that such an Order could not be granted retrospectively. The FSA informed the Society of their decision, and the reason for it.

June and July 2000

162 On 27 June 2000, Equitable applied for a section 68 Order for a future profits implicit item of £1,100 million, for use in their 2000 returns. On 30 June 2000, Equitable submitted their regulatory returns for 1999. A detailed description of those returns is contained in the chronology entry for that date within Part 3 of this report.

163 On 7 July 2000, GAD recommended to the FSA that the Society's application for a future profits implicit item should be granted on the grounds that there was a significant margin between the sum applied for and the maximum for which Equitable could have applied (£3,300 million). GAD also noted that the Society's Appointed Actuary had confirmed that he had taken account of the reinsurance agreement in determining the value of future profits.

164 In the meantime, on 4 July 2000 the FSA's relevant Managing Director told his senior colleagues that one of the Society's directors had approached him to say that there were *'straws in the wind'* that the House of Lords would find against Equitable – and that the Society was considering *'what level of sacrifice'* might be needed at the top of the organisation if that proved right.

165 On 18 July 2000, the FSA and GAD met with Equitable to discuss contingency planning for the House of Lords' judgment, which was due to be delivered two days later. The Society expressed the view that it was unlikely that the House of Lords would find against it, but nevertheless the meeting discussed the possibility that Equitable might be prevented from altering the rate of bonus for those with policies containing guaranteed annuity rates and who chose to take benefits to which those rates were applied.

[20] See the entry for 30 June 2000 within Part 3 of this report.

166 Whilst this had previously been identified as a possible (but not a probable) outcome, it was noted that this outcome was beginning to appear more likely, in the light of the arguments which had been put forward for the first time before the House of Lords. It was stated that the cost of that outcome (referred to as the third option) would be in the region of £1,000 to £1,500 million, and would have a profound effect on the Society's regulatory solvency position.

167 Equitable informed the FSA and GAD at the meeting that the Society had not attempted to renegotiate the reinsurance agreement to take account of such a ruling and that such renegotiation was unlikely to be viable.

168 In the event of such a ruling, the Society said that it would immediately announce an intention to seek a partner. The Appointed Actuary said that he *'did not think that the company would be insolvent if the company suffered this judgement, but he was currently conducting some scenario modelling'*.

169 Equitable's Chief Executive said that he was keen to avoid precipitous regulatory action should the judgment go against the Society, mainly because that was likely to have a detrimental effect on the value of the business. The FSA's Head of Life Insurance:

> *... reassured the Society that we would not rush to take remedial action in these circumstances and understood the importance of maintaining the value of the society. We would, however, need to be convinced that a suitable buyer for the Society was likely to be found quickly.*

Equitable envisaged that substantive sales negotiations could begin in August 2000, with the view to completing a sale by the end of that year. Equitable said that, if the House of Lords simply upheld the Court of Appeal's decision, the Society expected to reduce the bonuses payable to guaranteed annuity rate policyholders as a class; they did not consider that this would contravene any such judgment.

170 On 19 July 2000, the FSA prepared a note, which was effectively an update of earlier scenario planning, setting out the possible outcomes of the appeal, and the regulatory action that was likely to be appropriate in each case. The note recognised the third option as a possibility, but it was said that this was much less likely than the other two potential outcomes. The FSA noted that, should that third option become a reality, Equitable would only just be able to meet their required minimum margin and would therefore seek a partner. The FSA's note concluded that it was expected that there would be no shortage of potential partners.

171 On 20 July 2000, the House of Lords gave its decision, holding, in terms of both the guaranteed annuity rate policy contracts and the Society's Articles of Association, that Equitable could not apply different rates of bonus depending on whether or not the policyholder took benefits based on guaranteed annuity rates, and that the Society could not pay lower bonuses to guaranteed annuity rate policyholders as a class.

172 Equitable immediately announced that they were seeking a buyer, and told the FSA that the Society planned an immediate cut of 5% in the value of all with-profits policies at non-contractual termination and that no bonus would be allotted for the first seven months of 2000. The Society said that it expected bonus levels to be restored once a sale had been completed.

Events leading to closure

July 2000

173 On 21 July 2000, Treasury officials informed the FSA that it was likely that those officials would be asked by their Ministers for briefing on the situation regarding Equitable. The Treasury said that the decision of the House of Lords had prompted thoughts on the wider implications for the future development of the life insurance sector and the effectiveness of the regulatory system. The Treasury set out a number of key questions to be considered by the FSA, as part of preparing their input to such briefing. Those questions included whether the FSA now considered that they ought to have done more to prevent the situation from arising.

174 On 24 July 2000, the FSA told GAD that, in their view, the House of Lords' judgment had no implications for the life insurance industry as a whole, because companies had generally been required to reserve fully for the liabilities associated with those policies containing guaranteed annuity rates, with the same level of reserve being needed whether or not a differential terminal bonus policy was being applied.

175 The FSA said that the impact would be different on Equitable because the *Hyman* judgment had led to a reduction in the Society's assets, rather than an increase in its liabilities, because the reinsurance agreement had fallen away as a result of that judgment.

176 GAD replied, confirming the FSA's analysis. GAD said that:

> *Equitable was unique in the form of reassurance that it entered into, with its cancellation clause. In retrospect the Actuary is shown to have acted imprudently in taking credit for the reassurance. No doubt he was relying upon the Board's view, based upon legal advice, that they were unlikely to have to change their bonus policy.*

177 In an internal minute, the FSA commented that, while a sale could not be regarded as an absolute certainty, *'it must be close to 99.9%'*. The FSA also circulated an action plan, under which the FSA would:

- obtain confirmation as to the Society's regulatory solvency position and review projections of future solvency;
- review the reserving guidance which had been issued by the Treasury in 1998;
- ask other companies what implications they saw for themselves; and
- arrange discussions with the Society about the bidding process.

178 On 26 July 2000, the Society announced the changes to its bonus rates, but added that, through the sale, Equitable would be looking to secure funds to make good the lost growth. On the same day, the Society's Appointed Actuary also wrote to the FSA, setting out the company's solvency position. The Appointed Actuary said that:

> *On a continuing basis the position would be unacceptably weak. However, as you said last week, we have effectively implemented a plan to strengthen the position by taking the course of action which we have. Meanwhile I believe it is reasonable to regard the Society as continuing to meet its required minimum margin.*

179 Also on 26 July 2000, the FSA replied to the Treasury's questions. On the matter of whether the guidance that the prudential regulators had issued on meeting the cost of the liabilities associated with guaranteed annuity rates had been right, the FSA said that it would have been difficult for any guidance to be consistent with the full range of Court judgments which had been made. If the FSA had been wrong, then, it was said, so too had the actuarial profession – since the Faculty and Institute of Actuaries had gone on record as saying that the actuarial profession had fully supported the guidance.

180 The FSA said that they were not convinced that either the Treasury or the FSA could or should have pushed the Society to alter its differential terminal bonus policy; and that the Society's policy *'was not clearly unlawful'*, as had been demonstrated by the first judgment and by the fact that the Court of Appeal had found against Equitable only by a majority.

181 The FSA told the Treasury that:

> *The FSA did ensure that Equitable set up adequate reserves to cover their GAO exposure. As a result Equitable decided to enter into the reinsurance treaty in order to avoid having to take alternative courses of action that they considered to be against their policyholders' interests.*

The FSA also informed the Treasury that:

> *Equitable had been told that if the court upheld their practice, we would nevertheless consider whether PRE had been breached and whether intervention was appropriate. Obviously FSA's consideration of this issue was suspended whilst the matter was before the courts.*

August and September 2000

182 On 11 August 2000, the FSA and GAD met Equitable to discuss the regulatory aspects of the sale process. On 24 August 2000, the prudential and conduct of business divisions within the FSA met to discuss the implications of the *Hyman* judgment. The FSA's prudential division said that it was hoped that a buyer would be identified by December 2000, and that the process could be completed by June 2001.

183 The FSA's note of that meeting said that:

> *It was clarified that the judgment generally did not have solvency implications as the level of reserving had not been affected (it was just that some companies would experience higher real costs). Equitable Life had only experienced a weakening in its financial position because the reinsurance it held for* [guaranteed annuity rates] *had been terminated (because it was conditional on the company continuing to pay differential terminal bonuses).*

184 On 1 September 2000, the Society submitted an update of its estimated solvency position (showing the position as at 31 July 2000), which showed that Equitable had available assets of £2,500 million to cover the required minimum margin of £1,200 million.

185 On the same day, the FSA recommended to their Insurance Supervisory Committee that they should grant the Society's application for a future profits implicit item of £1,100 million. The FSA said that, although Equitable had been weakened as a result of the *Hyman* judgment, the Society was still solvent. The FSA noted that Equitable was seeking only a third of the sum to which they were entitled, and that the relevant calculation had been checked by GAD.

186 As a result, on 11 September 2000 the FSA's Head of Life Insurance and Chairman of their Insurance Supervisory Committee told members of that Committee, by e-mail, that the Society's section 68 application involved a *'fairly standard request'* for a concession for a future profits implicit item.

187 The FSA recommendation made clear that the Society's request was well within normal parameters, and no difficulty was envisaged in agreeing to the recommendation. The Head of Life Insurance added, however, that the implicit item was an important aspect of Equitable's overall financial position and that, given the Society's high profile at that time, he imagined that some members might wish to discuss the paper.

188 One member of the FSA Insurance Supervisory Committee responded that:

> *... the amount of the implicit item actually shown in Form 9 for the December 2000 return cannot exceed the amount that could be supported by a new application submitted with that return and bringing in the financial performance of the company in 2000. We expect a sharp fall in surplus in 2000 because of the* [House of Lords'] *judgment and this will need to be brought in to the figures ... In practice, the company may not actually be able to use the figure that we agree now.*

189 The FSA's Committee approved the application on 11 September 2000 without meeting and, on 13 September 2000, the Treasury issued a section 68 Order. At their quarterly meeting with the FSA the following week, the Treasury pointed out that Equitable were still advertising for new business. The FSA responded to this point by stating that the Society's recent difficulties *'have not affected its solvency position, only its freedom to invest'.*

190 On 21 September 2000, the FSA's relevant Managing Director told the FSA Board that the House of Lords had gone much further than the previous court rulings in that case, in that the House of Lords had held that Equitable could not 'ring-fence' guaranteed annuity rate business from other with-profits business, for the purposes of setting terminal bonus.

191 The extra costs of the guaranteed annuity rates therefore had to be spread amongst all policyholders in the with-profits fund. This, he said, had potentially serious implications for the reasonable expectations of the other with-profits policyholders of the Society.

192 On the same day, GAD informed the FSA that they had no questions to raise about the Society's regulatory solvency at that time, although GAD pointed out that, without the future profits implicit item, Equitable would have excess assets of *'just £300m'.*

October 2000

193 On 9 October 2000, the Society informed the FSA that, as at 31 August 2000, Equitable had available assets estimated to be £3,360 million to cover the required minimum margin of £1,195 million. Equitable said that this significant improvement from the July 2000 position had been due to the markets having strengthened in the interim.

194 Meanwhile, since Equitable had announced in July 2000 that they were seeking a buyer, a number of potential bidders had expressed interest and had been assessing the Society's financial position. A number of those had since withdrawn.

195 In a report to the FSA Board on 19 October 2000, the relevant FSA Managing Director said that, despite the difficulties in assessing the level of liability arising from the *Hyman* judgment, Equitable had received three serious expressions of interest – all of which would be sufficient to enable the repayment of the bonuses which had been withheld for the first seven months of that year, with an additional payment for goodwill. However, he also said that the FSA would need to see the detailed bids and their structure to determine whether the with-profits fund would, as a result, be strong enough to secure the desired restoration of investment freedom going forward.

196 On 30 October 2000, Equitable provided solvency figures which showed that, as at the end of September 2000, the Society had available assets estimated to be £2,345 million to cover the required minimum margin of £1,205 million.

197 On 31 October 2000, a potential bidder for Equitable (whom in this report I call bidder A) told the FSA that they believed that the shortfall in the Society's funds was greater than Equitable themselves had estimated.

198 Bidder A expressed concern that the wording of the Society's policies allowed guaranteed annuity rate policyholders to increase their contributions to the fund, to which the guarantee would attach, thereby increasing the fund's liabilities to the detriment of other policyholders. Bidder A said that they were investigating whether and, if so, how that liability might be capped, but explained that they were more pessimistic on the issue than were the Society's Directors.

199 On the same day at a meeting of FSA's Firms and Markets Committee, the FSA's Chairman expressed concern over press reports that there had been little interest in purchasing the Society. The minutes of that meeting record that, although only three potential bidders were left, the FSA still thought that it was likely that *'a good sale'* could be achieved.

November 2000

200 Meanwhile, GAD had been considering potential means through which Equitable might cap the liabilities, arising from guaranteed annuity rate policyholders making 'topping up' payments, without preventing the Society from writing new business. The closure of the Society to new business would, GAD said, almost certainly end any chance of a sale and there was a need to cap those liabilities.

201 It does not appear that, at this time, GAD's consideration of those matters had taken into account the fact that the Society's guaranteed annuity rate policyholders had a contractual right to make such 'top-up' payments even after any closure to new business.

202 On 3 November 2000, the FSA and GAD met Equitable to discuss the Society's current financial position. GAD noted that the Society did not appear to believe that the 'top-up' issue was a serious concern for potential bidders. GAD also recorded that the aggregate value of the recent cut in bonus rates had amounted to £1,500 million, which, it was expected, would be sufficient to cover the cost of paying guaranteed annuity rates on full asset shares.

203 GAD concluded, therefore, that:

> *With the recent cut in bonus rates ... new policyholders should not have to meet any* [of] *the cost of GARs, as indeed is likely to be their expectation. However, they will be joining a very weak fund.*

GAD also noted that, if no sale were to take place, the Society would almost certainly have to stop writing new business, and would probably have to rearrange the Society's investments to a more defensive position, to protect against possible liquidation in the event of a substantial fall in equity values.

204 Also on 3 November 2000, in the light of further complaints from policyholders about the appropriateness of the Society's advertising, the FSA prepared a draft response to those complaints, which they circulated to their conduct of business colleagues.

205 The draft, which was agreed by the FSA's Head of Life Insurance, stated:

> *As regulator, the FSA does of course monitor the financial position of insurance companies carefully. However, we understand that Equitable continues to be solvent for Companies Act purposes and indeed continues to maintain the required margin of solvency over its liabilities as required under the Insurance Companies Act 1982. As the Equitable continues to be a going concern, complying with the relevant regulatory requirements, we do not share your view that it should be prevented from marketing its products, which could be damaging to the business. Nor do we believe that at a time when the statutory requirements continue to be met, and when there is a realistic chance of a successful sale of the business, that the newspaper advertisement inviting potential customers to request additional information from the company is misleading.*

206 On 6 November 2000, another potential bidder, bidder C, met with the FSA and GAD and expressed significant concerns about the risks that they would be taking on if they were to acquire the Society, citing: the reinsurance arrangement; what appeared to be a zillmer adjustment applied to the Society's reserves in the resilience scenarios; and the possibility that, given the Society's precarious regulatory solvency position, Equitable might *'go through a period of statutory insolvency'*, before making a recovery.

207 On 10 November 2000, bidder C informed the FSA's Chairman that, although they had been very interested in acquiring Equitable, they:

> *... had reached the view that the Equitable's financial position was considerably worse than they had first thought. The hole was significantly larger than they had expected ...* [and their] *main motive in telling* [us] *this was to alert* [us] *to the fact that the Equitable's position might be rather more doubtful than we had been led to believe.*

208 In an internal note dated 14 November 2000, the FSA set out how each of the possible outcomes of the sales process might be handled. While noting the serious concerns raised by potential bidders about the Society's exposure to certain liabilities, the FSA concluded that, at this stage, '*there do not seem to be any grounds for considering action on the basis of insolvency since Equitable is able to meet its contractual obligations*'.

209 On the following day, bidder C told the FSA that they considered it would not be worth taking Equitable *'at any price'*, as some current policyholders were clearly expecting a restoration of bonuses forgone and perhaps even a de-mutualisation bonus, expectations which it would be impossible to meet.

210 On 16 November 2000, GAD commented that, if no buyer were found, the Society would be in a very difficult position. GAD told the FSA that:

> *... from a regulatory perspective, we know that* [Equitable's] *financial position remains very close to the edge of not covering their margin of solvency, there are a number of uncertainties (eg in the viability of their financial reinsurance, and resilience to changes in financial markets – they are unable at present to satisfy one of the recommended resilience tests which they argue is quite strong and they point to a known anomaly in Regulation 69), and we would then also know that it would be difficult to arrange a "rescue" by another insurer in the event of technical insolvency arising.*

211 GAD advised the FSA that the prudential regulators would have to require the Society to commission an independent investigation into its viability, in order to help to demonstrate to all concerned whether Equitable should be allowed to continue writing new business.

212 Over the next two weeks, Equitable and GAD continued to debate the determination of appropriate reserving levels. The FSA also continued to explore with the potential bidders various issues including:

- the possibility of capping the Society's liabilities;
- whether the acceptance of payments into non-guaranteed annuity rate policies (which might then have to be used to subsidise guaranteed annuity rate policy payments) might be viewed as mis-selling (as to which the conduct of business regulators provided advice that this would not be so viewed, if an appropriate warning had been given);
- whether the bidders' proposals would fulfil the reasonable expectations of the Society's policyholders; and
- whether the Society's existing future profits implicit items could be transferred to any buyer.

213 On 22 November 2000, Equitable's Appointed Actuary reported that, as at the end of October 2000, the Society's available assets were estimated to be £2,295 million to cover the required minimum margin of £1,215 million.

214 On 24 November 2000, GAD submitted to the FSA their detailed scrutiny report on the Society's 1999 regulatory returns. A detailed description of the content of GAD's report is contained within the chronology entry for that date within Part 3 of this report.

215 Although GAD said that the Society's solvency position appeared reasonable, with available assets of £3,860 million to cover a required minimum margin of £1,110 million, GAD noted that this figure included a future profits implicit item of £925 million, disregarded liability to repay a subordinated loan of £346 million, and benefited from a reduction in the liabilities of almost £1,100 million resulting from the reinsurance arrangement.

216 Without those factors, GAD noted that the Society's available assets would reduce to £1,510 million. The report went on to cite a list of further weaknesses in Equitable's position, and added that the question of whether the Society should continue to sell non-guaranteed annuity rate policies in a common fund with guaranteed annuity rate policies could be considered an *'environment risk'*.

217 On 29 November 2000, the FSA informed the Managing Director with responsibility for Equitable and their Chairman that two potential bidders (bidders A and B) remained interested in a possible sale. It was said that the Society's preferred bidder, bidder A, was to submit a recommendation to their Board on 7 December 2000 on whether or not to make a formal bid.

December 2000

218 On 1 December 2000, the FSA and GAD met Equitable. The discussion at that meeting concluded that there now seemed to be only one realistic bidder remaining, bidder A, and that it was doubtful that the sum that that bidder was likely to offer would be sufficient to allow Equitable to proceed with the sale. Should that be the case, it was noted that it was probable that the Society would close to new business and seek to sell its sales force and infrastructure.

219 The FSA noted at that meeting that there remained disagreement between GAD and Equitable on reserving requirements and on the use of a quasi-zillmer adjustment[21] in their returns. The FSA also noted that the Society *'did not appear to be unduly concerned about* [with-profits] *policyholders who joined the Society after the House of Lords judgement'.*

220 The FSA recorded that the Society had explained to the FSA that *'they had not considered whether post 20 July* [with-profits] *policyholders could be excessively disadvantaged in a closed fund. This is because after this date the preferential treatment of GAR policyholders was known'.* It was also noted that Equitable had confirmed to the FSA that their sales force had been adequately informed about the Society's circumstances and that Equitable's Board had taken legal advice on that matter.

221 On the same day, the FSA met with the two remaining prospective bidders (bidders A and B) and it became apparent during those meetings that both bidders might be about to pull out of the sales process.

222 Bidder B pulled out on 4 December 2000, after Equitable felt unable to agree to allow them a period of exclusive negotiation. On the same day, bidder A told the FSA that they were becoming increasingly concerned that acquisition of Equitable would be uneconomical. Bidder A said that they could not predict what their Board's decision on 7 December 2000 would be.

223 On 5 December 2000, the relevant FSA Managing Director was informed that GAD had made adjustments to the Society's free asset estimates to include various assumptions in the reserving basis *'to bring them into line with what* [GAD] *would normally expect'.*

224 It was said by GAD that, if all their assumptions were correct and if all the adjustments were made, this would leave the Society with free assets of only £70 million – although this was an arithmetical error, with the correct amount being £20 million – above the required minimum margin of solvency. GAD's estimate of the Society's available free assets was thus approximately £1,010 million lower than the Society's own estimate.

225 In reply, the FSA then said that, if no bid were forthcoming, the prudential regulators would have grounds for closing Equitable to new business, either for failing to meet the required minimum margin or because of the risk that policyholders' reasonable expectations would not be met. However, it was said that the FSA would prefer the Society's directors to take that decision on a voluntary basis.

[21] See the glossary for an explanation of this term.

226 On 5 and 6 December 2000, urgent meetings were held, including internal FSA meetings, meetings of the FSA Chairman's Committee, and meetings between the FSA, GAD and Equitable, to discuss the implications of a scenario in which the last remaining bidder withdrew.

227 On 6 December 2000, an urgent meeting of the Tripartite Standing Committee was also called to discuss whether the closure of Equitable would have any systemic consequences for financial stability. The Committee noted that closure to new business would be the only option if the sales process fell through.

228 The Committee agreed that the Society's position had been different to that of other insurance companies due to a unique combination of factors, which meant that the *Hyman* judgment had had a particularly significant effect on Equitable. At that meeting, the Treasury listed those factors as being:

- *It was a mutual, so (in the absence of a buyer) had limited access to capital.*
- *It did not have an estate of surplus assets.*
- *The terms of its guarantees were unusually generous and flexible.*

It was noted that Equitable could not refuse top-up payments from with-profits policyholders with such guarantees, even though those payments would potentially harm non-guaranteed annuity rate with-profits policyholders. The FSA said that that was why, given the Society's lack of substantial surplus, Equitable could no longer prudently write new business.

229 Treasury officials also briefed the then Economic Secretary at this time, informing her that a sale was unlikely to take place; those officials said that this was mainly because it had been impossible to cap the Society's guaranteed annuity rate liabilities.

230 The Treasury officials also said that, while it might be argued that the prudential regulators should have stopped Equitable writing new business sooner, there had, until a few days previously, been every sign that a sale could be achieved. It was said that those regulators had been just as surprised as the markets that no buyer could be found.

231 On 7 December 2000, prospective bidder A withdrew and on 8 December 2000, as is noted in Chapter 1 of this report, the Society closed to new business with immediate effect.

232 In the next Chapter of this report, I will summarise the way in which the prudential regulation of the Society was undertaken during the post-closure period – ending with 1 December 2001, when my jurisdiction over the relevant events ended.

Chapter 8 – The prudential regulation of Equitable in the post-closure period

Introduction

1 In this Chapter, I summarise how the prudential regulation of the Society was undertaken during the period from when the Society closed to new business on 8 December 2000 until the end of my jurisdiction over the relevant events on 1 December 2001.

2 As was explained in Chapter 6 of this report, this covers the period within my jurisdiction during which the Society was closed to new business. The regulatory approach to the Society changed to reflect its changed circumstances and the different nature of the issues faced both by Equitable and by the prudential regulators and GAD as a result of the closure of the Society to new business.

3 In the immediate aftermath of the closure of the Society to new business and for the rest of the period covered by this Chapter, a considerable amount of regulatory activity took place, as the Society's policyholders and annuitants – and the wider world – came to terms with the new reality and as both the Society and those regulators sought to find ways of putting the Society's financial position back onto a stable and sustainable footing.

4 The chronology of events set out in Part 3 of this report demonstrates the extent and nature of the issues that the Society – and thus its regulators – faced. It is impracticable in this Chapter to do anything other than summarise the key aspects of that activity. The reader is referred to the very extensive chronology of events if they wish to gain a fuller understanding of the extent and direction of the activity which occurred during this period.

5 I begin with an account of the events which occurred in the immediate aftermath of the Society's closure to new business. I then focus the account given in this Chapter on four important themes of regulatory activity during this period.

6 The first theme is the monitoring of the solvency position of the Society. The second theme is the information about the Society which was provided by the FSA to policyholders and others. The third theme is the FSA's reaction to the Society's bonus declaration for 2000 and to the July 2001 policy value cuts. The final theme is the FSA's review of the development of proposals for a scheme of arrangement under the Companies Act 1985, through which the Society hoped to compromise the competing claims of its policyholders and re-stabilise its financial position.

7 I conclude my account by indicating the other strands of regulatory work that were undertaken during the period covered by this Chapter.

8 This Chapter is structured in the following way:

- in paragraphs 9 to 29, I summarise events that occurred in the immediate aftermath of the Society's closure to new business on 8 December 2000;
- in paragraphs 30 to 114, I summarise events relevant to the monitoring of the Society's solvency position;
- in paragraphs 115 to 135, I set out the information that the FSA gave to policyholders during the post-closure period;
- in paragraphs 136 to 143, I summarise the consideration given by the FSA to the Society's bonus declaration for 2000 and to the July 2001 policy value cuts;

- in paragraphs 144 to 158, I summarise events relevant to the development of proposals for a Compromise Scheme, pursuant to section 425 of the Companies Act 1985, and to the consideration given by the FSA to those proposals; and

- in paragraphs 159 to 186, I summarise the other strands of work that the prudential regulators undertook during the period covered by this Chapter.

The immediate aftermath of the closure to new business

9 On the day that the Society closed to new business, 8 December 2000, the FSA noted internally that they did not believe that the Society's problems were symptomatic of a wider industry problem: it was said that *'the underlying cause is specific to Equitable's own circumstances'*.

10 FSA also prepared a more detailed note for internal use when briefing journalists. This set out some of the background to the closure of the Society to new business. The note dealt specifically with 'Regulatory Issues', setting out possible questions and suggested responses. In response to the question: *'Why didn't the FSA take action sooner – how could you let them keep taking new business?'*, it was said that:

> *The Company remained solvent and there was a realistic prospect of a sale which would have been in the long term interests of policyholders. So there was no clear reason or basis for taking action.*

11 In response to the question: *'How do you judge policyholders' reasonable expectations (PRE)? How can Equitable have been meeting them in recent months?'*, it was said that:

> *PRE can not be precisely defined but it is important to remember that this company is owned by its members and With Profit policyholders share in the fortunes of mutuals for good or ill. Generally speaking policyholders have received benefits from this arrangement either through improved investment returns or windfall benefits after demutualisations but it is a two way street.*

12 In response to the question: *'On what grounds would someone launch a legal action against FSA for its action or inaction, or are you just a law unto yourself?'*, it was said that it was:

> *Not clear to us that a person could have grounds to bring a case. FSA has acted in good faith and with integrity throughout. No statutory immunity for those functions of the FSA delegated by the Treasury under the Insurance Companies Act 1982. But FSA does have the protection of the common law which would make successful challenge very unlikely.*

13 In response to the question: *'Why didn't you at least require Equitable to explain to prospective policy holders its precarious position?'*, it was said:

> *We understand that prior to the House of Lords judgement the position as reported to potential policyholders would have been in line with the current understanding of the law – where a differential approach to GARs was justified. Post the* [House of Lords'] *judgement it is our understanding that potential policyholders were advised about the circumstances surrounding the proposed sale of the company.*

14 In response to the question: *'Would you like to have more or different powers over insurers?'*, it was said that *'it is not clear that there is any deficiency in the regulatory powers available.'*

15 On 13 December 2000, the Treasury prepared a response to a written question in the House of Lords, which had asked whether the FSA had taken adequate action to safeguard the interests of the Society's policyholders. The text of the suggested answer was: *'The FSA is working with The Equitable Life Assurance Society to look after the interests of its policyholders'*.

16 In the background brief for the proposed answer, Treasury officials explained:

> *The Society's difficulties stem from with profit guaranteed annuity rate policies (GARs) which it wrote up until the late 1980s. These pension policies gave policyholders the contractual right to an annuity at a specific percentage rate when the policyholder retired, which although appropriate for the time in which the policies were offered, can be seen in today's low inflation environment as generous. During the 1990s, when interest rates fell, the GARs began to exceed current annuity rates. Reserving standards were increased to reflect the revised expectations of investment performance in a low inflation environment, but it became apparent to the Society that the increased costs of reserving for these increased GAR benefits would add a significant financial burden on the company, with one set of members getting a larger slice of the assets of the mutual than another.*

17 The brief continued:

> *The Directors of the Society took the view that it would be inappropriate for one set of members to disproportionately benefit in this way and they put in place a bonus policy that differentiated between GAR and non-GAR policyholders on maturity of the investment. This policy caused resentment amongst some GAR policyholders who felt that they were being deprived of their full entitlement. The Equitable responded by funding a representative action in Court to decide the issue.*

18 The brief concluded by saying:

> *The result of the judgment meant that, although the solvency of the Equitable was unaffected, the cost of the GAR liability would curtail its investment freedom and so a decision was made by the Board that it would be in the best interests of policyholders to seek a buyer for the Society. When this option failed to materialise, the Society took the decision to close to new business in order to concentrate on safeguarding the interests of its existing policyholders.*

19 On 19 December 2000, GAD sent the FSA a paper, entitled 'Reserving and related issues', which it was said had been prepared in order to *'demonstrate the substantial dialogue that has been held between FSA (previously HMT), GAD, and the Society over recent years in respect of their reserving practices'*.

20 This paper summarised the background to the guaranteed annuity rate issue and set out the exchanges on this issue that had taken place between the Society and the prudential regulators and GAD since July 1998, when the issue had first become known to those regulators and GAD.

21 Turning to the financial reinsurance arrangement into which the Society had entered, GAD described the Treaty in general terms, noting that the *'most controversial'* aspect was that it could be cancelled in the event of the Society being wound up. GAD summarised the discussions that had taken place on this Treaty between the Society and the prudential regulators and GAD from the end of 1998 onwards.

22 GAD explained that the FSA and GAD had reviewed the Treaty in the early part of 1999 and *'were eventually satisfied that it was reasonable for the actuary to take credit for the cover provided'*. GAD continued:

> *Such treaties continue to depend on regulatory arbitrage to achieve the desired result. (It is unlikely that the reassurer,* [IRECO]*, will currently be setting up compensating reserves to those removed from the balance sheet of the Equitable.) ... The reliance on an offshore reassurer, and the cancellation clause leave the treaty as a more controversial device by the Society, but the treaty has been accepted as satisfactory in statutory reserving terms up until now.*

23 GAD then explained the Society's practice of reporting the valuation which accorded with the applicable Regulations as an appendix to their returns, saying that:

> *... in recent years, the resilience reserve reported by the Society in their bonus reserve valuation has been such that the free asset position in the net premium valuations and the bonus reserve valuations has been the same. This means that the resilience reserve in the BRV is simply a balancing item, and so the robustness of the BRV is somewhat dubious. However ... GAD do not use the BRV to monitor solvency.*

24 GAD explained that, in the early 1990s, the Society *'took advantage of its use of a bonus reserve valuation in the statutory returns to hide its resilience reserve'* and say that the Society's disclosure had improved, following the implementation of the 1996 Accounts and Statements Regulations.

25 GAD went on to quote the statement that the Society had made within its 1996 returns: *'For accumulating with profits pensions business, ½% pa of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses'*. GAD explained that this:

> *... was never questioned by GAD; it appeared to be a part of the Society's overall provision for renewal expenses. However, in our Scrutiny of the 1999 Returns – in October/November 2000 – and in discussion with potential purchasers of the Society, this was identified as an unusual statement.* [Equitable] *confirmed to GAD in* [their] *letter of 16 November 2000 that this was an allowance, not for renewal expenses, as we had understood, but a mechanism to recover as yet unrecouped acquisition expenses. GAD view this as totally unsatisfactory, since it anticipates that future premiums will be paid on the recurrent single premium pensions contracts, when there is no obligation on the policyholder to do so, and furthermore the Society is taking credit in advance for expense margins in those premiums, to reduce the accrued liability.*

26 GAD then set out how they had pursued this matter – the 'quasi-zillmer' adjustment – with the Society at the end of 2000. GAD concluded that *'there has been a history of unsatisfactory disclosure regarding the Society's approach to resilience'* and that the statement in the 1996 returns *'is particularly opaque'*.

27 Under a heading of 'other reserving issues', GAD stated that, in their scrutiny of the Society's 1995 returns, they had noted that Equitable had taken the view that their interests were best served by using a weak valuation basis in order to show as strong a free asset position as possible. GAD noted that the Society had made the same point at a meeting between them on 9 December 1994.

28 GAD also explained that they had had concerns at the time of the scrutiny of the 1995 returns about the sustainability of the Society's present contract structures, although GAD had not written to the Society about those matters, but instead had taken them up at a meeting on 8 November 1996.

29 GAD in their note recorded that, at that meeting, they had come away with the view *'that the Society had to be very careful that customers were not misled about their eventual benefits'*.

The monitoring of the Society's solvency position

30 Throughout the period covered in this Chapter, the FSA, with the advice and assistance of GAD in the period up to April 2001, monitored the financial position of the Society on a monthly basis. The Society first submitted monthly solvency figures to GAD and the FSA on 26 July 2000. It subsequently agreed to an FSA request on 11 August 2000 to provide information about the position as at each month-end (and did so for each month-end, with the exception of November 2000, when no report was submitted).

31 This was done to supplement the scrutiny process of the Society's returns, which was the usual way in which the prudential regulators and GAD monitored the solvency position of life insurance companies. Further consideration is given to the detail of this work in Chapter 10 of this report.

32 Shortly before the Society's closure to new business, GAD wrote to the FSA on 1 December 2000, ahead of a meeting with Equitable that day. GAD provided a summary of the implications of their assessment of Equitable's response (of 29 November 2000) to the questions that GAD had raised about reserving. Those implications were as follows:

- that GAD were looking for *'an increase from 85% to say 90% in the assumed GAR take-up rate'*. However, GAD said that this would have no effect on the net level of reserves whilst the reinsurance treaty remained in place;

- that GAD were unhappy with the 20% rate of decrement in future premiums when assessing the 'future premiums' part of the reserve for annuity guarantees. On the basis of information provided by Equitable's actuarial consultants, GAD estimated that, if no such decrement were assumed, Equitable's net liabilities would increase by up to £360 million;

- that GAD believed Regulation 72(3) of ICR 1994 might require Equitable to assume in future valuations that personal pensions benefits were all taken at age 50. On the basis of information provided by Equitable's actuarial consultants, GAD estimated that the effect on Equitable's liabilities would be an increase of up to £200 million;

- that GAD believed the new resilience test 2 would lead to increased reserves of £600 million, or £300 million if the Society adopted the 'synthetic bond' concept;

- that GAD believed that a more sophisticated hypothecation of assets in the resilience scenario could reduce the resilience reserve by up to £750 million (or less, if a synthetic bond were used); and

- that GAD did not accept the use of a 0.5% pa allowance for expenses in the resilience scenario. GAD stated that *'the resilience reserve is therefore weak and not in accordance with the guidance.* [Equitable's actuarial consultants] *say that reserves are £950m lower than they otherwise would have been because of this'*.

33 GAD noted that the Society's monthly solvency figures for the end of October 2000 showed that it had assets of £1,080 million in excess of its required minimum margin. GAD advised the FSA that taking account of those reserving issues increased Equitable's liabilities by £1,060 million, resulting in the Society having assets in excess of its required minimum margin of just £20 million. GAD also pointed out that, if the IRECO reinsurance treaty were to be terminated, Equitable's liabilities would increase by about £500 million.

After the Society's closure to new business

34 On 19 December 2000, GAD prepared a report on *'Reserving and related issues'*. GAD's report repeated what they had said in their note of 1 December 2000, namely that a corrected solvency position for the Society would show assets of only £20 million above the required minimum margin. GAD's report also discussed the level of the market value adjuster which was applied to non-contractual withdrawals, along with the current level of payouts against asset shares. I return to this issue later in this Chapter.

35 The following day, in response to being informed that the FSA were not going to approve Equitable's application for a section 68 Order to permit the Society to use a 'synthetic bond' or 'artificial bond' approach to the calculation of the valuation of certain fixed interest assets, GAD pointed out that:

> *We understand that the artificial bond approach would have led to reserves £300m. lower than otherwise in this scenario.*
>
> *The adjustments which we believe need to be made to the Society's liabilities ... become an increase of £1,360m. (instead of £1,060m.), when there are only £1,080m. of assets available (at end-October 2000).*
>
> *It is all very tight, to say the least.*

36 On 16 January 2001, Equitable told the FSA and GAD that they expected to show in their returns for 31 December 2000 that the Society would have free assets of approximately £500 million above its required minimum margin. However, Equitable said that this was subject to further work that their new Appointed Actuary had to undertake and to *'confirmation by* [the FSA] *of some technical waivers to the valuation rules as intimated to us last year (and as given recently to some other companies)'* (i.e. the section 68 Order for a *'synthetic bond'*, which GAD had said would reduce the reserves required to be held by £300 million, and which the FSA had decided they would not approve).

37 Equitable also said that this valuation included the various changes that had been agreed in recent correspondence *'(other than the possible additional £250 million for personal pension policies on which we await legal advice), but does not include a contingent liability for any possible redress for pension fund withdrawal contracts that might be imposed by PIA (estimated by the PIA as £40m on a worse case scenario)'.*

38. On 19 February 2001, the FSA wrote to Equitable's Appointed Actuary, ahead of a meeting arranged for the following day. The FSA said that they would like an indication of the Society's current solvency position and emphasised the importance of the timely provision of all solvency reports, while noting that Equitable had not yet provided the monthly reports for November and December 2000, and that the January 2001 report was due.

39 At that meeting, it appears that the solvency position as at 31 December 2000 was the only month that was discussed, with the FSA recording that:

The position disclosed demonstrated fairly thin solvency cover and had assumed that both the concessions for the artificial bond (valuation rate of interest) and for an increased valuation taking into account the sale of the Permanent [Insurance] *had already been given. Without these concessions the company would not be able to demonstrate coverage of the RMM in its statutory returns. The* [Appointed Actuary] *had, however, now adopted the stronger resilience basis that had been required by recent changes in the regulations in these figures. He thought that all other reserving issues had been ironed out but GAD pointed out that there was still an issue surrounding Regulation 72 and retirement dates to be resolved.*

40 Following that meeting, the FSA's Line Manager informed the Managing Director of Financial Supervision that the Society's Appointed Actuary had reported that Equitable had free assets above their required minimum margin of £340 million, as at 31 December 2000. However, the Line Manager explained that this valuation had relied on certain concessions which had at that time not been granted. The Line Manager listed those concessions, which the FSA had estimated as totalling approximately £430 million. The Line Manager suggested that this information about the Society's solvency position:

> *... does point to the need to be careful about what we say, if we want to be certain that we are right. Either we should refer specifically to the position at 8 December, or simply say that the company is solvent.*

41 The Line Manager also informed his Managing Director that Equitable would like to be able to report their year-end position as if those concessions had been in place at the year-end. The FSA's Chairman commented to all of the supervisory staff who held responsibility for the Society on this point that:

> *If we are to concede that, I hope there are precedents (and preferably hundreds of them)!*

42 On 21 February 2001, GAD recorded in an internal discussion that they had thought that Equitable had accepted GAD's interpretation of the requirements of Regulation 72 of ICR 1994 as to whether assumptions could be made concerning retirement ages. GAD's interpretation was that the Regulations required Equitable to *'set up a liability to cover the cash payment that would result from an exercising of the vesting of the option, at any time that the option may be exercised'*. GAD had estimated that this would lead to an increase of £200 million in the reserves required to be held (Equitable had themselves estimated that it would increase the reserves required by £250 million).

The Society's solvency position following the completion of the Halifax deal

43 At the beginning of March 2001, Equitable's administrative and asset functions were transferred to Halifax and the Society's solvency position was boosted by a £500 million payment in respect of that transfer.

44 The FSA and GAD met Equitable on 6 March 2001, in order to get an update on the key issues that the Society faced. On the solvency position that was to be reported within the Society's 2000 returns, the FSA recorded that:

> *... solvency cover was likely to be tight with only £300m free assets after RMM coverage. In making this assessment the Society was taking into account the benefit from the "artificial bond" concession that had yet to be formally*

> *applied for or given (which itself would be worth c£300m). It was also taking into account the debt from the sale of the Permanent* [Insurance] *to Liverpool Victoria which was not completed until 2001 ...*

45 Equitable told the FSA and GAD that, as at 31 January 2001 and before they had received the £500 million from the Halifax deal, it was estimated that the Society had free assets of approximately £700 million above its required minimum margin. The FSA also noted that:

> *Solvency was boosted by the sale of £1.8bn of equities and the reduction in the resilience test. It was thought that current solvency cover was of a similar magnitude despite the £500m injection, this was because the FTSE at c5900 was a lot lower than it was at the end of January.* [Equitable's Chief Executive] *disclosed that prior to the end of February with weak equity markets solvency cover was thin.*

46 On 8 March 2001, Equitable provided their estimated monthly solvency figures for 31 January 2001. Those figures showed that the Society had free assets of £1,930 million to cover its required minimum margin of £1,215 million.

47 On 15 March 2001, the FSA's Managing Director of Financial Supervision reported to his Board on Equitable's solvency position. He informed that Board that the Society had free assets of approximately £300 million. However, the Managing Director pointed out that this solvency position relied on certain concessions from the requirements of the Regulations, and that those concessions had not at that time been granted by the Treasury. The Managing Director explained that, if those concessions were not granted, *'the position will be very tight'*.

48 During a meeting held on 20 March 2001, Equitable confirmed to the FSA that they were at that time following GAD's interpretation of Regulation 72. The Society said that, should the FSA accept Equitable's interpretation instead, *'there could be a c£100m release from reserves'*. (The effect of this adjustment had previously been valued by the Society at approximately £250 million.)

49 On 27 March 2001, the FSA informed Equitable that they could not recommend to the Treasury that the Society's request for a section 68 Order in respect of the calculation of the valuation of certain fixed interest assets (i.e. the synthetic bond) should be approved.

50 The FSA explained that the reason for this was that the Treasury had no powers to grant such an Order, which would have had retrospective effect. However, the FSA suggested to Equitable that *'it is possible for the Treasury to make an order under section 68 that would require the Society to prepare its annual returns on a particular basis, even though that information would relate to a period that has already ended but has not yet been reported upon'*.

51 On the same day, the FSA were advised by Counsel that Regulation 72(3) *'did permit assumptions to be made as to the age at which the individual would take benefits'*. However, Counsel also advised the FSA that *'there was scope for amendments to ... put in a requirement for reserving so that there was a smooth curve leading to the position where regulation 72(2) took effect'*.

52 On 23 April 2001, Equitable reported to the FSA that the *'end of March figures were almost complete and would show the notable improvement in solvency following the £500m injection and the added knock on benefit of the reduction in resilience'*. However, the Society said that: *'Both the*

end of February and March figures are based on the latest test 2 for resilience, assume the Section 68 Orders for Permanent/equivalent bond but take a more conservative approach than required by the regulations for Regulation 72 (assumed age of retirement). The value of the equivalent bond concession was estimated at c£200m for the end of the year, although this would be reduced over time as the yield curve flattens'.

53 Equitable also provided to the FSA their estimated monthly solvency figures for 28 February 2001. Those figures showed that the Society had free assets of £1,500 million to cover its required minimum margin of £1,200 million.

54 During the first week of May 2001, there was extensive discussion, between the members of the FSA's Insurance Supervisory Committee (who were responsible for deciding whether to put a recommendation to the Treasury that a section 68 Order should be granted) and the Society's supervisory team, about the section 68 Orders for which Equitable had applied.

The implications for the Society's solvency position of Counsel's opinion on mis-selling

55 On 8 May 2001, the FSA were informed by the Society's Chairman that Equitable had received an opinion from Counsel which suggested that non-GAR policyholders might have reason to make claims that the Society had mis-sold their policies. The FSA immediately turned their attention to the implications of the opinion for the Society's solvency position.

56 A great deal of activity was undertaken by the FSA on this issue to establish what claims could legitimately have been made by policyholders and to quantify the potential values of such claims. That activity is recorded fully within Part 3 of this report.

57 The implications of Counsel's opinion were discussed the following day, during a meeting with Equitable. The FSA recorded that:

> *A significant additional reserve would almost certainly lead to the Society not covering its* [required minimum margin]. *The Appointed Actuary said that if required the Society could find the amount required in the worse case scenario (the £1.5bn) but this would mean that the Society would have to move entirely out of equities and into gilts.*

58 On the same day, the FSA decided that they should put their recommendation to the Treasury that the section 68 Orders in relation to the valuation of Permanent Insurance within the Society's 2000 returns and in relation to the valuation of certain fixed interest assets should be granted. On the latter Order, the FSA recorded that they had:

> *... concluded that on balance it supported the application, largely on the basis there were no clear grounds for rejecting it. It was agreed that this should be made clear to the Treasury, along with the points about the impact and reasonableness of Equitable Life's tendency to use the most favourable valuation basis to it.*

59 Also on 9 May 2001, Equitable provided their estimated monthly solvency figures for 31 March 2001. Those figures showed that the Society had free assets of £2,020 million to cover its required minimum margin of £1,150 million.

60 On 21 May 2001, the Treasury raised a number of concerns with the FSA about the FSA's recommendation that the section 68 Order, in relation to the calculation of the valuation rates of interests for certain fixed interest assets, should be granted. The Treasury explained that their concerns centred on *'consistency and presentation'.*

61 On 31 May 2001, the FSA provided to the Treasury a further explanation of the justification for their recommendation. The FSA also recorded at that time that the Society believed that the Order would improve its solvency position by approximately £150 million to £200 million.

62 On 8 June 2001, the Treasury granted the two section 68 Orders (in relation to the valuation of Permanent Insurance and the calculation of the valuation rates of interests for certain fixed interest assets) which had been requested by the Society.

63 The Society submitted its 2000 regulatory returns to the FSA on 28 June 2001. The solvency position shown in Form 9 of those returns said that, as at 31 December 2000, Equitable had free assets of £1,632 million to cover their required minimum margin of £1,221 million. A full description of the content of those returns is contained within Part 3 of this report.

64 On 10 July 2001, the FSA's Head of Actuarial Support commented on the emerging legal opinion of Counsel who were advising the FSA, saying that:

> [Counsel for the FSA] *is looking at possible mis-selling claims for all with-profit policies sold from around 1996 as being a possibility (though his view may well differ from* [Counsel for Equitable] *who has so far come at his from a rather different angle). The present policy values in respect of this business are likely to be of the order of £10bn, so that if the quantum of claim were say 15% of policy value (and it could be higher on the approach he is looking at), we could have mis-selling liabilities of £1.5bn or more.*
>
> *In present investment market conditions, this would very likely mean that the company was insolvent.*

65 Around this time, Equitable sent to the FSA copies of four papers which had been prepared for their Board. In one of those papers, the Society's Appointed Actuary commented on the financial position for the year-end 2000, as presented in its returns. The Appointed Actuary advised the Society's Board that:

> *It should be noted the £411m of free assets is after taking credit for the reinsurance benefit (£808m) and future profits (£1000m). It also ignores the value of the subordinated debt liability of £346m.*
>
> *These are all permissible and previously agreed with the FSA. However, their use clearly eats into any conservatism in the basic valuation regulations.*

In relation to the strength of the valuation basis used by Equitable, the Appointed Actuary advised the Board that:

> *In arriving at the valuation, specific assets are hypothecated to particular liabilities, and reallocated in the resilience scenarios. I believe that the process we used is close to the best achievable.*
>
> *Overall I think that whilst prudent in all respects according to the valuation regulations the Directors should be aware that it would, in my view, not be possible to produce a satisfactory valuation which produced a materially higher net asset position at 31/12/2000.*

66 At a meeting with PIA held on 18 July 2001, the FSA reported that they thought that a recent statement made by the Society's Chairman regarding the solvency of Equitable was *'arguably misleading'*.

67 It was agreed that the FSA should issue a Notice under section 44 of ICA 1982, requiring the Society to provide monthly financial information and to demonstrate that it was solvent under the requirements of both ICA 1982 and the Companies Act 1985. However, the FSA did not in fact impose formal reporting requirements on the Society. Instead, they asked for enhanced reporting but on an informal basis, so as to provide the FSA with *'greater flexibility to update the form and content of the information to reflect concerns at any particular time'*.

68 It was also agreed that there should be an independent review of Equitable's financial condition, to be carried out within three to four weeks.

69 On 18 July 2001, the FSA provided answers to certain questions which had been raised by the Economic Secretary to the Treasury. On solvency, the FSA advised that:

> *We are satisfied, on the basis of the latest figures supplied by the company, that it continues to meet its solvency margin requirements. As the company has made clear in its Annual Report and in its regulatory returns, it continues to face some fundamental uncertainties...*
>
> *There are however uncertainties, including in relation to the opinion on mis-selling which is due shortly (the FSA is also doing work on this topic). Subject to those uncertainties, at this stage, we do not think insolvency likely and we have been assured by the appointed actuary that there are further steps the company can take to avoid that, such as by cutting terminal bonus further ... If however insolvency was unavoidable, this would trigger the operation of the Policyholders Protection Act where the Policyholders Protection Board would in the first instance seek to secure a transfer of policies to another insurer. It would be able to provide financial assistance to achieve that. Alternatively, the business could be placed in liquidation and policyholders would be paid compensation up to 90 per cent of the guaranteed value of their policy at the point of liquidation.*

70 In the initial scrutiny of the Society's 2000 returns, undertaken by the FSA on 19 July 2001, it was noted that the absolute level of coverage for the required minimum margin was a matter *'of concern'* and that, even with the sale of assets to Halifax (which had improved the Society's free assets), *'the position remains tight'*.

71 On 20 July 2001, Equitable provided their estimated monthly solvency figures for April, May and June 2001. The figures for 30 April 2001 showed that the Society had free assets of £2,005 million to cover its required minimum margin of £1,155 million. The figures for 31 May 2001 showed that the Society had free assets of £1,790 million to cover its required minimum margin of £1,140 million. The figures for 30 June 2001 showed that the Society had free assets of £1,780 million to cover its required minimum margin of £1,120 million.

72 Equitable also informed the FSA that:

> *Last week I sent you our "ready reckoner solvency" matrix. Using this type of methodology we estimate the statutory solvency position daily and at the low point of the market at around lunchtime on 19 July 2001 when the FTSE 100 stood at 5320 it is likely that the cover ratio was about 1.0, i.e. just covering the required minimum margin. As discussed, and is clear from the matrix further equity market falls could lead to the required minimum margin being breached.*

73 On 23 July 2001, in response to the latest version of Counsel's opinion on the potential for mis-selling claims to be made against the Society, the FSA's Head of Actuarial Support commented that *'the potential liability could still be around £2-3 billion'*.

74 Later that day, the Head of Actuarial Support commented that the financial implications for Equitable looked *'quite bleak'*, and he said that:

> *If, for example, they are likely to incur mis-selling claims on all post-1993 policies, then the liability could be around £3-4 billion, which would be well beyond their current free reserves on a Companies Act basis of around £1½ billion. If the potential claims extend back to 1988 or even earlier, then the situation is clearly even worse.*
>
> *Even if the Limitations Act applies (which seems very odd to me as a layman given that it was not the fault of the policyholders that they could only have been likely to have become aware of the alleged non-disclosure in 1998 or even later), then the liability could be around £2½ to £3½ billion, assuming that there would be a liability in respect of all premiums paid in the last 6 years. The result is still then likely to be insolvency.*

The weekend of 28 and 29 July 2001

75 Leading up to, and immediately following, the weekend of 28 and 29 July, there was a great deal of activity concerning whether the Society was solvent and whether it could continue as a going concern. The details of those events are described in full within Part 3 of this report, and I will not repeat all of them here. However, there are five key events from this period which I will highlight.

76 First, there was a review of the situation by the three authorities responsible for financial regulation and stability. On 25 July 2001, a meeting of the Tripartite Standing Committee considered the case for intervention by the authorities and whether there existed arguments for an injection of public funds into Equitable. The note of that meeting recorded the following:

> [FSA's Chairman] *said that something between £3* [billion] *and £5bn would make* [Equitable] *solvent.* [FSA's Director of Insurance] *said that it was difficult to assess what additional contribution to the pot might be necessary to make a s.425 scheme attractive to* [Equitable] *policyholders. But while the insurance industry would probably not be keen on a rescue, it might be readier to consider this if the government was involved.* [FSA's Chairman] *said that if the government put money into the company, it would be interpreted as a problem with the past regulatory regime.*

77 Secondly, on 26 July 2001 the FSA approached the Association of British Insurers to see if an industry rescue could be arranged. The initial response was that such a proposal was unlikely to receive the support of the industry.

78 Thirdly, on 27 July 2001 the FSA served a Notice on Equitable. The requirement of that Notice, which was issued pursuant to section 44(2B) of ICA 1982, was that:

> *... the Society shall furnish the FSA on 20 August 2001 with a report by* [a named company] *analysing the financial position of the Society as at 30 June 2001 (or such later date as shall in the opinion of* [the named company] *be practical) such analysis to be in accordance with, and contain the information set out in Appendix A to this Notice.*

The FSA explained that their rationale for serving this Notice was as follows:

> *In order for us to assess the solvency of the Society, both to determine the baseline financial position against which the proposed compromise scheme needs to be assessed and to consider which of all options open to the Society best protects policyholders' interests, we consider it necessary to have a report prepared by a firm which is independent from the Society.*

79 Fourthly, over this period the FSA and the Treasury considered whether Article 4 of Equitable's Articles of Association meant that the amount of their liabilities would reduce in line with their assets. They also considered whether the prudential regulators possessed powers to prevent Equitable from using Article 4 to reduce the guaranteed amounts payable under their contracts.

80 Finally, on 29 July 2001 the Society informed the FSA that the Board had concluded, that morning, that:

> *The Society appeared to be solvent on every basis for calculating solvency.*

The FSA noted that, in reaching that conclusion, the Society's Board had taken a *'rational, worst case basis'* for assessing mis-selling liabilities of £900 million.

81 Throughout August 2001, the prudential regulators and the Society continued to attempt to establish some certainty on both the status of possible mis-selling claims and the quantification of those claims.

82 On 21 August 2001, the FSA returned their attention to the Society's 2000 returns, having asked some questions of Equitable following their initial scrutiny of the returns on 19 July 2001.

The results of the report into the Society's solvency position

83 On 24 August 2001, the FSA were given a presentation of the results of the review of the Society's solvency position as at the end of June 2001. The FSA were told that Equitable had assets above their required minimum margin of £758 million. However, when reporting on the presentation to his Chairman, the FSA's Line Manager pointed out that:

> *These figures do not take into account any explicit liability for future discretionary bonuses or for compensation to non-GARs.*

The Line Manager went on to say that:

> *In effect, on all three bases,* [the company] *have quantified the surplus assets that are available to pay the mis-selling and, after that has been paid, to fund future (non-contractual) bonuses. In advance of the finalisation of the work quantifying the mis-selling claims it is not possible to reach a definitive conclusion on Equitable Life's ability to fund those claims. However, based on the preliminary work that has been done the level of surplus assets reported by* [the company] *as being available to meet those claims does not give us any cause for concern.*

Disclosure of the side-letter to the IRECO reinsurance treaty

84 On 14 September 2001, the Society's Appointed Actuary wrote to the FSA to inform them that a side-letter, dated 1 April 1999, to the Financial Reinsurance Treaty had come to light. He reported that this *'purports to clarify the position if the balance insured and outstanding exceeds £100m sterling'* and said that the Society had sought legal advice about the implications of the letter, but that this had been unclear.

85 Reliance had been placed within the Society's 2000 returns on the financial reinsurance arrangement when setting the mathematical reserves. The Treaty giving effect to this arrangement had been amended for a second time in August 2000, in an attempt to reflect the changed position of the Society after the decision of the House of Lords in the *Hyman* litigation.

86 After this change, the Society took credit in its main valuation of £808 million for the financial reinsurance arrangement. The Society's 2000 returns disclosed that its assets exceeded the sum of its liabilities and its required minimum margin by £411 million.

87 On 21 September 2001, Equitable provided their estimated monthly solvency figures for 31 August 2001. Those figures showed that the Society had free assets of £1,733 million to cover its required minimum margin of £1,053 million.

88 On 24 September 2001, the FSA received a fax from the Society, enclosing a copy of the side-letter. The side-letter said that it was not intended to be legally binding but to clarify the intentions of the parties, that if any claim exceeded £100 million then the Treaty would be cancelled by mutual agreement, that the Society would not draw cash pursuant to the Treaty and that the purpose of the arrangement had been to create flexibility for the Society in reserving.

89 A handwritten note was made on the Society's fax by an FSA official, which recorded that the side-letter had not been seen before, that the intention to cancel the Treaty if the withheld amount exceeded £100 million was at odds with what GAD and the FSA had been told in February 1999, and that the undertaking not to draw cash could invalidate the reinsurance offset to the Mathematical Reserves shown in the returns.

90 On 28 September 2001, the FSA met the Society to discuss the side-letter. The Society said that it had been passed by the former Appointed Actuary to his successor on 7 August 2001. The day before the meeting, the reinsurer had informed the Society that it felt that the side-letter gave them the option to cancel the Treaty if the £100 million trigger level were reached.

91 The Society had not accepted this, citing legal advice it had received that the side-letter was not necessary to interpret the Treaty. However, the Society had been concerned that, in the event of a dispute between the parties and if that dispute became subject to arbitration, which would be heard in Ireland where the reinsurer was based, the letter might have some force.

FSA's exercise of powers pursuant to ICA 1982 to require the Society to produce a plan for the restoration of a sound financial position

92 By the beginning of October 2001, the FSA had reached a view of their best estimate of the level of provision for mis-selling that Equitable should be required to hold. On 1 October 2001, the FSA's Head of Actuarial Support had concluded that:

> *The overall accounting provision ... after taking account of the probability of success could then be around £300 - 550 million, with a best estimate likely to be in the range of £400 - £500 million. For the FSA returns, we would expect to see a greater margin for prudence, and probably a contingent liability for potential recission claims, which might indicate a provision of between £600 and £700 million.*

93. On 4 October 2001, the Head of Actuarial Support commented on the credit that could be taken for the reinsurance treaty, saying that:

> *In view of the letter apparently received from IRECO saying that they would intend the treaty to be cancelled if the claim ever exceeded £100 million, I think it would be very difficult for Equitable to take credit for more than this amount in a "prudent" statutory valuation, where the actuary has to take account of both the credit and legal risk under this reinsurance agreement.*

94 The following day, Equitable provided the FSA with an update on their solvency position under three different bases. Under the Society's normal valuation basis, yet still taking into account *'the full effect of the reinsurance treaty for GAR liabilities'*, it showed assets in excess of its required minimum margin of £150 million. Equitable explained that they had included in this valuation a provision of £220 million for any mis-selling of non-GAR policies.

95 In the light of this information, the uncertainty in relation to the reinsurance treaty, and their own work on the quantification of potential mis-selling liabilities, on 9 October 2001 the FSA exercised the power to require the Society to produce a plan for the restoration of a sound financial position. The FSA stated that:

> *Section 32(4) of the 1982 Act gives the FSA power to require the production of a plan for the restoration of a sound financial position in the event that a company has failed to maintain the prescribed margin of solvency. In present circumstances the FSA must now formally ask for the submission of such a plan within 2 weeks of the date of this letter.*

96 On 16 October 2001, the FSA returned their attention to the valuation basis that the Society had used in its 2000 returns. The FSA raised a number of questions in relation to how Equitable had reserved for surrender values for their accumulating with-profits business and whether the level of reserves was consistent with the Society's policyholders' reasonable expectations. The issues related to whether Equitable had fully explained to policyholders how they operated the market value adjuster. The following day, the FSA's Head of Actuarial Support commented that:

> *At end-2000, the reserves held were broadly equal to the guaranteed fund without any discounting. Therefore, the surrender value test was not relevant in the base scenario at that stage. However, I would agree that in view of the fall in equity markets since then, and the discounting of the guaranteed benefits that is now being applied, we do need to be satisfied that these reserves take account of the underlying current PRE surrender value.*

97 The FSA met the Society again on 22 October 2001. The meeting notes record that Equitable had been conducting negotiations with the immediate parent company of the reinsurer to clarify the situation. The meeting notes also record that the proposals that had been put forward by that parent company as a means to resolve the issue were unacceptable to both the Society and the FSA.

98 It was agreed that the FSA would meet the reinsurer because of the regulatory significance of the issue and the need to resolve matters, so that any ongoing uncertainty did not introduce further instability into the financial position of the Society at a time when it was seeking a way of compromising the competing claims of its policyholders.

99 On 25 October 2001, Equitable provided their estimated monthly solvency figures for 30 September 2001. Those figures showed that the Society had free assets of £1,340 million to cover its required minimum margin of £1,006 million.

100 On 26 October 2001, Equitable provided the FSA with their plan for the restoration of a sound financial position. The Society's plan comprised of three elements, those being:

- the renegotiation of the IRECO reinsurance treaty;
- the switching of funds from equities into fixed interest securities; and
- the Compromise Scheme.

A full description of the Society's plan is contained in the entry for this date within Part 3 of this report.

101 The FSA met the parent company of the reinsurer on 1 November 2001. The parent company stated that, in their view, the financial reinsurance arrangement had always been intended to be a *'riskless'* transaction. The FSA explained that that had *'very definitely not* [been] *our view at the time, of the basis of the information we were given'*.

102 Further discussions to renegotiate the terms of the arrangement took place. A draft of the amended arrangement was supplied to the FSA on 8 November 2001. On 12 November 2001, consideration was given by the FSA to the effect of the Treaty as it now stood in draft. The Head of Actuarial Support stated that he believed that the maximum reserving benefit that the Society could take was £250 million, based on the 10% cash payments allowed under the Treaty. The Line Supervisor responsible for the Society gave his view that the Treaty was still *'little more than window dressing and the reinsurer has no intention of assuming any serious risk at all'.*

103 On 15 November 2001, the FSA's Chairman wrote to the Economic Secretary to the Treasury to inform her of the Society's financial position. The Chairman explained the uncertainty which existed over the credit that could be taken for the reinsurance treaty, and said that:

> *This problem, together with the effect of various market movements, and the need to reserve for potential mis-selling claims following delivery of the Opinions of* [Counsel for Equitable and Counsel for FSA], *result, on our assessment, that the Society could be in breach of its solvency margin requirement by some £200m.*

104 On 16 November 2001, the Society's Appointed Actuary wrote to the FSA to ask about the offset that the Society could take within its returns if the new Treaty were to be signed. The Appointed Actuary suggested that, in his view, a £600 million offset was appropriate, based on the amount of the reserve (not discounted), but reduced by £100 million to allow for the new additional premium that was required by the updated Treaty. The Society asked the FSA to agree to this credit in writing.

105 On 20 November 2001, it was agreed within the FSA that the prudential regulators should accept that the effect of the Treaty was that an offset could be taken within the Society's returns but that it was not yet clear what the amount of this should be. The amount would be calculated by reference to the cash available to the Society, which it was suggested might be in the range of £250 million.

106 On 22 November 2001, the FSA were advised by Counsel that the existence of the side-letter to the reinsurance treaty added nothing to the provisions within the reinsurance treaty itself and that there would have been no need to renegotiate the treaty if the 'Reinsurance Claims Amount' had exceeded £100 million. However, on the credit that could be taken for the reinsurance treaty, the FSA recorded the following:

Could [Equitable] *call* [in the Reinsurance Claims Amount] *in cash?* [Equitable's solicitors] *said no.* [Chief Actuary C] *said makes treaty worthless then.* [Counsel] *agreed.*

Need clarity that [the Reinsurance Claims Amount would] *be* [payable] *in cash by IRECO on* [liquidation, otherwise] *only thing you can take credit for is the 10%.*

107 The FSA informed Equitable, that day, that they should not take credit in their returns for the reinsurance treaty of more than £350 million.

108 On 23 November 2001, the FSA issued a press statement about the disclosure of the side-letter to the reinsurance treaty. The statement said that the FSA:

> *... took the view that the contents of the letter raised questions about the true value of the reinsurance contract that Equitable Life had entered into in early 1999 and which was shown in its regulatory returns. The FSA concluded that, had it been aware of the letter at the earlier stage, it would not have been prepared to accept the reinsurance arrangements as providing as much security for reserving purposes as was in fact taken.*

109 The statement went on to say that the FSA:

> *... has seen and reviewed the terms of a renegotiated reinsurance agreement and has confirmed that it has no objection to them.*

110 However:

> *... in the light of advice from leading Counsel, the FSA has taken the view that the value that Equitable Life should reasonably ascribe to the reinsurance contract is lower than it previously took. The FSA has made clear to Equitable Life that it must properly disclose the effect of the revised agreement, so that policyholders are made aware of the impact on Equitable's financial position for regulatory purposes.*

111 FSA also stated:

> *On the basis of the information received by the FSA, Equitable Life continues to meet its regulatory solvency requirements even taking account of the lower credit for the revised reinsurance policy.*

112 On 26 November 2001, Equitable provided their estimated monthly solvency figures for 31 October 2001. Those figures showed that the Society had free assets of £1,395 million to cover its required minimum margin of £985 million.

113 There remained a number of issues which were yet to be resolved before the new regulatory regime came into force, at which time my jurisdiction over the relevant events ended.

114 Those issues included whether Equitable's approach to discounting the reserving established for their accumulating with-profits policies was consistent with policyholders' reasonable expectations. The regulators also continued the discussions on the credit which could be taken for the financial reinsurance treaty, an issue which was also by that time linked to the success of the Compromise Scheme, to which I return later in this Chapter.

The information provided by the FSA

115 Throughout the post-closure period, the FSA were contacted by many policyholders seeking information and advice about the position of the Society and about their own options. In response to this, the FSA decided that they would provide general information to assist those policyholders.

116 The information provided by the FSA during the relevant period can be divided into three types: general information provided on websites and in press notices; responses to individual communications from concerned policyholders; and the published assessment of the Compromise Proposals that was published in December 2001.

General information

117 On 14 December 2000, the FSA put the following information on their website:

The FSA is:

- *monitoring the Equitable's position closely;*
- *making sure that policyholders are given timely and comprehensive information so that they can consider their options fully;*
- *requiring the Equitable to have effective arrangements for dealing with any complaints they receive; and*
- *the Equitable has, with the encouragement of the FSA, established a process for helping policyholders to decide whether they should take any immediate action.*

Since current Equitable policyholders may be asking other firms for advice, the regulators will shortly be reminding all firms of their obligations to give suitable advice, taking properly into account the personal circumstances and aspirations of their customers.

118 On 8 October 2001, the FSA noted that, in response to the question *'is the Society solvent?'*, their website had stated for some time that:

> *We have been monitoring Equitable Life's financial position closely, and on the basis of the information available to us, we are satisfied that it continues to meet its regulatory solvency margin requirements. Nevertheless, Equitable Life made clear in its annual accounts and in its regulatory return (a report that* [they] *must make to us), that it continues to face some fundamental uncertainties – for example, in relation to the cost of its liabilities to the Guaranteed Annuity Rate (GAR) policyholders. The proposed compromise scheme is designed to address those uncertainties.*

119 It was said that this was also the line that had been taken consistently by the FSA's press office.

Specific responses

120 I have also reviewed the many files of policyholder correspondence held by the FSA. Having done so, it is clear to me that, for understandable reasons, the FSA developed and used standard paragraphs to include in responses to individual policyholders who wrote to them following the Society's closure to new business. On occasion, they also replied on an individual basis, tailoring their reply to the specific points raised with them. What follows largely refers to the standard paragraphs that were used by the FSA on many occasions.

121 Prior to the closure of the Society to new business, the FSA often used the following standard paragraph in responses to communications from policyholders:

> *Your letter questions the solvency of the Society. As regulator, the Financial Services Authority monitors the financial position of insurance companies carefully. We are satisfied on the basis of the information provided to us*

that, even after having made appropriate provision to cover benefits on a basis consistent with the House of Lords ruling, the Equitable continues to satisfy regulatory requirements under the Insurance Companies Act 1982.

122 Another standard paragraph stated:

> *... as you may be aware, the Society takes the view that its financial position has now been weakened and that the future interests of policyholders will be best protected by seeking a buyer for the business. This would enable the Society to raise additional capital to support its future business.*

123 In relation to early criticisms that the prudential regulators were failing to prevent the Society from advertising for new business in the light of the House of Lords' judgment, the FSA often replied:

> *... given that the Society continues to meet the relevant statutory requirements and is therefore able to continue to trade, we see no reason why the Society should not continue to advertise to attract new business.*

124 Less than a month prior to closure, the FSA also felt able to deal with the way in which the Society had acted in relation to its regulatory obligations:

> *As regulator, the FSA monitors the financial position of insurance companies carefully. We are satisfied on the basis of the information provided that the Equitable continues to be solvent and satisfies all relevant regulatory requirements under the Insurance Companies Act 1982. As the Equitable continues to be a going concern, complying with the relevant regulatory requirements, we do not share your view that it should be prevented from marketing its products, which could be damaging to the business.*

125 For natural reasons, the volume of communications from Equitable's policyholders greatly increased when the Society closed to new business. The line taken by the FSA in response to such correspondence included the following standard material:

(i) *I would point out that the Society remains solvent and will continue to pay out benefits and accept premiums under existing policies;*

(ii) *I should point out that the company continues to be solvent and to meet the statutory requirements for insurance companies;*

(iii) *I can assure you that the Equitable remains solvent, existing policies are still valid and the Company continues to be able to meet its contractual obligations to policyholders; and*

(iv) *The Equitable remains solvent, existing policies are still valid and it continues to be able to meet its contractual obligations to its policyholders.*

126 In response to correspondents seeking specific information about the position of the Society, in January 2001 the FSA replied:

> *You asked for some reassurance concerning the future security of your investments with the Equitable. The Equitable remains solvent, existing policies are still valid and it continues to be able to meet its contractual obligations to its policyholders. Of course, the FSA also continues to monitor closely the operations of the Equitable in accordance with our powers under the Insurance Companies Act 1982 and the Financial Services Act 1986.*

127 In February 2001, the FSA wrote:

It might be helpful if I first clarify that while the Equitable announced on 8 December 2000 that it would from that day close to new business, the Equitable was solvent and remains so, complied with all relevant statutory solvency requirements for insurance companies, and was able to meet its contractual obligations to its policyholders.

128 From June to August 2001, one of the standard paragraphs used by the FSA was:

We are satisfied, on the basis of the latest figures supplied by the company, that it continues to meet its solvency margin requirements. The company has made it clear in its Annual Report and in its regulatory returns, that it continues to face some fundamental uncertainties.

129 Following the policy value cuts in July 2001, the FSA would reply to correspondents, saying:

Equitable Life, like many companies, is having to cope with very difficult investment conditions. The position is that policies have notionally been growing in value at an annualised interim rate of 8 per cent. However, because of the current investment climate, the returns on the with-profits fund over the last couple of years have been minimal. The notional increase in policy values has therefore been eating away at the company's free assets. The board has therefore decided it is time to act to bring policy values back into line with the value of the assets that back them, and to reset the interim rate of return at a sustainable level. The guaranteed elements of any policy values will not be affected.

130 In August 2001, the FSA informed a policyholder who asked about possible compensation being made available to mitigate the effects of the policy value cuts:

You ask whether anything is being done to compensate policyholders for the reduction in policy values. This reduction was to bring the value of policies on maturity or surrender into line with the value of the underlying investments which have fallen considerably as a result, in part, of recent falls in stock market values. This was to ensure that those leaving the Society were not paid more than a fair share of the funds. Our understanding is that the Equitable's overall policy values, which include an element in respect of expected final bonus at maturity, were expressly stated not to be guaranteed except when the policy matures or at other contractual dates when funds can be withdrawn without penalty.

131 The standard response from the FSA, when asked what the reasons for the policy value cuts were and whether regulatory failure had played any role in the events at the Society, was:

I am sorry that you feel the information you received from us regarding the Equitable Life Assurance Society (the Equitable) was incorrect in light of the recent announcement about the reduction in policy values. It might be helpful if I clarify why this reduction has occurred.

The Equitable announced that it would have to reduce pension policy values by 16 per cent and not award any growth for the first six months of 2001 because of:

- *heavy falls in stock markets over the last 18 months;*

- *the need to align policy values so they do not exceed the value of the investments underlying them; and*
- *the number of policyholders taking their benefit out on retirement*

The Equitable is not the only life assurance company reducing final bonuses because of falls in the stock market.

132 On 5 January 2001, the FSA also wrote in the following terms to a policyholder, concerning what might happen should Equitable become insolvent:

However, should the need arise, there is a scheme designed to assist with the transfer of policies or arrange compensation.

The immediate objective of the scheme would be to arrange for your contract to be transferred to another provider to ensure continuity of cover as the case may be. If that were not possible, the scheme provides for compensation to be paid, generally of 90% of the contractually guaranteed benefits at the time of the insolvency.

133 On the role of the regulators, the FSA explained to policyholders that:

The Financial Services Authority... has, in accordance with its statutory objectives, been actively working in a number of areas to protect the interests of the Equitable's policyholders. We have been carefully monitoring the Equitable to ensure that it continues to meet the requirements under the Insurance Companies Act 1982 and complies with the rules of the Personal Investment Authority. We are working with the Equitable to try to make sure that clear and appropriate information is available to policyholders as developments happen. And that the Equitable continues to give support and advice to its customers.

134 The FSA also was often asked for advice as to what an individual policyholder should do in the light of the ongoing uncertainty surrounding the future of the Society. A standard reply given was:

Our advice to policyholders has not changed. Policyholders will need to think carefully about the options open to them, and the consequences of those actions. We would also recommend policyholders consider carefully whether to take independent advice on their position. In considering your options you will wish to be aware it is often possible to transfer or surrender policies. However, where that is possible, surrendering or transferring with-profits policies at points other than on contractual dates may result in policy values being reduced. Contractual dates might be maturity, retirement or other dates which may be specified in the contract. Policyholders withdrawing funds at such specified dates are not affected by these adjustments, nor are most of those with unit linked policies. You will need to check the terms of your policies or with the Equitable to establish the position as it relates to your policies.

135 Finally, while the proposals for the Compromise Scheme were being developed, those who contacted the FSA were often told that:

The main effect of the closure to new business was that at the time, the Equitable thought it would have to hold a higher proportion of its funds in more secure investments, such as gilts, which might have led to a slight reduction in returns. The Equitable has since announced *plans to buy out rights to an annuity at guaranteed rates, which it believes would provide a degree of certainty for policyholders going forward. The Equitable also believes that the increased certainty would allow it to release statutory reserves held to cover the GARs and, combined with the amounts payable by Halifax, this would restore the company's investment freedom for the future, thereby enabling it to operate more like an open fund. We understand that details of the proposals will be announced over the summer.*

The FSA's consideration of Equitable's bonus declaration for 2000 and the July 2001 policy value cuts

136 At several points over this period, the prudential regulators raised the matters of the level of benefits that Equitable were paying out on their policies, the amount of bonus that would be declared for the year 2000 and the interim rate to be used going forward, and the relationship between policy values and asset shares.

137 In their report to the FSA on reserving and related issues, GAD said that they could not say whether the current level of a 10% market value adjustment applied to non-contractual surrenders was the correct one. GAD's report noted:

> *However, we understand from figures supplied* [by Equitable's auditors to Prospective Bidder A] *last month, that Equitable are overpaying (on monies leaving the fund) at 30.09.00 at the rate of £2.3bn (across the whole portfolio) and this suggests that some correction to the level of payouts is overdue. In the normal course, the Society would seek to recover this overpayment in future years, but in the situation they now find themselves in, this would be to the particular detriment of the remaining policyholders.*

GAD's report continued:

> *The Insurance Companies' Regulations and the actuarial guidance do not require companies to reserve for Terminal Bonus in statutory valuations, and most companies/societies take advantage of this exemption. When Terminal Bonus is paid on a claim, the cost is met from the Society's free assets. However, as shown ... above, we do not believe the Equitable have any free assets of any size. There is therefore a danger that if the Equitable allow out-going policyholders to leave the fund on terms which are too generous, there could then be insufficient assets available to meet the guaranteed benefits of the remaining policyholders. The whole situation is very delicate, and needs to be handled carefully.*

138 On 21 December 2000, GAD suggested to the FSA that they should discuss with Equitable the year-end bonus declaration and the impact of this on the Society's reserves. Also on that day, GAD suggested that Equitable should be questioned on the current level of payouts, and how those payouts compared to asset shares. GAD also suggested to the FSA that the Society should be asked to explain why, according to its auditors' figures, the '"*deficit on the smoothing account to recover in future" stood at £2.3bn. at 30.09.2000*'. GAD advised the FSA that this:

> *... suggests that the underlying amounts payable on termination are currently too high. Answers to these questions will help us to understand the dynamics of the business and the ramifications of those leaving the fund on the continuing policyholders.*

139 The regulators raised the question of the bonus declaration with Equitable on 16 January 2001. GAD's note of that meeting recorded that the Society was expecting not to declare any bonus that year, as it did not have sufficient emerging surplus. GAD also noted that Equitable were reviewing the interim bonus of 9% which was being applied to maturing policies.

140 On the bonus declaration for 2000, the FSA noted in a meeting held on 20 February 2001 that: *'The* [Appointed Actuary] *proposed to postpone the 2000 bonus notice until after the vote on the accommodation. If there was a positive vote it may be possible to offer a* [guaranteed] *bonus to everyone for 2000 of possibly 4%, (although as 3.5% is guaranteed under some GAR policies the real additional cost of this bonus was effectively the same as a 1% bonus across the board)'.*

141 On 30 April 2001, the FSA realised that Equitable's Companies Act annual report and accounts had been published. Within those accounts, it was said that the Society had decided to maintain the interim rate of bonus at 8% until further notice. It appears that the FSA gave no further thought to those matters until the issue of the July 2001 policy value cuts emerged.

142 At the time that Equitable submitted their returns at the end of June 2001, the Society wrote to the FSA to inform them that its Board intended to address the situation which existed, namely that policy values exceeded asset shares.

143 On 10 July 2001, the FSA received copies of four Equitable Board papers on the issue. A full description of these papers is included within the relevant entry for this date in Part 3 of this report. Following Equitable's announcement, made on 16 July 2001, that the Society's Board had decided to cut policy values by 16%, the Treasury asked the FSA a number of questions. In response to the Treasury's questions '*Do you consider saying anything about yesterday's announcement?*' and '*Did you consider urging EL to make it sooner, or saying something yourselves beforehand?'*, the FSA said:

> *We considered carefully whether it would be helpful for the FSA to make an announcement in parallel with that from Equitable Life. We concluded that there was nothing that we wished to say proactively since this was an announcement by the company. However, we prepared lines to take in response to enquiries and were in close touch with the company to review the proposed terms of its statement to ensure that it was appropriately expressed. The announcement was made as soon as practicable after the board had decided on its course of action, so an earlier announcement was never a possibility. It should also be remembered that part of the reason for the need for such extreme action was the continuing decline in the financial markets at a time when Equitable Life policies were continuing to attract notional annual growth of 8 per cent taking the value of the policies and the assets further out of line.*

In response to the Treasury's question *'How does the size of yesterday's revaluation compare with market movements generally over a directly comparable period?'*, the FSA said:

> *The adjustment to policy values, as compared with the year end position, was of 16 per cent. The FTSE 100 closed at about 6220 on 31 December 2000; on 17 July 2001 it closed at 5430, a fall of about 13-14 per cent. However, at the year end, policy values were already some way ahead of the value of the underlying assets because of the continued application of an 8 per cent interim rate of return. The overall effect is to reduce policy values to close to the value of the underlying assets at the present time.*

The development of the Compromise Scheme and the FSA's consideration of that Scheme

144 Throughout the post-closure period, the Society sought the means to stabilise its financial position in the light of its precarious financial position and the competing claims of different groups of policyholders. In particular, the Society sought to resolve any possible claims for mis-selling from policyholders who did not have policies with guaranteed annuity rates and to mitigate the potential detrimental impact on its solvency position of the open-ended liabilities arising from top-ups, which those policyholders with policies which contained guaranteed annuity rates were contractually allowed to make.

145 Having analysed the various options open to it, the Society decided that the best means of ensuring such stability was to compromise the claims of policyholders through a scheme of arrangement under the Companies Act 1985.

146 The preparations for this Scheme were undertaken throughout the period covered by this Chapter and it is impractical to seek to summarise those developments here, although as can be seen from Part 3 of this report, the Society kept the FSA regularly informed as to the progress on putting such a scheme in place.

147 The role of the FSA in such a scheme was explained by the FSA in their published assessment of the Society's proposals. It was noted that while *'the Companies Act does not give the FSA a formal role in the process... it has general regulatory powers... to take action in relation to the Compromise if it considers it appropriate in order to protect the interests of policyholders'*.

FSA assessment of the Compromise Scheme

148 On 19 November 2001, the FSA wrote to Equitable concerning their proposals for a Compromise Scheme. This followed an extensive dialogue between the prudential regulators and GAD, on the one hand, and the Society and its advisers on the other, which is set out within Part 3 of this report.

149 The prudential regulators listed a number of matters that remained to be resolved to their satisfaction but concluded that, subject to the resolution of these matters, the FSA *'would be content for its view to be recorded in the Scheme documentation in the following terms'*, namely that:

> *The Scheme has been formulated by the Society, which has satisfied itself about the fairness of the offer and the detail of the terms. The Society is also responsible for determining and disclosing its financial condition. The FSA's review has been directed to deciding whether it should exercise powers to intervene to prevent the Scheme being put to policyholders on the grounds that, in doing so, the Society was acting without due regard to the interests of policyholders. The FSA has determined that it should not do so, and considers that the Scheme is one which it is appropriate for the Society to put to policyholders. The FSA will publish more detail of its views on the Scheme before policyholders vote.*

150 This formulation was used by Equitable in section 7.7 of the information pack that they sent to all their members to explain the background to the proposals and to provide information about the various options.

51 The FSA subsequently, as it said that it would do, published a formal 'assessment' of the Scheme proposals, which is reproduced in full in Part 4 of this report. The assessment, published on 7 December 2001, summarised the view of the FSA thus:

> *The FSA is content that, in relation to the relevant groups of guaranteed annuity rate (GAR) and non-GAR policyholders, the level of increase to policy values is a fair offer in exchange for the GAR rights and potential mis-selling claims that would be given up. While there are variations from person to person, within each relevant group, we are content that there are no categories of policyholder within the groups who would receive disproportionately greater or lesser benefits.*

152 The FSA then described their role in relation to the compromise arrangement and explained that they had no formal role in the procedure under section 425 of the Companies Act 1985. However, the FSA explained that they could seek to be heard if the compromise were to be put to the court for formal approval after the vote by policyholders. The FSA went on to say:

> *As the FSA has made clear, we firmly believe that a successful compromise would, in principle, offer the best prospect of bringing stability to the with-profits fund and improving the outlook for concerned policyholders.*

153 After having set out their view as to the principal considerations to which both GAR and non-GAR policyholders should have regard, the FSA dealt with *'some important wider points that policyholders should take into account'*.

154 The first of these was entitled *'continued uncertainty'* and the FSA explained that:

> *Without the Compromise, the outlook for all policyholders would remain much more uncertain. In already difficult market conditions, the with-profits fund would remain seriously unstable...*
>
> *Equitable Life would need to continue to keep reserves against the range of competing rights and claims that would have been resolved under the Compromise. It would also need to adopt a more restrictive investment policy, which could affect policyholders' returns over the long term. There would also be a greater risk of extensive and costly litigation to sort out the various claims for mis-selling that would otherwise be settled by the Compromise. And those claims would in turn have to compete with the cost to the fund of meeting the GARs. All these costs would have to be met out of the with-profits fund. It is also likely that many of the remaining non-GAR policyholders would take the view – that some others have already taken – that they should take their money out rather than stay in a weaker fund.*
>
> *In order to be able to manage the business so that it continues to comply with regulatory requirements, Equitable Life could well, as the appointed actuary has made clear, find it necessary to take an extremely cautious approach to its management of the with-profits fund and to setting future bonus policy, in order to ensure that those leaving the fund in the near future, whether contractually or otherwise, do not take more than their fair share of the fund. If bonus rates had to be cut further, this could mean that all policyholders could find themselves materially worse off than if the Compromise had gone ahead.*

155 After explaining that another consideration to be borne in mind if the proposals were not agreed was that *'the benefit of the additional £250 million Halifax money would be lost, as would any chance of the further £250 million that is also contingent on certain future business targets being met'*, the FSA dealt with the alternatives to the proposals:

> *Some policyholders have suggested that winding up Equitable Life would be better, even though Equitable Life is solvent. The FSA does not agree. For a start, this would affect all Equitable Life policyholders, not just the with-profits policyholders who would be affected by the Compromise. If a winding up order were made, we would expect a liquidator to continue to run the with-profits fund and to attempt to assess and pay claims in the short term.*
>
> *However, a liquidator would probably be unable to declare any final bonuses, so the fund available to both GARs and non-GARs would be smaller. A liquidator would then attempt to transfer the policies to another insurer, if a willing recipient could be found. The value of a policy could be reduced on such a transfer. If a transfer were not practicable, then a liquidator would need to value all policies, on a basis agreed by the court, in order to make a distribution of the available assets. Significant costs arise on a liquidation, and any lump sum payments to policyholders might be taxed.*
>
> *There are additional consequences of a liquidation in the event of insolvency. We would expect the Financial Services Compensation Scheme ("FSCS") to protect the interests of policyholders, in the first instance by seeking to assist the liquidator to transfer the business to another insurer. As an alternative, the Court might be asked to reduce policyholders' contractual benefits, or crystallise them, in order to restore solvency and stability. If a transfer were not possible, the FSCS is able to compensate policyholders but any compensation would be limited to 90% of the value of the policy. The fact that the future returns or other benefits under a policy were guaranteed in certain circumstances, does not necessarily mean that the FSCS can pay compensation for those guarantees. This is because the FSCS is required to consider whether the benefits under a policy may be excessive.*

156 The FSA then concluded by dealing with the effects on other policyholders that an individual's vote might have.

157 The FSA's concluded view on the detail of the Scheme was that *'a successful compromise would, in principle, offer the best prospect of bringing stability to the with-profits fund and improving the outlook for concerned policyholders'*.

158 The Compromise Scheme was sanctioned by the Court on 8 February 2002, following a vote of the Society's policyholders in favour of its terms.

Other strands of regulatory work during this period

159 During the period covered by this Chapter, the FSA were also involved in a number of other strands of work concerning the supervision of the Society.

160 These included:

(i) the appropriateness of the use by the Society of market value adjusters which it applied in respect of the funds built up by policyholders who wished to transfer out of the Society to another pension provider – in the light of the concerns expressed by the Office of Fair Trading (OFT) about whether the use of such adjusters, which it saw as a penalty, was contrary to the Unfair Terms in Consumer Contracts Regulations;

(ii) the sale of part of the Society's infrastructure and non-profit business – to which I have already referred in Chapter 2 of this report;

(iii) consideration as to whether compensation from the Policyholder Protection Board (or action by it to effect the transfer of the Society's with-profits business to another provider) would be available if the Society became insolvent, given that the Society's Articles of Association appeared to limit its liabilities to the assets it possessed; and

(iv) attempts to gain an understanding of the potential liabilities that the Society faced as a result of any mis-selling that may have occurred in respect of those policyholders whose policies contained no guaranteed annuity rates – and the provision of compensation, by way of a rectification scheme, to those policyholders with guaranteed annuity rates who had been denied the opportunity to apply such rates to their fund, when taking benefits during the period in which the Society had operated its differential terminal bonus policy.

The OFT and the market value adjuster

161 On 12 December 2000, the OFT wrote to the FSA. They explained:

> *We are considering whether we need to take enforcement action in relation to reports that Equitable Life has imposed a new charge of 10% on transfers of assets out of the Society. We are beginning to receive complaints and enquiries about this charge. The relevant terms and conditions could be unfair if they give the Society discretion to make new charges or to vary existing ones. The Director General of Fair Trading has powers to prevent the use of unfair terms, by seeking an injunction in the High Court. The Office is prepared to move swiftly on the matter to protect the interests of consumers. However, we know insufficient about the basis on which Equitable is making the charge to justify formal action at this stage. Whatever light you can throw on the question would therefore be most welcome.*

162 This had been prompted by policyholder complaints. GAD provided advice on the letter to the FSA. This advice said that:

> *... the Equitable would very likely become insolvent if they were to remove this adjustment at the present time and experienced a large number of surrenders. This is a result of the combination of GAO costs, a negative investment return in the present year, the final bonus additions for which no provision is required under the regulations, and unrecovered "deferred acquisition costs". I hope that FSA will therefore not insist on them removing or reducing this adjustment factor on surrenders without considering the impact on their solvency.*

163 The FSA's Managing Director commented on the OFT approach, expressing particular concern that, if the OFT were to take the view that the Society's market value adjuster amounted to an unfair contract term, *'the position could become highly problematic'*.

164 This issue continued to be considered by the FSA. Legal advice provided internally to the FSA on 21 December 2001 stated:

> *... it would seem to be odd were we to be taking action against* [Equitable] *on the grounds that the 10% deduction was contrary to the Unfair Terms in Consumer Contracts Regulations (particularly where similar reductions appear to have been imposed in the past by* [Equitable] *without adverse regulator comment). I would also think that it would be odd, given the above considerations, for the OFT to consider taking action under those regulations against* [Equitable]*, though that of course is a matter for the OFT.*

165 The advice *'therefore'* concluded *'that the "exit charge" imposed by* [Equitable] *is unlikely to be contrary to the Unfair Terms in Consumer Contracts regulations'.*

166 The FSA's response to the OFT of 21 December 2001 explained that:

> *Equitable announced last week that its "exit charge" would be increased to 10% from its previous level of charges which averaged around 5%. On the basis of information available to the Government Actuary's Department, we understand that, even following this increase, surrender values of Equitable policies are not out of line with the industry average. The FSA will be monitoring the adjustments made by Equitable and we have powers to intervene at any time, if we consider the figure to be excessive.*

167 On 16 January 2001, at a meeting between the FSA, GAD and the Society, Equitable:

> *... explained that the present 10% MVA is* [needed] *to cover the additional cost of* [GAOs] *arising following the* [House of Lords'] *judgment (probably around 5%), along with the relatively poor investment return last year (around 2.5%), and the need to recover all initial expenses incurred (around 2.5%). They have made a robust response to the OFT on this topic. The MVA is applied of course to the full value which was increased on an interim basis by around 4% last year, as compared with an actual investment return on the fund of around 2-2.5%. Meanwhile, they are not keen to draw any further attention to the MVA and its link to investment conditions in view of the possible adverse publicity. They stressed to us that the MVA is not intended to act as a penalty; rather the objective is that payments on noncontractual termination should be fair to both outgoing and remaining policyholders.*

168 On 19 January 2001, the OFT's provisional views, which had been informed by the response of the Society to their query about the market value, were communicated to the FSA. The FSA recorded those views as being that the OFT accepted the *'explanation we gave them and the criteria that Equitable apply in calculating a suitable adjustment',* while the OFT were not being in a position to form a view as to whether the 10% level applied by the Society was a reasonable one in terms of the unfair contracts legislation. However, *'the bad news'* was that the OFT *'took exception'* to the terms of the policies which provided that the Society had absolute discretion to make such adjustments.

169 On 7 February 2001, the FSA wrote to the OFT about their concerns. The FSA noted that the OFT's:

> *...concern is not so much about the application of an mva in itself, but rather the way in which any adjustment is calculated. You indicated that you might be looking to ask* [Equitable] *to take steps to amend the wording of its policy documentation to explain more precisely the basis on which adjustments would be made... I think that achieving your objective by way of a contractual change may present some difficulties and you will understand our concern, for prudential reasons, that nothing should be done to undermine* [Equitable's] *(or any other life office's) ability to adjust contract values at early termination in appropriate circumstances.*

170 The OFT replied on 15 February 2001, saying:

> [We] *are clear that the Regulations apply here. We cannot agree with the argument that the mva terms are fair or fall outside our scope to take action under the Regulations if they are operated fairly. The question is whether the terms have the potential to be used unfairly in the future or mislead customers, and we consider that they have. Equitable will need, in order to meet the requirements of the Regulation, to limit the scope of its "absolute discretion" and conform its conditions to the fair practices that it says it applies and the fair principles that are enforced by regulation, though these principles may need further elucidation. Similarly, the scope of the FSA to regulate Equitable and Equitable's present practice in operating the relevant terms, do not remove the problem or confer any kind of exemption... Whether a standard term is unfair does not depend on an assessment of factors such as the practices and potential remit of any regulators, the likelihood that the courts will overturn the unfair term when it is challenged, or the current practices and policies or culture of the business using the terms.*

171 The OFT concluded by saying:

> *I note your concern that nothing should be done to undermine Equitable's ability to adjust contract values at early termination in appropriate circumstances. However the effect of the Regulations is that the relevant terms should not enable Equitable to make unfair adjustments. The width of the terms is without doubt challengeable under the Regulations and could therefore be seen as unenforceable, whereas fair terms would not be. It seems to us essential therefore for Equitable to face this concern and that it would meet both your prudential concerns and ours for Equitable to do so by revisiting the terms to clarify and objectify the expectation that investors can legitimately have.*

172 In meetings subsequent to this exchange, the FSA and the OFT continued to disagree about the issue. In a report to the FSA Board given on 15 March 2001, it was said:

> *Policyholders had been complaining to the Office of Fair Trading that the adjustments made to the policy values on surrender (which was increased from an average of 5% to 10% after the closure announcement) were contrary to the unfair contract terms legislation. As a matter of policy, we share the concerns that adjustments should not be excessive and serve materially to disadvantage one group of policyholders over another. However, for prudential reasons, it is important that any life office has sufficient*

flexibility to protect its insurance funds. OFT accepted that a 10% penalty was not unfair but were concerned about the 'absolute discretion' reserved to the Society to determine surrender values. We have worked closely with both the OFT and Equitable on this and assisted them [to] *reach agreement about a way forward. OFT will not seek to challenge the relevant powers, and in return, Equitable will seek to improve the information about MVAs available to policyholders, including the reasons why they may be applied. The biggest short-term concern is that continuing falls in equity prices may lead Equitable to want to raise the MVA ...*

173 On 3 April 2001, the OFT informed the FSA that the OFT had already begun enforcement action against Equitable, following more than 60 complaints about the way they used the market value adjuster. The OFT said:

> *Equitable has explained how it exercises this discretion in practice but it is clear that there is no transparency and consumers cannot take an objective view of how it will be used. We think Equitable may be able to meet our concerns by giving an undertaking to limit the exercise of the discretion so that the term is used fairly and in a way that is – within the limitations imposed by varying market conditions – predictable and objectively verifiable by consumers. However, we would need to undertake a good deal of research before we could be confident that the undertaking effectively met our serious consumer protection concerns.*

174 From 1 May 2001, the FSA took over responsibility from the OFT for complaints made under the unfair contract terms legislation. Prior to this, on 17 April 2001, the FSA's Chairman had written to the OFT, saying:

> *I am sure you are correct to suggest that for OFT to pursue these cases would risk cutting across the review of with-profits business which I announced in February. Since the FSA will shortly gain powers under the UTCC Regulations I think it does make sense for us to take on these complaints, and we shall be happy to do so.*

175 By the time that my jurisdiction over the relevant events ended, those complaints were still under consideration by the FSA.

Contingency planning and winding-up

176 The chronology of events set out in Part 3 of this report details how the other issues arose, the degree of regulatory involvement in each, and the way in which these issues were resolved, if they were, during the period covered by this report.

177 Consideration was given on almost every day of the period covered by this Chapter as to the options which the prudential regulators and the Society faced. The FSA identified at an early stage the need for contingency planning and analysis of the possible methods and implications of winding the Society up.

178 The FSA secured the services of a secondee who was an expert in insurance insolvencies to advise and assist the FSA to consider these options. This resulted in a significant volume of analysis. What rapidly became clear, however, was that there was little by way of precedent, the rules were extremely complex, and the actual mechanics of winding up were very uncertain, but likely to be prolonged. It is not practicable to replicate here all the entries which set out this activity. Those are set out in Part 3 of this report.

Liability for mis-selling

179 On 8 May 2001, the Society's Chairman provided the FSA with an initial draft of Counsel's opinion on the possibility of mis-selling claims to be made by non-GAR policyholders. The FSA said that they would need to consider the implications of this opinion for the Society's solvency position. The FSA and the Society met the following day, continuing their discussions on the issue.

180 On the possible costs of mis-selling and the Society's solvency position, the FSA recorded that:

> *A significant additional reserve would almost certainly lead to the Society not covering its RMM. The Appointed Actuary said that if required the Society could find the amount required in the worse case scenario (the £1.5bn) but this would mean that the Society would have to move entirely out of equities and into gilts.*

181 On 5 July 2001, the Society informed the FSA that it had not reached a firm view on how it would act but had concluded that solvency could be maintained by switching almost the entire fund from equities to bonds. The FSA's Director of Insurance commented that the FSA needed to get a better *'handle'* on Counsel's opinion regarding mis-selling compensation and that the sums which had been mentioned of between £1,000 million and £1,500 million sounded very alarmist.

182 On 6 July 2001, the Society's auditors telephoned the FSA to discuss Counsel's opinion, which had suggested that the Society could face significant mis-selling claims.

183 At a meeting of the prudential and conduct of business regulators to discuss Equitable on 18 July 2001, it was agreed that:

- the FSA should ask Counsel to produce provisional advice on mis-selling;
- the FSA should also ask the Society about its strategy for pensions mis-selling claims on publication of Counsel's opinion;
- the FSA did have powers to prevent the Society publishing their Counsel's opinion but that it was unlikely to be in the interests of policyholders to exercise those powers; and
- the FSA should ask the Society about its ability to reserve for mis-selling claims.

It was noted that work would be needed to quantify claims and that the Society would need adequate contingency planning to cope with a range of possible outcomes.

184 This work continued throughout the rest of the period covered by this Chapter. For example, the FSA commissioned work by consulting actuaries to assess the value of possible mis-selling claims, calculated against both the Society's and the FSA's legal advice as to the Society's potential exposure. Discussions between Counsel for the Society and Counsel for the prudential regulators remained ongoing.

185 Prior to an emergency meeting on 29 July 2001 to discuss the results of the Society's Board meeting of that same day which discussed whether the Board considered the Society to be solvent, the Society's Chairman informed the FSA that the 'worst case' basis for the value of mis-selling liabilities was £900 million.

186 Estimates of the potential liabilities to which the Society might be exposed ranged from £250 million (see the entry for 29 July 2001 in Part 3 of this report) to £5,000 million (see the entry for 25 July 2001 in Part 3 of this report). Those liabilities were eventually compromised under the scheme of arrangement which the Society concluded pursuant to the provisions of the Companies Act 1985.

Conclusion

187 In this Chapter, I have set out a summary of the main themes and work strands related to the supervision of the Society that the prudential regulators and GAD were involved in during the third period covered in this report.

188 I now turn to consider what the events and actions that have been summarised in the last three Chapters of this report – and set out more fully in Part 3 of this report – disclose. Before doing so, I must address certain submissions I have received which dispute my approach to the standard I should apply when assessing those events and actions.

Chapter 9 – Preliminary assessments

Introduction

1 In this Chapter, I set out some assessments which I have made in respect of disputed questions, concerning not the particular facts relevant to the Society, but what standard of regulation it would be appropriate for me to apply, when considering the actions of those charged with the prudential regulation of insurance companies during the period covered in this report.

2 Those disputed questions, which I address as matters which are preliminary to my findings of fact, relate to the nature of the applicable regulatory regime, what duties were imposed on the prudential regulators and what approach I should adopt when assessing the discharge by those regulators of their powers.

3 This Chapter is structured in the following way:

- in paragraphs 4 to 13, I summarise the key statutory functions – that is, the powers and duties – that were conferred on the prudential regulators of insurance companies. I also summarise the standard which I have applied when considering the discharge by those regulators of their functions;
- in paragraphs 14 to 28, I outline the submissions that I have received on those matters from the public bodies whose actions were subject to complaint, disputing certain aspects of the approach that I proposed to adopt to those questions; and
- in paragraphs 29 to 118, I set out my assessment of those submissions, which deal with:

1. the aim and objectives of the regulatory regime, in paragraphs 29 to 47;
2. the purpose of the regulatory returns, in paragraphs 48 to 57;
3. the duties imposed on the prudential regulators by section 22(5) of the Insurance Companies Act 1982, in paragraphs 58 to 79;
4. intervention on the grounds of the protection of PRE, in paragraphs 80 to 86;
5. actuarial judgement and the regulatory margin of appreciation, in paragraphs 87 to 109; and
6. the application of hindsight, in paragraphs 110 to 118.

The statutory functions of the prudential regulators and the standard of regulation that I have applied

4 In Chapter 5 of this report, I summarised the statutory and administrative framework which was relevant to the actions which have been the subject of the complaints within the terms of reference for the investigation which led to this report. This I did as part of establishing the basis on which I would determine those complaints.

5 I explained that there had been four influences on the regulatory regime which existed at the time covered by this report: the traditional approach within the United Kingdom to insurance regulation, the central place of the actuarial profession within that system of regulation, the introduction of intervention powers in the aftermath of certain high profile insurance company failures in the 1960s and 1970s, and the influence of the United Kingdom's membership of the European Union and the creation of a Single Market for insurance.

6 I also explained that those influences had created four cornerstones of the specific regulatory regime, which together laid the foundations on which were built the way in which the prudential regulation of life insurance companies was undertaken and the powers, duties and means conferred on those responsible for undertaking that regulation.

7 Those cornerstones were:

- the concept of 'freedom with publicity';
- the central role of the Appointed Actuary;
- the protection of the reasonable expectations of both policyholders and potential policyholders; and
- the fulfilment of the criteria of sound and prudent management.

8 Overlaying that specific framework were certain general principles of both good administration and public law, which were applicable to the actions of any public authority.

9 The principles of good administration that I identified as being generally relevant to the complaints which formed the basis for the investigation which led to this report were getting it right and being open and accountable.

10 The principles of public law that I identified as being generally relevant to those complaints were:

- that public bodies must carry out their legal duties in accordance with the law;
- that, where public bodies have a power granted to them, they must properly consider whether to exercise that power; and
- that, when public bodies exercised a power, they must act fairly and reasonably and in accordance with any conditions imposed by law.

11 At the end of Chapter 5 of this report, I summarised the general and specific legal and administrative obligations which I considered that the prudential regulators and/or GAD had at the relevant time.

12 Those were:

(i) a specific duty to consider whether the regulatory returns of an insurance company were complete and accurate and to communicate with such a company if those returns appeared to be inaccurate or incomplete in any respect;

(ii) specific duties to consider whether an insurance company valued its assets and determined its liabilities in accordance with the requirements of the applicable Regulations and to verify the solvency position of such a company;

(iii) a general duty to give proper consideration to the use of their powers of intervention where the circumstances had or might have arisen which gave grounds for the use of such powers;

(iv) a general duty to exercise their statutory powers in a right and proper way, in accordance with the presumed intention of the legislature which conferred those powers – in good faith, reasonably, for a proper purpose, and with procedural propriety; and

(v) a general obligation to act in accordance with established principles of good administration - by acting lawfully and in accordance with published and internal policy and guidance, by taking proper account of established good practice, by taking reasonable decisions based on all relevant considerations, by having kept proper and accurate records, and by providing information which was clear, accurate, complete and not misleading.

13 All the above established the standard which I will apply in my consideration and assessment of the facts of this case and of the way in which the prudential regulators and GAD discharged their statutory functions and other obligations.

The submissions of the public bodies

14 In their response to a draft of this report, the public bodies whose actions were the subject of complaint made submissions to me which disputed certain aspects of this approach. There are five important respects in which those bodies disputed my approach.

15 The first relates to the purpose of the regulatory returns submitted by life insurance companies to the prudential regulators and scrutinised by GAD on behalf of those regulators.

16 The second relates to the specific statutory duties imposed on the prudential regulators, pursuant to section 22(5) of the 1982 Act, to consider the returns of an insurance company and, if those returns appeared to be inaccurate or incomplete in any respect, to communicate with the company with a view to the correction of any such inaccuracies and the supply of deficiencies.

17 The third relates to the powers of the prudential regulators to intervene to protect PRE.

18 The fourth relates to a range of reasonable professional judgements on certain questions and the margin of appreciation to be afforded to those responsible for exercising regulatory functions.

19 The fifth relates to whether hindsight is permissible within my assessment of how the prudential regulators and GAD discharged their obligations.

The purpose of the regulatory returns

20 The public bodies whose actions were subject to complaint submitted to me that:

> *...in forming a view of an insurance company, policyholders, potential policyholders and other parties would generally have given much more consideration to material such as its Companies Act accounts, policy illustrations, bonus notices and With Profits Guides than they would to its returns to the prudential regulator.*
>
> *The returns were not designed for the purpose of enabling comparative analyses to be made; nor was the information they provided relevant to an assessment of the suitability of an insurance company's products to investors or potential investors. In contrast to the Companies Act accounts, which were sent to all policyholders, the returns were only available on request.*

The duties contained in section 22(5) of the 1982 Act

21 I have been invited by the public bodies whose actions were subject to complaint to conclude that the performance of the statutory duty imposed on the prudential regulators by section 22(5) of the 1982 Act only arose where those regulators considered, acting with the advice and assistance of GAD, that an error in or omission from the returns was material.

22 Three grounds have been advanced for that submission:

- first, it was submitted that, although section 22(5) imposed a duty on the prudential regulators, that section nevertheless afforded those regulators a substantial margin of appreciation. The duty to communicate with the company only arose in circumstances where the returns '*appear*[ed]' to be inaccurate or incomplete. The section was thus framed in a subjective form, which expressly recognised that any determination of this question involved an exercise of judgement on the part of those bodies to whom responsibility to undertake the prudential regulation of insurance companies had been delegated;

- secondly, it was submitted that, in relation to the words *'inaccurate or incomplete'*, the touchstone of accuracy and completeness was the requirements of the 1982 Act and of the applicable Regulations made under that Act. Accordingly, a company's regulatory returns could be considered inaccurate or incomplete only if they did not comply with the relevant legislation; and

- finally, it was submitted that section 22(5) did not require the prudential regulators to secure the correction of errors or omissions which were not material. Guidance at the time had set out the prudential regulators' view, based on legal advice, that the expression *'inaccurate or incomplete in any respect'* in section 22(5) ought to be interpreted in a common sense way to mean *'in any material respect'*. This approach was said to be supported by well-established principles of statutory construction.

23 The public bodies told me that:

> *There was no obligation to follow up every point that might arise on the returns. The proper role of GAD and the prudential regulator was to exercise professional regulatory judgement to determine which points were significant in the overall context...*
>
> [The] *practical application of the regulatory requirements required regulators and actuaries to use judgement in reaching decisions on which issues to pursue and the level of satisfaction needed to resolve issues in the best interests of policyholders. These judgements are necessarily made on the basis of the facts available at the time, not all the knowledge which might be available with the benefit of hindsight.*
>
> *They were also made, quite properly, on the basis of the regulations, prudential and actuarial guidance, and generally accepted actuarial principles, as they stood at the time.*

Intervention on the grounds of PRE

24 I have also been invited by the public bodies whose actions were under investigation to conclude that the powers of intervention conferred on the prudential regulators to intervene in the affairs of an insurance company, in order to protect PRE, were only to be used sparingly and as '*long-stop*' powers.

25 As can be seen from paragraphs 282 to 286 of the initial response of the public bodies to the complaints, reproduced in Part 4 of this report, I have been invited to conclude that:

> *... the 1982 Act... made it clear... that powers of intervention on the grounds of PRE were to be extremely limited. In particular, this was spelled out by section 37(6) of the 1982 Act which made it clear that the power to take action for the purpose of protecting PRE under section 45 was a merely residual power, only to be used by the prudential regulator when other powers of intervention could not achieve the necessary goals... from 1994 onwards... the primary responsibility for monitoring PRE was placed on the Appointed Actuary...*

Actuarial judgement and the regulatory margin of appreciation

26 The public bodies have submitted that my proposed approach failed sufficiently to recognise the scope for a range of reasonable judgements on the subject matter of the complaints within the terms of reference for the investigation which led to this report.

27 Those bodies have also submitted that my proposed approach failed to allow a sufficient margin of appreciation to the prudential regulators when assessing how the prudential regulation of insurance companies was undertaken at the time covered by this report.

Hindsight

28 The public bodies have submitted that I have been influenced by hindsight, in particular by 'retrospective actuarial advice' and by '*knowledge of subsequent events*'.

My assessment of the submissions made by the public bodies

The aims and objectives of the regulatory regime

29 Having considered the submissions that have been made to me on these matters, I am not persuaded by any of those submissions and I am satisfied that the approach that I adopt in this report is appropriate.

30 In my view, those submissions which relate to the purpose of the regulatory returns, to the duties imposed on the regulators, and to intervention on the grounds of the protection of PRE, all take a view as to the aims and objectives of the system of prudential regulation that is inconsistent with the regulatory regime as Parliament created it.

31 Moreover, I consider that the submissions on those matters which have now been made to me are inconsistent with the views expressed by those undertaking prudential regulation or the scrutiny of the regulatory returns at the time covered by my report.

32 I have noted in Chapter 5 of this report that the aim of the system of prudential regulation was to protect the interests of policyholders and potential policyholders. Securing that aim was to be done in such a way as to balance the need to take such action as was necessary to protect those interests, without interfering in the business of insurance companies to such an extent as would stifle competition and prevent innovation, thus harming consumer interests. That this was so does not appear to be a matter of contention.

33 The objectives of prudential regulation were set out in, among other places, the guidance which those regulators produced.

34 The DTI's Policy Guidance Notes, produced in September 1991, and thus in place when those regulators were considering whether to approve the appointment of the Society's Appointed Actuary to be also its Chief Executive - and by the time that the scrutiny of the Society's 1990 returns was being undertaken - set out the objectives of prudential regulation.

35 After stating that the prudential regulators *'should operate, and be seen to operate, a firm but fair regulatory regime'* and that *'the message to the public should be that the Department is watching very carefully and is likely to err on the side of caution rather than to adopt a relaxed attitude'*, those objectives were said to be:

- in relation to the carrying on of insurance business (Guideline 2.2):

  The protection of policyholders and potential policyholders is paramount.

- in relation to the power to withdraw authorisation from a company carrying out insurance business (Guideline 2.5):

  By withdrawing a company's authorisation in respect of new business... if we have serious concerns about their solvency position, we would be able to limit the risk to potential policyholders.

- in relation to the authorisation of the controllers of insurance companies (Guideline 4.2):

  To prevent persons or companies that appear to the Secretary of State not to be 'fit and proper' to be controllers of insurance companies from assuming such positions.

- in relation to the duties imposed by section 22(5) of the 1982 Act to consider the regulatory returns submitted by insurance companies and to communicate with such a company with a view to the correction of any inaccuracies and the supply of deficiencies (Guideline 5.4):

  To secure the correction of material errors and the supply of deficiencies in annual returns... in order that neither the Department nor the public, including shareholders and actual or potential policyholders, form a view of the company based on inaccurate or incomplete information.

- in relation to the valuation of a life insurance company's long-term liabilities (Guideline 6.2):

  To be satisfied that the valuation of long-term liabilities is in accordance with the 1981 Regulations and is correctly reported in Schedule 4 (and Schedule 5 where appropriate) of the 1983 Regulations. In addition, to be satisfied that the required margin of solvency is covered at all times and that it appears likely that the company will continue to maintain adequate cover for its solvency margin in the future.

- in relation to the general powers of intervention that Parliament conferred on the prudential regulators (Guideline 8.1) and in relation to the specific power that the prudential regulators possessed to impose notices of specified requirements on an insurance company (Guideline 8.2):

  To ensure that the Secretary of State's powers of intervention are exercised whenever it is necessary for the protection of policyholders, without companies being subject to unnecessary restrictions.

- in relation to the specific power that the prudential regulators possessed to limit the premium income which an insurance company received while it was authorised to write new business (Guideline 8.5):

  To limit the risk of a company becoming insolvent in the future by controlling its rate of expansion.

- in relation to the specific power that the prudential regulators possessed to require an insurance company to have an actuarial investigation carried out (Guideline 8.6):

  To ascertain the financial condition of a company's long-term business and the adequacy of a company's general business reserves.

- in relation to the specific power to require the submission by an insurance company of accelerated regulatory returns (Guideline 8.7):

  To ensure that the [prudential regulators have] *up to date information regarding companies whose financial position may be deteriorating.*

- in relation to the specific power that the prudential regulators possessed to require an insurance company or other body to provide information additional to that contained within the regulatory returns (Guideline 8.8):

  To ensure that the [prudential regulators are] *fully informed of a company's affairs or other aspects of its activities giving cause for concern.*

- in relation to what was described as *'the power of the Secretary of State to intervene in the affairs of companies otherwise than in pursuance of statutory powers'* (Guideline 8.10):

  To intervene in a company's affairs in the most appropriate manner for protecting policyholders or potential policyholders.

- in relation to the specific power that the prudential regulators possessed to modify certain provisions of the 1982 Act through the making of a section 68 Order (Guideline 9.1):

  > *To ensure that UK authorised insurance companies comply with all relevant primary and secondary legislation, whilst recognising that in particular circumstances in relation to particular companies it may be appropriate to modify the legislative requirements...*

- in relation to disclosure by the prudential regulators to, and liaison with, other regulators (Guideline 10.2):

  > *To avoid regulatory failures arising because an issue, company, or group of companies or person falls between regulators.*

36 Those objectives, as set out in that guidance, were reinforced by the views expressed by the prudential regulators and GAD at the time.

37 For example, in briefing produced within the DTI in March 1983, as part of the preparations for a scrutiny of the efficiency of the supervision of insurance companies, it was explained that:

> *The Department of Trade is responsible for the administration of the insurance companies' legislation, the primary objective of which is to protect consumers (i.e. policyholders and prospective policyholders) against the risk of loss or exploitation, due to insolvency, incompetence, dishonesty, or other unlawfulness of insurers... The intention is that the system of supervision should bring to notice any danger signals sufficiently early so that action can be taken to prevent the failure of a company...*

38 In a presentation given by a DTI official in June 1988, it was said that there were *'probably two major strengths in the present system: one is the extensive discretionary powers given to supervisors which enable us to take action at an early stage; another is the generally high standards of integrity and competence promoted by our "fit and proper" powers'*.

39 Other presentations given by regulatory officials at this time conveyed similar messages. In a talk entitled 'the regulatory environment', a DTI official explained that *'our aim... is to allow maximum freedom to the managers of insurance companies to manage in the light of their own judgement, but against the background of the careful supervision of their conduct by the Department and very full public disclosure of their company's affairs'*.

40 Briefing provided by DTI officials for Ministers in January 1990, which contained *'points on insurance regulation'*, stated that:

> *The aim of regulation is to create an environment which provides a fair level of protection for the policyholder but which does not inhibit competition and freedom to innovate.*

41 The then Government Actuary, in a paper entitled 'the Supervision of Life Insurance Business in the United Kingdom' given in 1990, said, in respect of insurance companies, that:

> *... information about the business they are carrying on, the assets held, income and expenditure, solvency, etc must be given in*

full in returns to the DTI. These are placed on public record so that anyone who wishes to may refer to them.

In principle, the information which is publicly available should be sufficient to permit another actuary to make an evaluation of the financial state of the company and to estimate the probable level of future profits which could be attributable to policyholders.

42 The balance that underpinned the system of prudential regulation was explained further in a speech, made in July 1990, by the then junior DTI Minister responsible for insurance regulation. In it, the Minister noted that:

There is a difficult area of judgement between excessive regulation and ineffective regulation... The correct balance is to provide reasonable standards within the industry within which investors can take their own judgements about the risks and rewards of their investments. The setting of the correct balance is a matter of constant vigilance and clear analysis. The Department is far from thinking that it can be purely reactive.

43 After setting out several developments that were then currently underway, the Minister said that these demonstrated *'a pro-active and vigorous regulatory role by the Department'*.

44 The powers conferred by Parliament on those responsible for operating the system of prudential regulation during the period covered by this report were, as I have explained in Chapter 5, robust and wide-ranging.

45 The objectives of that system, as those were seen at the time by those operating that system were not, in my view, grounded in a limited view as to the purpose of prudential regulation or in a philosophy or approach now characterised as 'light touch'. Nor was that what the prudential regulators and GAD said at the time.

46 The central aim of prudential regulation was the protection of the interests and reasonable expectations of policyholders and potential policyholders.

47 It is in this context that I have made the following assessments of the submissions made by the public bodies as to the standard of regulation I should apply in this case.

The purpose of the returns

48 I consider that the submissions of the public bodies on the purpose of the regulatory returns and the uses that those returns were put to during the period covered by this report are inconsistent with the reality of the system created by Parliament.

49 I would first note that I also received a submission on this matter from the Society's former auditors, who told me:

The purpose of the regulatory returns was to provide a prudent means of monitoring a life company's solvency and its ability to withstand potential future adverse experience. The returns were relied on by the regulator in performing its supervisory role in relation to insurance [companies]. *They also formed the primary source of information about the company's financial status for most informed observers. By contrast, the Companies Act* *accounts were of limited usefulness to external observers, presenting purely historical information and giving only limited information about the room for manoeuvre available to the company in question.*

50 It would thus appear that no consensus on this matter exists among those involved with the Society's affairs at the time covered by this report. In such circumstances, I look to what those operating the system of prudential regulation said at the time.

51 I consider that, when regard is had to those statements, it is clear that the submission, scrutiny, and publication of the regulatory returns were the prime mechanisms of the prudential regulation of insurance companies at the time covered by this report.

52 I also consider that an argument that the information contained in those returns would not, or did not, influence policyholders, their advisers, the financial press, the actuarial profession, or other industry commentators could not be sustained.

53 The DTI in May 1991, in a consultation document concerning proposals to transpose the European Third Life Directive into domestic law, explained that the system of prudential regulation was:

> *... designed to maintain public confidence in the continuing solvency of insurers while not being over-prescriptive or burdensome on insurers. This is possible because the activities of insurers are open to enquiry by the public, and to scrutiny by DTI and others, to ensure sound and prudent management.*

54 In a DTI paper published in December 1994, and entitled 'Insurance Supervisory Powers and Practice', the prudential regulators explained that the publication of the returns meant that:

> *Consequently, policyholders, competitors, brokers, market analysts, and journalists have access to the information contained in the annual DTI returns. This has resulted in a growing number of comparative analyses of data and an increasing market in insurance information – producing a more informed market in insurance products and their financial security.*

55 Further insight was given by an article in the 22 July 1993 edition of Money Marketing, in which the then Government Actuary was interviewed. The article appeared under the title *'The Government Actuary maintains that his role in examining life-office accounts means that* [independent financial advisers] *need not worry about the issue of financial strength'*.

56 The article stated that the Government Actuary had said that, *'by being aware that DTI criteria are being met,* [independent financial advisers] *should satisfy themselves that offices are well-managed and look at areas such as performance and distribution philosophy rather than at highly complex actuarial issues'*. It also quoted the Government Actuary as having said:

> *I think differences in financial strength should not be too much of an issue to the financial adviser because, so long as the company is adequately capitalised, it is not really relevant from the point of view of the policyholder whether the security is covered twice or 10 times over. If it is covered 10 times over, it may just reflect a*

philosophy of stacking away surplus and not distributing it to the policyholders.

57 I do not accept that the submissions of the public bodies on this question can be sustained, when regard is had to the position as it was seen at the time by those operating the system of prudential regulation. I am satisfied that my approach is appropriate in those circumstances.*The duties imposed by section 22(5) of the 1982 Act*

58 In relation to the duty imposed by section 22(5) of the 1982 Act, I agree with the public bodies that, for the purposes of that duty, the accuracy and completeness of the returns was governed by the provisions of the applicable law, which prescribed in great detail what information was required to be provided within those returns and how that information was required to be calculated and disclosed.

59 However, I consider that the other grounds put forward in support of this submission are highly unpersuasive.

60 The prudential regulators were under a statutory duty *'to communicate with the company with a view to the correction of any... inaccuracies and the supply of deficiencies'*. That is the duty to which the prudential regulators were subject at the relevant time. It is what Parliament provided that they '*shall*' do. That duty was not qualified by reference to what may or may not have been material.

61 Section 22(5) of the 1982 Act imposed a duty on the prudential regulators to do what Parliament prescribed, not a discretion to do it or not according to whether an inaccuracy or deficiency was material in the view of those regulators, whether or not those regulators acted with the advice and assistance of GAD.

62 I accept that the law does not concern itself with trifles and I would not be critical of the prudential regulators if they had not concerned themselves with trifling matters. But there is in my view no sound basis for rewriting this provision of the 1982 Act by inserting a reference to materiality.

63 I am also not persuaded that the submissions made to me by the public bodies on this matter reflect the approach which those bodies took to this question at the relevant time.

64 During the period covered by this report, there is clear evidence of the prudential regulators communicating with insurance companies, pursuant to the duty imposed by section 22(5) of the 1982 Act.

65 In respect of every year covered by this investigation, the insurance industry annual reports laid by Ministers before Parliament show that the duty to communicate to seek corrections to the returns led to the prudential regulators communicating with insurance companies on more than one hundred occasions in each year and, in most years that are relevant to this investigation, on many more occasions than this. Details are shown in Table 9a below.

66 I have reviewed the files containing the documents which record this communication during some of the years covered by this report. I have seen that the prudential regulators often undertook such communication in respect of relatively trivial matters.

67 For example, I have seen that, in one case, the prudential regulators communicated with an insurance company to seek the correction of an arithmetical error of less than £50 within the returns of a multi-million pound fund. I have seen other such examples, although that is the starkest.

68 Furthermore, the public statements of the prudential regulators made at the time suggest that those regulators accepted that a duty was imposed on them – indeed, on occasion going beyond recognition of the simple duty on the face of the 1982 Act to communicate with the relevant company with a view to the correction of the returns, extending the scope of their powers to an apparent ability to require such corrections.

69 For example, in the Annual Reports on the insurance industry that were laid before Parliament by the prudential regulators, it was said, in the reports for every year from 1988 to 1997, that *'section 22(5) requires the* [prudential regulators] *to arrange for companies to correct inaccuracies in the returns submitted'*. The communication envisaged by section 22(5) was thus described as a requirement.

70 Another example is the FSA's consultation draft of the proposed Interim Prudential Sourcebook, which also described that communication as a requirement on the prudential regulators. Issued in March 2000 and said to restate the existing law, that Sourcebook contained a draft rule 9.6(5), which, it was said, restated the requirements of section 22(5) of the 1982 Act. This provided, under the heading *'inaccurate and incomplete returns'*, that:

> *Rule 9.6(5) (Section 22(5)) requires the FSA to consider the* [returns] *and, if any such documents appears to it to be inaccurate or complete, to communicate with the insurer with a view to the correction of any such inaccuracies and making good any omissions.*

71 Parliamentary answers on occasion appeared to suggest that the prudential regulators could require insurance companies to correct their returns using this provision of the 1982 Act. For example, in a written answer given on 23 April 1996, the then

Table 9a – number of times regulators exercised powers to require amendments to regulatory returns

During...	Number of times power used
1988	141
1989	187
1990	139
1991	262
1992	401
1993	210
1994	201
1995	136
1996	112

Note: This table refers to the number of times the DTI exercised their power under section 22(5) of the Insurance Companies Act 1982 to require the amendment of errors or the supply of deficiencies in the returns.

The number provided in this table does not relate to the number of companies in respect of which this power was exercised but rather to the number of errors/deficiencies identified and required to be corrected.

Source: Insurance Annual Reports, Department for Trade and Industry

Minister of State at the DTI, explaining the changes which had been made as a result of the Deregulation (Insurance Companies Act 1982) Order 1996, and particularly the introduction of an ability to submit returns in electronic form, said (with added emphasis):

> *This measure is for the convenience of the industry and cost savings will be small, representing the difference between the cost of the production and submission of four paper copies of the return, and that of producing a diskette. The administrative cost to companies of taking corrective action, **if required to do so under section 22(5) of the Act**, should also be reduced.*

72 The prudential regulators produced detailed guidance which dealt with this provision of the 1982 Act. Guideline 5.4 of the DTI's Policy Guidance Notes, issued in September 1991, dealt with the correction of inaccuracies and the supply of deficiencies related to the regulatory returns.

73 After noting that section 22(5) of the 1982 Act placed an obligation on the Secretary of State to communicate with the company with a view to the correction of any inaccuracies and the supply of deficiencies where it appeared to him that any document was inaccurate or incomplete *'in any respect'*, the guideline set out the regulatory objective underpinning this provision. This was:

> *To secure the correction of material errors and the supply of deficiencies in annual returns... in order that neither the Department nor the public, including shareholders and actual or potential policyholders, form a view of the company based on inaccurate or incomplete information.*

74 The guideline continued:

> *Supervisors should have few reservations about formally requesting companies to correct inaccuracies and/or to supply deficiencies. Errors in and omissions from a company's return may be discovered at any stage during the examination process...*
>
> *There may be occasions when it is not entirely clear whether there is an inaccuracy in a return although one may be suspected. Whilst it only has to "appear" to the Secretary of State that there is an inaccuracy or a deficiency, it may be necessary to query the point with the company before concluding there is definitely an error.*

75 The guideline then set out 'implications for our understanding of a company's position', noting:

> *Clearly, any return may be misleading if it contains material inaccuracies or is deficient. It is important that any inaccuracies or deficiencies be rectified as soon as possible. The materiality of an inaccuracy depends, inter alia, on the extent to which it affects the validity of the conclusions which may be drawn about the company.*

76 The guideline then set out legal advice received, which stated that the statutory framework *'imposes on the Secretary of State a duty to "police" the documents rather than merely to act as a depository for them'*. The legal advice continued thus:

Notwithstanding the use in s22(5) of the expression "inaccurate or incomplete in any respect", this can be interpreted in a common sense way to mean "in any material respect".

Materiality must, however, be judged not only from the point of view of the supervisor acting on behalf of the Secretary of State, but also from the point of view of a shareholder or policyholder who applies to the company for a copy... or inspects a copy on the public record at Companies House.

Therefore, the Department must communicate with the company to secure the correction of inaccuracies and/or the supply of deficiencies. This must be the case, even though the supervisor, because of his skill and experience, may be able to see through the inaccuracy or deficiency and ascertain the true meaning if there is a risk that a policyholder or shareholder will not be able to do so.

77 The advice continued:

There is no legal obligation to take up every trivial error in an annual return, provided we are satisfied that it is indeed trivial and does not hide serious compensating errors...

All errors in items which are used in solvency tests should be regarded as material unless, or until, the supervisor is satisfied that either they will not affect the results of the solvency test in current or future years, or effective supervision is possible without the test.

78 I consider that my view as to the duties imposed on the prudential regulators by section 22(5) of the 1982 Act – to consider the returns and to communicate with an insurance company to seek the rectification of errors or omissions in those returns unless those regulators had satisfied themselves that any error or omission was trivial, in the sense used within the DTI guidance, and would not mislead the reader of the returns – is the correct one. I have judged the acts and omissions of the prudential regulators and/or GAD against the standard set out in their own guidance.

79 For all these reasons, I reject the submissions by the public bodies on this question.

Intervention on the grounds of PRE

80 I also do not accept the submissions of the public bodies regarding intervention on the grounds of the protection of PRE.

81 I consider that those submissions confuse the 'residual' power in section 45 of the 1982 Act – the power to take any action other than those actions listed principally within sections 38 to 41 of the 1982 Act as being powers of intervention – with the grounds on which the exercise of such powers had to be considered and could be used, which were set out in section 37 of that Act.

82 The protection of PRE gave grounds for the potential use of any or all of the powers listed in sections 38 to 41 of the 1982 Act. There was nothing 'residual' about the protection of PRE as a basis for using those powers of intervention that the prudential regulators possessed.

83 It was only where the objective of those regulators could not be achieved through use of the other powers available to them that the 'residual' power – to take whatever other form of action appeared

appropriate – arose. This power was residual; the ground on which it might be exercised (i.e. the protection of PRE) was not.

84 I agree with the public bodies that the Appointed Actuary had certain responsibilities in respect of PRE. However, the existence of those responsibilities cannot detract from the obligations imposed by Parliament on the prudential regulators, who acted with the advice and assistance of GAD.

85 I also accept that, under the regulatory regime which applied during the period covered by this report, there was no obligation on the prudential regulators constantly to monitor PRE or proactively to seek information from insurance companies about their marketing strategies, the contents of all of their publications, or what their sales force were telling existing or potential customers. I accept that the Government of the day decided that the protection of PRE would be largely reactive to what was found in an insurance company's regulatory returns. That made the scrutiny process undertaken in respect of those returns even more important.

86 Where information which was before the prudential regulators called into question whether an insurance company was acting in a manner that enabled it to fulfil PRE – and that, therefore, the grounds for the exercise of one of the powers of intervention conferred on those regulators may have arisen – the prudential regulators were under an obligation to satisfy themselves, by seeking further information or otherwise, whether such grounds had arisen and, if they had, to consider whether it would be appropriate to exercise their powers.

Actuarial judgement and the regulatory margin of appreciation

87 With regard to the submissions made by the public bodies concerning actuarial judgement and the margin of appreciation to be afforded to regulators, I readily accept that two professionals, acting reasonably, might, when considering the same facts, come to different but entirely rational views.

88 At all times relevant to my investigation, the actuarial profession, in its Memorandum of Professional Conduct, emphasised that this was the case. For example, in paragraph 17 of version 6.0 of that Memorandum (effective from 14 April 1997), the profession stated:

> *A member should recognise that there is room for differences of opinion in relation to actuarial advice and must avoid any action that would unfairly injure the professional reputation of any other actuary. However, this is not intended to prevent criticism to the client of another actuary's work for that client where this is properly reasoned and felt to be justified.*

89 Where matters of professional judgement come into play in my consideration of the facts that an investigation has disclosed, my general approach is to consider whether the judgements in question are consistent with the relevant legal and administrative framework as it stood at the time and with then prevailing professional guidance and accepted good practice.

90 If a professional judgement is within the range which a professional could reasonably reach in all the relevant circumstances, acting with the skill and care that could reasonably be expected from a professional acting in such a capacity, I would not be critical of such a professional judgement.

91 In making the findings set out in this report, I have had regard to the fact that many relate to actuarial matters. However, I have also had regard to the key obligations of the prudential regulators and/or GAD, to which those bodies were subject. Those are grounded in the general and specific legal and administrative framework which existed at the time relevant to the events recounted in this report.

92 In that context, it is my view that the concept of actuarial judgement has limited or no application to many of the issues which I have considered.

93 I accept that, in respect of issues including the exercise of professional judgement, for example as to the prudence of a particular valuation rate of interest, so long as the conclusion reached was within the range that a professional of the relevant discipline could reasonably reach, no criticism should be made of that exercise of professional judgement.

94 However, where information which a life insurance company was required in law to provide has not in fact been provided within the regulatory returns or where a duty imposed on such a company has not been performed, it does not seem to me possible, in general, to apply the concept of a wide range of professional views to this omission; whether it occurred is a matter of fact, not of judgement.

95 And in a situation in which the prudential regulators were under a duty to communicate with an insurance company where there were apparent omissions from or errors within the regulatory returns, once it has been established that such an omission or error existed, there is no scope for professional judgement as to whether to perform a duty imposed on those regulators by Parliament.

96 Similarly, where enquiries are made of, and responses are received from, a company or its Appointed Actuary in respect of apparent breaches of the applicable Regulations or in respect of a valuation basis that appeared to be weaker than the prescribed minimum basis (or indeed on any other matter of concern which involved issues on which reasonable professionals might disagree), consideration of those responses might well involve the exercise of professional judgement.

97 GAD in those circumstances might have come to the view that the responses provided clarified matters acceptably or that they indicated a genuine and perfectly reasonable divergence of professional views.

98 However, I consider that such matters of professional judgement are irrelevant in a situation where such breaches were apparent but no action was taken. Any decision that, on the facts, no action is appropriate should be recorded at the time it was taken, together with cogent reasons for that decision.

99 My approach to this question mirrors that which was adopted at the time covered by this report. For example, GAD themselves, in exchanges concerning Equitable, made this very point.

100 As can be seen from the relevant entry in Part 3 of this report, on 3 December 1998, the Treasury and GAD met Equitable. One issue which arose at that meeting was a disputed interpretation of a particular statutory requirement concerning reserving for the liabilities associated with those of the Society's policies which contained guaranteed annuity rates.

101 The Appointed Actuary of the Society argued that the dispute centred on a professional disagreement. But GAD said that there was no professional matter to consider and that there was:

... a distinction between the legal position as required by [the relevant Regulations] *and* [other matters] *where there was more scope for professional judgement and interpretation.*

102 GAD thus recognised and drew a distinction between those legal obligations on insurance companies and the relevant professionals which were mandatory and those powers (or matters) which were discretionary (or which were covered by professional judgement). I too would draw such a distinction and I apply that distinction to the relevant actions of the prudential regulators and GAD.

103 Similar considerations apply to questions concerning the margin of appreciation which I consider should be afforded to the prudential regulators.

104 Where a duty to act has arisen, I consider that there is no such margin. Consideration should be given at that time as to whether it would be appropriate to exercise any of the powers granted to those regulators.

105 Where the circumstances for the performance of a duty appear to have arisen but the prudential regulators have taken a reasoned decision that no such duty has in fact arisen, it is open to those regulators to take such a decision. But that decision should be recorded at the time, together with cogent reasons for their decision that no duty has in fact arisen.

106 There is a considerable margin of appreciation to be afforded to the decisions taken by the prudential regulators in relation to the exercise of their discretionary powers. So long as those decisions are taken on a proper legal and factual basis, those regulators have discretion to decide what the most appropriate form of action would be, if any.

107 However, where no consideration is given by the prudential regulators to the use of their powers (where such consideration should have been given) or where such consideration as is given proceeds on a flawed legal and/or factual basis, no margin of appreciation is to be afforded to the prudential regulators, unless the subject matter in question was determined by them at the time (or which can now be seen) to be trivial.

108 While I will pay due regard both to the scope for a range of reasonable professional views and to the margin of appreciation in relation to the exercise of discretion that should be afforded to regulators, I am satisfied that my approach to the identification of the legal and administrative obligations to which the prudential regulators and GAD were subject is appropriate.

109 I do not accept that my approach is flawed in the manner suggested by the public bodies.

Hindsight

110 I agree with the public bodies that, in making my findings of fact and determinations whether those facts constitute maladministration, I cannot have regard to hindsight.

111 Those findings and determinations must be grounded in the standards which applied at the relevant time and must be based on the information and knowledge that the relevant public body or bodies possessed at the time – or should reasonably have possessed if they had acted according to the obligations to which at the relevant time they were subject.

112 However, I reject the submission that, on this occasion, I have in any way been influenced by hindsight.

113 As I have explained in Chapter 5 of this report, having established the facts in any investigation, I assess those facts against the standards, both those of general application and those which are specific to the circumstances of the case, which applied at the time that the events complained about occurred and which governed the discharge of administrative functions by those whose actions are subject to investigation.

114 In this report, I have identified those standards having regard only to the legal and administrative framework as it existed at the time. From this, I have identified the key obligations to which the prudential regulators and/or GAD were subject at the relevant time.

115 My assessment of the acts and omissions of those regulators and/or GAD will be based on the information or knowledge that those bodies had at the relevant time or on the information that a prudential regulator and/or an actuary charged with the scrutiny of regulatory returns, acting reasonably, would have had before them.

116 My findings will thus be grounded in the applicable standards and obligations to which the prudential regulators and GAD were subject and in the information and awareness that those bodies possessed or should have possessed at the relevant time.

117 I do not accept that my seeking actuarial advice during the investigation which led to this report about matters which occurred some years ago necessarily introduces hindsight or undermines my approach.

118 So long as my assessments are grounded in the overall standard, derived from the obligations which existed at the relevant time, and only pay regard to the information that was – or should have been – before the relevant body at that time, hindsight can – and, in this case, has been – avoided.

Conclusion

119 In this Chapter, I have made some preliminary assessments in respect of disputed questions concerning the standard of regulation that it is appropriate for me to apply, when considering the actions of those charged with the prudential regulation of insurance companies during the period covered in this report.

120 I now turn to set out the results of my review of the evidence I have obtained and to make findings of fact regarding the subject matter of the complaints which have formed the basis for the investigation which led to this report.

Chapter 10 – Findings of fact

Introduction

1 In this Chapter, I set out the results of the review I have conducted of all the evidence, submissions and other material that was before me.

2 I also set out the findings of fact that I consider are key to my determination of the heads of complaint within the terms of reference for the investigation which led to this report.

3 This Chapter is structured in the following way:

(i) in paragraphs 4 to 38, I provide an overview of the principal findings of fact which I have made; and

(ii) in paragraphs 39 to 698, I explain, in relation to each finding of fact, the basis on which I have made those findings.

Overview of my principal findings of fact

4 My review of all the evidence, submissions and other material before me has led me to make ten principal findings of fact. Those findings relate to:

- the way in which the DTI, as prudential regulators, handled the 'dual role' – that is, the holding by one person for more than six years, from 1 July 1991 to 31 July 1997, of the position of the Society's Chief Executive simultaneously with the position of its Appointed Actuary – which I cover in paragraphs 40 to 131;

- the scrutiny of the Society's regulatory returns, which was undertaken by GAD on behalf of the prudential regulators, for each year from 1990 to 1993 – which I cover in paragraphs 132 to 202;

- the way in which GAD, as part of their scrutiny on behalf of the prudential regulators of the Society's 1993 returns, handled the intimation within those returns of the introduction by the Society of what came to be known as its differential terminal bonus policy – which I cover in paragraphs 203 to 297;

- the scrutiny of the Society's regulatory returns, which was undertaken by GAD on behalf of the prudential regulators, for each year from 1994 to 1996 – which I cover in paragraphs 298 to 343;

- the way in which GAD, as part of their scrutiny on behalf of the prudential regulators of the Society's returns for 1990 to 1996, handled issues arising from the presentation by the Society within those returns of two separate valuation results – which I cover in paragraphs 344 to 396;

- the way in which the FSA, acting on behalf of the prudential regulators, handled issues arising from a financial reinsurance arrangement into which the Society had entered – which I cover in paragraphs 397 to 486;

- the way in which the FSA, acting on behalf of the prudential regulators, handled the issue of whether the potential impact on the Society of it losing the *Hyman* litigation should be disclosed within the Society's regulatory returns – which I cover in paragraphs 487 to 522;

- the way in which the FSA, acting on behalf of the prudential regulators, approached the taking and recording of their decision to permit the Society to remain open to new business following its loss of the *Hyman* litigation – which I cover in paragraphs 523 to 613;

- the basis on which the FSA, acting on behalf of the prudential regulators, took their decision to permit the Society to remain open to new business following its loss of the *Hyman* litigation – which I also cover in paragraphs 523 to 614; and

- the information given by the FSA, acting on behalf of the prudential regulators, to policyholders and others about the Society's solvency position and its record of compliance with other regulatory requirements during the period after the Society closed to new business in December 2000 – which I cover in paragraphs 615 to 698.

The 'dual role'

5 My first finding of fact is that, in June 1991, the prudential regulators approved, when they should not have done, the appointment of a new Chief Executive without insisting that he should demit office as the Society's Appointed Actuary and without applying subsequently a closer degree of scrutiny of the Society's affairs.

6 Furthermore, for the next six years, those regulators failed to consider the use of their powers to seek the ending of his 'dual role', despite the assurance that had been given at the time of his appointment that he would hold such a dual role for 18 months only.

The scrutiny of the Society's regulatory returns for 1990 to 1993

7 My second finding of fact is that, with regard to the scrutiny of the Society's annual regulatory returns for the year-ends for 1990 to 1993, GAD, in providing advice to the prudential regulators, failed to satisfy themselves that the way in which the Society had determined its liabilities and had sought to demonstrate that it had sufficient assets to cover those liabilities accorded with the requirements of the applicable Regulations.

8 Accordingly, those regulators were unable to verify the solvency position of the Society as they were under a duty to do. The aspects in respect of which the Society's returns for these years raised questions which should have been identified, pursued and resolved were:

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

- the affordability and sustainability of the bonuses previously declared by the Society, which appeared to raise the expectations of the Society's policyholders which might not be met.

9 On the information before GAD, the Society's approach to discounting appeared to suggest that a significant amount of any future surplus would be required simply to fund current guaranteed benefits. This occurred in a situation in which GAD knew that the Society had informed its policyholders that, subject to smoothing, the additional returns they would receive by way of future bonus declarations would reflect the future investment performance of the with-profits fund.

10 In addition, serious questions arose from the information within the returns about whether the Society could afford the level of bonus it was paying and whether it could continue to pay out at that level, in a situation in which, as GAD knew, the Society was unique in illustrating to its policyholders the full policy fund value, including terminal bonus.

11 From the information before GAD, it was not clear how the Society could fund guaranteed future bonuses (applying the guaranteed investment return) or manage to pay future discretionary bonuses, in line with the reasonable expectations of the Society's policyholders that such bonuses would continue to be paid.

12 Despite those questions, raising issues concerning the prudence of the Society's approach and whether the Society would be able to fulfil the reasonable expectations of its policyholders, no action was taken by GAD to seek to resolve these questions or raise them with the prudential regulators.

The intimation of the Society's differential terminal bonus policy

13 My third finding of fact is that GAD identified the introduction of a differential terminal bonus policy when scrutinising the Society's 1993 returns in October 1994, but failed to inform the prudential regulators, as GAD should have done, of that introduction or to raise the matter with the Society.

14 This failure by GAD to raise the matter occurred despite there having been full disclosure by the Society within its 1990 returns of the extent and level of the guaranteed annuity rates within its older policies and despite the Society referring to such guarantees when it disclosed the introduction of the differential terminal bonus policy in its 1993 returns – which, GAD noted, was a policy which had the effect of reducing the final bonus payable to policyholders.

15 That failure also occurred despite GAD knowing, or having information before them which suggested, both that the Society had told its policyholders that Equitable would only change bonus policy gradually and also that the Society's With-Profits Guides did not (at that time) inform its policyholders of the differential terminal bonus policy.

The scrutiny of the Society's regulatory returns for 1994 to 1996

16 My fourth finding of fact is that, in carrying out the scrutiny of the Society's annual regulatory returns for each year from 1994 to 1996, GAD, in providing advice to the prudential regulators, failed to satisfy themselves that the way in which the Society had determined its liabilities and had sought to demonstrate that it had sufficient assets to cover those liabilities accorded with the requirements of the applicable Regulations. Those regulators were thus unable to verify the solvency position of the Society.

17 The issues arising from the Society's returns which GAD failed to address and resolve to a satisfactory conclusion were:

- the continuation of the two issues which had arisen within the returns for 1990 to 1993 (questions concerning discounting through the use of imprudent and/or impermissible valuation interest rates and the affordability and sustainability of the Society's bonus declarations);

- what appeared to be arbitrary changes to the assumed retirement age for personal pension policies, contrary to European Directives and the applicable domestic Regulations;

- the absence of explicit reserves for prospective liabilities for capital gains tax and for pensions review mis-selling costs, stating instead that such liabilities were covered by implicit margins in the valuation basis; and

- the absence of reserves in respect of guaranteed annuity rates, which by then GAD should have known were biting and should therefore have been provided for.

18 GAD failed to identify all those issues, to pursue them with the Society, or to seek to resolve the issues that they raised.

The presentation of the Society's two valuation results

19 My fifth finding of fact is that GAD failed in certain respects to act, when they should have acted, to question the Society's practice of producing two valuations within the regulatory returns but omitting crucial information from one of those valuations. After 1996, the Society continued to produce two valuations but published the missing information.

20 That information was the amount of the resilience reserves required in the Society's appendix valuation, produced to demonstrate compliance with the Regulations. That omission meant that the Society appeared financially stronger than it was and that its solvency position was capable of being misconstrued.

21 While GAD asked the Society for that information in all but one year, GAD did not take steps to ensure that the reader of the returns had that information.

22 Even though the Society was not in breach of any of the applicable Regulations by presenting its valuations in the way that the Society did, GAD recognised at the time that this position meant that the Society's returns, which were the main mechanism through which 'freedom with publicity' was delivered, might mislead those who read them.

23 Although the Society was permitted to produce an alternative valuation from that specified in the applicable Regulations, it was required, by those Regulations, to demonstrate that its chosen alternative valuation was at least as strong as that specified in those Regulations.

24 GAD considered that such demonstration was provided through the provision by the Society to GAD – but not through the returns – of the amount of the reserves omitted from the Society's alternative valuation. However, GAD failed to ask for this information in November 1996 when they were conducting their scrutiny of the Society's 1995 returns. GAD were therefore unable to verify whether those returns had complied with the applicable Regulations.

25 In addition, from November 1993 onwards GAD had possessed information, in the form of ratings of the Society produced by Standard & Poor's – an expert ratings agency, which showed that the position was not only capable of being misconstrued but also that it was being misconstrued.

26 Those ratings, which were provided to GAD by the Society and retained on GAD's files, were used as part of briefing for Ministers and others. Standard & Poor's erroneously concluded that the Society was stronger than it really was. This was as a direct result of the information which GAD knew was missing from the returns.

27 GAD took no action to raise or to seek to resolve this issue.

Financial reinsurance

28 My sixth finding of fact is that the FSA permitted the Society, when they should not have done so, to take credit within its 1998 returns, which were submitted on 30 March 1999 and which were

available to the public by 1 May 1999, for a financial reinsurance arrangement which had not been concluded either at the valuation date or at the date that those returns were submitted. This was done without an appropriate reporting concession being given.

29 Moreover, even leaving that aside, the FSA permitted the Society within its returns for 1998, 1999, and 2000 to take credit for the financial reinsurance arrangement that did not reflect the economic substance of that arrangement.

30 This was despite the fact that GAD had identified the potential problems with the proposed financial reinsurance arrangement and had informed the FSA of those problems, recognising that this arrangement had little or no value for the purposes of the determination of the Society's solvency position.

The potential impact of the *Hyman* litigation on the Society

31 My seventh finding of fact is that the FSA failed to pursue the failure by the Society to include contingent liability notes within its regulatory returns for 1998 and 1999 regarding the potential impact of losing the *Hyman* litigation. This failure to check why the Society had not included any such disclosure in those returns occurred despite the reminders by the prudential regulators that the Society should do so, reminders given prior to the submission of the Society's 1998 returns.

32 No action was taken to seek to ensure that the Society had a sound basis for not publicly disclosing the fact that the outcome of the legal action could have profound effects, including for the operation of its differential terminal bonus policy (and hence its reserving practices) – effects which would have a significant impact on the solvency position of the Society and on the amount of money available to meet the liabilities it had to its policyholders.

33 This failure by the FSA to act also occurred in relation to the Society's 1999 returns in a context in which the FSA knew that the Society had informed its policyholders that no significant costs would be imposed on the Society if it lost the *Hyman* case.

The decision to permit the Society to remain open to new business

34 I make two findings of fact concerning the decision to permit the Society to remain open to new business following the decision of the House of Lords in the *Hyman* case.

35 My eighth finding of fact is that the FSA failed to record that decision. No contemporaneous record was made of that decision or of the factors and evidence which were taken into account by the FSA when they took it, or what alternative options, if any, the FSA had considered. That decision was highly significant for the interests both of existing and potential policyholders.

36 My ninth finding of fact is that, having established from those involved the basis on which the FSA took that decision, the decision to permit the Society to remain open at that time was not grounded in a sound factual or legal basis. Relevant considerations – such as the nature of the Society's business, which meant that it was not just new policyholders who were potentially affected by the decision – were not taken into account. No proper consideration was given to the use of the full range of powers that the prudential regulators possessed.

The information provided by the FSA after closure

37 My final finding of fact is that the information provided by the FSA in the post-closure period was misleading and unbalanced, with assurances being provided that the Society was solvent, when that was in considerable doubt and was not the view held by the FSA, who, on behalf of the prudential regulators, had exercised formal intervention powers on the grounds that the Society was likely to be in breach of its regulatory solvency requirements.

38 Nor were the assurances given by the FSA that the Society was at that time fulfilling and always had fulfilled all of its other regulatory requirements appropriate, when the FSA knew that this was not the case.

The basis for each finding of fact

39 Having summarised the ten principal findings of fact that I have made, I now explain in more detail the basis on which I have made each of those findings.

The basis for my finding concerning the 'dual role'

The issue and relevant background

40 The role of the Appointed Actuary was, at the time relevant to this report, a central component of the system of prudential regulation of insurance companies. As the actuarial profession noted in the July 1992 version of its mandatory guidance note GN1:

> *The responsibilities of* [appointed] *actuaries... are central to the financial soundness of long-term insurance business... It is incumbent upon all Appointed Actuaries to ensure, so far as is within their authority, that the long-term business of the company is operated on sound financial lines and with regard to its policyholders' reasonable expectations.*

41 Key to this role was the relationship that Appointed Actuaries had with the prudential regulators but more especially with GAD. As the then Government Actuary noted in a paper entitled *'The Supervision of Life Insurance Business in the United Kingdom'* that he gave in 1990 to the *Groupe Consultatif* Summer School:

> *The UK system of supervision has worked well over many years and has shown itself well-suited to a diverse and innovative insurance industry, providing flexibility and not inhibiting change. A heavy load of responsibility is placed on the Appointed Actuary, but this is balanced by an active actuarial involvement in the supervisory process through GAD... The result is an effective partnership between the actuarial profession and the supervisory authority for the benefit and protection of policyholders...*

42 Given this regulatory role, which was one cornerstone of the system of prudential regulation in the United Kingdom, an Appointed Actuary needed to ensure that he or she had sufficient independence from the executive management of a life insurance company to enable him or her to undertake effectively the responsibilities (to the company, to its policyholders, and to the prudential regulators and GAD) that were conferred on the Appointed Actuary – and to enable him or her to do so in line with the intention of Parliament when it had created the role in 1973.

43 If an Appointed Actuary was unable to secure or retain the necessary degree of operational independence that would raise serious questions about the ability of the Appointed Actuary in those circumstances to perform the regulatory functions conferred on him or her.

The facts

44. On 28 March 1991, the Society notified the DTI, then the prudential regulators of insurance companies, that Equitable proposed to appoint the Society's then Appointed Actuary to the post of Chief Executive, once its current Chief Executive retired on 30 June 1991. The Society said that it was intended that the Appointed Actuary would not relinquish his existing post.

45 In the event, one person held both posts (Appointed Actuary and Chief Executive of the Society) for six years and one month, during the period between 1 July 1991 and 31 July 1997.

46 The Society's proposal echoed the position that had prevailed during 1980 and 1981, when the then Chief Executive of Equitable had also been the Society's Appointed Actuary.

47 The DTI sought the views of GAD on the proposed appointment. As GAD's policy was believed to be against combining the roles of Chief Executive and Appointed Actuary, the matter was referred to the Government Actuary himself to consider. On 17 April 1991, the Government Actuary commented:

> *I think we would certainly want to discourage him from holding both positions, other than on a very temporary basis. It would be appropriate for DTI to write asking what* [the Society's] *intentions are regarding the Appointed Actuary position, bearing in mind the fact that it is not now generally thought desirable for the same person to be* [Chief Executive] *and* [Appointed Actuary]. *If they get a dusty response I will speak to* [him].

48 This advice was referred to the DTI, under cover of a note by GAD, in which GAD wrote:

> *As it is not now thought desirable for the same person to be both Chief Executive and Appointed Actuary I think it would be best to clarify the Society's intentions.*

49 In the light of this advice, the DTI asked the Society's Secretary what Equitable proposed regarding the Appointed Actuary and withheld consent to the appointment of the Appointed Actuary as Chief Executive, pending clarification of the position. This prompted a telephone call from the Appointed Actuary on 30 April 1991.

50 He explained that, although Equitable had several good in-house actuaries, it was considered that they needed 12 months or so senior management experience before assuming the role of Appointed Actuary. Accordingly, Equitable would prefer him to retain the role of Appointed Actuary for a further period of approximately twelve to eighteen months.

51 On 2 May 1991, the Society's Secretary wrote to the DTI to confirm the position. He explained that Equitable were of the view that the Appointed Actuary role should be regarded and operated at a senior and influential level. The Secretary confirmed that Equitable did not currently have an actuary with the desired seniority but that they expected to have an appropriate person for the role of Appointed Actuary in twelve to eighteen months' time. The Secretary continued:

Accordingly, rather than moving away from the general approach and resorting to a purely technical interpretation of the Appointed Actuary's role, we regard it as substantially more satisfactory in professional and business terms for [him] *to continue to undertake the Appointed Actuary role for a limited period longer, as mentioned above.*

52 On 8 May 1991, the DTI sought the views of GAD, indicating that they were prepared to accept the position now reached, provided it was for a limited period. In response, GAD commented that they were also prepared to accept the position, on the basis that Equitable had confirmed that the incumbent would remain Appointed Actuary for twelve to eighteen months only after his appointment as Chief Executive.

53 On 16 May 1991, in the light of this advice, the DTI line supervisor for the Society wrote to the Society's Secretary to explain that the Secretary of State had no objection to the proposed appointment of the Appointed Actuary also as Chief Executive:

... on the understanding that [he] *will only retain the Appointed Actuary role for a further 12 to 18 months as indicated in your letter.*

54 On 31 May 1991, the Society's Secretary raised concerns about the terms of the DTI's letter. He suggested that the Secretary of State's acceptance of the Appointed Actuary's appointment as Chief Executive appeared conditional on his only continuing in the role of Appointed Actuary for a further twelve to eighteen months. The Secretary stated:

Whilst it is certainly the Society's current intention to separate the roles and appoint another Appointed Actuary within that timescale, we would not wish a condition to that effect to apply to [his] *appointment as Chief Executive. In making no objection to* [his] *appointment the Secretary of State appears to accept that* [he] *is a "fit and proper person". We cannot see that this will change if for some at present unforeseen reason,* [he] *does not cease to be the Appointed Actuary within the timescale mentioned. There is, we believe, a point of principle here.*

55 The Secretary asked the DTI to accept the appointment without the implied condition. However, the DTI official's view was that this was unacceptable. He passed Equitable's letter to the DTI senior line supervisor responsible for the Society, with a note, which said:

I do not think we can accede to [the appointment without condition]. *GAD consider 18 months exceptional! Suppose* [he] *falls ill – no Chief Executive – no Appointed Actuary – a successor should have been groomed by now to take on role of Appointed Actuary. I suggest we initially telephone* [Equitable's Secretary] *to express our views – I could not contact him today.*

56 The GAD Directing Actuary responsible for the Society intervened and pointed out that the emphasis of the Government Actuary's advice had been changed subtly, saying:

... he knows our concerns and respects them. However, if someone hasn't matured as quickly as they had hoped, there is no point in DTI getting up-tight. [The incumbent] *now sees this issue as a point of principle for him – and I take his point. We should explain to* [the DTI] *that*

Equitable is not a one-man show, likely to be dominated by [him]. *There are several good actuaries in the company, and they are unlikely to fall into the kinds of problems we have seen elsewhere purely because he holds two key posts. DTI should accept the company's assurances that they will separate the two posts as quickly as it is prudent to do so.*

57 On 17 June 1991, the DTI senior line supervisor wrote to Equitable's Secretary to note their:

> *... current intention to separate the roles of Appointed Actuary and Chief Executive within the time frame suggested... In the light of that and the points made during our conversation I am happy to confirm our acceptance of* [the] *appointment without condition.*

58 The DTI senior line supervisor, in a minute to the DTI official, noted that he had told the Society's Secretary that:

> *If the Appointed Actuary is also the Chief Executive and therefore responsible for taking the decisions on the direction of the company there is, almost by definition, a conflict of interest. The Appointed Actuary is most unlikely to blow the whistle on the Chief Executive!* [Equitable's Secretary] *took the point but said he would still prefer our acceptance to be unconditional. I said we were prepared to lift the condition but nevertheless we noted the company's intention to find a new Appointed Actuary within 12-18 months and that we would not be constrained from raising the point again if no appointment had been made at the end of that timescale. On that basis I wrote the letter* [of 17 June 1991].

59 During May 1992, GAD identified the continued combination of the roles as one of a number of current concerns they had about Equitable. GAD noted that the incumbent's *'position as Chief Executive and Actuary may create problems because there is nobody to blow the whistle when things go wrong'*. The DTI also noted that they were not happy with the combined role and had regarded this as a temporary situation.

60 Both GAD and the DTI raised these concerns when they met Equitable on 19 May 1992. The Appointed Actuary and Chief Executive denied any conflict of interest but stated that, if one were to arise, then he would give up one of the posts. He had explained that he was expecting to retire in three to four years' time, at which point the combined role would end and that, in the meantime, the appointment of a new Appointed Actuary was now at least one year away.

61 Following this meeting, GAD expressed disappointment that they had only met the Appointed Actuary and Chief Executive. In response, the Appointed Actuary and Chief Executive provided information about Equitable's 'actuarial management area'.

62 He also explained that this area was under the control of a senior actuary to whom three actuaries reported. One of these provided technical support to him in his Appointed Actuary role. The DTI and GAD did not then pursue further the issue of the combined role at this time.

63 I have seen that, during 1993, the continuing combined role was also a matter of concern within Equitable. In March of that year, Equitable's former Managing Director advised Equitable's President that the roles should be separated.

64 The former Managing Director identified a member of Equitable's staff whom he thought could be appointed to the post of Appointed Actuary within three months. In June 1993, in his personal notes the President highlighted the need to settle the retirement date of the Appointed Actuary and Chief Executive and to separate those roles.

65 The Society's auditors also advised the President that it was essential that the combined role was terminated at the earliest possibly opportunity, as it was *'completely wrong'* for any one person to have so much power in his own hands. In September 1993, in his personal notes, Equitable's President again highlighted the separation of the roles as a matter of great importance.

66 It appears that, during 1993, neither the DTI nor GAD raised the combined role with Equitable. The contact they had with the Society was almost exclusively with the Appointed Actuary and Chief Executive. The DTI and GAD appear to have been unaware of the fact that there was support within Equitable for ending the combined role or that advice to that effect had been provided to the Society by its auditors.

67 In February 1994, the DTI noted the concern that GAD and the DTI had expressed at the meeting in May 1992 but concluded that the situation would be brought to an end when the Appointed Actuary and Chief Executive retired in 1995 or 1996 (that is, three or four years from May 1992).

68 In November 1994, GAD, in their scrutiny report on the Society's 1993 returns, noted the continuance of the combination of both roles. The DTI identified this as an issue for discussion at a meeting with Equitable to be held on 9 December 1994.

69 At that meeting, the Appointed Actuary and Chief Executive confirmed that the roles would be split on his retirement. His response made clear that the appointment of a new Appointed Actuary prior to his departure was no longer being considered.

70 Neither the DTI nor GAD raised with him (or with the other directors of the Society) the fact that his appointment as Chief Executive in July 1991 had been agreed on the understanding that the roles were likely to be separated within eighteen months. That information had been provided to the prudential regulators as part of the process of authorising the Appointed Actuary to act also as Chief Executive.

71 I have seen that this continued to be a matter of concern within the Society. In June and December 1994 and in August 1995, Equitable's President and auditors noted that the combined role remained an issue that was in need of resolution.

72 In January 1996, GAD, in their scrutiny report on the 1994 returns, noted again that both roles were combined but that the Appointed Actuary and Chief Executive was *'due to retire within a few years (though it is dangerous to speculate exactly when!)'*. GAD did not pursue this issue with Equitable as part of their follow up work on the returns.

73 However, following correspondence on other matters, the Appointed Actuary and Chief Executive had suggested that GAD and the DTI should take *'a far tougher line on whom they allow to become appointed actuaries'*. GAD replied that neither they nor the DTI had any powers in this respect.

74 The Appointed Actuary expressed surprise at this and, on 15 April 1996, he stated:

Although I accept that the [1982] *Act does not require approval of Appointed Actuary appointments, there would appear to be an avenue of influence under the "sound and prudent management" criteria. That is via the requirement that any office "is directed and managed by a sufficient number of persons who are fit and proper persons to hold the positions which they hold".*

75 A handwritten note on the GAD file copy of this letter expressed doubt on this, saying that *'this would not pass review'*. It appears that neither the DTI nor GAD gave any further consideration to the use of the power to which the Appointed Actuary/Chief Executive had drawn their attention in order to influence the situation at Equitable, either before he had done so, at that time, or subsequently. Nor did the DTI give consideration to the use of any other of their powers.

76 In November 1996, in their scrutiny report for the 1995 returns, GAD noted again that the roles of Appointed Actuary and Chief Executive were combined. GAD also noted, apparently as an example of a counterbalance to this concentration of responsibilities, that the Society's Board of thirteen was chaired by a non-executive director and had a total of eight non-executives on it.

77 GAD did not pursue the combined roles of Appointed Actuary and Chief Executive as part of their follow up work on the Society's 1995 returns.

78 On 8 November 1996, GAD and the DTI met Equitable. There is no evidence that the combined role of the Appointed Actuary and Chief Executive was discussed with the Society. At that meeting, the Appointed Actuary gave no date for his retirement but explained that he would stay at Equitable until current changes had been consolidated.

79 On 1 August 1997, following the retirement of the incumbent the roles of Chief Executive and Appointed Actuary were separated. His successor as Appointed Actuary was the member of staff identified to the Society's President in March 1993.

The statutory and administrative context

80 The prudential regulators were not required to approve the appointment of an Appointed Actuary, although the name of such a person had to be notified to those regulators. The Government Actuary would also meet a new Appointed Actuary shortly after he or she was appointed.

81 The prudential regulators, however, were given powers to refuse to authorise an individual seeking appointment as the Chief Executive of an insurance company, if those regulators did not consider that person to be fit and proper to hold the position that it was intended they should hold.

82 The powers of intervention available to the prudential regulators, with effect from 1 July 1994, included those which enabled them to seek to remove a director, controller, or senior manager on a number of grounds.

83 Where a Chief Executive had already been appointed, section 37(5) of the 1982 Act provided that certain powers of intervention could be exercised within a five-year period from that appointment, whether or not any of the grounds in sections 37(2) or 37(4) of the 1982 Act existed, provided that there was good reason for doing so.

84 It also from that date became a ground for intervention if it appeared to the prudential regulators that the criteria of sound and prudent management – set out in Schedule 2A to the 1982 Act – were not fulfilled or might not be fulfilled in respect of a particular company.

85 Paragraph 2 of Schedule 2A to the 1982 Act provided that one of the criteria of sound and prudent management was that each director, controller, manager, or main agent of an insurance company was a fit and proper person to hold that position.

86 Paragraph 4 of that Schedule also provided that one of the criteria of sound and prudent management was that an insurance company was directed and managed by a sufficient number of persons who were fit and proper to hold the positions that they held.

87 Paragraph 4(1) of Schedule 2D to the 1982 Act provided that, where it appeared to the prudential regulators that the criteria of sound and prudent management were not or might not be fulfilled by reason of the ability of a person who is a controller of an insurance company to influence that company, those regulators could serve on the company a written notice of objection to that person continuing to be a controller of that company.

88 In Guideline 8.10 of the DTI's Policy Guidance Notes, the prudential regulators dealt with what was described as *'non-statutory intervention'*. Paragraph 4 of that Guideline stated:

> *The legislation should not be interpreted as setting out exclusively all actions which the Secretary of State can take in pursuance of his duty to regulate the insurance industry. It presupposes that action will be taken, for the purpose of protecting policyholders, which is covered by the statutory provisions.*

89 Paragraphs 7 to 9 of that Guideline continued:

> *In addition to his statutory powers, the Secretary of State enjoys the benefit of the general principle that everything is permitted by law unless it is specifically prohibited. In considering action to be taken, regard must be had not only to whether the action is specifically prohibited by law but whether there is an implicit prohibition either by UK or EC law.*
>
> *In principle, if there are express statutory powers to deal with a particular situation, then the situation should be dealt with by the exercise of these statutory powers. Although the exercise of the powers is discretionary, there is a duty to give proper consideration to whether the discretion should be exercised.*
>
> *Although it is unlikely that a course of action will arise for failure to exercise a discretionary power ... the failure to exercise the powers could well result in criticism of the* [prudential regulators].

My assessment

90 At the outset, I should emphasise that, in considering the existence of such a dual role, I make no judgement on the fitness or propriety of the particular individual in this case to hold an individual position within an insurance company.

91 My concerns do not relate to his specific qualities or to those of any other person who held similar dual roles at that time. Whatever his personal attributes or experience, I consider that it is not the specific attributes of the person who held both posts which is in issue, but a wider matter of principle.

92 The purpose of the 1982 Act – the protection of the interests of policyholders and potential policyholders – was, it seems to me, capable of being frustrated if the Appointed Actuary was constrained in the discharge of his or her functions by a conflict of interest.

93 By acting simultaneously as Chief Executive, the Society's Appointed Actuary was subject to significant constraints on his or her capacity to act as part of the system of prudential regulation.

94 Given the unique position of the Appointed Actuary within that regulatory regime, the centrality of which is recognised by the public bodies, this had the potential to lead to the dysfunction of the system of regulation created by Parliament.

95 An Appointed Actuary was, in my view, by definition not a fit and proper person to hold concurrently the position of Chief Executive of the same insurance company. The Society's application for authorisation of its new Chief Executive in that context should have been denied unless a condition was imposed that he should demit office as Appointed Actuary forthwith.

96 Once the appointment had been approved, there were a number of possible ways in which the prudential regulators could have prevented an Appointed Actuary and a Chief Executive of a mutual (or any other) life insurance company from holding both posts concurrently. None of those ways was considered in this case by the prudential regulators.

97 Given that the prudential regulators and GAD recognised at the time that the dual role in question led to what they referred to as an inherent *'conflict of interest'* – one which would exist at the heart of the regulatory system of checks and balances – it seems to me that questions arose as to whether the situation could prejudice the interests of policyholders. Those questions were never considered.

98 From 1 July 1994, three years after the dual role had been created, the failure of the prudential regulators to consider taking action to seek to end the position that they had been told was intended to last for approximately eighteen months became even more inexplicable and unacceptable. Yet those regulators took no action on the continuing situation.

99 The rationale for the Society not appointing a successor to the incumbent as Appointed Actuary – a role which all concerned recognised was central to the efficient operation of the system of prudential regulation of insurance companies – was that there was no-one within the Society of sufficient stature and with the relevant experience to take on this role.

100 Rather than assuaging any concerns that the prudential regulators should have had about one person holding perhaps the two most central roles in a life insurance company at the same time, the information that there was purportedly no-one else within the Society experienced or senior enough to succeed as Appointed Actuary should have raised further concerns.

101 Nor was it necessary for a successor as Appointed Actuary to come from within the Society. Why Equitable had not considered advertising for a replacement or using a firm of actuarial consultants, given the rationale for the dual role which the Society had put forward, was not a question that the prudential regulators considered putting to the Society.

102 Nor was the possibility considered by the prudential regulators of their taking action themselves to seek to encourage the Society to recruit a suitable Appointed Actuary from outside its then current staff.

103 The precise rationale that the Society put forward for the initiation and continuance of the position in which one person held the dual role was the lack of appropriately qualified and experienced people within the Society to take over as Appointed Actuary.

104 Given that rationale, I find it inexplicable that the prudential regulators did not take action to prompt the Society to seek to recruit its Appointed Actuary from outside, using their powers of intervention under the sound and prudent management criteria.

105 From 1 July 1994, there was also a further potential means whereby the dual role of Appointed Actuary and Chief Executive might have been brought to an end.

106 As I have noted above, paragraph 4(1) of Schedule 2D to the 1982 Act gave the prudential regulators the power to object to a controller or senior manager of a company continuing to hold such a position where it appeared that the criteria of sound and prudent management were not or may not in the future be fulfilled by reason of the ability of that person to influence the company.

107 The exercise of this power to resolve the dual role of the Appointed Actuary and Chief Executive of the Society – a situation in which it could not be doubted that he had considerable influence over it – was never considered by the prudential regulators at any time after that power became available to them.

108 Even without relying on the exercise of their statutory powers, to which the prudential regulators gave no consideration, there still remained a wide range of means – for example, non-statutory action, contact with the Society's President or Board, or professional influence – which could have been considered and/or taken by the prudential regulators but which were not considered and/or taken by those regulators.

109 The prudential regulators should have been concerned that, not only did the dual role negate one of the cornerstones of the regulatory regime, but also that there appeared to be no-one else within the Society with the seniority to temper any abuse of power that might occur.

110 A more intensive level of scrutiny could, moreover, have been applied to mitigate the effect of there being no 'whistle-blower', if the prudential regulators had come to the view that it was not appropriate to exercise any of their statutory or other powers.

111 None of these avenues was considered. The prudential regulators took no action to seek the ending of the unacceptable dual role. Furthermore, those regulators and GAD throughout the period had little contact with anyone at the Society other than the Chief Executive and Appointed Actuary.

112 My conclusion is that the prudential regulators failed in two respects. First, those regulators approved, when they should not have done, the appointment of a new Chief Executive without insisting that he should demit office as the Society's Appointed Actuary and without applying subsequently a closer degree of scrutiny of the Society's affairs.

113 Secondly, for the next six years, those regulators failed to consider the use of their powers to seek to end that 'dual role', despite the indication that had been given at the time of appointment that he would hold such a dual role for a limited period only.

Submissions I have received and my evaluation of those submissions

Submissions by the public bodies

114 When I informed the public bodies that I was minded to come to this view, those bodies told me that, in their view, I had misinterpreted or misapplied the applicable law.

115 The public bodies said that the prudential regulators had had no power to force the incumbent to resign either as Chief Executive or as Appointed Actuary of Equitable, without evidence either that his conduct was such as to justify regulatory intervention or that Equitable were not being properly managed. The public bodies said that those regulators had been aware of no such evidence.

116 In support of these views, the public bodies submitted that:

> *... there was no legal requirement for the Appointed Actuary of a company to be independent of the company's executive. It was plainly permissible for the Appointed Actuary to be on the company's board, and to hold the role of Chief Executive. Similarly, there was nothing which either required or prevented the Appointed Actuary from being a policyholder and/or a shareholder.*

117 The public bodies told me that they did:

> *... not accept that there was in fact a conflict of interest within Equitable, or that the prudential regulator recognised such a conflict of interest to exist. There was no reason to consider that, for a mutual such as Equitable, the Chief Executive and the Appointed Actuary would not have interests that were broadly coincident interests in favour of the policyholders. Moreover, particular safeguards against conflicts of interest in respect of Appointed Actuaries were put in place by the actuarial profession, as reflected in specific provisions in both the Memorandum of Professional Conduct and GN1.*

118 The public bodies told me that, accordingly, *'put at its highest, there was a potential for conflict, in respect of which the prudential regulator had been given assurances that* [the incumbent] *would relinquish one of his roles'*.

119 The public bodies submitted that, in addition:

> *... one person holding both roles was not unique to Equitable, this situation having also applied in the then recent past to at least four other large mutuals in particular. Consistency of approach between companies was (and remains) an important principle of regulation, save where different treatment was specifically provided for by the Insurance Companies Act 1982 or justified by the systems of priority ratings and other objective criteria employed by GAD and the prudential regulator relating to solvency and compliance with the Insurance Companies Act 1982 and its associated regulations. There was no justification for different treatment on either basis in Equitable's case.*

120 The public bodies then told me that they did not accept that the powers within the Insurance Companies Act 1982, to which I have referred above:

> *... provided a legal basis that would have enabled the prudential regulator to intervene in respect of the dual appointments... none of the... powers of intervention could have been used by the prudential regulator to object to* [the incumbent]*'s dual role. The prudential regulator was well aware that it did not have the power to force* [him] *to relinquish one or other post.*

121 The public bodies submitted that, additionally, *'it must be presumed that Equitable's auditors took the same view'*, as:

> *From 1 July 1994, the auditors had a duty to report to the prudential regulator in circumstances in which they had concerns that there was a question as to whether the prudential regulator ought to consider exercising its powers of intervention, including in relation to potential breaches of the criteria of sound and prudent management... At no point did Equitable's auditors make such a report to the prudential regulator.*

122 The public bodies concluded that, for all these reasons, *'given the pressure which the prudential regulator had already brought to bear on Equitable on this point, the bodies under investigation consider that it was reasonable for the prudential regulator not to have taken action beyond what it actually did'*.

123 The public bodies told me that any adverse finding would be unreasonable and flawed.

My evaluation of those submissions

124 I was not persuaded by the submissions made by the public bodies on this matter. Whether or not the position which existed at the Society was unique seems to me to be an irrelevant consideration.

125 That other situations which are incompatible with the regulatory regime designed by Parliament have arisen and been accepted by those operating that regime does not make the underlying incompatibility acceptable.

126 Nor have I said that Appointed Actuaries were, or should have been, prevented from sitting on a Board or becoming a policyholder or shareholder, where relevant. Those submissions go therefore to conclusions which I have not reached and are irrelevant to the dual role issue.

127 As will be seen, in their other submissions, the public bodies have suggested that the prudential regulators and GAD were entitled to rely on the certification of the Appointed Actuary when considering the Society's regulatory returns and the information he provided in correspondence or at meetings.

128 I have had regard to the nature of the duties which the prudential regulators had at the relevant time, which included the verification of the solvency position of insurance companies and of the way in which those companies had determined their liabilities and sought to demonstrate that they had sufficient assets to cover those liabilities.

129 I do not accept that it was open to the prudential regulators to fail to consider the taking of action to deal with the conflict of interest arising from the dual role, whereby the person who was their main means of ascertaining information from within the Society about those questions – the Appointed Actuary – was also the Chief Executive of that company.

130 The failure by the prudential regulators to consider whether to take appropriate action was exacerbated by their failure to ensure through other means – heightened scrutiny of the Society's affairs – that the information they were being provided with was accurate and reflected a prudent assessment of the Society's position.

My finding

131 **I find that the way in which the DTI, as prudential regulators, handled the 'dual role' – that is, the holding by one person for more than six years, from 1 July 1991 to 31 July 1997, of the position of the Society's Chief Executive simultaneously with the position of its Appointed Actuary – fell short of the standard that could reasonably be expected of such regulators.**

The basis for my finding concerning the scrutiny of the Society's returns for 1990 to 1993

The issue and relevant background

132 Each year, the Society, like every other insurance company, was required to submit annual returns to the prudential regulators. Those returns set out a considerable amount of detail about the business of the Society, about its liabilities, about the assets covering those liabilities, and about the solvency position of the Society.

133 The submission and scrutiny of those returns were the two prime mechanisms of prudential regulation during the period covered by this report.

134 The Society's returns for the years 1990 to 1993 raised certain issues about the approach that the Society was adopting to its business, which the scrutiny process was designed to highlight in order to enable the prudential regulators, acting with the advice and assistance of GAD, to ascertain whether there was any need to raise and pursue those issues.

135 The particular issues which arose during these years were:

- the valuation rate of interest used to discount the Society's liabilities, which appeared to be imprudent and/or impermissible (and resulted in the discounting of liabilities well below the guaranteed fund – the sum assured plus allocated guaranteed interest and bonuses – of policies); and
- the affordability and sustainability of the bonuses previously declared by the Society, which appeared to raise the expectations of the Society's policyholders which, on the information before GAD, the Society was unlikely to be able to meet.

The facts

136 The contents of the regulatory returns submitted by the Society each year, the notes and reports which together constituted the scrutiny of those returns by GAD, the correspondence between the Society and the prudential regulators and GAD, and the meetings held between them are extensively cited within Part 3 of this report. They are also summarised within Chapter 6 of this report. It is not practicable to reproduce all of that material again here.

137 Table 10a sets out the principal entries within Part 3 of this report which are relevant to the scrutiny of the Society's returns for each year from 1990 to 1996.

Table 10a: the scrutiny of the Society's regulatory returns

Year	Date submitted	GAD initial scrutiny	GAD detailed scrutiny to regulators	Correspondence from GAD to Equitable	Correspondence from Equitable to GAD
1988	26/06/1989	A1 – 24/07/1989 A2 – 11/09/1989			
1989	29/06/1990	A1 – 06/07/1990 A2 – 10/07/1990	05/12/1990	04/12/1990	17/12/1990
1990	27/06/1991	A1 – 24/07/1991 A2 – 29/07/1991	20/11/1991	19/11/1990	22/11/1990
1991	29/06/1992	A1 – 03/08/1992 A2 – 10/08/1992	29/10/1992	29/10/1992	06/11/1992
1992	29/06/1993	A1 – 30/06/1993 A2 – 05/07/1993	28/03/1994	28/03/1994	07/04/1994
1993	27/06/1994	A1 – 15/07/1994 A2 – 07/07/1994	15/11/1994	15/11/1994	22/11/1994
1994	30/06/1995	A1 – 24/07/1995 A2 – 25/07/1995	23/01/1996	23/01/1996	21/02/1996
1995	28/06/1996	A1 – 08/07/1996 A2 – 18/07/1996	01/11/1996		
1996	30/06/1997	A1 – 18/07/1997 A2 – 07/08/1997	16/12/1997	16/12/1997 16/01/1998 27/02/1998 21/04/1998	13/01/1998 04/02/1998 12/03/1998

138 I have noted above that, with respect to the Society's returns for each year from 1990 to 1993, the issues arising from those returns which should have raised questions in the mind of those scrutinising the Society's returns were the valuation rate of interest used to discount the Society's liabilities and the affordability and sustainability of the bonuses it had previously declared.

139 Table 10b shows the Mathematical Reserves for non-linked business as shown in the Society's appendix valuations within its returns for 1992 and 1994, along with the average valuation interest rates and the appropriate regulatory asset yields, as estimated by my actuarial adviser. The last column shows the margin between the asset yields and the valuation interest rates.

140 To meet the requirements valuation regulations, this margin should be greater than zero and significantly so if an allowance is made for future bonus on with-profits business.

The statutory and administrative context

141 Section 22(5) of the Insurance Companies Act 1982 required the prudential regulators to consider the regulatory returns, prepared pursuant to sections 17 and 18 of the 1982 Act and deposited pursuant to section 22(1) of that Act.

142 Section 22(5) also required those regulators, if it appeared to them that those returns were inaccurate or incomplete in any respect, to communicate with the company with a view to the correction of any such inaccuracies and the supply of deficiencies.

143 Section 18(4) of the 1982 Act required, when an investigation into the financial condition of the company was undertaken by the Appointed Actuary, that the value of any assets and the amount of any liabilities should be determined in accordance with the valuation Regulations. The valuation Regulations applicable to the Society's returns for 1990 to 1993 were those contained in the Insurance Companies Regulations 1981.

144 Section 18(5) of the 1982 Act required the Appointed Actuary to produce the abstract of his or her report of the results of that investigation into the financial condition of the company in conformity with the Accounts and Statements Regulations. The Regulations applicable to the Society's returns for 1990 to 1993 were those contained in the Insurance Companies (Accounts & Statements) Regulations 1983.

145 The prudential regulators issued internal guidance in 1991 – the DTI Policy Guidance Notes, which set the policy framework for the discharge by those regulators of their statutory functions. Those functions included the duty to consider the regulatory returns submitted by insurance companies.

146 The prudential regulators had, in 1984, also issued guidance to insurance companies on the preparation of the annual returns. Paragraph 12.1 of that guidance stated that:

> *... sufficient information must be given about the basis of the valuation to enable the Department to be satisfied* [that the Mathematical Reserves conformed to the applicable Regulations]*, and in particular that the reserves meet the minimum standards required under Regulations 55 to 64 of the 1981 Regulations.*

147 Paragraph 12.3 of that guidance also stated that the returns should:

Table 10b – the Society's valuation rates of interest v asset yields

	1992			
	Weighted average of the valuation rates %	*Appendix valuation reserve £m*	*Weighted average of the yield on the hypothecated assets%*	*Margin %*
With-profits business	*6.20*	*5,932*	*6.09*	*(0.10)*
Non profit business	*7.63*	*1,193*	*7.63*	*0.00*
Total non-linked business	*6.44*	*7,125*	*6.35*	*(0.09)*

	1994			
	Weighted average of the valuation rates %	*Appendix valuation reserve £m*	*Weighted average of the yield on the hypothecated assets%*	*Margin %*
With-profits business	*5.68*	*8,829*	*5.52*	*(0.16)*
Non profit business	*7.58*	*1,841*	*7.58*	*0.00*
Total non-linked business	*6.01*	*10,669*	*5.87*	*(0.13)*

... give details of any guarantees and options on non-linked contracts which the actuary considers to be significant. Common examples are guaranteed surrender values, guaranteed annuity rates, guaranteed minimum rates of interest on deposit administration contracts, and options to increase sums assured without evidence of health.

148 Paragraph 12.4 continued that *'the guarantees and options to be specified... should include details of any guaranteed surrender basis which is specified in the policy, whether expressed in monetary terms or as percentage deductions from the value of units'*.

149 Acting under the terms of a service level agreement made in 1984, GAD undertook the scrutiny of the regulatory returns on behalf of the prudential regulators.

150 Paragraph 25 of that agreement specified that, as soon as possible after the receipt of the returns, GAD would *'carry out an initial scrutiny of the return with a view to advising* [the prudential regulators] *of any serious solvency or compliance problems in respect of the company's long-term business and to determine an order of priority for GAD's main examination of the returns'*.

152 That main examination aimed to produce a detailed scrutiny report which GAD would submit to the prudential regulators. The primary objectives of those reports were:

- to form a view about the solvency position of the company and to determine whether, at the valuation date for the returns, the company met the margin of solvency required in respect of its long-term business and whether, in the foreseeable future, it seemed likely that the company would continue to meet that margin;
- to determine if the returns complied with the relevant statutory requirements; and
- to determine, as far as possible from the returns, whether the company appeared to have complied with other requirements relating to its long-term business.

153 The detailed scrutiny report was, pursuant to the terms of the service level agreement, to include:

- a general description of developments in the year covered by the returns which might affect the company – examples of such developments were said to be changes in the company's philosophy or business approach, changes in the type, volume or mix of its business, and any other internal or external factors that could have a special effect on the company;
- a general commentary on the present and future financial position;
- details of breaches, or possible breaches, of the applicable Regulations or of any undertakings given by the company to the prudential regulators;
- details of significant errors in or omissions from the returns;
- details of any qualifications in any of the certificates which were required to be submitted with the returns;
- details of high lapse rates; and
- details of correspondence between GAD and the company.

153 GAD also issued internal guidance, the Insurance Supervisory Work Manual, to assist those of its actuaries who had responsibilities for the scrutiny of the returns of insurance companies. Paragraph D.9 of that manual stated that:

> *If a company's business is straightforward and we have no concerns, we should not ask for information which is not required, explicitly or implicitly, by the Regulations, but where there is anything which suggests concern, we should not hesitate to ask for further information to be given. If the matter is one that the public should know about, particularly where the returns are misleading, we should ask through DTI for an amendment to the returns. A middle course is to ask for an answer by letter and for future returns to be amended.*

154 Paragraph K.5 of the GAD manual said:

> *In general, it is not necessary to look at interest, mortality and expenses in watertight compartments. The main point is whether the valuation basis as a whole is adequate. However, where weaknesses in one area are offset by strengths in another, we may need to ask questions to establish that the overall result is adequate.*

155 Section K of the GAD manual also invited scrutinising actuaries to:

- consider whether a company's contracts had been *'adequately described'*, saying in relation to deposit administration contracts, that the description in the returns should include a description of any guarantees and surrender options contained in those contracts and any interest guarantees built into them;
- consider the resilience test and whether the GAD guidance on the tests to be applied had been followed;
- consider whether any reserve for maturity guarantees had been calculated in line with the basis set out within the report of a professional working party; and
- consider whether the valuation interest rates were supportable and in compliance with the applicable Regulations, noting that, *'in doubtful cases, it may be necessary to ask for a "matching rectangle"'*.

156 For the 1993 returns, GAD also developed a scrutiny proforma with notes on the content to be included in those detailed scrutiny reports. Among the issues which the proforma stated should be included were:

- *'a view as to the soundness of the company in the short and longer term'*;
- *'cover for the solvency margin'* – which was said to be *'a key DTI supervisory responsibility'*;
- a clear statement *'where there is any doubt as to whether the valuation basis used is in accordance with the Regulations'*; and
- a series of *'key features'*, including *'recent trends in financial results, especially if adverse'*, the *'approach to valuation and a general view as to strength'*, and the *'supportability of bonuses and recent trends in bonus declarations'*.

157 Professional guidance was also issued by the Faculty and Institute of Actuaries with regard to the conduct of the Appointed Actuary when undertaking an investigation under section 18 of the 1982 Act.

My assessment

158 The Society's returns for 1990 to 1993 gave rise to a number of questions as to whether the Society was acting in contravention of the applicable Regulations with respect to the valuation interest rates used as part of the determination of the Society's liabilities within the returns for all these years.

159 In 1990, 1991 and 1992, the valuation interest rates used by Equitable for most of their non-profit business were near the maximum that could be supported by the current assets, leaving little or no margin between those rates and the appropriate risk-adjusted yields.

160 However, the current assets were of shorter duration than a significant proportion of the liabilities, which meant that those assets would have to be reinvested at some future date.

161 In such circumstances, Regulation 59(7) of the 1981 valuation Regulations limited the yield that could be assumed to be earned after such reinvestment and, in turn, this limited the valuation rate of interest that could be supported by those assets.

162 This rate was significantly below the rate supported by the current assets. Overall, the maximum valuation interest that could be used was the weighted average of (i) the risk-adjusted yield on the current supporting assets and (ii) the maximum yield that could be assumed to be earned on future reinvested assets.

163 As the valuation interest rates used by the Society were close to, or equalled, the maximum that could be supported by its current assets, the content of the Society's returns raised issues as to whether the Society had properly allowed for the requirements of Regulation 59(7) when determining what valuation rates to use.

164 GAD did identify the existence of, and raise concerns about, some of these issues with Equitable. However, GAD did not do so in relation to every potential contravention of the Regulations. For example, GAD did not identify that, in the Society's 1992 returns, the valuation rates used in relation to significant elements of the Society's business appeared not to be supported by the backing assets.

165 Moreover, on the occasions that GAD did raise concerns with the Society, GAD did not pursue those concerns to a satisfactory resolution.

166 On 15 November 1994, GAD wrote to the Society concerning its 1993 returns. GAD noted that the valuation interest rates that had been used by the Society seemed high compared to the available yields on assets shown in Form 45 of those returns.

167 GAD asked the Appointed Actuary to provide a matching rectangle in relation to the valuation basis prescribed in the Regulations, in order that GAD could be satisfied that the returns complied with the requirements of Regulation 59 of the applicable Regulations.

168 The Society replied on 22 November 1994. The Appointed Actuary provided rudimentary information which did not include a hypothecation of assets to categories of business.

169 The Appointed Actuary said that the weighted average valuation rate of 4.78% was supported by the asset yields shown on Form 45 of the return. The Appointed Actuary stated that he did not consider that, when establishing the maximum valuation interest rates allowed by the Regulations, hypothecation of assets to categories of liabilities was necessary or required by the applicable Regulations.

170 GAD responded on 23 November 1994 and expressed some surprise at the interpretation of the Regulations that the Appointed Actuary professed to hold.

171 GAD reminded the Society's Appointed Actuary that the Regulations did not permit an individual valuation interest rate to be higher than the overall yield on the assets hypothecated to liabilities valued at that rate – and that, consequently, valuation rates could not be averaged for the purposes of demonstrating compliance with the statutory requirements.

172 GAD asked the Society to hypothecate assets to each category of business for which a different interest rate had been used.

173 Further correspondence ensued. On 2 December 1994, GAD told the Society's Appointed Actuary that GAD did *'not agree with your interpretation of Regulation 59'*. GAD explained their understanding of the applicable Regulations and concluded:

> *We trust that in considering your bases for the net premium test in the 1994 valuation you will verify that each interest rate can be supported in terms of the new Regulation 69(11) with the application of paragraph 12 if required.*

174 That correspondence culminated in a letter from the Appointed Actuary to GAD on 7 December 1994, in which he stated that he did *'not wish to prolong this correspondence unduly since, on this occasion, it relates only to our "appendix" demonstrations of compliance with the Regulations'*. However, he accepted that the position adopted by GAD would *'become more pertinent under the new Regulations and I shall give further consideration to that'*.

175 The Society's Appointed Actuary also stated that *'looking back through my files, I see that a similar presentation to that* [used by the Society]*... has been provided on a number of occasions in the past without being questioned by your predecessors'*.

176 Thus, GAD's attempt to secure compliance with the relevant Regulations was left unresolved, with only an indication from the Appointed Actuary that GAD's interpretation would be *'considered'* for future returns.

177 Using higher valuation interest rates to calculate the Mathematical Reserves than was supportable by the assets held by the Society meant that the amount of the liabilities that were used when calculating the solvency position of the Society would be significantly understated, thus giving a more favourable impression of its financial condition.

178 The content of the Society's returns for 1990 to 1993 also gave rise to a number of issues regarding the affordability and sustainability of the Society's bonus declarations. Those issues related to the interest rate differential which the Society applied and the associated issue of reserving for future declarations of reversionary bonus.

179 The way in which Equitable made provision in its reserves for the payment of future reversionary bonuses, above the guaranteed interest rates which applied to policies written before 1996, should have raised concern. This was because the Society's practice did not appear to be consistent with the reasonable expectations of its policyholders.

180 The Society used net discount rates – that is, valuation interest rates less any explicit allowance for future bonuses – which were higher than the guaranteed investment return in the calculation of

its Mathematical Reserves. The Society did so (i) in the appendix valuations for all years from 1988 to 1999 and (ii) in the main valuations from 1990 to 1996. This is illustrated in table 10c, which sets out the information contained within those returns.

181 The difference between the net discount rate and the guaranteed investment return constitutes an 'interest rate differential'. Where such interest rate differentials were used, the resulting Mathematical Reserves were lower than the guaranteed fund in respect of each policy.

182 The information in the Society's regulatory returns did not demonstrate that the Society was complying with the requirements of the applicable Regulations in regard to these matters. However, GAD did not query this with the Society or bring it to the attention of the prudential regulators.

183 I consider that the contents of the Society's returns for 1990 to 1993 raised a number of issues which GAD should have raised with the Society. That was not done and that failure constitutes a departure from the proper performance by GAD of its obligations under the service level agreement with the DTI.

Submissions I have received and my evaluation of those submissions

Submissions by the public bodies

184 When I informed the public bodies that I was minded to come to this view, those bodies told me that, in their view, any conclusion that the Society's returns raised questions as to the compliance of the Society with the applicable Regulations, or as to the affordability and sustainability of its bonus policy had no sound basis in fact or in the relevant law.

185 Those bodies provided detailed actuarial analysis to support their view with regard to the valuation rates of interest used. It is not practicable to reproduce that detailed analysis here – nor that of my actuarial advisers in response.

Table 10c: the Society's interest rate differentials used for recurrent single premium with-profits business with guaranteed investment returns

	Main valuation	*Appendix valuation*	
	Interest rate differential used % p.a.	*Interest rate differential used % p.a.*	*Estimated value of differential applied to guaranteed policy funds £m*
1988	*-*	*1.50*	*181*
1989	*-*	*1.50*	*286*
1990	*1.25*	*3.75*	*901*
1991	*1.25*	*3.00*	*1,017*
1992	*1.25*	*3.00*	*1,170*
1993	*0.25*	*1.00*	*516*
1994	*1.50*	*2.25*	*1,315*
1995	*1.00*	*1.75*	*1,205*
1996	*0.75*	*1.50*	*1,264*

My evaluation of those submissions

186 I was not persuaded by the submissions of the public bodies. While I accept that it might now be possible to show that the Society was acting appropriately, the question before me is not what, with the benefit of hindsight, the true position was at the time.

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

188 I consider that the information within the Society's returns gave rise to questions which should have been asked in order to enable GAD to be so satisfied.

189 On the information before GAD at the time, the Society's approach to discounting appeared to suggest that a significant amount of any future surplus would be required simply to fund guaranteed benefits.

190 That occurred in a situation in which GAD knew that the Society had informed its policyholders that the additional returns they would receive by way of bonus declarations would reflect the investment performance of the with-profits fund.

191 In addition, the information within the Society's returns gave rise to serious questions about whether the Society could afford the level of bonus it was paying and whether it could continue to pay out at that level, in a situation in which, as GAD knew, the Society was unique in illustrating to its policyholders the full policy fund value, including terminal bonus.

192 From the information before GAD, it was not clear how the Society could fund future guaranteed bonuses and pay future discretionary bonuses, in line with the reasonable expectations of the Society's policyholders that such bonuses would continue to be paid. Nor was it clear that the valuation rates of interest used by the Society accorded with the applicable Regulations.

193 Despite those questions raising issues concerning the prudence of the Society's approach and whether there was a risk that the Society would not be able to fulfil the reasonable expectations of its policyholders, no action was taken by GAD to seek to resolve those questions or to raise them with the prudential regulators.

194 This was despite the fact that GAD had raised concerns at the time. As can be seen in the entries for the relevant dates in Part 3 of this report:

- GAD's Scrutinising Actuary B had noted, on 14 May 1992, that *'Equitable had used up investment reserves quickly in paying very good bonuses'* and, on the same day, it was noted that GAD's Chief Actuary B *'thinks they have been paying too much in bonuses'*;

- GAD's Directing Actuary A had referred, on 30 July 1992, to the Society as being one among the *'companies on whom we have been keeping a close watch for a number of years'* and which *'remain companies which cause serious concern'* – referring on 21 August 1992 to the Society's solvency position as being *'a cause for concern'*;

- a note from GAD to the prudential regulators on 15 September 1992 had said, in relation to GAD's view of the Society's position, that *'our view is that the Society has over-distributed in the last few years, compared with the return on investments.'*;

- a further note from GAD to the prudential regulators on 29 October 1992 had said that *'in order to pay bonuses in* [respect of 1990 and 1991] *the company had to earn 11.25% per annum on the assets backing the with profits contracts... In fact the company earned about +3% over the two years rather than the required +23%, and this is the main reason why the available assets have been reduced and the valuation basis has been weakened'*; and
- the Head of Life Insurance for the prudential regulators commented on the above further note from GAD on 4 November 1992 that *'this paints a worrying picture. Over-distribution by a company with a (deliberately) small coverage of its RMM and a (continuing) policy of high equity exposure'*.

195 The Society was also described, in internal briefing by the prudential regulators (see the entry for 26 October 1993 in Part 3 of this report), as a company to whom those regulators should be *'paying special attention to in the remainder of 1993 and 1994'*.

196 However, despite the views as to these issues which I have set out above – and those other occasions on which such doubts were expressed which any reader of the chronology of events that is set out in Part 3 of my report will identify – GAD failed to raise those questions with the Society or to seek to resolve them in other ways.

197 I am not suggesting that it can be established that the Society was in breach of the regulatory requirements to which it was subject. Nor am I coming to a view as to whether what is generally called 'over-bonusing' has occurred.

198 I am of course aware that the basis of the complaints which were made to me was that the Society operated a uniquely flawed business model which was always going to, and did, cause the Society to fail.

199 However, I also recognise that a view could be taken that, in a context in which the smoothing implicit in with-profits business meant that policies would typically receive more or less than their unsmoothed asset share, a particular sequence of financial conditions led most with-profits offices, including the Society, to pay out more than unsmoothed asset share to maturing policyholders throughout much of the 1990s.

200 Whether one or other view is the right one is not a matter for me to determine and I have no power to do so. My focus is on the acts and omissions of the prudential regulators and/or GAD.

201 Given the doubts that existed within GAD at the time and the nature of the information before GAD when it conducted the scrutiny of the Society's returns for 1990 to 1993, the submissions of the public bodies on these matters did not persuade me to come to a different conclusion.

My finding

202 I find that the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1990 to 1993, related to (i) the valuation rate of interest used to discount the Society's liabilities and (ii) to the affordability and sustainability of the Society's bonus declarations, fell short of what could reasonably be expected of GAD.

The basis for my finding concerning the introduction of the differential terminal bonus policy

The issue and relevant background

203 As is well known, the Society wrote policies containing guaranteed annuity rates. Those policies guaranteed the rate at which the proceeds available at retirement (based on the sum assured plus associated bonuses) would be converted to pension – and thus the minimum amount of pension available at retirement.

204 The Society stopped providing guaranteed annuity rates on new policies from June 1988, although new members of some existing group schemes continued to be provided with policies containing guaranteed annuity rates until the early 1990s.

205 The Society's guaranteed annuity rates continued to apply to the benefits that would be purchased by the future premiums (including in relation to recurrent single premium policies) that might be paid in respect of policies which already enjoyed this guarantee.

206 Those guaranteed annuity rates were both more flexible, in that they applied over a wide range of ages without penalty, and potentially more widespread than was the case with similar guarantees provided by other companies. In addition, policyholders could pay future premium payments and still benefit from the same guaranteed annuity rate at the same range of ages.

207 No new fund was established by the Society at the time of the changes it made to exclude guaranteed annuity rates and, subsequently, to exclude guaranteed investment returns from the policies it wrote.

208 Thus the assets held in respect of the different classes of policy thereby created were held in one fund. Nor was there a separate bonus series declared or any differentiation in treatment between the various classes of with-profits policyholders in terms of the level of bonuses declared by Equitable, despite the changes in policy terms and the associated guarantees that had occurred.

209 In late 1993 and early 1994 and continuously from April 1995 onwards, the Society's guaranteed annuity rates became generally more favourable than then current annuity rates. This meant that the cost of providing the guaranteed annuity benefit exceeded the total policy fund, which was only sufficient to provide the lower benefit available at the current annuity rate.

210 In order to deal with this situation, the Society introduced what came to be known as the 'differential terminal bonus policy', by restricting the value of benefit paid to the amount of the total policy fund.

211 The Society said that this was done to enable it to continue to reflect the Society's philosophy of 'full and fair' distribution to all its policyholders through its bonus policy and to pay each policyholder just their share of the fund.

212 Therefore, under the Society's differential terminal bonus policy, the amount of final bonus payable when a policyholder took benefits would be dependent on the form in which those benefits were taken and so, if the guaranteed annuity benefit was selected, the amount of the final bonus attributed to that policy was reduced.

The facts

213 Equitable submitted a statement of their business within Schedule 5 of their regulatory returns in both 1985 and in 1990. In those statements, the Society produced tables which disclosed both the level of the guaranteed annuity rate and the value of the business to which such a rate was applicable.

214 For example, in Form 67 of Schedule 5 of both the 1985 and 1990 returns, it was stated underneath tables which set out the value of the business that, for *'Individual Pension Arrangements – Variable Premiums'*:

> *Examples of the guaranteed annuity rates applicable to this business are:*
>
> *Men – at 60 £10.26%; at 65 £11.55%.*
>
> *Women – at 60 £9.34%; at 65 £10.33%.*

215 There is no evidence that, in either year, the GAD scrutinising actuary considered that information or any other such information within Schedule 5 of the Society's regulatory returns.

216 The Society had also stated in its regulatory returns for each year from 1988 onwards (until 1997) that *'it was considered unnecessary in current conditions to make explicit provision for the other guarantees and options described'* within the returns.

217 The description provided was that *'the premiums provide a cash fund at the pension date, to which (for policies issued prior to 1 July 1988) a guaranteed annuity rate is applicable'*.

218 Equitable stated, on page 71 of their 1993 returns:

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

219 This was a description of the differential terminal bonus policy that the Society had adopted and which was used from the date of bonus declarations in respect of the 1993 year-end until the date of the decision of the House of Lords in July 2000.

220 That description was included in each of the returns from 1993 to 1997. In their 1998 returns, Equitable stated:

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

221 The copy of the Society's 1993 returns that was held on the GAD file was annotated in red ink and in pencil. Several sections of the returns were marked *'new'*, including the disclosure of the differential terminal bonus policy.

222 On 24 October 1994, GAD prepared 'detailed scrutiny notes' as part of their consideration of the Society's 1993 returns. In these notes, the GAD scrutinising actuary listed the key points arising from his first read-through of the returns. On the third page of his notes, the actuary typed:

Bonus rate changes

- *New rules reducing final bonuses, see page 71*
- *Various changes in bonus rates.*

223 However, while the GAD actuary identified this in his notes to assist him to conduct the detailed scrutiny of the returns and to write a scrutiny report to the DTI, the issue was not covered in the scrutiny report he provided to the prudential regulators on 15 November 1994.

The statutory and administrative context

224 Section 17 of the Insurance Companies Act 1982 required every insurance company to prepare a revenue account for the year, a balance sheet as at the end of the year, and a profit and loss account for the year in a prescribed form. Those documents formed part of the regulatory returns.

225 All insurance companies which wrote long term business were also required by Section 18 of the 1982 Act to cause an annual actuarial investigation to be made into its financial condition by its Appointed Actuary, who had to report the results of that investigation in a prescribed form. The abstract of the actuary's report formed part of the regulatory returns.

226 The amount of the long term liabilities as calculated by the Appointed Actuary, pursuant to Section 18 of the 1982 Act, were included in the balance sheet required by section 17 of the 1982 Act.

227 Section 18(4) of the 1982 Act provided that, for the purposes of the investigation that the Appointed Actuary undertook into the financial condition of the company, the value of any assets and the amount of any liabilities were required to be determined in accordance with the applicable valuation Regulations.

228 With effect from 1 July 1994, those regulations were set out in Part VIII and Part XI of the Insurance Companies Regulations 1994, replacing the Insurance Companies Regulations 1981.

229 Regulation 54 of the Insurance Companies Regulations 1981 stated that:

> *The determination of the amount of long term liabilities (other than liabilities which have fallen due for payment before the valuation date) shall be made on actuarial principles and shall make proper provision for all liabilities on prudent assumptions in regard to the relevant factors.*

230 Regulation 64(1) of the Insurance Companies Regulations 1994 stated that:

> *The determination of the amount of long term liabilities (other than liabilities which have fallen due for payment before the valuation date) shall be made on actuarial principles which have due regard to the reasonable expectations of policy holders and shall make proper provision for all liabilities on prudent assumptions that shall include appropriate margins for adverse deviation of the relevant factors.*

231 Regulation 64(3) of the 1994 Regulations provided that the amount of a company's long-term liabilities should take into account, among other matters, all guaranteed benefits and all options available to the policyholders under the terms of their contracts.

232 Regulation 62(1) of the Insurance Companies Regulations 1981 required that provision should be made to cover any increase in liabilities caused by policyholders exercising options under their contracts. Regulation 72(1) of the Insurance Companies Regulations 1994 required that provision should be made on prudent assumptions to cover any increase in liabilities caused by policyholders exercising options under their contracts.

233 Section K of the GAD Insurance Supervisory Work Guidance Manual invited the GAD scrutinising actuary to *'draw DTI's attention to changes in bonus rates, compared to those of the previous year (or at previous declarations)'*.

My assessment

234 GAD did not identify the full disclosure within Schedule 5 of the Society's 1990 returns of the nature and extent of the Society's exposure to guaranteed annuity rates. GAD therefore did not take this information into account when undertaking their scrutiny of the Society's 1990 returns, or in relation to their scrutiny of subsequent returns, or when the issue of reserving for such guarantees became a matter of considerable concern. That was a missed opportunity.

235 While it seems to me arguable that GAD should have used the information provided within Schedule 5 of the 1990 returns in order to assist the prudential regulators to verify the solvency position of the Society, I do not, on balance, conclude that GAD acted unreasonably by not doing so at the time that they scrutinised those returns.

236 However, the Society in later returns continued to refer to the existence of policies which contained guaranteed annuity rates and did so in meetings with the prudential regulators and GAD.

237 GAD and the prudential regulators were aware that interest rates had lowered for a sustained period and that mortality was improving. Thus, when the Society introduced its differential terminal bonus policy – designed to address the fact that the Society's guaranteed annuity rates were now 'biting' in an environment of lower current annuity rates – that introduction cannot have been seen in isolation.

238 Yet, while the GAD scrutinising actuary noted that the Society had introduced this policy and that it had the effect of reducing the terminal bonus payable to certain policyholders, this was not taken forward as part of the scrutiny process nor notified to the prudential regulators.

239 I find this omission inexplicable. Moreover, the disclosure within the Society's 1993 returns of the differential terminal bonus policy did not feature in GAD's scrutiny of those returns.

240 I consider that the disclosure in the 1993 returns of the differential terminal bonus policy raised three separate issues which should have been considered and addressed: the first being how the Society's new policy impacted on the reasonable expectations of its existing policyholders; the second being whether that policy was being clearly described to potential policyholders; and the third being its impact on the Society's approach to reserving.

241 On 20 July 1993, Equitable had provided GAD with their completed response to a with-profits survey then being conducted by GAD on behalf of the prudential regulators.

242 In that response, Equitable explained that *'part of the Society's stated philosophy is to achieve a reasonable degree of stability in proceeds with gradual, rather than sudden, changes in proceeds'*. The response also stated that, while no specific information was given within the Society's publications about the period and magnitude of smoothing or the likely frequency of changes to final bonus rates, general comments in their 'With-Profits Guide' could be expected to lead policyholders to expect relatively gradual changes to bonus rates.

243 The actuarial profession had also noted, in the report of the professional working party on PRE, published in June 1993, that it was reasonable to expect that an insurance company would exercise continuity in its approach to determining benefits and change its approach to smoothing only gradually.

244 GAD had been provided with information by Equitable that suggested that the Society's policyholders would not generally expect changes to bonus rates and to its distribution policy. That information had also expressed the view that the philosophy of the Society was to effect gradual and not sudden changes in the way in which it disbursed proceeds to its members.

245 Given all of the above, I consider that GAD should have pursued with Equitable the new policy, which GAD noted had the effect of reducing bonuses, in order to be able to advise the prudential regulators as to whether the differential terminal bonus policy accorded with policyholders' reasonable expectations.

246 In a letter sent by the Government Actuary to Equitable on 7 July 1993, in response to the Appointed Actuary's concerns about how the survey had been announced, the Government Actuary emphasised that *'GAD and the DTI have always taken a close interest in policyholders' reasonable expectations'* and that the rationale for the survey had been partly to underline *'the need to focus on this area and for DTI to be seen to be doing something positive to indicate that it has policyholders' reasonable expectations very much in mind'*.

247 GAD did not, however, bring the new policy to the attention of the prudential regulators or raise the matter with the Society. That was a lost opportunity to establish the way in which the Society's differential terminal bonus policy worked and how that policy affected policyholders and their reasonable expectations.

248 Given that GAD were aware that the material published by Equitable led the reader to expect only gradual changes to bonus policy, that was also a lost opportunity to recommend to the prudential regulators that liaison with the conduct of business regulators should be undertaken and to advise the prudential regulators that concerns should be raised with the Society as to whether it was properly describing this new policy in the Society's marketing and other literature, in order that the reasonable expectations of potential policyholders were fulfilled.

249 The disclosure of the differential terminal bonus policy in the Society's 1993 returns also referred to the 'guaranteed annuity rate'. That reference was further indication of an issue that could and indeed did become critical in later years. Had it been pursued at the time, the question of whether the Society was reserving for such policies might have arisen earlier.

250 GAD's failure to ask the Society to explain what the new bonus policy entailed, why it had been adopted, and the nature and extent of the problem that it was designed to address was a lost opportunity to identify and address the issues that would cause the Society great problems some years later.

251 The failure by GAD to pursue this at the time led to a further lost opportunity. The Society's bonus statements and With-Profits Guides did not reflect this change in bonus policy until some years later. That might have been identified and remedied had GAD pursued this matter when it first arose.

252 I consider that GAD should have raised, pursued and sought to resolve issues arising from the introduction of the Society's differential terminal bonus policy – but failed to do so. GAD should, moreover, have reported those issues to the prudential regulators but also failed to do so.

Submissions I have received and my evaluation of those submissions

Submissions by the public bodies

253 When I informed the public bodies that I was minded to come to this view, those bodies told me that, in their view, I had attached far too much significance to the disclosure of the differential terminal bonus policy, at a time when there had been no basis for concluding that it was unlawful or otherwise objectionable, and at a time when its ultimate implications for Equitable, following the decision of the House of Lords in the *Hyman* litigation, could not have been foreseen.

254 The public bodies also said that, at the time that Equitable had introduced and disclosed the differential terminal bonus policy, such a policy had not been generally seen as imprudent or surprising.

255 The public bodies told me that disclosure by Equitable of the new policy within its 1993 returns would not, at that time, have raised any concerns with regard to PRE, the way in which the policy was described to potential policyholders, or the impact on reserving by Equitable.

256 The public bodies said that any adverse finding on this matter would be unreasonable and could only be made with the benefit of hindsight.

257 The public bodies accepted that the introduction of the differential terminal bonus policy had been identified by GAD as part of its scrutiny of the Society's 1993 regulatory returns.

258 However, in support of their view that such a conclusion was unreasonable, the public bodies submitted that:

> *... the reference to "new rules" in the scrutinising actuary's notes, and his recognition that these rules involved the reduction of terminal bonus in certain circumstances, were no more than records of fact. They did not indicate that the scrutinising actuary had identified the* [differential terminal bonus policy] *as a matter of potential concern for any reason, or that it ought to be commented on in the detailed scrutiny report which he would be preparing for the prudential regulator...*

259 The public bodies further submitted that:

> *In these circumstances..., it is wholly unsurprising that no comment was made on the* [differential terminal bonus policy] *in the detailed scrutiny report. There was no reason for the scrutinising actuary to consider the description of* [that policy] *in the 1993 returns... as referring to a practice which Equitable was*

not contractually entitled to carry out. Indeed, it was only the House of Lords' judgment in 2000 that established that the practice was in breach of Equitable's Articles of Association.

260 The public bodies went on to submit that:

> *The practice described was not unique to Equitable, a similar approach having been adopted by several other companies. Nor was it considered by most actuaries at the time to be unfair or to raise any issue with regard to PRE.*

261 The public bodies said that the view taken by GAD, that no action needed to be taken as part of the scrutiny of the Society's returns, had been a reasonable one for GAD to take at the time.

262 Turning to the issue as to whether the introduction of the differential terminal bonus policy raised questions regarding its impact on the reasonable expectations of existing policyholders, whether and how the policy was being described to new policyholders, and on the reserving practice of the Society, the public bodies submitted that *'the disclosure of* [that policy] *in the 1993 returns did not (and reasonably did not) give rise to concerns in any of these respects.'*

263 As for issues regarding the impact of the policy on the reasonable expectations of existing policyholders, the public bodies submitted that recognition that this policy might have had such an impact was:

> *... based entirely on an assessment made with the benefit of hindsight. At the time, other companies used a* [differential terminal bonus policy] *and it was generally regarded by actuaries as an approach which was consistent with contractual rights and PRE. In particular, it resulted in a maturity payment to the policyholder which was targeted on the individual "asset share", which was widely accepted among actuaries at the time as setting a benchmark for satisfying PRE.*

264 The public bodies further submitted that:

> *... there was no PRE reason why mention of the* [differential terminal bonus policy] *should have been made in GAD's report to the prudential regulator on its detailed scrutiny of Equitable's 1993 returns. This was also the case in later years. It is only with the benefit of hindsight, and knowledge of the House of Lords' judgment, that* [that policy] *can be seen as having been an improper approach to bonus distribution for Equitable to have adopted.*

265 The public bodies went on to submit that the *'circumstances in which the prudential regulator would have considered intervention on PRE grounds in relation to bonus declarations were far from being fulfilled at the material times in relation to the* [differential terminal bonus policy]*'*.

266 As for issues regarding whether and how the Society's policy was being described to new policyholders, the public bodies submitted:

> *The marketing to potential policyholders through Equitable's literature (including the bonus statements and With-Profits Guides...) was a matter for the conduct of business regulator, not the prudential regulator. It was not the responsibility of GAD or the prudential regulator to raise with the conduct of business regulator the issue of the* [differential terminal bonus policy] *and how it might be communicated by Equitable to potential policyholders.*

267 As for issues regarding the reserving practice of the Society, the public bodies submitted that:

> *... the point is misconceived because there was no need to reserve for terminal bonus under the regulations, and the* [differential terminal bonus policy] *(relating as it did only to payments of terminal bonus) would therefore properly have been considered by GAD to have no impact on Equitable's reserves. The subsequent wholly inappropriate reliance that was placed on the* [policy] *by Equitable, in relation to avoiding setting up reserves which should properly have been held under the regulations for the benefits guaranteed under the relevant contracts, could not have been foreseen from the disclosure of the* [differential terminal bonus policy] *in the 1993 returns.*

268 As regards the disclosure within Schedule 5 of the Society's regulatory returns for 1990, and also within the Society's returns for later years, of its policies containing guaranteed annuity rates, the public bodies told me that, in their view, it was only with the benefit of hindsight that the Society's disclosure regarding guaranteed annuity rates in the years from 1990 to 1996 could be seen to have been misleading.

269 The public bodies also said that it was not reasonable now to criticise GAD for failing to use the disclosure of the extent and nature of the guarantees within the Society's 1990 returns to test the Society's assertion that it did not need to establish an explicit reserve for the liabilities associated with policies which contained guaranteed annuity rates.

270 The public bodies told me that:

> *With the benefit of hindsight, it is clear that, had GAD interrogated the relevant Schedule 4 disclosure using the data in the Schedule 5 statements, it would have discovered the problem with Equitable's GARs and the lack of an explicit reserve in respect of them.*

271 The public bodies submitted, however, that my conclusion had been informed by:

> *... the impermissible application of* [such] *hindsight and a failure to acknowledge (i) the inadequate and misleading nature of Equitable's disclosure in the returns and (ii) that any deficiency that there may have been in the relevant reserves was not significant before 1997.*

272 The public bodies also said that they did not consider that the disclosure of the position by the Society within its returns had been adequate, submitting that:

> *With the benefit of hindsight and in the knowledge of the extent of its exposure to GARs revealed by its reply to the GAR survey, it is now clear that Equitable did not provide the disclosure required by the regulations. Further, Lord Penrose, in his report, described the disclosure provided by Equitable as wholly inadequate. It is now clear that the disclosure was insufficient to enable GAD to have a clear understanding of the true position at the time the disclosure was made.*

273 The public bodies further submitted that:

> *GAD was entitled to rely on the Appointed Actuary to provide full and proper disclosure in the returns in accordance with his*

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

274 The public bodies went on to submit that:

> *It is only with the benefit of hindsight that the disclosure provided by Equitable can be seen to have been misleading. At the time of the relevant disclosures, the clear implication of the information which Equitable provided was that the need to make explicit provision for the GARs had been considered and dismissed by the Appointed Actuary because they were not "in the money", or they attached to an immaterial amount of business, or both.*
>
> *The information available to GAD in the relevant years was not such as to have caused it to question whether Equitable was being disingenuous in giving this impression. In particular, Equitable made no reference to the Differential Terminal Bonus Policy, a policy which it is now known Equitable relied upon to seek to justify the lack of a GAR reserve. GAD did not know, nor could it at the time reasonably have been expected to discern, that (contrary to Equitable's assertion) reserves were in fact required in respect of its GAR exposure, arguably in 1993 and 1994 (although at that time only in respect of the resilience reserve), and in the base valuation from the 1995 returns onwards.*

275 In relation to any meetings held between the Society and the prudential regulators and GAD, at which mention had been made of the existence of the guaranteed annuity rates, the public bodies submitted that:

> *With the benefit of hindsight, it can now be seen that the comments made by* [the Society's Appointed Actuary] *at the meeting in relation to the GARs were misleading. Contrary to the clear impression that he gave, the GARs must in fact have been at least close to biting in the base valuation at that time, and would have been biting to some extent in the resilience scenario in which interest rates were assumed to fall. At the time, however, GAD and the prudential regulator had no way of knowing this, and it was reasonable for them to have accepted the statements made by the Appointed Actuary.*

276 In relation to the full disclosure of those guarantees within Schedule 5 of the Society's 1990 regulatory returns (and in similar earlier returns), the public bodies told me that:

> [We accept] *that, in providing the periodic statements of its long-term business required under Schedule 5... as part of its returns for 1982, 1985 and 1990, Equitable did disclose data from which the level and extent of its GAR exposure could be discerned.*

277 However, the public bodies went on to submit that:

> *... there was no explicit requirement under the terms of its Service Level Agreement with the prudential regulator for GAD to "review the returns for previous years" at the time in question. Nor did GAD's own internal guidance require reference back to Schedule 5 statements submitted for earlier years.*

278 The public bodies also submitted that:

> *Further, from 1990 to 1997, Equitable stated expressly in Schedule 4 to its returns that no explicit GAR reserve was required. That assurance was made by Equitable's Appointed Actuary, who had professional responsibility to provide full and proper disclosure of Equitable's financial position.*
>
> *Accordingly, the prudential regulator, through GAD, was entitled in all of the* [relevant] *years... (including 1990) to rely on that assurance when scrutinising the relevant returns and was not required to go behind it and test its veracity against the data contained in Equitable's Schedule 5 statements.*
>
> *The position would have been different if, as it ought to have done in at least some of* [those] *years..., Equitable had disclosed in Schedule 4 to its returns the need for it to establish an explicit GAR reserve. In that case,* [we] *accept that the prudential regulator, through GAD, would have been required to verify the sufficiency of the reserve established with reference to the data in the Schedule 5 statements.*

279 The public bodies concluded by submitting that they did:

> *... not accept as well-founded criticism of GAD for failing to:*
>
> - *detect the inadequacy of Equitable's (opaque) disclosure of the existence and extent of its GARs in its 1990 to 1996 returns; and*
> - *advise the prudential regulator to seek further information from Equitable¸ whether under section 22(5) of the Insurance Companies Act 1982 or otherwise, about its exposure to GARs.*
>
> *GAD's scrutiny of the returns was conducted in a proper and appropriate manner.* [I had] *rightly acknowledged, and endorsed, the robust approach which GAD and the prudential regulator adopted in relation to Equitable's 1997 returns. However, that approach reflected a key change in circumstances – namely the unambiguous disclosure by Equitable in a single statement in those returns of the existence, level and extent of its exposure to GARs, and the way in which it was using its* [differential terminal bonus policy] *to seek to justify avoiding the need to set up reserves for the GARs. GAD and the prudential regulator simply did not have that information when scrutinising the returns for each of the years up to 1996.*

My evaluation of those submissions

280 The public bodies have accepted that, had GAD used the information provided by the Society within Schedule 5 of its 1990 returns, *'it would have discovered the problem with Equitable's GARs and the lack of an explicit reserve'*. Had GAD done so, it is thus reasonable to conclude that much of the subsequent history of the Society's problems might have been different.

281 The public bodies have submitted, however, that any criticism of GAD's failure to use that information can only be sustained by having regard to hindsight. However, I am not persuaded by the submissions of the public bodies on this matter.

282 While I accept, on balance, that there was nothing before GAD when it scrutinised the Society's 1990 returns that would have made that scrutiny focus on the existence, nature and extent of maturity

guarantees within the Society's business, the position was entirely different when GAD were scrutinising the Society's 1993 regulatory returns.

283 GAD knew that interest rates had fallen on a sustained basis over the previous years. More importantly, the Society disclosed within those regulatory returns that it had introduced a new bonus policy directed at the reduction of bonuses in a context of policies which contained guaranteed annuity rates.

284 It is arguable whether the Society provided sufficient and sufficiently clear disclosure of the guarantees contained within its business and whether its description of the differential terminal bonus policy was appropriate. I consider, however, that it was sufficient to put GAD on notice that questions about those matters needed to be asked if GAD did not fully understand the position.

285 But, in any event, in undertaking the scrutiny of the regulatory returns on behalf of the prudential regulators, GAD was required to verify the solvency position of the Society, and to verify that it had determined its liabilities in accordance with the applicable Regulations.

286 Those Regulations provided that appropriate reserves should be established within the Society's Mathematical Reserves in respect of liabilities arising from the guaranteed annuity rates.

287 The Society, however, did not include in its regulatory returns any provision for the liabilities which would arise in respect of any policyholder taking the guaranteed default benefits, calculated by applying the guaranteed annuity rate to the guaranteed fund, or for the liabilities which would arise where such policyholders paid additional premiums to 'top-up' the existing policies they held which had the benefit of guaranteed annuity rates.

288 Instead, the Society merely held reserves equal to the guaranteed fund of each policy, which provided only for less valuable annuities calculated at the current annuity rates.

289 I accept, on balance, that none of this was obvious on the face of the Society's regulatory returns. However, the very *'opaque'* disclosure which the public bodies submit made it unreasonable to expect GAD to have picked up these issues from those returns was, on the contrary, something which should precisely have prompted GAD to raise questions with the Society.

290 I do not accept that GAD would only have had to satisfy themselves that appropriate reserves had been established if the Society had stated within its returns that it needed to reserve for those guarantees.

291 The statements that the Society had such guarantees and that it did not consider that there was any need to reserve for them should have prompted GAD to ask questions. That was even more the case in a context of a sustained downturn in interest rates, the introduction of a new bonus policy to address the cost of those guarantees, and the tight financial position that the Society was then disclosing within its regulatory returns.

292 If GAD could not ascertain what the Society's reserving practice was, why a new differential terminal bonus policy had been introduced, and the resulting effect on the Society's solvency position, then GAD was required to take the matter further, pursuant to GAD's obligations under the service level agreement to provide advice and assistance to the prudential regulators.

293 That could have been done either by asking the Society to explain the approach it was adopting or by recommending to the prudential regulators that

further information about the Society's new bonus policy was sought. GAD could also have looked back at the Society's returns for earlier years, including those for 1990, to ascertain how the issue had developed over time and what previous discussions or action had been undertaken.

294 I consider also that the submissions of the public bodies regarding the PRE issues that were raised by the introduction of the differential terminal bonus policy do not address all the relevant facts.

295 GAD had before them information that the Society was not communicating its new policy to its policyholders. It is not the case that such matters were only matters for the conduct of business regulators, although recommending to the prudential regulators that liaison with those regulators was needed was one option open to GAD. The fulfilment of the reasonable expectations of the Society's policyholders was central to the role of the prudential regulators.

296 I was not persuaded by the submissions of the public bodies. I conclude that GAD should have addressed these issues as part of their scrutiny of the Society's 1993 returns.

My finding

297 **I find that the failure by GAD, when the introduction of the Society's differential terminal bonus policy, intimated within the Society's 1993 returns, was identified by GAD as part of their scrutiny of those returns, (i) to inform the prudential regulators about the policy, (ii) to raise the matter with the Society, or (iii) to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders, fell short of the standard that could reasonably be expected of GAD.**

The basis for my finding concerning the scrutiny of the Society's returns for 1994 to 1996

The issue and relevant background

298 Further issues arose in respect of the Society's regulatory returns for 1994 to 1996, namely:

- the continuation of the two issues which arose from the returns for 1990 to 1993 (questions concerning discounting through the use of imprudent and/or impermissible valuation interest rates and the affordability and sustainability of bonus declarations);
- apparently arbitrary changes to the assumed retirement age for personal pension policies, contrary both to European Directives and the applicable domestic Regulations;
- the absence of explicit reserves for prospective liabilities for capital gains tax and for pensions review mis-selling costs, stating instead that such liabilities were covered by implicit margins in the valuation basis, when GAD knew that the effect of the applicable Regulations was that they should be provided for explicitly; and
- the absence of reserves in respect of the liabilities arising from guaranteed annuity rates, which GAD by then should have known were biting and should therefore have been provided for.

The facts

299 Again, it is not necessary to reproduce all of the material again here concerning the contents of the regulatory returns submitted by the Society each year, the notes and reports which together constituted the outcome of the scrutiny of those

returns by GAD, the correspondence between the Society and the prudential regulators and GAD, and the meetings that were held.

300 That material is contained in Part 3 of this report and is summarised in Chapter 6 of this report. Table 10a above sets out the entries within Part 3 of this report of most relevance to the scrutiny process.

The statutory and administrative context

301 The statutory and administrative context for the scrutiny of the Society's returns for 1994 to 1996 was largely unchanged from that which was applicable to the scrutiny of the Society's returns for 1990 to 1993, with the exception that the valuation Regulations were now contained within the Insurance Companies Regulations 1994 and that, in 1996, the Insurance Companies (Accounts & Statements) Regulations 1996 replaced the 1983 Accounts and Statements Regulations.

302 For the scrutiny of the 1995 and 1996 returns, a new service level agreement was in place between GAD and the prudential regulators. In this agreement, the primary objective of prudential regulation was said to be:

> *... to regulate the insurance industry effectively (within the duties and powers set out in the Act) so that policyholders can have confidence in the ability of UK insurers to meet their liabilities and fulfil policyholders' reasonable expectations.*

303 The prime function of GAD was to *'advise* [the prudential regulators] *in the fulfilment of these aims'*. GAD's scrutiny reports were now required to set out where a company was not complying with statutory requirements, was failing to meet the statutory solvency requirements, or was in danger of failing to meet them in the future, or appeared not to be meeting policyholders' reasonable expectations.

My assessment

304 In addition to the two issues which had arisen from the Society's returns for 1990 to 1993, which were questions concerning discounting through the use of apparently imprudent and/or impermissible valuation interest rates and the affordability and sustainability of bonus declarations, three further issues arose.

305 The first was the way in which the Society assumed the retirement age that would be chosen by its policyholders when calculating its liabilities. Changes to those assumptions appeared to breach the requirements of the applicable Regulations.

306 This question arose because, in both 1994 and 1996, the Society changed in what appeared to be an arbitrary manner the retirement age it assumed would be prudent when calculating its reserves. On both occasions, the effect of those changes was to reduce the reserves that the Society needed to hold.

307 After July 1988, Equitable wrote large numbers of recurrent single premium personal pension policies, which allowed policyholders to retire without penalty at any time from age 50. Thereafter, a cash sum equal to the guaranteed benefits that had accrued in respect of a policy became available and could be used to buy an annuity either from the Society or, using the open market option, from any other pension provider.

308 In the years prior to 1993, the Society calculated its reserves for these policies by discounting the guaranteed benefits from the age of 50, the earliest retirement age allowed under the policies. That was a prudent approach.

309 However, the Society in its 1994 returns assumed, for the purposes of determining the liabilities in respect of such policies, that personal pension policyholders would retire aged 55. The Society did the same in its 1995 returns.

310 In the years from 1996 to 1999, Equitable changed its approach again and assumed that personal pension policyholders would retire aged 60.

311 In addition, for policyholders retiring between the ages of 50 and 55 – and later between 50 and 60 – this meant that the reserves held by the Society in relation to their policy might be less than the cash sum that would be immediately available to those policyholders by way of guaranteed benefits, or under any other option in those policies, or which was available to buy an annuity from another pension provider.

312 The effect of those changed assumptions was that, in all its returns from 1994 onwards in the period covered by this report, the liabilities that the Society showed in its returns, in respect of which it needed to hold reserves, could have been considerably understated. Information that this was so was available to GAD when they scrutinised those returns but GAD took no action until November 2000.

313 The second issue that arose was the failure by the Society to hold explicit reserves for prospective liabilities to tax on capital gains and for pensions mis-selling costs. This was in a context in which GAD had recognised that there were only small, if any, margins in the Society's valuation basis, and that the Society had selected that basis at the limits of what the Regulations allowed.

314 In the years prior to 1997, the Society stated in both its main and appendix valuations that, although a liability for capital gains tax existed, a provision for that liability was not made as it could be covered by margins elsewhere in the basis used to determine its long term liabilities.

315 That approach did not appear to be consistent with Regulations 60 and 64 of the Insurance Companies Regulations 1994 or the professional guidance in GN8, the effect of which required explicit provision for those liabilities.

316 The Society failed to establish reserves for its disclosed capital gains tax liability – of £22m, £37m and £48m respectively in 1994, 1995 and 1996 – within both its main and its appendix valuations. From 1997, the Society provided for this liability.

317 GAD identified this issue in their scrutiny of the Society's 1994 returns but did not take any action to raise it with the Society or with the prudential regulators. GAD did comment on the issue in its detailed scrutiny report to the DTI on the 1995 returns, however – but again GAD did not raise the issue with the Society.

318 GAD identified the issue once more when they were scrutinising the Society's 1996 returns and this time pursued it with the Society.

319 GAD asked the Appointed Actuary to reconsider this matter for the 1997 returns. The failure to establish a reserve for the Society's prospective liability to tax on unrealised capital gains was rectified in the Society's 1997 returns, although no amendment was required to be made to its 1996 returns. The 1994, 1995 and 1996 returns may therefore have understated the Society's liabilities in this respect.

320 With regard to personal pensions mis-selling, the Society stated that its liability in that respect could be covered by margins elsewhere in the valuation basis.

321 That too appeared not to be consistent with Regulation 64 of the applicable Regulations. Although GAD was aware of the issue, as it had been discussed in a meeting that GAD and the prudential regulators held with the Society on 9 December 1994, GAD took no action in respect of this breach in relation to the 1994 and 1995 returns.

322 However, on 16 January 1998 during the scrutiny of the Society's 1996 returns, GAD wrote to the Society, requiring it to make explicit provision for those reserves in future returns. Yet GAD did not seek any amendments to the Society's 1996 returns. The Society made provision for those reserves in later returns. However, the Society's 1994, 1995 and 1996 returns understated the Society's liabilities in this respect.

323 The final issue which arose was the failure by the Society to reserve for the liabilities associated with those policies which contained guaranteed annuity rates.

324 The Society did not make any provision for the liabilities associated with those guarantees, despite the fact that the applicable Regulations required that the calculation of the Mathematical Reserves should include provision for such liabilities. The public bodies told me during my investigation that, by their reckoning, reserves of £275 million and £325 million were omitted from the Society's returns for 1995 and 1996 respectively. My advisers suggest a higher figure, but either way the omission was, in my view, material.

325 Whilst the Society had disclosed the existence of those guarantees within its returns for each year, no information had been provided within those returns about the level and extent of the guarantees since that information had been provided within Schedule 5 of the Society's 1990 returns.

326 This issue, the failure by the Society to establish reserves in respect of the liabilities associated with those of its policies containing guaranteed annuity rates was not noted by GAD in its scrutiny of any of the Society's returns from 1994 to 1996 and did not come to the attention of GAD or the prudential regulators prior to July 1998.

Submissions I have received and my evaluation of those submissions

Submissions by the public bodies

327 When I informed the public bodies that I was minded to come to this view, those bodies told me that, in their view, any criticism of GAD's scrutiny of the Society's regulatory returns was misconceived.

328 In support of that view, the public bodies submitted that:

> *There was no requirement to hold an explicit reserve for the contingent liabilities for tax on unrealised capital gains or pensions mis-selling costs. Equitable's practice of making implicit provision for these through reliance on margins elsewhere in the valuation basis was in accordance with the applicable regulations.*
>
> *Equitable's retirement age assumptions complied with the applicable regulations and there is no evidence that changes made to them were arbitrary.*
>
> *The requirement for a reserve for guaranteed annuity rates in the base valuation can only be established with the benefit of hindsight, but, in any event, only a very limited GAR reserve was required in 1995 and none for 1994.*

There was no requirement for an explicit allowance for future reversionary bonus to be made in Equitable's appendix valuation and Equitable's practice was again in accordance with the applicable regulations.

There is no evidence that Equitable's use of an "interest rate differential" was not reasonable, which... was not precluded by the applicable regulations at the time in question.

329 The public bodies submitted that, given the above, the contemporaneous view of GAD and the prudential regulators, that there were no grounds for regulatory intervention, was a reasonable one. Accordingly, any adverse finding would be unreasonable and flawed.

My evaluation of those submissions

330 I was not persuaded by the submissions of the public bodies on these matters. By the time that GAD undertook the scrutiny of the Society's 1994 returns, they had available to them information which indicated that the Society's valuation basis appeared to be weaker than the minimum permitted by the valuation Regulations.

331 As part of the preparation by GAD of their annual report to the prudential regulators on the industry, GAD carried out work to analyse the strength of the valuation bases used by the principal life insurance companies in the United Kingdom.

332 That work included a comparison of those valuation bases, measured by reference to the difference between the valuation rate of interest adopted and the rate of return available on the backing assets, against the minimum standards set out in the applicable Regulations.

333 As a result of that work, GAD now had information before them that the valuation basis that the Society had adopted within its 1993 returns appeared to be materially weaker than that minimum standard. The Society's result was 66.8%, where 100% denoted that a valuation basis was approximately aligned to the minimum prescribed strength.

334 GAD was also aware, from the equivalent work it had done in respect of the 1994 returns of life insurance companies (including the Society), which was available to GAD prior to their scrutiny of the Society's 1994 returns, that the valuation basis that Equitable had adopted within those returns appeared still to be below the minimum prescribed strength, at 96.3%.

335 The analyses carried out by GAD in respect of the Society's 1993 and 1994 returns also indicated that the Society was significantly out of step in this regard with the rest of the life insurance industry.

336 However, despite this empirical evidence, no action was taken by GAD to secure that the Society's valuation basis complied with the applicable Regulations – beyond an enquiry about the valuation rate of interest that had been used. The Society's response to this enquiry was not analysed, or pursued to a satisfactory resolution by GAD or raised with the prudential regulators. It was simply accepted at face value.

337 I received further submissions from the public bodies which said that the original analysis that had been undertaken by GAD had been vitiated with arithmetical errors and which submitted that, once those figures were re-worked, the figure for the strength of the Society's valuation basis was approximately 100%. The public bodies also submitted that the type of business in respect of which GAD's analysis had been undertaken was a small part of the Society's business and that, thus, that analysis was 'irrelevant' for the Society.

338 I do not accept those submissions. Whether it can now be shown that the valuation basis met the statutory requirements is itself irrelevant. I have to be concerned only with the information that was before those scrutinising the Society's returns at the time. Nor do I accept that the material in question would have been irrelevant to the way in which GAD should have conducted the scrutiny of its returns.

339 I consider that GAD, in advising and assisting the prudential regulators through undertaking the scrutiny of the Society's returns, were required to satisfy themselves that the Society was acting soundly and prudently, in accordance with the applicable Regulations, and in such a way as to fulfil the reasonable expectations of its policyholders. GAD were also required to advise the prudential regulators of any issues of concerns which came to the attention of GAD.

340 Questions as to whether the Society was so acting or questions as to whether its valuation basis, including the interest rate used to determine the Society's liabilities, was appropriate – and as to whether the method by which the Society determined its surplus was appropriate – had to be raised by GAD with a view to verifying the Society's financial position. The information before them at the time should have been taken into account, but was not.

341 I would finally note, as to the relevance to the Society of the comparative analysis that GAD undertook, that the types of business in respect of which that analysis was undertaken were precisely the same business types as formed the basis for evidence provided to me by the public bodies, also based on comparative analysis, to support their submission that industry-wide bonus cuts had occurred around the time that the Society made its policy value cuts in July 2001, as part of their submission that financial injustice had not been sustained by policyholders.

342 I was not persuaded by the submissions of the public bodies on these matters and those submissions did not persuade me that my conclusions are flawed.

My finding

343 **I find that the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1994 to 1996, related to (i) the valuation rate of interest, (ii) the affordability and sustainability of bonus declarations, (iii) apparently arbitrary changes to the assumed retirement ages, and (iv) the holding of no explicit reserves for the liabilities associated with prospective liabilities for capital gains tax, for pensions mis-selling costs, and for guaranteed annuity rates, fell short of what could reasonably be expected of GAD.**

The basis for my finding concerning the presentation of the Society's two valuations

The issue and relevant background

344 Most insurance companies used the valuation method and basis set out in the applicable Regulations to calculate their Mathematical Reserves.

345 However, throughout the period covered by this report, insurance companies were entitled to use an approach which differed from the statutory minimum basis, so long as the alternative method that was used produced Mathematical Reserves that were at least as high as that which would have been produced using the statutory minimum basis.

346 During the period covered by this report, the Society always used an alternative valuation method within its returns.

347 In order to seek to demonstrate compliance with the Regulations, the Society set out information about the amount of its Mathematical Reserves using a basis that its Appointed Actuary considered was compatible with the method set out in the Regulations. This was done in an appendix at the end of Schedule 4 of the Society's returns.

The facts

348 In its regulatory returns for every year from 1990 to 1996, the Society, when producing its appendix valuation, did not provide complete information in that valuation. The amount of the resilience reserves that would be needed if the statutory minimum basis had been used by the Society was omitted from each of those returns.

349 For each year from 1990 to 1994, as part of their scrutiny of those returns, GAD asked the Society to provide the omitted information. This the Society provided.

350 This was done so that GAD could verify what the amount of the Society's Mathematical Reserves using the statutory minimum basis would be, before comparing the results of the Society's chosen method with the results on the statutory minimum basis. GAD could thereby be satisfied that the Society's chosen alternative had produced a result at least as strong as would have been produced on the statutory minimum basis.

351 GAD carried out their scrutiny of the Society's 1995 regulatory returns in November 1996. Although the Society again omitted the figure for the resilience reserve, GAD did not ask the Society to provide that figure. Instead, GAD simply assumed that it would be less than the difference between the Mathematical Reserves in the main and appendix valuations before the allowance for resilience reserves.

352 During their scrutiny of the Society's 1992 returns, GAD had suggested to the Society's Appointed Actuary that this information should be disclosed. The Appointed Actuary did not agree and GAD did not pursue the matter further.

353 At no other time did GAD seek to require the Society to include within its published returns the missing figures for the resilience reserves, so that the information which GAD possessed, for years other than 1995, would become available to all readers of the returns.

354 GAD and the prudential regulators were also in possession of information about how the Society's financial position as set out in its regulatory returns was being interpreted by industry commentators.

355 The ratings given by Standard & Poor's, an expert ratings agency, were used extensively by Equitable in their marketing material and other policyholder communications. Those ratings were also cited in support of the Society's position when doubts were expressed about the long-term viability of the Society.

356 Standard & Poor's first considered Equitable in 1993, when the Society received an 'AA (Excellent)' rating, which it continued to receive until May 1999. Companies which were given such a rating by Standard & Poor's were described as offering *'excellent financial security'* with their *'capacity to meet policyholder obligations* [being] *strong under a variety of economic and underwriting conditions'*.

357 Explaining its rationale for giving the Society this rating, Standard & Poor's stated, in November 1993, that:

> *On the basis of its published valuation,* [Equitable] *appears to have relatively weak free asset and investment leverage ratios: 2-5% (since 1990) and above 920%, respectively. However, free assets are understated by the use of a very conservative valuation basis. Adjusted to a more conventional reserving basis, the free asset ratio is much stronger, nearer 10% in 1992... S&P expects these levels of strength to continue.*

358 The same rating was given to the Society in April 1995. A similar rationale for that rating was given by Standard & Poor's, as follows:

> *Although* [Equitable] *uses a conservative valuation methodology, S&P still believes that it shows a significant degree of capital strength. The Society's published returns display a strong level of capitalization, despite a significant strengthening of the valuation in 1993, with the free asset ratio rising to 9.4% and coverage of the required minimum margin to 3.7 times... from 5.09% and 2.4x, respectively, in 1992. An alternative net premium valuation, more comparable with peers, would increase the free asset ratio to almost 12% and coverage of the required margin to over 4.4x.*

359 Similar explanations as to why the ratings agency believed that the Society's financial strength was understated in its main valuation – and that the (incomplete) appendix valuation indicated a much stronger real financial position – were provided as late as October 1997. Those ratings were provided by the Society to the prudential regulators and GAD.

360 Table 10d summarises the information available from the Society's returns for 1990 to 1993 and the surplus assets understood by Standard & Poor's to be available, as based on the main and appendix valuations, and measured in terms of the free asset ratio and cover for the required minimum margin.

361 The table then shows the resilience reserve information provided to GAD and how this reduces the surplus assets and the free asset ratio available based on the appendix valuations to levels near that in the main valuations.

The statutory and administrative context

362 Regulation 54 of the Insurance Companies Regulations 1981 required that the amount of the Mathematical Reserves reported in the returns (the published reserves) should not be less than those calculated under Regulations 55 to 64 of the 1981 Regulations (the minimum reserves).

363 Regulation 57(1) of the 1981 Regulations required that, for the purpose of calculating Mathematical Reserves, the future premiums to be valued by an insurance company should not exceed the net premium value of those premiums.

364 The requirements on the valuation of future premiums did not materially change when the Insurance Companies Regulations 1994 came into force. However, Regulation 64(3) of the 1994 Regulations required that a company's liabilities had to comply with each of the provisions of Regulations 65 to 75 of those Regulations. This meant that the calculation of the minimum reserves under Regulations 65 to 75 had to comply with each of these Regulations and not just that the total did so in aggregate.

Table 10d - the Society's presentation of Resilience Reserves

	1990 Main valuation £m	1990 Appendix valuation £m	1991 Main valuation £m	1991 Appendix valuation £m	1992 Main valuation £m	1992 Appendix valuation £m	1993 Main valuation £m	1993 Appendix valuation £m
Admissible Assets	5,932	5,932	7,452	7,452	9,565	9,565	13,382	13,382
Total Liabilities	5,520	5,026	6,964	6,565	8,721	8,243	11,666	11,343
Required Minimum Margin (RMM)	233	233	293	293	357	357	458	458
Surplus Assets	179	673	195	594	487	965	1,258	1,581
Free Asset Ratio (FAR) as calculated by S&P	**3.0%**	**11.3%**	**2.6%**	**8.0%**	**5.1%**	**10.1%**	**9.4%**	**11.8%**
RMM Cover as calculated by S&P	**1.8**	**3.9**	**1.7**	**3.0**	**2.4**	**3.7**	**3.7**	**4.5**
Resilience Reserve disclosed to GAD		450		390		462		236
Surplus after allowance for Resilience Reserve		223		204		503		1,345
FAR allowing for Resilience Reserve		**3.8%**		**2.7%**		**5.3%**		**10.0%**
RMM Cover allowing for Resilience Reserve		**2.0**		**1.7**		**2.4**		**3.9**

365 Guidance issued by the prudential regulators (PGN 1984/1, paragraph 12.1) stated that, where an insurance company was using a method other than that prescribed in the Regulations, that company was required to provide sufficient information about the basis of the valuation to enable those regulators to be satisfied that the requirements of the Regulations were fulfilled.

366 GAD's scrutiny proformas, which assisted them to conduct the scrutiny of the regulatory returns, stated that those scrutinising such returns should look for *'sufficient demonstration'* of this.

My assessment

367 I consider that, in two ways, omissions by GAD bring into question whether they were fulfilling the obligations to which they were subject.

368 The first relates to the failure by GAD to ask the Society to provide the figure for the missing resilience reserves in the appendix valuation within the Society's 1995 returns.

369 In my view, it is arguable that the Society should have been asked to set out the missing figure within its returns to enable the reader of those

returns to be provided with sufficient demonstration that the alternative method of valuation used by the Society had produced a result at least as strong as the minimum prescribed in the Regulations.

370 Without this information, the returns were capable of being misconstrued. However, on balance, I accept that, as this was not required by the Regulations, it was not something that GAD or the prudential regulators could insist on. However, there was also nothing to prevent them from taking non-statutory action to ask the Society to consider the point.

371 That said, it was quite another thing for this information not to be sought by GAD as part of their scrutiny of the Society's returns.

372 The prudential regulators were under a duty to verify the financial position of life insurance companies. In order to do this, they needed, among other things, to be satisfied that the Society had determined its liabilities in such a manner as would produce Mathematical Reserves at least as high as was prescribed in the Regulations.

373 By not asking the Society for this information in respect of its 1995 returns, GAD, acting on behalf of the prudential regulators, were unable to verify that the Society's alternative method had produced a result at least as strong as the statutory minimum. Without that information, GAD could not be satisfied that the Society had acted in accordance with the regulatory requirements to which it was subject.

374 The second way in which the actions of GAD bring into question whether they were fulfilling their obligations relates to how GAD handled the information before them, contained in the ratings about the Society produced by Standard & Poor's. Those ratings demonstrated that the Society's method of presenting the two valuations, but without including the figure for the resilience reserve, was being misconstrued.

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

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

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

378 I consider that both these failings – to ask for the Society's figure for the missing resilience reserves in respect of the 1995 returns and to inform the prudential regulators of the fact that the Society's returns were being misconstrued due to the way in which those returns were presented – represent a failure to do what GAD should have done in the circumstances.

Submissions I have received and my evaluation of those submissions

Submissions by the public bodies

379 When I informed the public bodies that I was minded to come to this view, those bodies told me that, in their view, I had misinterpreted or misapplied the applicable law.

380 The public bodies said that Equitable had disclosed the fact that any resilience reserves required in the appendix valuation could be financed without recourse to the investment reserve in the main valuation. Those bodies said that this disclosure had complied with the applicable law and related guidance.

381 The public bodies also told me that there had been no obligation on GAD to ask for the amount of the resilience reserve required in the appendix valuation within the Society's 1995 regulatory returns.

382 Furthermore, the public bodies said that they did not accept that *'ratings agencies (or other industry commentators), on whom reliance might reasonably have been placed by policyholders, were misled by Equitable's returns, nor that, even if they were, the prudential regulator or GAD bore any responsibility for this'*.

383 As to whether or not GAD should have asked the Society for the amount of the resilience reserve required in the appendix valuation within the Society's 1995 returns, the public bodies, after accepting that the amount of the resilience reserve required in the appendix valuation had not been requested by GAD in respect of the 1995 returns, submitted that:

> *However, as for previous years, the returns were not misleading in that year, and the amount of the resilience reserve required in the appendix valuation did not have to be provided to GAD, nor did it have to be requested by GAD.*

384 The public bodies further submitted that:

> *The 1995 detailed scrutiny report shows that it was a deliberate decision by GAD not to request the amount for that year and not an oversight. The basis for this decision was reasonable. The disclosure provided the required demonstration of compliance with the 1994 Regulations, and GAD stated in their report that they had no reason to doubt this, giving their reasons.*
>
> *These were: (1) the size of the quantified excess of the aggregate liability in the main valuation over the aggregate policy reserves shown in the appendix valuation; (2) the Appointed Actuary's statement that the resilience reserve required in the appendix valuation was covered by that excess; and (3) the lack of evidence from the returns to doubt that statement, having made appropriate comparison with the previous year's returns.*
>
> *That comparison took into account the margin between the resilience reserve required in the appendix valuation in 1994 on the one hand and the excess of the aggregate liability in the main valuation over the aggregate policy reserves in the appendix valuation in 1994 on the other, and also the percentage increase in the aggregate liability in the main valuation between 1994 and 1995.*

385 As to the use made of the content of the Society's regulatory returns by ratings agencies and other industry commentators, the public bodies submitted that:

The very nature of rating agencies' work was to undertake analysis and make their own, independent assessment of companies, and policyholders and other parties would reasonably have expected them to do so. In carrying out this task, the rating agencies had access not just to the returns but generally also to much additional information, and it was reasonable to expect them to discuss any issues arising with the companies they were rating, such that they were confident they had a full understanding of the position of those companies.

386 The public bodies further submitted that:

To the extent that rating agencies placed any reliance on Equitable's appendix valuation, and if they failed to recognise from the disclosure provided in the returns that the amount of the resilience reserve required in that valuation was not disclosed, then those were entirely matters for the agencies concerned. The prudential regulator and GAD had no duty to vet the rating agencies' understanding of the regulations; it was for the agencies to analyse the results of the main and appendix valuations and the disclosure provided in relation to the resilience reserve required in the appendix valuation, and seek any further information they required to be satisfied that they fully understood the position before commenting on it.

387 For these reasons, the public bodies told me that, in their view, any adverse finding would be unsustainable.

My evaluation of those submissions

388 I was not persuaded by the submissions of the public bodies on these matters. With respect to the failure by GAD to ask for the figure for the 1995 returns, what should have prompted them to ask for it was not a judgement on their part that those returns were misleading, as appears to be the basis of the submissions of those bodies, but instead the need for GAD to satisfy themselves as to the conformity of the Society's returns with the applicable law.

389 That it was a conscious decision not to ask for this figure on the part of GAD does not excuse this failure. The prudential regulators were under a duty to verify the financial position of the Society. In giving advice to those regulators on this question, without the information that they had asked for in every other year, GAD could not have verified the financial position of the Society, including by being satisfied that the Society had determined its liabilities in such a manner as would produce Mathematical Reserves not less than the statutory minimum reserves.

390 It was impossible for GAD to have concluded that the Society's chosen valuation method had produced a result that was at least as strong as that which would have been produced had the Society used the method prescribed in the Regulations, unless GAD knew what that prescribed method would have produced.

391 Without access to the omitted information, GAD could not know whether the Society had conformed to the regulatory requirements to which it was subject.

392 Nor was I persuaded by the submissions with regard to the ratings produced by Standard & Poor's.

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

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

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

My finding

396 **I find that the failure by GAD (i) to ask for the information GAD needed in respect of the Society's 1995 returns to enable them, as part of the scrutiny process, to be sure that the Society had produced a valuation that was at least as strong as the minimum required by the applicable Regulations, and (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society, fell short of what it was reasonable to expect from GAD.**

The basis for my finding concerning financial reinsurance

The issue and relevant background

397 During 1998, the prudential regulators and GAD became aware that the Society had not made provision for the liabilities arising from guaranteed annuity rates contained within certain of its policies. Those regulators had required that the Society should do so within its 1998 returns.

398 That requirement had led to an immediate increase of £1,600 million in the amount of reserves required to be shown as at 31 December 1998, as well as additional associated resilience reserves. As a result, the Society investigated means whereby those additional liabilities could be offset – in order not to disclose a much weaker financial position in those returns.

399 Had such offsetting action not been taken, the 1998 regulatory returns would have shown such a weak financial position that the Society's future as an independent mutual would have been threatened and its continued ability to write new business and declare bonuses would have been in doubt. Indeed, the prudential regulators told the Society in December 1998 that they would take action if they considered that the 1998 bonus declaration made by the Society was imprudent.

400 The Society therefore needed to take urgent action to either raise capital or to reduce its Mathematical Reserves.

401 This the Society did through a financial reinsurance arrangement. Within its published returns for 1998, 1999 and 2000, the Society took credit for such an arrangement that it had entered into with IRECO, a reinsurer based in Dublin. That treaty, in its original and subsequently amended forms, is reproduced within Part 4 of this report.

402 The amount of the credit taken for those years was, respectively, £809 million, £1,098 million, and £808 million. The Society's Mathematical Reserves were reduced by more than those amounts, however, as the resilience reserves that the Society was required to hold were also reduced.

403 The Society's published returns for 1998 showed that it had excess available assets and implicit items of £1,516 million over the required minimum margin, the returns for 1999 showed the excess asset figure as £2,747 million, and those for 2000 showed a figure of £411 million. The prudential regulators permitted those credits to be taken.

The facts

404 The full account of the events relevant to the development of the Society's reinsurance arrangement, how it was treated within the Society's returns, and the later developments on those issues is set out within Part 3 of this report. It is not practicable to recount the relevant events here. That account is also summarised within Chapters 7 and 8 of this report. This is only a brief summary of those events.

405 At a meeting on 3 December 1998, the Society's Appointed Actuary informed the prudential regulators and GAD that he considered that reinsurance was an *'option for protecting the balance sheet'* but that a reinsurance agreement was unlikely to be in place by 31 December 1998. Those regulators informed the Appointed Actuary that it might be possible to give a reporting concession (under section 68 of the 1982 Act) so that the effect of any such arrangement would be retrospective to cover the 1998 year-end position.

406 A letter dated 7 December 1998 from the prudential regulators to the Society's Managing Director, recording the outcome of the meeting on 3 December 1998, stated:

> Reinsurance was suggested as a possible means *of overcoming the difficulties that Equitable Life would face in reserving on the assumption that 100% of policyholders took their benefits in the form of a guaranteed annuity. You pointed out that it would be difficult to put in place such an arrangement before the end of the month. We acknowledged this but indicated that we would be willing to consider the possibility of treating any such reinsurance arrangement as having been effective from the year end provided that at least the broad terms of the agreement were in place by that date and a firm intention to enter into the agreement could be shown.*

407 On 31 December 1998, the Society informed the prudential regulators that it had received an offer in respect of a financial reassurance arrangement and enclosed a fax from IRECO, which confirmed that a meeting was to take place on 7 January 1999. The Society informed the prudential regulators that it hoped that the remaining issues could be resolved at that meeting in order to enable a contract to be drawn up.

408 On 21 January 1999, the Society wrote to the FSA, enclosing 'draft detailed terms'. On 27 January 1999, GAD informed the FSA that they had reviewed the reserving effect of the draft terms sent under cover of the Society's letter of 21 January 1999.

409 Among other things, GAD:

- raised the absence of information as to the financial strength of IRECO;
- identified the proposed treaty as a 'financing arrangement' (as opposed to a traditional contract of reinsurance);

- identified that no payment of any reinsurance claims amount would be made by IRECO to the Society;
- identified that the draft terms limited IRECO's (non-cash) *'overall exposure'* to £100 million;
- drew attention to the wide cancellation clause (which was retrospective to 31 December 1998); and
- drew attention to the term that the treaty would also be cancelled if the Society changed its practice on guaranteed annuity rates (that is, changed its differential terminal bonus policy), including as a result of losing litigation.

410 GAD further advised the FSA that *'the treaty will not achieve the intended reserving effect for a number of reasons set out in GAD's advice including the definition of reinsurer's liability, the breadth of the cancellation clause and the provision for the treaty to be cancelled retroactively'*.

411 GAD went on to advise the FSA that:

> *The treaty limits the total withheld reinsurance claims balance to £100m at any 31 December or otherwise the treaty would have to be restructured. It is difficult to reconcile this with* [the Society's] *intention to allow a reinsurance credit in their returns of around £700m. We believe therefore that there should be a commitment for the treaty to be continued, but that the schedule of reinsurance payments to the reinsurer could be revised in the event of this credit of £100m being exceeded.*

412 GAD also provided, as an annex to their advice, a simplified example *'for the purposes of demonstrating that the reinsurance treaty fails to achieve its intended reserving effect'*.

413 None of those matters were the subject of substantive amendment in the terms of the agreed slip (evidencing the financial reinsurance contract entered into between the Society and IRECO on or shortly after 1 April 1999) or in the treaty entered into between them (signed on behalf of the Society on 11 October 1999).

414 Notwithstanding that this was the case, the FSA permitted the Society, without challenge, to take a reinsurance offset of £809 million within its 1998 returns – without any concession under section 68 of the 1982 Act.

415 Nor did the FSA take any adequate steps to ascertain the financial strength of IRECO. Reliance was instead placed on the credit rating given to IRECO by Standard & Poor's.

The statutory and administrative context

416 Financial, or finite, reinsurance is often an arrangement under which, as part of a traditional reinsurance treaty, the reinsurer undertakes to make a loan to the ceding office, in this case the Society, either immediately or in the future. The availability of the loan is normally related to a claim event under the treaty.

417 Without modification to such a treaty, ceding offices could not take a full reserving credit for the future availability of such a loan as, if they did, they would also have to provide for the liability to repay it. One modification that was frequently used in such treaties during the period covered by this report was to make the liability to repay the loan dependent on sufficient profits being generated by the ceding office.

418 Once any loan where the liability to repay was dependent on sufficient profits being generated was received by a ceding office, it would not have to be recognised as a liability in the balance sheet contained in the regulatory returns the ceding office produced. In this way, the value of the initial cash payment provided by the loan could be recognised in the returns of the ceding office even before such a loan was drawn down.

419 Therefore, even though credit was taken for the loan, the liability to repay that loan did not have to be recognised in the calculations of the Mathematical Reserves of the ceding office, as that calculation excluded liabilities that would arise only if sufficient profits were generated – for example, the liability to pay terminal bonus.

420 This treatment contrasted with the way such transactions would be shown in Companies Act accounts, where the liability to repay such a loan, in those circumstances, could not be omitted.

421 If, in the event of a claim, a reinsurance treaty did not pay cash or if a reinsurer delayed claim payments, then the ceding office would account for the monies due to it as a debtor on its balance sheet within the regulatory returns, which would count as an asset for the purposes of matching policyholder liabilities.

422 In such circumstances, section 35A of the 1982 Act applied. This provided that an insurance company was required to secure that its liabilities under contracts of insurance were covered by assets of appropriate safety, yield and marketability and such considerations would apply to the recognition of that debt.

423 Insurance companies could recognise the future availability of such an asset by reducing their Mathematical Reserves by an amount that represented the full value of debt for which they intended to take credit.

424 Such a reduction in respect of reinsurance was, at the relevant time, generally permitted by Regulation 64(3)(e) of the Insurance Companies Regulations 1994. That Regulation provided that the amount of the long-term liabilities *'shall take into account any rights under contracts of reinsurance in respect of long-term business'*, having regard to Regulation 64(1) of those same Regulations.

425 Regulation 64(1) of the Insurance Companies Regulations 1994 required that the determination of those liabilities were to be made on actuarial principles, which meant, amongst other things, that those liabilities had to be determined by taking into account the time value of the cash flows due under a policy or contract of reinsurance.

426 Paragraph 6 of section 5.5 of the Treasury's 1998 guidance on the preparation of the annual returns provided, with respect to the determination of long-term liabilities:

> *The Insurance Directorate interprets "liabilities arising under or in connection with contracts for long term business" to include liabilities arising under reinsurances of those contracts for long-term business. This includes liabilities under financial reinsurances and by extension even liabilities under non-reinsurance financing arrangements provided the liability under the financing arrangement is closely linked to performance of contracts for long-term business. Therefore liabilities under financial reinsurances and such analogous financing arrangements... are to be determined under actuarial principles.*

This is important as the crystallisation of such liabilities is often – although not invariably – linked to the emergence of future profits. Future profits are not in themselves an asset admissible to match liabilities... However, provided the reinsurance or financing liability is repayable – as a matter of form and economic substance – only upon the emergence of future profit, actuarial principles may sometimes allow for the future profit to be taken into account in determining the amount of the liability.

427 Paragraph P.3 of the GAD Insurance Supervisory Work Guidance Manual stated that the 'points to consider' in relation to any reinsurance agreement were:

- *'If the agreement is not with a company that is authorised to transact business within the UK, do we know enough about it? Is it commercially sound? It may be necessary for* [the prudential regulators] *to write to the authority that supervises the reinsurer's home country to obtain more information'*;

- *'Does the agreement give appropriate cover? Too much? Too little?'*; and

- *'Are the arrangements... on a fair commercial basis?'*

428 Section 37 of the 1982 Act gave the prudential regulators powers of intervention where they considered that an insurance company had failed to satisfy an obligation to which it was subject by virtue of the 1982 Act or where those regulators were not satisfied that adequate arrangements were in force or would be made for the reinsurance of risks against which persons were insured by the company.

My assessment

429 In considering the acts and omissions of the FSA and/or GAD in respect of the events relevant to the Society's reinsurance arrangement, I have considered two questions:

(i) whether the Society was entitled within its 1998 returns to have regard to the financial reinsurance arrangement – which revolves around the date on which that arrangement was entered into and whether the arrangement had any legal effect at the date to which those returns applied; and

(ii) whether the financial reinsurance arrangement had any value for the purposes of the Society's 1998, 1999 and 2000 returns and, if so, what that value should have been.

430 I am advised that, in order to constitute a valid contract as a matter of English law, there must be: (i) a sufficiently certain agreement in the form of an offer which has been accepted; (ii) an intention that the agreement be legally binding; and (iii) save in the case of a contract under seal, consideration moving from each party to the other.

431 What was required before a legally binding contract between IRECO and the Society came into existence was agreement upon every material term of the contract of reinsurance which the parties wished to make, accompanied by an intention on the part of both parties that the contract was intended to be legally binding.

432 The financial reinsurance arrangement between IRECO and the Society was not entered into on or before 31 December 1998. In the absence of a reporting concession pursuant to section 68 of the 1982 Act, the Society was, accordingly, not entitled to have regard to that arrangement within its 1998 returns, which were prepared with the valuation

date of 31 December 1998 and submitted on 30 March 1999.

433 No such concession was sought or granted. No credit for the financial reinsurance arrangement was permissible within the Society's 1998 published returns in the absence of such a concession.

434 However, even had a reporting concession been granted, the Society was not entitled to take the credit that it did for the financial reinsurance arrangement within its 1998 returns. Nor could such credit have been taken within the Society's 1999 and 2000 returns.

435 Article 4 of the financial reinsurance treaty provided that IRECO was to be *'liable for claims arising from the business covered to the extent detailed in Appendix 1'* of the treaty. Appendix 1 provided that a Reinsurance Claims Event (RCE) occurred if the proportion of guaranteed annuity rate policyholders electing to take their benefits in guaranteed annuity rate form exceeded 25% by value of the retirements of such policyholders in any calendar year.

436 The Reinsurance Liability represented the extra cost, compared to current annuity benefits, to the Society of providing benefits at guaranteed annuity rates – but only in respect of the guaranteed funds (rather than the total policy value, including terminal bonus) of the relevant policies.

437 However, the Reinsurance Liability was reduced by the terminal bonus on the relevant policies, prior to the application of the differential terminal bonus policy, to give the Reinsurance Claims Amount (RCA). The RCA matched the Society's extra costs above the total policy values (including terminal bonus) as long as the differential terminal bonus policy continued to operate.

438 The treaty, however, placed no obligation on IRECO to make any payment to the Society in respect of the RCA. On the contrary, Article IV of the treaty, expressly provided that *'the* [RCA] *as defined in the said Appendix 1 will be withheld by* [IRECO]', i.e. no payment in respect of the RCA was to be made by IRECO to the Society.

439 The obligations, under Article IV of the treaty, on IRECO to make payments under the treaty to the Society arose following the occurrence of an RCE and were limited to:

- an obligation, on request, *'to pay an interest amount ... on the outstanding* [RCA] *but only if that payment was required by* [Equitable] *to properly satisfy the requirements of s35(1)(a) of the Insurance Companies Act 1982'*: any such payment was to be calculated by reference to 12 months LIBOR and the RCA; or

- an obligation, on request, to pay *'a cash amount of up to 10% of the outstanding RCA'* but only if payment of an *'interest amount'* had not been requested by Equitable.

440 If IRECO was called upon to make a payment to the Society of an interest amount or a cash amount, the Society became liable to pay to IRECO *'a fee of LIBOR plus 3.5% ... annually on the opening balance of this individual portion for each annual period until such time as this interest amount or cash payment is repaid in full to* [IRECO]', according to Appendix II of the treaty. That annual fee was payable by the Society to IRECO irrespective of any future surplus achieved by it.

441 The substance was that the Society was entitled, according to the terms of the treaty, to require IRECO to make a loan to Equitable of the interest amount or the cash amount at a penal rate of interest. Neither the repayments of any loan nor the annual fee payable in respect of the loan were

dependent upon any surplus being achieved by the Society.

442 The calculation of the offset to the Society's Mathematical Reserves in respect of the treaty had to value the cash flows actually payable under the treaty. In the circumstance of a loan to the Society, those cash flows would include both the amount of the loan (cash to the Society) and the payment of interest and repayments of cash to IRECO. In that case, the net value of these cash flows was nil.

443 In terms of the calculation of this offset, the intended effect of the treaty was that the Society could take full credit for the Reinsurance Liability, rather than the RCA. This meant that the reserves held were reduced by the terminal bonus on the relevant policies.

444 No cash was payable, but any future liability to repay that amount by way of additional premiums was disregarded, since any such repayment was dependent on the emergence of future surplus. The offset used by the Society was calculated in this way and, in effect, assumed that a reinsurance asset would arise in the event of a claim.

445 In addition, the permissibility of the reductions in its guaranteed annuity rate reserve which the Society made within its returns was, under the terms of the applicable Regulations, dependent on the arrangement being a contract of reinsurance.

446 A reinsurance contract is one whereby, for a consideration, the reinsurer agrees to indemnify another wholly or partly against loss or liability by reason of a risk the latter has assumed under a separate and distinct contract as the insurer of a third person.

447 Here, the second part of that definition of a reinsurance contract was satisfied. The Society had assumed a risk under contracts with a guaranteed annuity rate option into which it had entered. The Society suffered loss or liability if a guaranteed annuity rate policyholder exercised his or her option to take his or her benefits in guaranteed annuity rate form.

448 However, the first part of that definition of reinsurance was not satisfied. The only payment, pursuant to the treaty, which IRECO might have been required to make to the Society was a loan at a penal rate of interest under a drawdown facility which was not (and was not intended to be) utilised.

449 On the contrary, the Society agreed to make payments to IRECO as consideration for IRECO lending its name to a transaction which had no genuine economic purpose. IRECO did not agree in any respect to indemnify the Society against any loss or liability to which the Society might become subject under policies with a guaranteed annuity rate option.

450 It follows that the treaty did not constitute reinsurance and therefore could not be taken into account in determining the Society's long term liabilities. I consider that the Society should not have been permitted to take any credit for this arrangement in any of its returns for 1998, 1999 and 2000.

Submissions I have received and my evaluation of those submissions

Submissions by the public bodies

451 When I informed the public bodies that I was minded to come to this view, those bodies told me that, in their view, the Society's reinsurance treaty had been an example of an acceptable arrangement commonly used by insurance companies to manage their liabilities, and that such arrangements had been expressly permitted by the regulatory regime.

452 The public bodies also said that it was their view that Equitable had concluded their reinsurance contract in January 1999, with the reinsurance cover effective from 31 December 1998.

453 The public bodies also told me that the terms of the treaty had been such as to justify the amount of credit which Equitable had taken in their returns in all the years in question.

454 In support of these views, the public bodies submitted that:

> *A binding contract, complete with payment of premium by Equitable, was entered into in January 1999, to be effective from 31 December 1998. By the time the 1998 returns were submitted, on 30 March 1999, the prudential regulator and GAD had also requested Equitable to amend the terms of this contract to meet their concerns relating to the amount of credit that could properly be taken for it in the returns, and it was the professional responsibility of the Appointed Actuary to take credit for the treaty in the returns taking into account those requests.*

455 The public bodies further submitted that:

> *The amount of the credit taken for the contract in the returns was fully consistent with, and reflected the present value of, the cash flows payable under the contract... The contract was undoubtedly a contract of reinsurance; but even if it had not been, the regulations in force at the time still permitted credit to be taken for it in the returns.*

456 The public bodies also submitted that, accordingly, there had been nothing impermissible or unreasonable *'in permitting credit to be taken for the reinsurance contract in the returns in the manner and to the extent that it was'*.

457 The public bodies submitted that:

> *At the time of submission of Equitable's 1998 returns on 30 March 1999, the prudential regulator knew the following:*
>
> *(a) Equitable had stated, by letter dated 21 January 1999, that it had entered into a binding contract of reinsurance;*
>
> *(b) Equitable's returns acknowledged the first premium of £150,000 in relation to this contract;*
>
> *(c) The detailed terms of the reinsurance had been amended a number of times to comply with the requests of the prudential regulator and GAD, over a period of many weeks, and all the points which they considered needed to be addressed in the final terms of the contract to achieve the desired reserving effect in the returns had been advised to Equitable over a month previously.*
>
> *Furthermore, on 20 April 1999 the prudential regulator was provided by Equitable with the final version of the term sheet. Before the scrutiny of the 1998 returns was completed, GAD was also provided by Equitable with the signed reinsurance treaty wording itself, and GAD satisfied itself that the credit that Equitable had taken for the reinsurance treaty in those returns was appropriate in the light of the finally executed treaty – which was fully in accord, in all respects relevant to the credit that could properly be taken for the reinsurance in the returns, with the final version of the term sheet, and confirmed to be so by GAD.*
>
> *For these reasons, GAD and the prudential regulator were of the view that the treatment*

of the reinsurance treaty in Equitable's 1998 returns (and those for subsequent years) was satisfactory. The bodies under investigation consider that, on the basis of their knowledge at the time, they were reasonably of that view.

458 The public bodies then turned to the credit taken for the financial reinsurance arrangement within the Society's 1999 and 2000 returns, and specifically as to whether the credit taken ought to have reflected the net present value of the cash flows payable under the reinsurance treaty, which was nil.

459 The public bodies first said that they agreed that, under the terms of the treaty, the Reinsurance Claims Amount *'was not payable in cash to Equitable, but was rather to be withheld by IRECO (a feature which was common to many types of financial reinsurance arrangements at the time in question)'*.

460 The public bodies submitted, however, that it would be wrong to suggest that the Society had in fact taken credit within its returns for the Reinsurance Claims Amount *'to an extent which was not justified having regard to the present value of the cash sums, associated with and expressed as percentages of the Reinsurance Claims Amount, which Equitable was entitled to receive under the treaty'*. The public bodies said that *'on the contrary, the amount of credit taken for the treaty was justified having regard to the present value of those cash sums'*.

461 The public bodies further submitted that:

The real issue is whether and to what extent Equitable was entitled to take credit for the Reinsurance Claims Amount on the basis of the cash sums it was entitled to receive under the reinsurance treaty.

462 The public bodies went on to submit that:

These cash sums included, in particular, the interest amounts on the Reinsurance Claims Amount available to Equitable annually under Article IV of the treaty. In the calculation of the credit taken for the treaty, it was appropriate to assume that these interest payments would be drawn by Equitable. This was because they provided the positive yield on the reinsurance offset against Equitable's gross liabilities which was required to comply with section 35A of the Insurance Companies Act 1982.

Furthermore, the annual interest payments applied to the Reinsurance Claims Amount, unreduced from its original level, and were payable in perpetuity. The reason for this was that the Adjustment Premiums, by which the Reinsurance Claims Amount would be repaid over a number of years under the treaty, did not need to be allowed for in the calculation of the offset. This was because their payment was contingent on the emergence of future surplus in Equitable (in accordance with sections 5.5 and 5.6 of PGN 1998/1). The present value of the annual interest payments exceeded the face value of the Reinsurance Claims Amount in all the years 1998 to 2000.

It was for this reason that the terms of the treaty justified the amount of credit that was taken for it in the returns.

463 The public bodies further submitted that:

Article IV of the treaty also entitled Equitable to make annual 10% draw downs in cash against the Reinsurance Claims Amount, as an alternative to drawing the annual interest payments described above.

This provision was included in the treaty to ensure that cash amounts were still available to Equitable in respect of the Reinsurance Claims Amount in circumstances in which the reinsurance offset was made against gross liabilities valued at a zero rate of interest and the annual interest payments were therefore not required to comply with section 35A of the Insurance Companies Act 1982.

464 The public bodies submitted that *'accordingly, the criticism of GAD and the prudential regulator… for allegedly failing to follow up concerns which they had expressed in relation to the terms of the treaty in the period during which these were amended is entirely misplaced'*.

465 The public bodies went on to submit, in relation to cash repayments and interest fees, that my conclusion was based on an assumption:

> *… that, in valuing the cash sums payable to Equitable under the treaty, it was necessary to include both the amount of the repayments of the cash sums, and the accumulated interest on the cash sums due to IRECO, because their payment was not contingent on the emergence of future surplus in Equitable. On this basis,* [I have concluded] *that the net present value of the cash flows under the treaty was zero, so that no credit could properly be taken for it in Equitable's returns.*

466 The public bodies further submitted that:

> *This view of the appropriate treatment of the reinsurance treaty under the applicable regulations and associated prudential guidance depends upon adopting an interpretation of the treaty which is contentious and contrary to the intention and contemporaneous understanding of the actual parties to the treaty. The way in which the treaty was intended and understood to operate at the time was as requiring cash repayments and interest fees to be payable only out of future surplus (so that Equitable's liability in respect of them could be left out of account in accordance with sections 5.5 and 5.6 of PGN 1998/1 and in particular its paragraph 5.5.6).*

467 The public bodies submitted that it had been reasonable for GAD and the prudential regulators to have understood this to be the effect of the treaty at the time.

468 The public bodies went on to submit that:

> *If the prudential regulator or GAD had taken the view that a change to the wording of the treaty was required in order for it to achieve its intended effect of making cash repayments and interest fees payable only out of future surplus, there can be no doubt that such a change would have been requested and made. As it was, it was reasonable for Equitable, IRECO, the prudential regulator and GAD to understand that the treaty had this effect without the need for amendment.*
>
> *It was not the general policy of the prudential regulator to instruct counsel to review the legal contracts entered into by the companies they were regulating. The bodies under investigation have, however, received legal advice in the context of this investigation that the understanding of all concerned at the time as to the effect of the treaty is arguably correct.*

469 The public bodies continued by submitting that *'the fact that…, acting years later with the benefit of hindsight,* [it is possible to conclude] *that*

another legal interpretation of the treaty is preferable does not in any way undermine the reasonableness of the conduct of the prudential regulator or GAD at the time'.

470 Dealing with the limit of £100 million to the reinsurer's exposure under the treaty (with the implication that any credit taken by Equitable in their returns for the reinsurance should not have exceeded £100 million), the public bodies submitted that it was *'essential in this regard to distinguish the position under the terms of the treaty and the position under the side letter between Equitable and IRECO'*.

471 The public bodies further submitted that:

> *By the side letter the parties agreed that "should the withheld fund exceed £100,000,000 sterling and no solution can be found" under the terms of the agreement, then the treaty would be cancelled.*
>
> *However..., the regulator and GAD were not aware of this letter as Equitable did not disclose it at the time, and it did not come to light until 24 September 2001. The side letter should therefore be left out of account for present purposes.*

472 The public bodies went on to submit that:

> *The relevant term of the treaty (the last paragraph of Article XIII) provided: "In the event that the total withheld reinsurance claims balance exceeds £100,000,000 at any December 31 negotiations will take place to find a mutually agreeable restructuring of the treaty which will include a redefinition of the Adjustment Premiums in respect of future years."*
>
> *The only obligation which this term even purported to impose on Equitable was an obligation to take part in negotiations. There was no obligation to act in good faith, or even reasonably, in the conduct of such negotiations, let alone to agree anything. Furthermore, as a matter of law, an agreement to negotiate is unenforceable. Accordingly, this term did not impose any legal obligation on Equitable or confer any legal right on IRECO at all. In those circumstances, the treaty remained in force indefinitely and could not be cancelled by IRECO. It is therefore wrong to suggest that the terms of the treaty imposed a limit of £100 million (or any limit) on the reinsurer's exposure, or meant that the credit taken by Equitable for the treaty in its returns should have been limited to £100 million.*

473 The public bodies concluded by submitting that, for all these reasons, any adverse finding would be unreasonable and flawed.

My evaluation of those submissions

474 I was not persuaded by the submissions of the public bodies on this matter. The absence of a concession under section 68 of the 1982 Act – a concession to which the Treasury referred when they first discussed with the Society the possibility of arranging a financial reinsurance treaty – meant that no credit could be taken within the Society's 1998 regulatory returns as it was concluded after the valuation date for those returns.

475 While I have not examined the financial reinsurance arrangements of all other life insurance companies at the time relevant to my report, I gain no assistance from the fact that others are said to have used such arrangements.

476 Nor am I persuaded that the issues concerning the proper reserving treatment for the Society's arrangement can only be identified with the benefit of hindsight or through contentious interpretations of the terms of the treaty.

477 GAD at the time identified the issues which I have concluded meant that no offset was permissible and notified the FSA of those issues. The concerns expressed by GAD were not resolved but the FSA, acting on behalf of the prudential regulators, nevertheless permitted the Society to take credit in its regulatory returns for the financial reinsurance arrangement with IRECO. The FSA were wrong to do so.

478 Nor do I agree that the existence of the 'side-letter' had any impact on the amount of offset that the Society could take for the arrangement within its regulatory returns – although in reaching my conclusion, I disregarded the existence and terms of the side-letter.

479 I would note also that the FSA received an opinion, first given orally to them by Counsel on 22 November 2001 (see entry 4 for this date within Part 3 of this report), with a written draft provided on the following day (see the entry for that date at 17:01) which (i) advised that the side-letter added nothing to the provisions of the arrangement and (ii) which otherwise confirmed the conclusion to which I have come as regards the economic substance of both the original and revised versions of the IRECO treaty. Such legal advice was not sought at the time that the FSA had to decide whether to permit the credit sought.

480 Nor would I accept that the existence of side-letters in relation to financial reinsurance treaties was something distinctive about the Society at this time. As was noted in a paper prepared for the actuarial profession's 1991 General Insurance Convention:

> *It is not easy to describe an elephant but "you know one when you see one". Financial reinsurance is similar... Financial reinsurance contracts will tend to depart from some of the features* [of traditional reinsurance]*... and examples of such departures are...* [that] *there may be side agreements which significantly modify the terms of the policy document... In order to operate effectively, a number of financial reinsurance contracts may need side agreements not apparent from the contracts themselves, or at least a clear understanding between the parties covering how the contract is to be managed over the longer term.*

481 The declaration by the Society of a bonus in March 1999, and the publication of its regulatory returns shortly afterwards, were together a critical juncture in the story which unfolded in relation to the Society.

482 The context in which the Society decided to conclude a financial reinsurance arrangement needs to be remembered. The prudential regulators told the Society that, without some means of improving its solvency position, those regulators would act to prevent the declaration of a bonus.

483 Given the nature and extent of the problems which had brought the Society to that position, the prudential regulators were, in my view, under an obligation not simply to accept assurances about the existence, scope, nature and effect of the proposed arrangements, without having verified that those assurances were correct and could be relied on.

484 Those regulators should not have accepted any reserving offset <u>unless and until</u> they had seen the terms of the financial reinsurance arrangement, had considered those terms, and concluded that the terms and economic substance of the treaty entitled the Society to take the credit that it took.

485 None of that happened. The submissions of the public bodies do not detract from the reasons underlying my conclusion. If anything, those submissions serve to confirm the correctness of that conclusion.

My finding

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

The basis for my finding concerning the disclosure of the potential impact of the *Hyman* litigation

The issue and relevant background

487 While the *Hyman* litigation was proceeding through the Courts, the Society – and the prudential regulators – undertook scenario planning to consider the likely impact of a range of possible outcomes to that litigation.

488 Consideration was given to what those scenarios would mean for the financial position of the Society and for its freedom to maintain the policies it had adopted to manage its affairs, and what other consequences the possible outcomes of the *Hyman* case could have for the Society and its members.

489 Even assuming that the financial reinsurance arrangement which the Society had entered into, and for which it proposed to take a substantial offset within its 1998 regulatory returns, entitled the Society so to do, the continuation of that arrangement was contingent on the Society being able to continue to apply its differential terminal bonus policy. Yet that ability was precisely the issue at stake in the *Hyman* proceedings.

490 Furthermore, if the Society were found not to have been able to apply its differential terminal bonus policy, the question would arise as to how to remedy the position of those policyholders with policies which contained guaranteed annuity rates who had retired since 1 January 1994, but who had not been provided with the option of taking benefits without the reduction in terminal bonus applied under the Society's differential terminal bonus policy. The question of compensating such policyholders would thus arise if the Society lost the *Hyman* case.

The facts

491 On 7 December 1998, the Treasury, then the prudential regulators of insurance companies, had written to the Society to record the outcome of a meeting which had been held on 3 December 1998. The Treasury recorded that, at that meeting:

> *We also indicated that we expected an appropriate statement on contingent liabilities to appear in your regulatory returns, related to the risk* [of] *successful challenge to the Equitable Life's bonus practice with regard to guaranteed annuities.*

492 However, no such statement was made in the Society's 1998 or 1999 returns, despite the invitation of the prudential regulators at the meeting and in the follow-up letter.

493 In addition, continuation of the financial reinsurance arrangement that Equitable were negotiating at the time their 1998 returns were submitted to the prudential regulators was dependent on the continuation of the Society's differential terminal bonus policy. That was also not disclosed within the Society's 1998 returns.

494 On 4 May 1999, the Society informed the FSA – by now, under contract, undertaking on behalf of the Treasury the prudential regulation of insurance companies – that it estimated that an immediate provision of £400 million would be required if the Society lost the *Hyman* litigation, in order to compensate those GAR policyholders who had retired between 1995 and 1998 without receiving benefits which had attracted the full guaranteed annuity rate applied to the total policy fund. No statement to that effect was made within the Society's regulatory returns.

495 On 21 January 2000, prior to Equitable submitting their 1999 returns, the Court of Appeal had ruled against Equitable in the *Hyman* case, thus increasing the likelihood that the differential terminal bonus policy would be found to be unlawful and that compensation would have to be paid.

496 On 1 February 2000, the Society wrote to its policyholders, informing them that, even if the Court of Appeal ruling was upheld by the House of Lords, no significant additional costs would be imposed on the Society. A copy of this letter was provided to the prudential regulators and to GAD.

The statutory and administrative context

497 Section 17 of the Insurance Companies Act 1982 required every insurance company to prepare a revenue account for the year, a balance sheet as at the end of the year, and a profit and loss account for the year in a prescribed form. These documents formed part of the regulatory returns.

498 All insurance companies which wrote long term business were also required by Section 18 of the 1982 Act once in every twelve months to cause an actuarial investigation to be made into its financial condition by its Appointed Actuary, who had to report the results of that investigation in a prescribed form within the returns.

499 The amount of the long term liabilities as calculated by the Appointed Actuary, pursuant to Section 18 of the 1982 Act, were then included in the balance sheet required by Section 17 of the 1982 Act.

500 Section 18(4) of the 1982 Act provided that, for the purposes of the investigation that the Appointed Actuary undertook into the financial condition of the company and reported in the returns, the value of any assets and the amount of any liabilities set out therein were required to be determined in accordance with the applicable valuation Regulations. With effect from 1 July 1994, those Regulations were set out in Part VIII and Part XI of the Insurance Companies Regulations 1994.

501 Regulation 60 of the 1994 Regulations provided that, subject to the detailed requirements of Part XI, the amount of liabilities of an insurance company in respect of long term business was required to be determined in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies. It also provided that, in determining the amount of liabilities of an insurance company, all contingent and prospective liabilities were to be taken into account within the returns.

502 Schedule 1 to the Insurance Companies (Accounts & Statements) Regulations 1996 set out the form of the balance sheet to be reported in the returns. Paragraph 13(1)(c) of that Schedule required the disclosure of contingent liabilities, subject to a *de minimis* exemption, not already recognised in the balance sheet, other than those arising under inward contracts of insurance or reinsurance.

503 Paragraph 12(2)(d) of Schedule 4 to the Insurance Companies (Accounts & Statements) Regulations 1996 required the Society to indicate the nature and extent of the cover given under each outward reinsurance treaty.

504 Paragraphs 25 and 26 of section 5.6 of the Treasury's 1998 guidance on the preparation of the returns stated:

> *"Inward" in the expression "inward contracts of insurance and reinsurance" is intended to exclude from the* [disclosure] *exemption contracts of reinsurance where the reporting company is the reinsured.*
>
> *The disclosure of contingent liabilities is subject to a de minimis exemption. One or more contingent liabilities need not be disclosed provided that the aggregate value of the non-disclosed contingent liabilities does not exceed 2.5% of the... long term business amount.*

My assessment

505 The question arose as to whether the two issues raised above – that the continuation of the Society's financial reinsurance arrangement was contingent on the Society maintaining its differential terminal bonus policy, and that the Society, if it lost the *Hyman* case, would be exposed to significant compensation costs – should have been disclosed within the Society's regulatory returns for 1998 and 1999 as being contingent liabilities above the minimum disclosure threshold.

506 I am aware that other proceedings are ongoing which focus, among other matters, on the treatment that the Society and its auditors gave to these issues within the Society's Companies Act accounts and within its regulatory returns. In that context, it seems to me appropriate to make no finding regarding that matter.

507 However, whatever the position may be as to that, the prudential regulators at the time asked twice – first in a meeting on 3 December 1998 with the Society and then in a follow-up letter from the Treasury on 7 December 1998 – that such disclosure should be made. That indicates that those regulators at the time considered that this needed to be done.

508 Yet when no such disclosure was made, those regulators did not query that omission or ask for justification as to the basis on which the decision not to make such a statement had been made.

509 Nor did those regulators, when considering the Society's regulatory returns for 1999, ask the Society to justify the content of the letter it had sent to its policyholders. That letter had said that no significant additional costs would be imposed on the Society. However, the information provided by the Society to the prudential regulators was that an immediate provision of £400 million would be needed in respect of the compensation costs alone. That appeared to be inconsistent with the content of the Society's returns.

510 I consider that the prudential regulators should have followed up their concerns and should have satisfied themselves that the Society's decision was reasonable and that it was, in this respect, acting prudently and not contrary to the interests of its policyholders.

Submissions I have received and my evaluation of those submissions

Submissions by the public bodies

511 When I informed the public bodies that I was minded to come to this view, those bodies told me that, in their view, neither the lapse of the Society's financial reinsurance arrangement nor the potential costs of it losing the *Hyman* case had constituted a contingent liability under the applicable Regulations.

512 In addition, the public bodies said that, even if one or both of those matters constituted a contingent liability, they were less than the threshold value, below which there had been no disclosure requirements, and therefore they did not have to be disclosed.

513 The public bodies also told me that those matters had also not been disclosed in the Society's Companies Act accounts, which had been approved by Equitable's external auditors. Those bodies said that the treatment in the returns was required to follow that in the accounts, and Equitable's auditors had also agreed with the position taken in the returns.

514 In support of these views, the public bodies submitted that, with regard to the decision by the Society not to disclose these matters within its 1998 and 1999 returns:

> *Equitable's decision not to disclose these matters was reasonable in the light of the legal advice which Equitable had received at the material times. Any criticism of Equitable in this regard relies on the use of hindsight, with knowledge of the House of Lords' judgment in the Hyman litigation, rather than being judged in the context existing at the relevant times.*

515 As to the two occasions, prior to the submission of the Society's 1998 regulatory returns, on which the prudential regulators had asked the Society to include such notes within those returns, the public bodies submitted that:

> *Notwithstanding the fact that there was no requirement to this effect under the applicable regulations, and that there was therefore no formal basis on which to insist upon it, the prudential regulator did suggest to Equitable that it should include a statement in its returns concerning the risk of successful challenge to the* [differential terminal bonus policy]*, as indicated in HMT's letter to Equitable dated 7 December 1998. This was entirely a matter for Equitable (and its auditors) to decide, and not an issue in respect of which the prudential regulator could have required Equitable to amend its returns. Ultimately, Equitable chose not to include such a statement in its returns. At that point, there was nothing further that the prudential regulator reasonably could do, given that Equitable was not in breach of the regulations.*

My evaluation of those submissions

516 I was not persuaded by the submissions of the public bodies on this matter. It may well be that it can now be established that the Society had received legal advice to support its position.

517 However, that the Society was acting on such advice does not help explain why those regulators failed to pursue a matter which they had raised and about which they received further information that the Society's public position may not, at that time, have been consistent with what the Society had told the prudential regulators.

518 The legal advice received by the Society was not known to the prudential regulators at the time nor

had those regulators been told then on what basis the Society's decision had been taken.

519 Moreover, the submissions by the public bodies have addressed a conclusion that I have not reached – nor is it one that I could reach. It is not for me to question the reasonableness of the Society's decisions. What I am concerned with is the acts and omissions of the prudential regulators.

520 There is no evidence that the existence of legal advice to the Society concerning its obligations in respect of the disclosure of the possible impact on it of losing the *Hyman* case was known to the prudential regulators at the time or that GAD took such advice into account when scrutinising the Society's regulatory returns.

521 The failure by the prudential regulators to pursue, as part of their consideration of the Society's returns, matters which they had raised and which were of potential significance to the Society and its policyholders constituted a departure from what it is reasonable to expect from those regulators.

My conclusion

522 **I find that the failure of the FSA, acting on behalf of the prudential regulators, to pursue the issue of the proper disclosure, within the Society's regulatory returns for 1998 and 1999, of the potential impact on the Society of it losing the Hyman litigation fell short of the standard that could reasonably be expected of such regulators.**

The basis for my two findings concerning the decision to permit the Society to remain open

The issue and relevant background

523 Following the decision of the House of Lords in the *Hyman* case, the Society had been faced with an extremely serious situation. That decision had profound effects.

524 The financial reinsurance arrangement that the Society had entered into was to lapse, as a result of the ending of the Society's differential terminal bonus policy. Without the credit that had been taken by the Society within its returns for that arrangement, a serious question arose as to whether the Society could meet its required solvency margin.

525 The Society was immediately faced with a significant reduction in what the Society regarded as the assets available to meet the costs in respect of those policyholders who chose to take benefits calculated with regard to guaranteed annuity rates. Those costs had to be shared, almost certainly by benefit reductions, across all policyholders – as any 'ring-fencing' of policyholders with annuity guarantees had been declared unlawful by the House of Lords.

526 That gave rise to inbuilt conflicts between the interests of different classes of policyholders which, in the circumstances facing the Society at the time, could not be resolved using the normal mechanisms available to life insurance companies – and which meant that the Society's situation was inherently unstable.

527 In that context, the Society decided to put itself up for sale. The question arose as to what the regulatory response to that decision should be.

The FSA decided not to intervene to require the Society to close to new business whilst it sought a buyer.

The facts

528 I have been unable to find any documentary evidence relating to the decision taken by the FSA to permit the Society to remain open to new business after the *Hyman* judgment. During the investigation, the basis on which that decision was taken by the FSA was explained to me.

529 According to the FSA, the basis of their decision to permit Equitable to remain open to new business and seek a buyer, which, according to the FSA, was the right decision in light of all the facts and circumstances known to the FSA at the time, was as follows.

530 I have been told that the FSA believed that it took a reasonable decision to allow the Society to remain open, balancing the interests of those persons holding approximately one million existing policies against the possible risks to a small number of new joiners, on the basis that new joiners could be compensated if there were any mis-selling – and that the FSA had taken a reasonable view of the availability of compensation in the event that any mis-selling did occur.

531 I have been told that, if the FSA had not allowed the Society to write new business, this would have had a detrimental effect on its sale value, which would, in turn, have been damaging to the interests of the Society's existing policyholders. It is said that the proceeds of de-mutualisation and sale would have benefited all policyholders and would have enabled the Society to restore the bonus cuts which it had imposed following the decision of the House of Lords.

532 I have also been told that, at the time, the FSA believed that the Society was *'in compliance with its statutory requirements and was also solvent on a regulatory basis'*. Accordingly, had the FSA decided to intervene to close the Society to new business or to prevent it from advertising, it was not clear what powers the FSA would have had to do so.

The statutory and administrative context

533 By section 11 of the Insurance Companies Act 1982, the prudential regulators were empowered to withdraw the authorisation of an insurance company to write new business, where it appeared to those regulators either that the company had failed to satisfy an obligation to which it was subject by virtue of the 1982 Act or where there existed a ground on which those regulators would have been prohibited from issuing an authorisation to the company.

534 With effect from 1 July 1994, section 12A of the 1982 Act gave the prudential regulators powers in urgent cases to suspend the authorisation of an insurance company to write new business.

535 The grounds on which that power could be used included that the company appeared not to be satisfying the criteria of sound and prudent management. Those criteria included requirements that the company carried on its business with integrity, due care, and the professional skills appropriate to the nature and scale of its activities and that the company conducted its business with due regard to the interests of policyholders and potential policyholders.

536 Throughout the period covered by this report, the prudential regulators also had powers of intervention which could be used in situations where it appeared that a company might not be able to fulfil the reasonable expectations of policyholders or potential policyholders, where it

appeared that a company might not be able to meet its liabilities, or where it appeared that a company might not be able to satisfy an obligation to which it was subject by virtue of the 1982 Act.

537 The grounds on which those powers were exercisable were specified in section 37 of the 1982 Act and the powers of intervention were set out in sections 38 to 45 of that Act.

538 Public authorities are under an obligation generally to act in accordance with established principles of good administration. As part of that obligation, those authorities are required to take reasonable decisions based on all relevant considerations and leaving out of account irrelevant considerations.

539 Such public authorities are also required to keep proper and appropriate records as evidence of their activities, including a record of the reasons for their decisions.

My assessment

540 I accept the account provided by those involved in the decision not to intervene to close the Society to new business and I have assessed that decision having regard to that account. However, the lack of any documentary record means that I have been unable to verify the evidence which underpinned that decision at the time.

541 I consider that the failure to record their decision and the reasons for that decision at, or shortly after, the time it was taken represents a departure by the FSA from the standard expected of such regulators.

542 But what of the basis on which that decision was taken? The question before me is whether the rationale for that decision indicates that the FSA took their decision having regard to all relevant considerations, leaving irrelevant considerations out of account, and whether they reached a decision that, acting reasonably, it was open to the FSA to make.

543 Parliament bestowed on the prudential regulators a power to intervene where it appeared that an insurance company might not have been able to fulfil the reasonable expectations of policyholders and/or of potential policyholders.

544 When that power was introduced, Parliament recognised that circumstances would arise where the interests and expectations of existing and potential policyholders would be different or might conflict.

545 The prudential regulators were under a duty to consider whether particular circumstances or events amounted to grounds for the exercise of a power of intervention and, if so, whether it was appropriate to exercise such a power.

546 There can be no doubt that, after the decision of the House of Lords in *Hyman*, the circumstances which gave rise to the duty to consider what action, if any, to take to protect the reasonable expectations of potential policyholders had arisen.

547 Those regulators were therefore under a duty to consider whether it would be appropriate to exercise any of the powers of intervention that the prudential regulators possessed for that purpose.

548 However, in the circumstances which pertained after the decision of the House of Lords in the *Hyman* case, it was not only the reasonable expectations of potential policyholders which required consideration. Those of existing policyholders were also at stake.

549 I consider that, in this context, the aim of the FSA, acting on behalf of the prudential regulators and acting reasonably, should have been to identify an appropriate course of action which met the aim of protecting the interests and reasonable expectations of both existing and potential policyholders and which minimised any adverse impact on the other class of policyholder if the interests and/or expectations of those different classes were considered to conflict.

550 Consideration had to be given, as distinct questions, to what action was necessary in order to protect the interests of (i) existing policyholders, (ii) potential policyholders, and (iii) both classes of policyholder.

551 A number of factors were not taken into account by the FSA, acting on behalf of the prudential regulators, which were relevant to their consideration of the question of what action, if any, was appropriate to protect the interests and reasonable expectations of both the existing and potential policyholders of the Society.

552 Without ring-fencing and in a context of increased liabilities to others, it was inevitable that new policyholders would be significantly disadvantaged by entry into a fund which the FSA knew, or should have known, could not continue to honour the guarantees that the Society had given, as it was required to do, while at the same time continuing to provide the investment return which potential policyholders would reasonably have expected to receive once they joined.

553 I consider that any prudential regulator, acting reasonably, would not have made the assumptions that the FSA made about the nature of the expectations that the Society's advertising might be creating or about the availability of compensation which might exist for any mis-selling as a result of such advertising.

554 The FSA did not, for example, review the advertising that the Society was issuing to ensure that the FSA understood what the reasonable expectations of new policyholders were likely to be.

555 The FSA also made no enquiries to satisfy themselves that mis-selling compensation, the cost of which in any case would have to be met by the members of the Society themselves – including those joining in this period – was in principle and in practice likely to be available. Those considerations were left out of account by the FSA.

556 That brings me to a further point. The basis of the FSA's decision to take no action appears to have been largely predicated on a balancing exercise undertaken to weigh the relative interests of the Society's existing policyholders against those of new entrants. That the former, in the FSA's view, were considerably larger in number than the latter was a significant consideration in their decision.

557 However, for two reasons I consider that this approach was significantly flawed. The first is that those who might be directly affected by the decision by the FSA to take no action were not limited to those who became new policyholders during this period. The second is that the FSA had no sound basis at the time they took their decision for assuming, as the FSA did, that the number of people newly investing in the Society would be minimal.

558 As the FSA knew, the bulk of the Society's business constituted recurrent single premium business, where an existing policyholder had the right – but not the obligation – to pay further premiums at any time. The majority of the Society's existing policyholders, including those with guaranteed annuity rates, were entitled to pay further money into the with-profits fund during this period.

559 Those who were considering whether to do so – particularly those whose policies did not contain guaranteed annuity rates, who were most exposed to the risks inherent in the position – were directly affected by the FSA's decision to take no action concerning the Society's continued ability to write new business.

560 Even though the withdrawal or suspension of authorisation would not itself have prevented policyholders from making further contributions under existing policies, such intervention action would have put those existing policyholders on warning as to the problems that such action was designed to address.

561 That relevant consideration was not among the considerations to which the FSA had regard in coming to its decision.

562 The FSA's assumption that only a small number of new policyholders would be affected by their decision to take no action was, furthermore, not based on any empirical analysis that might have provided a sound basis for such a decision. The FSA did not seek, as they did after Equitable had closed to new business, information from the Society as to the number of the transactions it was undertaking.

563 The FSA did not therefore know the number of new entrants or the number of further premiums being paid. The FSA's decision was largely based on an assumption, for which there was no apparent basis, that only a small number of people might be affected by that decision.

564 I consider that the decision by the FSA to take no action did not take into account relevant considerations that should have been taken into account and that considerations which were accorded importance in their decision-making process were based on assumptions made by the FSA which had no sound basis in fact.

565 That conclusion is strengthened when consideration is given to the legal basis on which it is said that the FSA's decision was taken. It is not the case, as has been suggested to me, that the prudential regulators had no powers to take intervention action unless an insurance company was already in breach of its regulatory requirements or was insolvent on a regulatory basis.

566 The powers which Parliament conferred on the prudential regulators were exercisable in situations where those regulators considered that there was a risk that a company <u>might not be able</u> to fulfil the reasonable expectations of policyholders or potential policyholders, where it appeared that a company <u>might not be able</u> to honour its liabilities, or where it appeared that a company <u>appeared to have</u> failed to satisfy an obligation to which it was subject by virtue of the 1982 Act. The exercise of those powers should have been, but were not, considered by the FSA when they took their decision to take no action.

567 Furthermore, given the financial position of the Society at that time, any prudential regulator, acting reasonably, could not have been satisfied, without reviewing the information contained in the advertisements that it was using, that the Society, by advertising and writing new business, was acting in line with the interests of its potential policyholders in this respect. The FSA, however, did not review those advertisements.

568 Nor do I consider that any prudential regulator, acting reasonably, could take into account of the possibility of compensation for mis-selling when it had not established that such compensation would be available.

569 I consider that the FSA acted unreasonably in assuming that such compensation would be available where the FSA knew, or should have known, that it was not likely to be available to those existing policyholders who made further contributions without relying on anything that the Society did or said.

570 I am not suggesting that it was unreasonable for the prudential regulators to give the Society an opportunity to find a buyer. However, it does not follow that the only options open to the FSA in such a situation were either to close the Society to new business or to do nothing.

571 The FSA had other options available to them which the FSA failed to consider. A requirement could have been imposed on the Society as to advertising. Equitable, after all, had made much of its ability to attract new business without the assistance of third parties and had also treated much of its new business as 'execution-only'.

572 A premium limitation could have been imposed, which restricted new business to a certain amount. That would have enabled the FSA to be sure that those effecting new business with the Society were indeed limited in number or that such business was at least limited in value, as the FSA had simply assumed would be the case.

573 The authorisation of the Society could also have been suspended as a matter of urgency, pending the completion of the sale – after which time the Society could have submitted an application for re-authorisation. Any such suspension could have been explicitly linked to the sales process and imposed as an interim way of recognising the desirability of progressing the sale of the Society while seeking to protect the interests of existing and potential policyholders.

574 Given that the Society's attempts to sell itself were no secret, such a suspension, if linked to that process, should not have been seen as anything other than caution while the sales process was underway. That might have protected the interests of those existing policyholders who were considering making further contributions and also the interests of potential policyholders, pending the outcome of the sales process.

575 Even in the absence of considering any of these actions, non-statutory action could have been considered by the FSA with a view to persuading the Society to take a different line.

576 The DTI had used such action in the Nation Life case in the 1970s, persuading that company to delay banking any cheques it received from existing or new policyholders and/or to delay issuing new policies while the sales process continued. The FSA should have considered what equivalent forms of non-statutory action were available to them – but did not do so.

577 My conclusion is that the decision by the FSA to permit the Society to remain open to new business was flawed. That decision was taken leaving out of account relevant considerations which should have been taken into account and without having regard to the range of powers and other options available to the FSA.

Submissions I have received and my evaluation of those submissions

Submissions by the public bodies

578 When I informed the public bodies that I was minded to come to this view, those bodies told me, in relation to the failure to record the decision by the prudential regulators to permit the Society to remain open after the decision of the House of Lords in the *Hyman* case, that, in their view, there

was no doubt that the decision to allow Equitable to remain open was taken after careful consideration and at the most senior level of the FSA.

579 While accepting that the decision had not been recorded, the public bodies disputed that this justified an adverse finding as, they said, there is no public law obligation to record decisions not to take action.

580 In support of that view, the public bodies submitted that, *'whilst it is undoubtedly good practice, it is not obligatory and in a crisis situation it is not always achievable'* to record such decisions.

581 In relation to the basis on which the decision was taken by the prudential regulators to permit the Society to remain open after the decision of the House of Lords in the *Hyman* case, the public bodies told me that, in their view, it had been not just appropriate but necessary for the FSA to balance the interests of existing and potential policyholders when taking that decision.

582 The public bodies told me that the FSA had considered that a successful sale of the business was in the best interests of policyholders, and that allowing Equitable to remain open to new business was essential to give Equitable the best chance of finding a buyer.

583 In the circumstances, the public bodies said, none of the other regulatory steps available to the FSA would have been appropriate and they would instead have acted to undermine the prospects of a successful sale.

584 In support of these views, the public bodies submitted that my conclusion rested on:

> *... the misplaced belief that there were realistic options available to the FSA which would have protected such investors and which were consistent with permitting Equitable the opportunity to find a buyer. The reality is that any such options proposed would have undermined the sale process and would therefore have acted counter to the overall course of action which was reasonably being pursued.*

585 As to why the FSA had not made enquiries into the availability of compensation for those existing or new policyholders who might suffer loss as a result of the Society being permitted to remain open, the public bodies submitted that:

> *No specific enquiries were made by the FSA because none was necessary: there was no uncertainty on the FSA's part as to whether compensation would be available in principle or in practice. New policyholders who were victims of mis-selling would have recourse to the Financial Ombudsman Service (FOS) or its predecessor, in the event that Equitable itself did not resolve a complaint satisfactorily. The FSA was well aware of the operation of both bodies, not least because it was involved in setting up the FOS during 2000 and 2001 ...*
>
> *The only circumstance in which compensation would not have been available by this route would be in the event of Equitable's insolvency. However, in this situation the Financial Services Compensation Scheme (or its predecessor) would have been available to pay claims (subject to the rules of that Scheme).*

586 As to the basis on which the FSA had concluded that only a small number of people would be potentially affected by the decision to permit the Society to remain open, the public bodies submitted that they:

... consider that it was reasonable for the FSA to have formed the view that the number of policyholders who might pay new premiums to Equitable (including existing policyholders) would be small relative to the total number of existing policyholders. The FSA formed this view on the basis of its knowledge of Equitable (which was under intense scrutiny at this stage), including the fact that existing and potential policyholders were aware of the problems facing Equitable from widespread reports in the press.

587 The public bodies also submitted that:

Furthermore, the FSA had already noted that it would only allow Equitable to remain open if "a suitable buyer for the Society was likely to be found quickly". Equitable itself had set a deadline for bids of 20 November 2000 and believed that a sale would be agreed "in principle" by the end of 2000. This would further have limited new premiums which might be paid.

588 The public bodies went on to submit that:

The common sense conclusion that the number of policyholders who may pay new premiums to Equitable would be small was also reasonable in light of information from previous years. It could reasonably have been anticipated that the number of new policyholders joining, up to the point at which it was clear there would (or would not) have been a buyer, would have represented no more than 2-3% of the number of existing policyholders, and their premiums would be no more than 1% of the total fund. In the event new business turned out to be much smaller even than that estimate; only around 16,000 policyholders joined Equitable between the House of Lords' judgment and closure to new business – some 1% of the existing membership.

589 The public bodies submitted that, in addition:

Existing policyholders paying further premiums were historically a smaller group than new policyholders, and given the extra information they had received it was reasonable for the FSA to conclude that their premiums would represent less than 0.5% of the total fund.

590 As to the inevitable disadvantage that new policyholders would suffer, the public bodies submitted that:

The FSA was mindful of the possible risks of investing in Equitable during this period and this was a factor which was taken into account when balancing the interests of different groups of policyholders and potential policyholders. However, there were no realistic options available to the FSA which would have protected such investors and which were consistent with permitting Equitable the opportunity to find a buyer, which was the FSA's overriding objective.

591 Turning to the available options that had been open to the FSA by way of the powers of intervention, the public bodies told me that they agreed that:

... the FSA's regulatory powers could be used where it appeared that a company may be unable to meet its liabilities or fulfil the reasonable expectations of policyholders, and that the FSA had at the relevant time a discretionary power (under section 12A of the Insurance Companies Act 1982) to suspend the

authorisation of an insurance company to write new business in urgent cases.

592 However, the public bodies submitted that:

> *... the regulator only needs to consider the exercise of the available powers where they may be useful. There is no need to consider exercising powers when there is no action the regulator wishes to take.*
>
> *The duty of a reasonable prudential regulator is to assess each situation on its merits, determine what outcome it wishes to achieve and consider what, if any, powers it might exercise to that end. In accordance with that obligation, and fully aware of the legal powers available to it, the FSA consciously decided in this case that taking any action against Equitable would have undermined the desired outcome of a successful sale.*

593 The public bodies further submitted that:

> *In circumstances where the prudential regulator does not wish to take action against a firm, it cannot sensibly be suggested that the prudential regulator is guilty of maladministration if it does not go through each and every potential legal power one by one and explain why its use is not appropriate in the particular case.*
>
> *In this case, the options available to the FSA were in fact very limited, if it did not want to undermine the achievement of a sale.*

594 Turning to each of the specific powers the prudential regulators at that time possessed, the public bodies, with respect to the power to impose a requirement on advertising, submitted that:

> *... it was reasonable for the FSA to permit Equitable the opportunity to find a buyer. In practice, it was a necessary consequence of that decision that Equitable must be permitted to remain open to new business. Permitting Equitable to advertise for such new business was consistent with that decision. It is difficult to envisage a situation where the FSA would intervene to prevent a firm advertising, while not intervening to prevent it from selling at all: either the company is open and therefore allowed to advertise, or it is not.*
>
> *To have insisted on a ban on advertising or to have required riskwarnings would also have undermined the prospects of a successful sale. This would have had a detrimental effect on the interests of existing policyholders.*

595 The public bodies further submitted that:

> *... in considering whether Equitable should have been subject to a ban on advertising, it was legitimate for the FSA to take into account the fact that a conduct of business regulatory regime was in force which monitored financial promotions and prohibited firms from advertising in a way which was misleading. Further, the possible need for risk-warnings was reduced due to the knowledge which ... both potential and existing policyholders could reasonably be assumed to have had about Equitable's situation.*

596 As to why the FSA had not reviewed the Society's advertising in that period, the public bodies submitted that:

> *... it was reasonable for the prudential regulator not to review Equitable's advertising. Quite apart from the existence of a separate*

conduct of business regime, there were no particular requirements which the prudential regulator would have wished to impose on Equitable in this respect, as to do so would have undermined the prudential regulator's main objective of maximising the prospects of a sale.

597 With respect to consideration of the use of the power of intervention which would have imposed a limit on the premium income received by the Society, the public bodies submitted that:

> *Imposing a limitation on premiums would not have been appropriate in this case because it would have indicated to potential purchasers that the FSA lacked confidence in the future of the business and the prospects of a sale. This would itself have made the firm a less attractive purchase prospect. A previous report from the Ombudsman's office, into the DTI's regulation of Nation Life, concluded that it would not have been appropriate to apply premium limits, precisely because it would have damaged attempts to find a buyer for that firm.*

598 With respect to consideration of the use of the power of intervention to suspend the authorisation of the Society, the public bodies submitted that:

> *Suspension of authorisation, whether or not linked to the sale process, would have had the same effect as closure to new business. Either would have made Equitable a considerably less attractive prospect for purchase as it would have made it difficult for Equitable to retain its main asset, the sales force. In any event, to have taken such action in order to put existing policyholders "on warning" would have been an arbitrary step which bore no direct relation to the risk involved.*

599 With respect to the consideration of non-statutory action, the public bodies submitted that:

> *Even if such persuasion would have been appropriate, the bodies under investigation do not consider that the FSA can be guilty of maladministration for failing to consider persuading a company to take unenforceable non-statutory action. In any event, such action would have undermined the principal objective of securing a sale because it would have meant that the product which consumers were considering purchasing was not in practice available: this would have been tantamount to closure with the same negative consequences on the prospects for a sale.*

600 The public bodies told me that, for all these reasons, any adverse finding that the basis on which the decision had been taken to permit the Society to remain open to new business would be, in their view, unreasonable and flawed, submitting:

> *The FSA reasonably decided not to intervene to prevent Equitable from seeking to secure a successful sale having taken the view that this was the best way to protect policyholders' interests. Having taken this decision, it was reasonable to conclude that there were no additional actions which could have been taken further to protect the interests of policyholders, either by the exercise of any discretionary powers, or by the provision of any additional or different information, or by any other means which would not undermine this wider objective.*

My evaluation of those submissions

601 I was not persuaded by the submissions of the public bodies on these matters. Whether or not there is a legal obligation on public bodies to record their decisions, it is a basic principle of good

administration that public bodies should record and maintain adequate records of their decisions and the reasons for those decisions, including the factors taken into account or left out of account and the alternative options considered.

602 The public bodies have accepted that no record was made of the decision to permit the Society to remain open for new business. I conclude that the failure by the FSA to record their decision and the reasons for that decision constitutes a departure from accepted principles of good administration.

603 As for the basis on which the decision was taken, I will first address the surprising submission by the public bodies that:

> *... the regulator only needs to consider the exercise of the available powers where they may be useful. There is no need to consider exercising powers when there is no action the regulator wishes to take.*
>
> *The duty of a reasonable prudential regulator is to assess each situation on its merits, determine what outcome it wishes to achieve and consider what, if any, powers it might exercise to that end.*

604 I reject that submission. It is necessary for a public body to consider the range of powers and options open to it before deciding what course of action to take and which of those powers, if any, that body will exercise.

605 In Chapter 5 of this report, I have explained that there are certain basic principles of public law to which public bodies exercising statutory functions must have regard.

606 Those principles include that such bodies must carry out their legal duties in accordance with the law and that, when public bodies exercise a power, they must act reasonably and in accordance with any conditions imposed by law.

607 Public bodies must properly consider whether to exercise any statutory powers given to them. A public body must give proper consideration to the use of its powers at the point when it reasonably considers that grounds for the exercise of those powers have or may have arisen. Such a body cannot fetter or constrain its ability to give proper consideration to the exercise of its powers.

608 I consider therefore that the FSA were required to consider whether it would be appropriate to exercise any of the powers that they possessed, in acting on behalf of the prudential regulators, before taking a decision not to do so. That consideration did not take place.

609 Finally, I am not persuaded by the submissions which deal with the assumptions made by the FSA. I am satisfied that, <u>at the time that they took their decision</u>, the FSA did not have sound evidence on which they could base those assumptions.

610 That it later turned out to be the case, so I am told, that a limited number of people were affected by that decision does not detract from the fact that the FSA had no basis at the time that they were made for the FSA's assumptions on these matters.

611 I would also note that it is still not known how many existing policyholders with policies which did not contain guaranteed annuity rates paid further money towards those policies during the relevant period. It is by no means certain, even now, that the number of those affected by the decision of the FSA was as limited as has been suggested to me.

612 The submissions of the public bodies on this matter do not provide any basis on which to change my conclusions on these matters. I consider that the FSA, in failing to record their decision and in failing to take into account all relevant considerations when making it, departed from the standard that could reasonably be expected from the FSA.

My finding

613 **I find first that the failure by the FSA, acting on behalf of the prudential regulators, to record their decision to permit the Society to remain open to new business, following its loss of the Hyman litigation fell short of the standard that could reasonably be expected of such regulators.**

614 **I find secondly that the basis on which the decision was taken by the FSA, acting on behalf of the prudential regulators, to permit the Society to remain open to new business was unsound, not taking into account all relevant considerations and not having a proper legal and factual basis and that this fell short of the standard that could reasonably be expected of such regulators.**

The basis for my finding concerning the information provided by the FSA in the post-closure period

The issue

615 In the period between the Society's closure to new business on 8 December 2000 and the end of my jurisdiction in relation to relevant events on 1 December 2001, the FSA, acting on behalf of the Treasury as the prudential regulators of insurance companies, were contacted by many hundreds of the Society's policyholders, concerned about the position that the Society was in and about their own future options.

616 The FSA also during this period issued general information relating to the Society through updates, website material, and factsheets.

617 As the Society prepared proposals for a scheme of arrangement under the Companies Act 1985, to compromise the competing claims of the Society's policyholders, the FSA was also contacted by policyholders about the Society's proposals and about the attitude of the FSA to those proposals.

The facts

618 In Chapter 8 of this report, I set out the terms of the information published or otherwise provided by the FSA through its general publicity, through its specific responses to the correspondence it received, and through its published assessment of the Society's Compromise Scheme proposals.

619 I will not repeat all that information here. However, it can be seen from the account given in Chapter 8 of this report that the information produced by the FSA contained the following two key messages:

(i) that the Society was and always had been solvent; and

(ii) that the Society had always met and at that time continued to meet all of the regulatory requirements to which it was subject by virtue of the applicable law, particularly those related to the required minimum margin of solvency.

620 That information, it was said, was based on the information that had been provided by the Society to the FSA and on the assessment that the FSA had made of that information.

621 The Society began to submit monthly solvency figures to GAD and the FSA on 11 August 2000, providing information about the position at each month-end from June 2000 until November 2001, with the exception of November 2000 when no report was submitted. The figures in those monthly reports were based on the Society's valuation approach.

622 However, at the same time the Society was in protracted discussions with the FSA and GAD about outstanding issues concerning the way in which the Society had determined its liabilities and had purported to establish sufficient provisions to cover those liabilities. Work was also ongoing at that time to establish what the additional potential liability of the Society might be in respect of compensation for any mis-selling of policies which did not contain guaranteed annuity rates without informing those new policyholders of the potential impact of that issue.

623 The monthly solvency reports provided by the Society did not take these issues into account and thus were statements of the solvency position of the Society before the impact on its solvency position of several significant issues was assessed – all of which had an adverse effect on its solvency position, although not all of the issues affected the position in every month.

624 The Society often quantified and provided to GAD and the FSA such quantification of the impact of these issues. GAD or the FSA sometimes sought to quantify other issues themselves.

625 This information informed the analysis that the FSA undertook in relation to the difficulties faced by the Society. That analysis often set out the views of FSA officials and actuaries as to what the solvency position of the Society was at any given time.

626 For example, on 9 July 2001, the FSA's Head of Actuarial Support asked whether the Society's Appointed Actuary or its auditors had expressed a view as to the solvency position that the Society was in, commenting:

> *It is not at all clear to me from the limited information provided at present that there is much margin at all on a Companies Act basis, particularly if they have in due course to make any material provision for mis-selling claims.*

627 The Head of Actuarial Support was informed in response on the same day that the Society had said that it was solvent as at 30 June 2001, but that such a view had been given before any provision was made for any mis-selling claims.

628 On 10 July 2001, the FSA's Head of Actuarial Support provided an estimate of what the quantum of the liability in respect of any such mis-selling claims might amount to, based on the work that Counsel had been doing to seek to establish who might be eligible to make such a claim and how such claims could be quantified. The Head of Actuarial Support noted that the Society *'could have mis-selling liabilities of £1.5 bn or more. In present investment market conditions, this would very likely mean that the company was insolvent.'*

629 On 19 July 2001, the FSA's Head of Actuarial Support recorded the main points to emerge from an internal FSA discussion about the Society. Those points included an observation that *'a provision for mis-selling would take them right up to the line'* in Companies Act (i.e. absolute) insolvency terms.

630 On 23 July 2001, by which time further work had been done as to liability for mis-selling and as to the quantification of any such liability, the FSA's Head of Actuarial Support noted that:

If, for example, [Equitable] *are likely to incur mis-selling claims on all post-1993 policies, then the liability could be around £3-4 billion, which would be well beyond their current free reserves on a Companies Act basis of around £1½ billion. If the potential claims extend back to 1988 or even earlier, then the situation is clearly even worse. Even if the Limitation Act applies (which seems very odd to me as a layman given that it was not the fault of the policyholders that they could only have been likely to have become aware of the alleged non-disclosure in 1998 or even later), then the liability could be around £2½ to £3½ billion, assuming that there would be a liability in respect of all premiums paid in the last 6 years. The result is still then likely to be insolvency.*

631 A note made by the conduct of business regulators of the discussion at a meeting they had attended with the FSA on 25 July 2001 referred to the view of Counsel, set out in his draft Opinion, which *'implied that* [Equitable] *was insolvent (and had been for some years)'*.

632 In the meantime, in the initial scrutiny of the Society's 2000 returns, undertaken by the FSA on 19 July 2001, it had been noted that the absolute level of coverage for the required minimum margin was a matter *'of concern'* and that, even with the sale of assets to Halifax (which had improved the Society's free assets), *'the position remains tight'*.

633 Those assessments took place in a context in which the Society's reported position made no allowance for liabilities arising from any mis-selling and in which credit had been taken of approximately £800 million for the financial reinsurance arrangement.

634 On 20 July 2001, the Society informed the FSA, as part of the scrutiny process on the 2000 returns, that:

... at the low point of the market at around lunchtime on 19 June 2001 when the FTSE 100 stood at 5320 it is likely that the cover ratio was about 1.0, i.e. just covering the required minimum margin. As discussed ..., further equity market falls could lead to the required minimum margin being breached.

Shortly thereafter, on 1 August 2001 the FSA noted that the FTSE index had stood at 5220 as at 25 July 2001.

635 Towards the end of July 2001, the Society was getting ready to pay the latest instalment of interest due on the subordinated loan capital it had issued. That instalment was at the time estimated to total approximately £30 million. The tight position that the Society was at that time in – even with no provision for mis-selling and having taken substantial credit for the financial reinsurance arrangement – gave rise to concerns that the Society might be unable to make this payment.

636 At a pre-meeting before the Tripartite Standing Committee meeting on 25 July 2001, the Chairman of the FSA reported that the Society had informed the FSA that it could make the payment but only if a waiver were obtained from the FSA in respect of the need to meet statutory solvency requirements.

637 Whether the Society could make that payment and remain solvent continued to be a matter of doubt. On 26 July 2001, after receiving information from the Society as to its financial position, the FSA recorded that:

On the basis of the 2000 regulatory returns, submitted at the end of June 2001, and reflecting the valuation as at end 2000 ... the payment could properly be made, as the [Required Minimum Margin] *would remain intact after the interest payment. But* [the Chief Executive] *implicitly recognised that in the Equitable's current circumstances, this test lacked some credibility. Therefore the directors were giving thought to whether it would be appropriate for them to make the interest payment if the company was insolvent in Companies Act terms. They might decide to do so, on the basis that a £28m payment was justifiable if it could sustain the Society through the period until an orderly administration could be arranged. But* [Equitable's Chief Executive] *recognised that this would be a brave decision.*

638 Further doubts were expressed as to the solvency of the Society. At the full meeting of the Tripartite Standing Committee, the FSA Chairman had informed the Committee that *'something between £3 and £5bn would make* [Equitable] *solvent'*.

639 On 1 August 2001, the FSA noted that *'the cover for the margin of solvency looks very thin at present, (after making a resilience provision but before allowing for potential mis-selling costs)'* – but also including a substantial offset for the financial reinsurance arrangement.

640 The FSA required the Society to commission an independent report into its financial condition. On 24 August 2001, a note was sent to the Chairman of the FSA, in which was recorded the outcome of discussions that the FSA had held with the Society after the receipt of a draft of the report. The note recorded that:

... a surplus of assets over liabilities [is reported]. *At one extreme, on the Insurance Companies Act basis, ... Equitable covered its required minimum margin by £758 million at the end of June 2001 (£1,025m at the end of July). At the other extreme, on the Insolvency Act basis, they report that Equitable had a surplus of £2,200m. These figures do not take into account any explicit liability for future discretionary bonuses or for compensation to non-GARs.*

Those figures were, moreover, produced on a basis that allowed the Society to take £664 million in credit for the financial reinsurance arrangement.

641 The FSA continued to discuss internally what the appropriate regulatory response to this ongoing situation should be. On 28 September 2001, the FSA met the Society and its auditors. The FSA's note of that meeting recorded that, although the Society had yet to apply for a section 68 Order and despite the estimates of the quantification of the potential mis-selling liability that Counsel for both the FSA and the Society had provided:

[Equitable's Appointed Actuary] *said that the Equitable continued to meet its required margin of solvency. The assumptions which he made in reaching this view were that the Equitable would be granted a Section 68 order to take credit for the changes to the valuation rate of interest being brought in at N2; that the resilience test would not impose any additional liability; that the provision for non-GAR mis-selling was £220 million; that only £100 million credit could be taken for the Reinsurance Treaty; that the GAR takeup rate was assumed to be 85% rather than 90% as at present; and no provision had been made for those leaving the fund. On this basis, there would be an excess of about £400 million over the RMM.*

642 On 8 October 2001, the FSA's Head of Life Insurance noted that it was not clear whether the Society was in breach of its required minimum margin. He continued:

> *On the other hand, there is sufficient doubt about the position to make the present* [public] *line* [taken by the FSA as to the solvency of the Society] *difficult to sustain. What is new is that we now have (confidential) information which throws doubt on the credit for £700 million claimed under the Reinsurance Treaty. We are not yet in a position to reach a view on this.*

643 Later that day, after doubts had been expressed within the FSA as to whether they had the power to intervene, one of the FSA's Chief Counsel stated that *'just to be clear, I think we do have the power now to require a plan ...* [as Equitable] *are almost certainly underprovisioning for both misselling and resilience'*.

644 On 9 October 2001, the FSA decided to take formal intervention action under the Insurance Companies Act 1982 by requiring the Society to submit a plan for the restoration of a sound financial position. The FSA's letter informing the Society of that decision said that the information provided by the Society had made it:

> *... clear that the Society faces considerable uncertainty as to its ability to cover its required margin of solvency. Indeed, it appears that on 24 September 2001, which is the date used for the presentation of the figures quoted in the letter, on the basis of the scenario in which credit for reinsurance would be restricted to £100 million and mis-selling liabilities of £220 million are assumed, the Society would only just be able to cover its solvency margin, but with no free assets. However, in this scenario, credit is assumed for a concession under section 68 of the Insurance Companies Act 1982 ("the 1982 Act") for a modification of regulation 69(5), for which an application has been made only today. At the same time no provision is made for a resilience reserve. On the basis of that scenario, and in the light of our present dialogue on reserving for mis-selling, the FSA believes that the Society must have been in breach of its solvency margin requirement on that day. While markets have improved slightly in the last week, the FSA can have no confidence that this unsatisfactory position does not continue.*

645 The Society responded to this requirement by referring to the Compromise Scheme proposals that it was developing, saying that this was the plan that was to be used to restore the Society to a sound financial position. As has been noted elsewhere, the FSA later published an assessment they had made of that Scheme – which is reproduced in Part 4 of this report.

646 Doubts continued within the FSA as to the solvency position of the Society. On 15 November 2001, the FSA's Director of Insurance sent the FSA's Chairman a draft letter for consideration. This was to be sent to the then Economic Secretary to the Treasury to provide advice about how the Treasury should handle an application by the Society for a section 68 Order.

647 The Director of Insurance explained that:

> *We believe the Society to be £200m below its* [solvency] *margin requirement. This is* [the] *latest estimate this morning ... It does <u>not</u> include allowance for the* [section 68] *order concession or for the reinsurance treaty beyond the £100m initial limit. The effect of the s68 order, if granted, would just about restore the Society's margin.*

The statutory and administrative background

648 The information which the prudential regulators could give to the public about the entities which they regulated was limited by the terms of the European Directives, implemented in the United Kingdom through the Insurance Companies Act 1982 and by subsequent amendments to that Act.

649 There is also no common law or statutory duty on public authorities, such as the prudential regulators of insurance companies, to give information or advice to the public.

650 However, the prudential regulators were under an obligation generally to act in accordance with established principles of good administration. As part of that obligation, where those regulators chose to give information to the public, they were required to provide information which was clear, accurate, complete and not misleading.

My assessment

651 Did the information that was before the FSA during the post-closure period provide a sound basis in fact for the information provided by the FSA that the Society did meet, and always had met, its solvency and other regulatory requirements?

652 There are two factors which suggest that the information provided by the FSA during the post-closure period relevant to this report was not soundly based and was thus potentially misleading.

653 The first is that the information provided to the FSA and GAD about the financial position of the Society showed that, objectively, the Society's solvency position was in real doubt. The second is that such doubts were held and expressed by the FSA internally on numerous occasions.

654 The Society provided estimates as to the quantification of the outstanding reserving issues to which I have referred above. The FSA also internally considered those issues. Taking all that into account, I have analysed, with the assistance of my actuarial advisers, what the estimated solvency position of the Society would have been, if all those issues had been reflected in the Society's estimate of its position in respect of each month, for which figures are available, between June 2000 and November 2001.

655 That analysis shows, first, that, on the basis of the monthly solvency reports it provided, the Society was, throughout the period covered by the analysis, solvent for regulatory purposes on the basis of the information it provided to GAD and the FSA.

656 However, that analysis also shows that, once adjustments are made to the reserving requirements reported by the Society to take into account the outstanding issues of which GAD and the FSA were aware, there arose considerable doubt as to the Society's cover for the required minimum margin of solvency.

657 In response to a draft of my report, the public bodies produced similar analysis, although based on different assumptions. While that analysis produced different results, it did not remove all doubt as to whether or not the Society was meeting its regulatory solvency requirements throughout the relevant time.

658 Neither the analysis that I have undertaken nor that carried out by the public bodies resolves the doubts that should have concerned the prudential regulators at the time both about the compliance by the Society with all its regulatory requirements and also as to whether the Society was solvent on a regulatory basis throughout the post-closure period.

659 Furthermore, I would note that no such analysis was undertaken at the time. Whatever detailed analysis would show now, the question before me

is what information was before the FSA at the relevant time, not what the 'true' position might now be found to be using a range of assumptions.

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

661 I recognise that the figures provided by the Society were estimated and had not been subject to audit. However, the provision of unqualified assurances by the FSA at that time was untenable, given the position disclosed by the Society to those regulators.

662 That there existed very real doubts as to the ability of the Society to meet the regulatory solvency requirements to which it was subject and/or that it might be insolvent for regulatory purposes is further demonstrated by the fact that, during the post-closure period, on a number of occasions GAD and/or the FSA recognised in internal discussions that the Society was either in breach of its regulatory solvency requirements or might have been in such breach.

663 Indeed, with respect to at least two significant issues – the failure by the Society to establish reserves for all the liabilities associated with those of its policies which contained guaranteed annuity rates and the use by the Society of a quasi-zillmer adjustment, which had the effect at the 1999 year end of reducing the amount of the Society's liabilities it determined by £950 million – the FSA had no doubt at the time that the Society had not always satisfied the requirements to which the FSA considered the Society was subject.

664 It is thus unclear how the FSA reasonably have concluded that the Society had not been in breach of its regulatory requirements.

665 The Compromise Scheme was the Society's means both of responding to the prudential regulators' requirement to restore a sound financial position and of restabilising its broader financial condition in the light of the events which had led to its closure to new business.

666 In addition to removing the guaranteed annuity rates from those policies which had contained those guarantees, the Society's proposals involved remaining policyholders giving up the right to pursue complaints or claims against the Society for alleged mis-selling or other matters.

667 While those policyholders were considering how to respond to the Society's compromise proposals, the information provided by the FSA to the Society's policyholders emphasised that care needed to be taken if a policyholder was considering transferring out of the Society and indicated what some of the potential ramifications of exit at that time would be.

668 However, the FSA did not provide similar information to those who were considering their options about the possible ramifications of remaining with the Society.

669 Policyholders looked and were entitled to look to the FSA to ascertain reliable information about the financial condition of the Society as part of the process of considering the available options. Given that the Society did not generally do business through independent financial advisers or other such intermediaries, the FSA was an important potential source of relevant advice.

670 I accept that there was no obligation on the FSA to provide information or advice to policyholders. However, having chosen to provide information, such information as the FSA provided had to be clear, accurate, complete and not misleading.

671 The FSA, acting reasonably, should have known that the Society had been and still might be in breach of its regulatory requirements. From the solvency figures presented by the Society to the FSA, and without taking into account any of the reserving issues about which the FSA was well aware and which GAD or the FSA had quantified, it appeared that the Society could barely cover its regulatory solvency margin. During the early part of 2001, the FSA also knew that the Society's basis for determining its solvency position was further open to doubt, given the position of the OFT regarding market value adjusted.

672 The FSA, acting reasonably, should also have known that, when regard was had to the evidence before the FSA as to the financial impact of a number of highly material reserving issues that had not been resolved, it was possible that the Society was insolvent for regulatory purposes.

673 Indeed, it was on this basis that the FSA took formal intervention action in October 2001 to seek to rectify that position by requiring the Society to produce a plan for the restoration of a sound financial position.

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

675 By the time that the FSA provided a form of words to the Society for use within the scheme documentation to be provided to policyholders considering how to vote on the compromise proposals, neither of those things was a matter about which the FSA could have been satisfied at the relevant time. Nor could the FSA have been satisfied as to these matters on 1 December 2001, when my jurisdiction came to an end.

676 My conclusion is that, by giving reassurance through the information provided by the FSA that the Society was meeting its regulatory solvency and other requirements, when that was not something about which the FSA at that time could reasonably have been satisfied, the FSA failed to act in accordance with the standards reasonably to be expected of such regulators.

Submissions I have received and my evaluation of those submissions

Submissions by the public bodies

677 When I informed the public bodies that I was minded to come to this view, those bodies told me that, in their view, the information provided to policyholders in the period after Equitable's closure to new business had been accurate and not in any way misleading.

678 Those bodies said that it had been reasonable for the FSA to have taken the view that Equitable had been solvent at all times, and meeting the regulatory solvency margin requirements up to October 2001.

679 The public bodies told me that this had been the FSA's considered view, although part of its task was also to question and communicate the possible impact of various uncertainties on the position. The FSA's public statements about solvency, those bodies said, had properly and appropriately reflected this approach.

680 In support of that view, the public bodies submitted that:

> *The FSA's public statements about solvency were carefully considered, regularly reviewed, soundly based, and consistent with the considered view of the FSA, as determined by internal experts and supported by advice from third party experts.*
>
> *It is wrong to say that the FSA's statements about Equitable's solvency and wider regulatory position had no sound basis in fact, or that the FSA ... "should have known" this to be the case. The FSA believed that Equitable was and remained solvent at all material times, and compliant with the regulatory solvency margin requirements up to October 2001, and it was entirely reasonable for it to have taken this position.*

681 The public bodies told me that the basis on which the FSA had reached that position had been informed by the facts that:

- *The Appointed Actuary reported that Equitable was meeting all of its regulatory requirements at all times.*
- *The FSA made its own judgements about Equitable's solvency and reasonably concluded that Equitable was solvent at all times, and did not breach the solvency margin requirements until October 2001.*
- *The FSA required Equitable to commission an independent review of its position in July-August 2001, and this confirmed the view which both Equitable and the FSA held at the time, that Equitable was meeting all its regulatory requirements.*

682 The public bodies told me that the views expressed within the FSA about the solvency position of the Society, which I have cited above, do not support my conclusion that the FSA had known that the Society's solvency position was questionable. The public bodies said that those views:

> *... cover a period from 9 July 2001 to November 2001. They show that throughout the period, uncertainties were expressed about the impact of non-GAR mis-selling liabilities and other factors on Equitable's solvency position.*
>
> *The comments are examples of the kinds of internal questioning and probing which was an integral part of the prudential regulator's considerations at that stage. The interim views were often differing or conflicting ... but in the end a considered and agreed view was taken by the FSA and no weight can properly be attached to the interim views of individuals.*

683 I was told that *'alongside this continual questioning of the position, there were at least three occasions during this period when the FSA took additional steps to satisfy itself as to Equitable's solvency'*. Those three occasions were:

- the meeting with Equitable on 29 July 2001, at which, the public bodies told me, *'Equitable (with its auditors, solicitors and Counsel) satisfied the FSA that it was solvent on all three bases and would have "no difficulty in making the payment on the subordinated loan"'*;
- the commissioning in July 2001 of an independent report on the financial condition of the Society, the results of which, the public bodies told me, *'confirmed that Equitable was solvent on all three bases, and had sufficient surplus assets to absorb the estimates of mis selling compensation calculated (even on a worst case basis) at the time'*; and

- the prompt action taken in October 2001 to require the Society to produce a plan for the restoration of a sound financial position once *'the FSA's analysis indicated that Equitable had breached the regulatory solvency margin requirements'*.

684 The public bodies submitted that:

> *It was these carefully considered views of Equitable's solvency position, rather than the points raised in the interim questioning and debate, which were – rightly – used to inform FSA's external communications ...*
>
> *Having taken the reasonable decision to communicate with the public, the FSA gave careful and continuous consideration to the content of its statements. Great care was taken to ensure that the language was clear, accurate, up to date and balanced and there were rigid processes in place (including involving technical and legal experts) to ensure that all public statements reflected the FSA's most up-to-date analysis. Rigorous procedures were also put in place to ensure that the agreed text was used consistently across all communications (letters to policyholders, letters to MPs, the FSA website and press enquiries).*

685 The public bodies continued:

> *Although the public statements always reflected the FSA's considered view that Equitable remained solvent, no reader of the FSA's public communications could fairly have concluded that they provided "unqualified assurances" about Equitable's prospects. In the period between the House of Lords' judgment and closure to new business, letters sent by the FSA commonly referred to Equitable's financial position being "significantly weakened" or that the House of Lords' judgment had "significant financial implications/impact". Later correspondence from the FSA stated that Equitable's "difficulties significantly increased" after the judgment, and from August 2001 there were statements that its "problems stemmed from uncertainties around GARs". Furthermore, the FSA's communications repeatedly referred to the "fundamental uncertainties" in the way that Equitable's financial situation might develop. The FSA also reminded policyholders that it could not give advice. A common statement was that "we would recommend that you do not make any hasty decisions and seek financial advice before taking any action".*

My evaluation of those submissions

686 I was not persuaded by the submissions of the public bodies on this matter. There can be no question but that the solvency position of the Society was a matter of great uncertainty throughout the post-closure period covered by this report. That is evident from the information before the FSA at the time and from the views expressed by them internally.

687 I accept that many of the opinions expressed within the FSA as to the real doubts surrounding the Society's solvency position were not concluded views but part of an ongoing process of supervision.

688 However, I do not accept, for example, that the reported view of the then FSA Chairman given to a Tripartite Standing Committee meeting can reasonably be seen as *'internal questioning and probing'* or *'interim questioning and debate'*.

689 Nor do I accept that the commissioning in July 2001 of a report into the financial condition of the Society, from the company for whom the Society's Appointed Actuary was a consultant, reflects

assurance on the part of the FSA that the Society was, in regulatory terms, fully meeting its solvency margin requirements. The commissioning of such a report instead underlined the doubts that existed at that time.

690 I also do not accept the notion that, after October 2001, the information given by the FSA was consistently changed to reflect the exercise of intervention powers on the basis that the Society was in breach of its regulatory solvency margin.

691 For example, as can be seen from the relevant entry in Part 3 of this report, on 26 November 2001 the FSA issued a press statement about the disclosure of the existence of the reinsurance 'side-letter'. After dealing with the implications of that letter, as the FSA saw those implications, that press statement stated that *'on the basis of the information received by the FSA, Equitable Life continues to meet its regulatory solvency requirements even taking account of the lower credit for the revised reinsurance policy'*.

692 In any case, the submissions of the public bodies on these questions appear to me to miss the point. If a public body is giving clear assurances about something, the onus is on them to have established that those assurances have a sound basis in fact before giving such assurances.

693 It is not the case, in terms of established principles of good administration, that such a body can proceed to give such assurances and continue to do so, while internal discussion and debate as to the real position continues, until the view underpinning those assurances is disproved. The very fact that many of the people directly involved in the supervision of the Society were expressing real and, sometimes, grave doubts as to the true position should in itself have led to no such assurances being given.

694 The submissions of the public bodies also address views which I have not expressed. I do not suggest that a reader of the FSA's information *'could fairly have concluded that they provided "unqualified assurances" about Equitable's prospects'*.

695 What I have concluded is that the information provided by the FSA promoted the assurance that the Society was, and had always been, solvent for regulatory purposes and that it was meeting, and had always met, the regulatory requirements imposed on it.

696 That the future of the Society was subject to uncertainty is a matter of common ground. Indeed, it was that very uncertainty which prompted many people to contact the FSA for information in the first place.

697 I conclude that the information provided by the FSA was misleading and fell short of what it would be reasonable to expect them to have provided.

My finding

698 **I find that the misleading information, about the Society's solvency position and its record of compliance with other regulatory requirements, that was produced by the FSA, acting on behalf of the prudential regulators, during the period after the Society closed to new business fell short of the standard that could reasonably be expected of such regulators.**

Conclusion

699 In this Chapter, I have set out the results of my review of the evidence I have obtained and made findings of fact concerning the subject matter of the complaints which were contained within the terms of reference for the investigation which led to this report.

700 In Chapter 11 of this report, I set out my conclusions as to whether those facts disclose that maladministration has occurred.

Chapter 11 – Determinations: Maladministration?

Introduction

1 In this Chapter, I set out my determinations as to whether the acts and omissions of the prudential regulators and/or GAD constitute maladministration. Those determinations are made in relation to the findings of fact that I have set out in Chapter 10 of this report.

My approach

2 In Chapter 5 of this report, I set out the approach that I adopt when making such determinations. First, I establish the facts and the overall standard which applies to the events which form the basis of the complaints made to me. I then assess the facts against that overall standard.

3 In particular, I assess whether or not an act or omission on the part of the body complained about (in this case the prudential regulators and/or GAD) constituted a departure from the applicable standard. If so, I then assess whether that act or omission was so unreasonable in the particular circumstances, when regard is had to the specific legal or administrative context of the case, as to constitute maladministration; and/or whether any such act or omission otherwise fell so far short of acceptable standards of good administration as to constitute maladministration.

4 Central to this approach is the identification of all the general and specific legal and administrative obligations which I consider that the prudential regulators and/or GAD had at the relevant time; and my consideration of the manner in which those regulators and/or GAD discharged those obligations.

5 Chapter 5, supported by the relevant detail in Part 2 of this report, provided the overview of all those obligations; and went on to identify the key obligations that the prudential regulators and/or GAD had at the relevant time. In this Chapter, I consider the manner in which the prudential regulators and/or GAD discharged those obligations.

6 For ease of reference, the key obligations of the prudential regulators and/or GAD are reproduced below.

Summary of the key obligations of the prudential regulators and/or GAD which are relevant to this investigation

7 The key legal and administrative obligations that the prudential regulators and/or GAD had at the relevant time were as follows:

(i) The prudential regulators were under a specific statutory duty, imposed by the 1982 Act and the Regulations made under that Act, to ensure that the regulatory returns were complete and accurate (in the sense of them being compliant with the applicable Regulations).

In complying with this duty, I would expect the prudential regulators (acting with the advice and assistance of GAD) to have considered the regulatory returns submitted by insurance companies and, if those returns appeared to be inaccurate or incomplete in any respect, to have communicated with the company with a view to the correction of any such inaccuracies and the supply of deficiencies.

(ii) The prudential regulators were under a specific statutory duty, imposed by the 1982 Act and the Regulations made under that Act, to ensure that an insurance company valued its assets and determined its liabilities in accordance with the requirements that were imposed on it by the applicable Regulations.

In complying with this duty, I would expect the prudential regulators (acting with the advice and assistance of GAD) to have considered whether the way in which an insurance company valued its assets and determined its liabilities that was set out within the regulatory returns had been undertaken in accordance with the requirements of the 1982 Act and the Regulations made under that Act and, if it appeared that the company had used a valuation basis that was not compliant with these requirements, to have considered whether to take action to remedy the position.

(iii) The prudential regulators were under a general public law duty to give proper consideration to the use of their powers of intervention where the circumstances had or may have arisen which gave grounds for the use of such powers.

In complying with this duty, I would expect the prudential regulators (acting with the advice and assistance of GAD) to have considered the use of their powers in the light of any information that they possessed – whether from the content of the regulatory returns, from contact with an insurance company, or from other sources – which gave rise to questions about the solvency position of that company, or about whether it was acting in line with the interests of its policyholders or in accordance with the reasonable expectations of those policyholders, or potential policyholders, or about whether it was acting soundly or prudently.

(iv) The prudential regulators were under a general public law duty to exercise their statutory powers in a right and proper way, in accordance with the presumed intention of the legislature which conferred those powers, in good faith, reasonably, for a proper purpose, and with procedural propriety.

In complying with this duty, I would expect the prudential regulators (acting with the advice and assistance of GAD) to have dealt appropriately with any regulatory issues which arose in relation to any insurance company other than through the scrutiny process and to have acted in such a manner as to ensure the effective operation of the regulatory regime as Parliament had established it – informed as that regime was by the concepts of 'freedom with publicity', the protection of the reasonable expectations of policyholders and potential policyholders, and the fulfilment of the criteria of sound and prudent management.

(v) Both the prudential regulators and GAD were under an obligation generally to act in accordance with established principles of good administration.

In complying with this obligation, I would expect the prudential regulators and/or GAD:

- to have acted in accordance with their general and specific legal duties and powers;
- to have acted in accordance with their own published and internal policy and guidance;

- to have taken proper account of established good practice, including professional practice;
- to have taken reasonable decisions based on all relevant considerations, ignored irrelevant ones and balanced those considerations appropriately;
- to have kept proper and appropriate records as evidence of their activities, including a record of the reasons for their decisions; and
- to have provided information, where it was appropriate to do so, which was clear, accurate, complete and not misleading.

The way in which the prudential regulation of the Society was undertaken

8 In Chapter 6 of this report, I explained that the way in which the prudential regulation of a life insurance company was undertaken, including the degree of intensity of the scrutiny given to such a company's affairs, reflected the circumstances of that company as those circumstances were known to the prudential regulators and/or GAD at the relevant time.

9 I also explained that the prudential regulation of the Society during the period covered by this report can be separated into three periods – the first being the period prior to 20 June 1998, the second being the period from 20 June 1998 to the closure of the Society to new business on 8 December 2000, and the third being the period from that closure until 1 December 2001, when my jurisdiction over the relevant events ended. Those events are covered, respectively, in Chapters 6, 7 and 8 of this report.

My findings of fact

10 In Chapter 10 of this report, I made ten findings of fact which indicate that certain complaints within the terms of reference for this investigation have a sound basis in fact and which are thus potentially capable of leading to a determination that maladministration occurred.

11 Those findings related to:

- the failure by the DTI, as prudential regulators, (i) to insist, when approving the appointment in June 1991 of a new Chief Executive, that he should demit office as the Society's Appointed Actuary, and (ii) during the period from 1 July 1991 to 31 July 1997, when one person held the position of the Society's Chief Executive simultaneously with the position of its Appointed Actuary, to consider the use of their powers to seek to remove that person from such a 'dual role' (paragraphs 40 to 131 of Chapter 10);
- the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1990 to 1993, related to (i) the valuation rate of interest used to discount the Society's liabilities and (ii) to the affordability and sustainability of the Society's bonus declarations (paragraphs 132 to 202 of Chapter 10);
- the failure by GAD, when the introduction of the Society's differential terminal bonus policy, intimated within the Society's 1993 returns, was identified by GAD as part of their scrutiny of those returns, (i) to inform the prudential regulators about the policy, (ii) to raise the matter with the Society, or (iii) to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders (paragraphs 203 to297 of Chapter 10);

- the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1994 to 1996, related to (i) the valuation rate of interest, (ii) the affordability and sustainability of bonus declarations, (iii) apparently arbitrary changes to the assumed retirement ages, and (iv) the holding of no explicit reserves for the liabilities associated with prospective liabilities for capital gains tax, for pensions mis-selling costs, and for guaranteed annuity rates (paragraphs 298 to 343 of Chapter 10);

- the failure by GAD (i) to ask for the information GAD needed in respect of the Society's 1995 returns to enable them, as part of the scrutiny process, to be sure that the Society had produced a valuation that was at least as strong as the minimum required by the applicable Regulations, and (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society (paragraphs 344 to 396 of Chapter 10);

- the failure by the FSA, acting on behalf of the prudential regulators, (i) to ensure that the financial reinsurance arrangement was not taken into account within the Society's 1998 returns without an appropriate concession being given, and (ii) to ensure that the credit taken by the Society within its returns for 1998, 1999, and 2000 properly reflected the economic substance of that arrangement (paragraphs 397 to 486 of Chapter 10);

- the failure of the FSA, acting on behalf of the prudential regulators, to pursue the issue of the proper disclosure, within the Society's regulatory returns for 1998 and 1999, of the potential impact on the Society of it losing the *Hyman* litigation (paragraphs 487 to 522 of Chapter 10);

- the failure by the FSA, acting on behalf of the prudential regulators, to record their decision to permit the Society to remain open to new business, following its loss of the *Hyman* litigation (paragraphs 523 to 613 of Chapter 10);

- the unsound basis on which the decision was taken by the FSA, acting on behalf of the prudential regulators, to permit the Society to remain open to new business, following its loss of the *Hyman* litigation (paragraphs 523 to 614 of Chapter 10); and

- the misleading information, about the Society's solvency position and its record of compliance with other regulatory requirements, that was produced by the FSA, acting on behalf of the prudential regulators, during the period after the Society closed to new business (paragraphs 615 to 698 of Chapter 10).

My determinations

The 'dual role'

12 I turn first to the way in which the DTI, as prudential regulators, handled the 'dual role' – that is, the holding by one person for more than six years, from 1 July 1991 to 31 July 1997, of the position of the Society's Chief Executive simultaneously with the position of its Appointed Actuary.

13 The role of Appointed Actuary was one cornerstone of the system of prudential regulation in the United Kingdom. An Appointed Actuary needed to ensure that he or she had sufficient independence from the executive management of a life insurance company to enable him or her to undertake effectively the responsibilities (to the

company, to its policyholders, and to the prudential regulators and GAD) that were conferred on the Appointed Actuary and to enable him or her to do so in line with the intention of Parliament when it had created the role in 1973.

14 A position in which an Appointed Actuary was unable to secure or retain the necessary degree of operational independence would therefore go to the heart of the prudential regulation of a life insurance company and would raise serious questions about the ability of the Appointed Actuary in such circumstances to perform the regulatory functions conferred on him or her.

15 The prudential regulators were under a general public law duty to give proper consideration to the use of their powers of intervention where the circumstances had or may have arisen which gave grounds for the use of such powers.

16 Those regulators were under a further general public law duty to discharge their statutory functions as prudential regulators reasonably and in line with the intention of Parliament.

17 The prudential regulators were also under an obligation generally to act in accordance with the established principle of good administration that their decisions should be taken reasonably, based on all relevant considerations.

18 I have found that the prudential regulators did not consider the use of any of their powers in relation to the continuing position in which the posts of Appointed Actuary and Chief Executive of the Society were held by the same person. That constitutes a departure from the applicable standard.

19 Did this failure to consider the range of powers that was open to the prudential regulators, when faced with this position, constitute an unreasonable departure from the applicable standard?

20 My consideration of this question turns on whether the prudential regulators took their decisions – not at first to object to the appointment of the Appointed Actuary as Chief Executive (an appointment that required regulatory approval) nor later to intervene to ensure that the posts were held by different persons – having properly understood the range of legal powers (and other means) that were available to them and having then considered the issue on a proper legal and factual basis.

21 I have found, in Chapter 10 of this report, that there were a number of powers that Parliament had granted to the prudential regulators which could have been used in situations such as this, where those regulators recognised at the time that what they described as a *'conflict of interest'* existed and would be perpetuated by allowing that situation to continue. I have also found that the use of those powers was not considered by the prudential regulators at the relevant time.

22 I consider that the decision by the prudential regulators not to object to the appointment of the continuing Appointed Actuary to the additional post of Chief Executive was not taken on a proper and balanced basis, as relevant considerations were left out of account in the decision-making process.

23 The prudential regulators also directed themselves to the wrong question – whether they had power to object to the incumbent remaining as Appointed Actuary – rather than the real questions before them. Those questions were, first, whether they had power to object to him being appointed as Chief Executive of the Society and, secondly,

whether, if so, it would be appropriate in the circumstances to exercise any such powers.

24 After his appointment, no consideration was given to the use of the powers that those regulators possessed to remove an incumbent Chief Executive or to seek through non-statutory action to persuade him to demit office as Appointed Actuary.

25 Those were significant failures. The prudential regulators failed at any time between 1991 and 1997 to consider the use of any of their powers of intervention and to take into account all relevant considerations when taking their decision not to object to the holding by one person of both the posts of Appointed Actuary and Chief Executive to the Society.

26 Given the importance of the role of the Appointed Actuary within the system of prudential regulation and the need for such Actuaries to be able to operate with sufficient independence from the executive management of life insurance companies, I consider that this constituted a departure from the applicable standard that was both unreasonable in the circumstances and fell far short of acceptable standards of good administration.

27 **I find that the failure by the DTI, as prudential regulators, (i) to insist, when approving the appointment in June 1991 of a new Chief Executive, that he should demit office as the Society's Appointed Actuary, and (ii) during the period from 1 July 1991 to 31 July 1997, when one person held the position of the Society's Chief Executive simultaneously with the position of its Appointed Actuary, to consider the use of their powers to seek to remove that person from such a 'dual role' constitutes maladministration. I therefore make such a finding of maladministration against the DTI.**

The scrutiny of the Society's returns for 1990 to 1993

28 I now turn to consider the scrutiny of the Society's regulatory returns, which was undertaken by GAD on behalf of the prudential regulators, for each year from 1990 to 1993.

29 Section 18(4) of the 1982 Act provided that, for the purposes of the investigation that the Appointed Actuary undertook into the financial condition of the company and reported in the returns, the value of any assets and the amount of any liabilities set out therein were required to be determined in accordance with the applicable valuation Regulations. Those Regulations were set out in Parts V and VI of the Insurance Companies Regulations 1981.

30 Regulation 54 of the 1981 Regulations provided that the determination of the amount of long term liabilities was required to be made on actuarial principles, making proper provision for all liabilities on prudent assumptions with regard to the relevant factors.

31 Section 37 of the 1982 Act gave the prudential regulators the power to intervene in the affairs of an insurance company, if they considered that such a company might not have been acting in such a manner as to fulfil the reasonable expectations of its policyholders.

32 I have found that GAD, in providing advice to the prudential regulators, failed to satisfy themselves that the way in which the Society had determined its liabilities and had demonstrated that it had sufficient assets to cover those liabilities accorded with the requirements of the applicable Regulations. Accordingly, those regulators were unable to verify the solvency position of the Society as they were under a duty to do.

33 I have found, specifically, that GAD failed to question the Society about issues which arose in its returns for 1990 to 1993 in respect of:

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

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

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

35 Both issues – whether the Society was discounting its liabilities in an impermissible way and whether the level of bonus that it was declaring was affordable and could be sustained – went to the heart of the interests of with-profits policyholders and of the Society's ability to fulfil their reasonable expectations.

36 The prudential regulators were under a general public law duty to give proper consideration to the use of their powers of intervention where the circumstances had or may have arisen which gave grounds for the use of such powers.

37 In complying with this duty, I would expect the prudential regulators (acting with the advice and assistance of GAD) to have considered the use of their powers in the light of any information that they possessed – whether from the content of the regulatory returns, from contact with an insurance company, or from other sources – which gave rise to questions about the solvency position of that company, or about whether it was acting in line with the interests of its policyholders or in accordance with the reasonable expectations of those policyholders, or potential policyholders, or about whether it was acting soundly or prudently.

38 While I accept that the information before GAD raised questions rather than gave clear evidence of any imprudence on the part of the Society, I consider that GAD were required to satisfy themselves, once those questions arose, as to the true position, as part of the advice they gave to the prudential regulators in order to enable them to verify the financial position of the Society and to ensure that it was acting in conformity with the obligations to which the Society was subject.

39 The failure to do so constitutes a departure from the applicable standard that was unreasonable in the circumstances.

40 **I find that the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1990 to 1993, related to (i) the valuation rate of interest used to discount the Society's liabilities and (ii) to the affordability and sustainability of the Society's bonus declarations, constitutes maladministration. I therefore make such a finding of maladministration against GAD.**

The intimation of the differential terminal bonus policy

41 I now turn to consider the way in which GAD, as part of their scrutiny on behalf of the prudential regulators of the Society's 1993 returns, handled the intimation within those returns of the introduction by the Society of what came to be known as its differential terminal bonus policy.

42 Section 37 of the 1982 Act gave the prudential regulators the power to intervene in the affairs of an insurance company if they considered that that company might not have been acting in such a manner as to fulfil the reasonable expectations of its policyholders.

43 With effect from 1 July 1994, those regulators also had the power to intervene if they considered that a company was not acting in accordance with the criteria of sound and prudent management, pursuant to which an insurance company was not to be considered as acting in such a manner if it did not have due regard to the interests of its policyholders.

44 The prudential regulators were under a general public law duty to give proper consideration to the use of their powers of intervention where the circumstances had or might have arisen which gave grounds for the use of such powers. Those regulators were under a further general public law duty to discharge their statutory functions as prudential regulators reasonably and in line with the intention of Parliament.

45 In order to comply with those duties, I would expect the prudential regulators, acting with the advice and assistance of GAD, to have considered whether the information before them gave rise to the need to exercise any of their powers. I have found that GAD identified the introduction of this new policy but did not pursue and resolve the questions that such an introduction raised. GAD also failed to inform the DTI of this development.

46 Did the failure of GAD to raise the issue within their detailed scrutiny report on the Society's 1993 returns to the prudential regulators or to raise the issue with the Society in correspondence on those returns constitute an unreasonable departure from the applicable standard?

47 I consider that the failure to alert the DTI to this development constituted such a departure from the applicable standard.

48 When considering whether that departure was unreasonable, it must be remembered that, on 20 July 1993, GAD and the prudential regulators had received the Society's response to the industry-wide bonus survey. That response did not mention the differential terminal bonus policy but had explained that the Society aimed to achieve a reasonable degree of stability in proceeds. With their response, Equitable had also provided a copy of its With-Profits Guide and its bonus leaflets. The Society had also sent GAD an updated copy of their guide on 24 May 1994.

49 The Society's 1993 returns had disclosed the differential terminal bonus policy which the Society had introduced abruptly. That policy, as GAD noted, was new and would have the effect of reducing the terminal bonus payable to certain policyholders. Yet GAD failed to enquire as to what the new bonus policy was, whether it was being properly described in the Society's publications, and what the rationale was for this change of a central policy in the operation of any life insurance company.

50 That failure occurred despite the recognition by GAD and the prudential regulators, when they were conducting the bonus survey only weeks before this disclosure, that the nature of bonus policies went to the heart of the reasonable expectations which policyholders would have.

51 That failure also occurred despite the fact that GAD had received a copy of the Society's May 1994 With-Profits Guide, published five months after the valuation date to which the Society's 1993 returns related, in which no disclosure of the new differential terminal bonus policy had been made.

52 In a context in which such a central policy was changed in a direction which had the effect of reducing the proceeds that some of the Society's policyholders would receive and where, on the information before GAD at the time, it appeared that no disclosure to policyholders of this change in policy was being effected, I find it surprising that GAD did not ask as part of the detailed scrutiny process for an explanation of the new system and for more details about its rationale. I find it even more surprising that GAD did not inform the DTI that all this had occurred.

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

54 **I consider that the failure by GAD, when the introduction of the Society's differential terminal bonus policy, intimated within the Society's 1993 returns, was identified by GAD as part of their scrutiny of those returns, (i) to inform the prudential regulators about the policy, (ii) to raise the matter with the Society, or (iii) to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders, constitutes a departure from the applicable standard that was both unreasonable in the circumstances and was far short of acceptable standards of good administration.**

55 **I consider that this constitutes maladministration and I therefore make such a finding of maladministration against GAD in relation to this aspect of their scrutiny of the Society's 1993 returns.**

The scrutiny of the Society's returns for 1994 to 1996

56 I now turn to consider the scrutiny of the Society's regulatory returns, which was undertaken by GAD on behalf of the prudential regulators, for each year from 1994 to 1996.

57 Similar issues arise here as did with my finding regarding the scrutiny of the returns for earlier years. However, the issues which had been raised in those returns remained and new issues had developed. Those new issues included the holding of no reserves in respect of guaranteed annuity rates, which GAD by then if they had acted earlier without maladministration, would have known were biting and should thus have been provided for by the Society.

58 I have found that GAD failed to identify and to raise these issues. GAD was required to satisfy themselves, once those questions arose, as to the true position, as part of the advice they gave to the prudential regulators in order to enable them to verify the financial position of the Society and to ensure that it was acting in conformity with the obligations to which it was subject.

59 Given the similar context, for the same reasons I have given in relation to the scrutiny of the Society's returns for 1990 to 1993, I consider that the failure to do so constitutes a departure from the applicable standard that was unreasonable in the circumstances.

60 **I find that the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1994 to 1996 – related to (i) the valuation rate of interest, (ii) the affordability and sustainability of bonus declarations, (iii) apparently arbitrary changes to the assumed retirement ages, and (iv) the holding of no explicit reserves for the liabilities associated with**

prospective liabilities for capital gains tax, for pensions mis-selling costs, and for guaranteed annuity rates – constitutes maladministration. I therefore make such a finding of maladministration against GAD.

The presentation of the Society's two valuations

61 I turn now to consider the way in which GAD, as part of their scrutiny on behalf of the prudential regulators of the Society's returns for 1990 to 1996, handled issues arising from the presentation by the Society within those returns of two separate valuation results.

62 The Society produced two valuations – in this report, I have called those the main valuation and the appendix valuation. The appendix valuation was provided to demonstrate that the main valuation that the Society chose to use in those returns had produced a valuation which was at least as strong as the minimum required by the applicable Regulations.

63 Those scrutinising the Society's returns needed to know the amount of the resilience reserves applicable to the appendix valuation, in order to be able to compare the strength of the alternative valuation that the Society used against the minimum prescribed by the Regulations. In respect of the Society's 1995 returns, however, GAD did not ask for this figure nor did the Society provide it.

64 Was this an unreasonable departure from the applicable standard? I would first note that the relevant regulatory regime was in part predicated on the concept of 'freedom with publicity'.

65 While, in my view, the Society was not in breach of the disclosure requirements imposed on it by the applicable Regulations, I consider that the way in which the Society presented its two valuations was capable of misleading users of the Society's returns.

66 Indeed, I note that, in their scrutiny report to the DTI on the Society's 1992 returns, GAD initially informed the prudential regulators that the Society's cover for the required minimum solvency margin was significantly higher under the appendix valuation method than under the main valuation. That was not the case. GAD rectified that advice, after they had communicated with the Society and had been provided by the Society with the figure for the required resilience reserve.

67 I have also accepted, with more hesitation, that the 'demonstration', which insurance companies were required to provide to satisfy the prudential regulators that they had used an alternative valuation method that was at least as strong as the prescribed minimum, did not have to be undertaken within the regulatory returns. That GAD permitted the provision of the omitted information by the Society only to GAD is, on balance, something that I do not criticise.

68 The prudential regulators possessed powers of intervention, which were exercisable on the grounds that an insurance company had not satisfied an obligation to which it was subject under the Insurance Companies Act 1982.

69 Section 18(4) of the 1982 Act required Appointed Actuaries, when investigating and reporting on the financial condition of the company, to value any assets and to determine the amount of any liabilities in accordance with the provisions of the valuation Regulations.

70 The prudential regulators were under a general public law duty to give proper consideration to the use of their powers of intervention where the circumstances had or might have arisen which gave

grounds for the use of such powers. In complying with this duty, I would expect the prudential regulators (acting with the advice and assistance of GAD) to have considered the use of their powers in the light of any information that they possessed.

71 As part of their scrutiny of the Society's 1995 returns, GAD were required to verify that the Society had complied with the regulatory requirements to which it was subject. As part of that verification, GAD needed to satisfy themselves that the Society's alternative valuation complied with the applicable Regulations, by producing a result that was at least as strong as the minimum required by the applicable Regulations.

72 By not asking the Society to provide the omitted information in respect of the 1995 returns, GAD disabled themselves from the carrying out of the verification that they were under an obligation to undertake as part of the provision of assistance and advice to the prudential regulators. That constitutes a departure from the applicable standard.

73 The verification of the financial position of an insurance company was the central duty imposed on the prudential regulators. At the relevant time, GAD had expressed some concern that particular vigilance had to be exercised, given the relative weakness of the Society's solvency position and given the method it adopted of presenting two valuations which, in reality, produced an almost identical result.

74 In those circumstances, I consider that the failure of GAD to seek the information it needed to verify the Society's solvency constituted an unreasonable departure from the applicable standard.

75 Moreover, GAD at the time had access to the ratings provided in respect of the Society by Standard & Poor's, which had demonstrated that even an expert third-party rating agency could be misled by the Society's practice in this respect.

76 Those ratings confirmed not only that the users of the regulatory returns might be misled by the Society's presentation but also that they had been misled.

77 I consider that, as this was so, GAD should have brought that to the attention of the prudential regulators. If a major ratings agency had been misled by the way in which the Society had presented the information in its returns, the question arose as to what individual policyholders would do as a result. Effecting industry comparisons was said to be one of the purposes of the publication of the regulatory returns. That regulatory returns would be used for this purpose was thus well known to GAD.

78 Yet GAD did not raise the fact that the reader of the Society's returns had been misled with the prudential regulators nor did it discuss that matter with the Society or take any other action.

79 In a regime which was predicated on the doctrine of 'freedom with publicity' and in a situation in which GAD should have known that the way in which Equitable were presenting their returns was capable of misleading a reader of those returns (and did know that at least one rating agency, whose work GAD knew would have been well publicised and which was used by the prudential regulators to brief Ministers, had indeed been misled), the failure of GAD to seek to persuade the Society to provide this information within its returns (or to recommend that the prudential regulators considered taking action to secure that it was so provided) is inexplicable.

80 That is all the more so when account is taken of the fact that GAD at the time knew that the absence of this information accounted for almost all of the difference between the results of the main and appendix valuations that the Society produced. As GAD now knew, that difference was seen by commentators as comforting given the weak position (based on its main valuation) that the Society reported in its returns.

81 The true financial position of the Society was a central consideration in any assessment of its viability as a potential investment vehicle. Those making such an assessment using the information disclosed within the returns were entitled, in my view, to rely on the role of the prudential regulators and GAD to ensure that the information published in those returns was not misleading.

82 The failure by GAD to ensure that this was the case was unacceptable and constituted a departure from the applicable standard that was unreasonable in the circumstances. There were clearly alternative courses of action open to GAD which it would have been proportionate for them to have taken in respect of information that could mislead the reader of the returns as to the actual financial position of the Society, as compared to the statutory minimum requirements.

83 Such potentially misleading information should have been of fundamental concern to any prudential regulator, acting reasonably. The failure by GAD to ensure that misleading information was not disseminated through the Society's returns thus also falls far short of acceptable standards of good administration.

84 **I consider that the failure by GAD (i) to ask for the information GAD needed in respect of the Society's 1995 returns to enable them, as part of the scrutiny process, to be sure that the Society had produced a valuation that was at least as strong as the minimum required by the applicable Regulations, and (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society, constitutes maladministration. I accordingly make such a finding of maladministration against GAD in these respects.**

Financial reinsurance

85 I now turn to the way in which the FSA, acting on behalf of the prudential regulators, handled issues arising from a financial reinsurance arrangement into which the Society had entered.

86 Section 37 of the 1982 Act gave the prudential regulators powers of intervention where they considered that an insurance company had failed to satisfy an obligation to which it was subject by virtue of that Act or where those regulators were not satisfied that adequate arrangements were in force or would be made for the reinsurance of risks against which persons were insured by the company.

87 I have found that the FSA permitted the Society to take credit for that arrangement within its returns for 1998, 1999, and 2000 when no such credit should have been taken.

88 The FSA were under a general public law duty to give proper consideration to the use of their powers of intervention where circumstances had or may have arisen which gave grounds for the use of such powers. The FSA were under a further general public law duty to discharge their statutory functions reasonably and in line with the intention of Parliament.

89 In order to comply with those duties, I would expect the FSA, acting with the advice and assistance of GAD, to have considered the use of their powers and to have acted appropriately and in line with the intention of Parliament to ensure the effective operation of the system of prudential regulation that Parliament had established.

90 In my view, there can be no doubt that the actions of the FSA in permitting the Society to take credit for the financial reinsurance arrangement constituted a departure from the applicable standard.

91 In determining whether those actions of the FSA constitute an unreasonable departure from the applicable standard, I consider that the significance of the financial reinsurance arrangement to the reported financial condition of the Society at the relevant time is central to my assessment of this question.

92 Without the offset that the Society was permitted by the FSA to take for the arrangement within its 1998 returns, it is unlikely that the Society would have been permitted to declare a bonus in March 1999. That was certainly the view of the prudential regulators at the time.

93 The Society's reported solvency position without the offset that was taken which – due to the early submission of its returns at the instigation of the prudential regulators – would have been published by 1 May 1999 would have made public the very serious financial position that Equitable was in.

94 The actions of the FSA – in insisting on the early submission of the Society's returns and in indicating that intervention was likely to prevent the declaration of a bonus which the Society could not afford if it did not find some way of improving its financial position – were entirely proper regulatory responses to a very serious situation.

95 However, I find it inexplicable that the FSA allowed the Society to take credit for an arrangement that was not in place at the valuation date for the 1998 returns (nor at the date when those returns were submitted) without granting a reporting concession to enable this to be done in accordance with the statutory framework that they operated.

96 I also find it inexplicable that, when all concerned recognised that this arrangement was central to the ability of the Society to pay a bonus and to demonstrate that it was clearly solvent in regulatory terms, the FSA permitted any credit to be taken in respect of the financial reinsurance arrangement.

97 I find it even more inexplicable that, even if some credit were permissible, the FSA permitted the Society to take an amount of credit which was greatly excessive and did not reflect the economic substance of that arrangement.

98 Those failures were compounded once the FSA finally saw the agreed terms of the arrangement. The FSA, acting reasonably, could not have been satisfied that such an asset could be brought within the valuation rules that applied to the Society's returns for 1999 and 2000 in the manner and amount for which Equitable relied on that arrangement.

99 However, I make no finding in this respect against GAD, as they raised with the FSA a number of concerns about the reserving effect of the proposed financial reinsurance arrangement. That was entirely proper.

100 I consider that those failures by the FSA constitute a departure from the applicable standard that was both unreasonable in the circumstances and fell far short of acceptable standards of good administration.

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

The disclosure of the possible impact of the Hyman litigation

102 I now turn to the acts and omissions of the prudential regulators and/or GAD in respect of the way in which those bodies handled the disclosure by the Society of the potential seriousness of the impact of the *Hyman* litigation.

103 Section 17 of the 1982 Act required every insurance company to prepare a revenue account for the year, a balance sheet as at the end of the year, and a profit and loss account for the year in a prescribed form. Those documents formed part of the regulatory returns.

104 All insurance companies which wrote long term business were also required by section 18 of the Act once in every period of twelve months to cause an actuarial investigation to be made into its financial condition by its Appointed Actuary. An abstract of the Actuary's report of that investigation also formed part of the regulatory returns. The amount of any liabilities as determined by the Appointed Actuary pursuant to section 18 were then included in the balance sheet required by section 17 of the 1982 Act.

105 Section 18(4) of the 1982 Act provided that, for the purposes of the investigation that the Appointed Actuary undertook into the financial condition of the company and reported in the returns, the value of any assets and the amount of any liabilities set out therein were required to be determined in accordance with the applicable valuation Regulations. Those Regulations were set out in Part VIII and Part IX of the Insurance Companies Regulations 1994.

106 Regulation 60 of the 1994 Regulations provided that, subject to the detailed requirements of Part IX, the amount of the liabilities of an insurance company in respect of long term business was required to be determined in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies. That Regulation also provided that, in determining the amount of the liabilities of an insurance company, all contingent and prospective liabilities were to be taken into account within the returns.

107 Schedule 1 to the Insurance Companies (Accounts & Statements) Regulations 1996 set out the form of the balance sheet to be reported in the returns. Paragraph 13(1)(c) of that Schedule required the disclosure of contingent liabilities not already recognised in the balance sheet, other than those arising under inward contracts of insurance or reinsurance.

108 The contingent liabilities associated with the Society losing the *Hyman* litigation were not taken into account in the balance sheet or disclosed in the actuarial part of the Society's returns. A significant part of those contingent liabilities related to the effect of the reinsurance arrangement, which was an <u>outward</u> contract of reinsurance, and also to compensation costs which would arise should the Society lose in the House of Lords.

109 It thus appeared, *prima facie*, that the Society was required to disclose those contingent liabilities within its returns. However, whether that was so in fact would have depended on analysis of the potential liabilities involved.

110 Section 37 of the 1982 Act gave the prudential regulators powers of intervention where they considered that an insurance company had failed to satisfy an obligation to which it was subject.

111 The FSA, acting on behalf of the prudential regulators, were under a general public law duty to give proper consideration to the use of the powers of intervention available to those regulators where the circumstances had or might have arisen which gave grounds for the use of such powers. In order to comply with this duty, I would expect the FSA, acting with the advice and assistance of GAD, to have considered the use of their powers in the light of the information before them.

112 The Society made no disclosure of the contingent liabilities arising from the possibility that it might lose the *Hyman* litigation. I have found that, although the prudential regulators twice told the Society that such liabilities had to be disclosed within its returns, the FSA took no action when that was not done.

113 I have made no finding as to whether the Society should have disclosed those liabilities as a matter of law or of professional practice. That question is the subject of other proceedings, which I consider are better placed than me to resolve the relevant issues.

114 However, the prudential regulators themselves, at the time, considered that the Society should have made such disclosure. When no such disclosure was made, the FSA, who had assumed responsibility for the prudential regulation of the Society, on behalf of those regulators, did not ask the Society to justify its position or to provide information as to the basis on which it was taken.

115 It seems to me that it would have been plain to any prudential regulator, acting reasonably, that the consequences of the Society losing the *Hyman* case were potentially disastrous and that thus this question was no mere trivial aspect of the regulatory returns.

116 Failure to persuade the House of Lords that the Court of Appeal decision had been incorrect was one of the scenarios considered by the FSA and GAD. Both also knew that, in such circumstances – however remote they considered them to be – the financial reinsurance arrangement that Equitable had entered into would lapse and that the Society's reported financial position would have been so bad that a real question mark as to its survival would have arisen in a very public way.

117 Yet the Society did not disclose in its 1998 or 1999 returns that it had contingent liabilities relating to the *Hyman* litigation. Such disclosure, if it had been made, would have occurred in the early part of the returns in which the solvency position of the Society was stated and would have been very visible to any reader of those returns, who would have been alerted to the possible financial impact of losing the case.

118 At the very least, the prudential regulators were under an obligation to satisfy themselves *at the time* that the Society's decision had been taken on sound legal advice and with due regard to the interests of its policyholders. Yet no action was taken by the FSA.

119 The later failure by the Society to disclose any such contingent liabilities in the 1999 returns was also not questioned, pursued or resolved by the FSA.

120 That happened in a context in which the Court of Appeal had already found against the Society and in which the Society had informed its policyholders in writing that the costs of losing the *Hyman* case would not be significant. The prudential regulators were aware of the contents of that letter.

121 I make no finding against GAD in this respect. The prudential regulators had raised the issue with the Society and I do not consider that it was unreasonable for GAD not to have further raised it with those regulators or with the FSA.

122 However, I consider that the omission by the FSA to take appropriate action to satisfy themselves that the Society had taken a proper decision not to disclose the potential effects on it of losing the *Hyman* litigation constituted a departure from the applicable standard that was both unreasonable in the circumstances and fell far short of acceptable standards of good administration.

123 **I consider that the failure of the FSA, acting on behalf of the prudential regulators, to pursue the issue of the proper disclosure, within the Society's regulatory returns for 1998 and 1999, of the potential impact on the Society of it losing the *Hyman* litigation, constitutes maladministration. I therefore make such a finding of maladministration against the FSA.**

The decision to permit the Society to remain open

124 I now turn to the way in which the FSA, acting on behalf of the prudential regulators, approached the taking and recording of their decision to permit the Society to remain open to new business following its loss of the *Hyman* litigation and to the basis on which the FSA took that decision. Did those acts and omissions constitute an unreasonable departure from the applicable standard?

125 I will first deal with the failure by the FSA to record, at the time that it was taken, their decision and the reasons for that decision not to intervene to close the Society to new business or to take any other form of action in order to protect the reasonable expectations of the existing or potential policyholders who were considering investing with the Society during the period after the decision of the House of Lords.

126 As I have explained in Chapter 10 of this report, I have seen no documentary evidence of any decision taken by the FSA on this question. None of the files which record the considerable amount of activity that the FSA engaged in after the decision of the House of Lords in the *Hyman* case included an assessment of the options available both to the Society and to the prudential regulators in terms of what the House of Lords' decision meant for the continued ability of the Society to advertise and to write such business.

127 Whether the Society should be permitted to continue to advertise and to write new business was not a consideration mentioned in the FSA's strategy for regulatory action that it developed in the days after the judgment, or as part of the scrutiny of the regulatory returns that the Society submitted in respect of the 1999 year-end, or in the meetings which the FSA and GAD had with the Society during this period. Indeed, I have seen no evidence that these matters were discussed with the Society at all until the week before it closed to new business.

128 I have no reason to doubt the account that I have been given by those involved as to the basis for the decision that the FSA took to permit the Society to continue to advertise and to write new business during this period.

129 I also recognise that, in the immediate aftermath of the House of Lords' decision, a considerable

amount of analysis and activity was required to be undertaken by the FSA and GAD as a result of the unexpected nature to those bodies of that decision and due to the significant consequences that the decision might have had both for the Society and for the wider industry. I recognise that this activity was a considerable strain on the resources of the FSA at that time.

130 However, that decision was an extremely important one for all concerned. The FSA, by their account, decided that, although the circumstances had arisen which constituted one of the grounds for the use of the intervention powers of the prudential regulators, no action should be taken – because the FSA considered that the interests of potential policyholders were outweighed by the interests of existing policyholders, in the context of a possible sale of the Society.

131 I have had regard to the explanation given by those involved that much discussion on important matters was undertaken in an open-plan office environment and was not always or routinely recorded at this time. I also have no reason to doubt that this was so.

132 I consider, however, that it is a basic principle of good administration that significant decisions affecting the rights and interests of citizens should be recorded by those public bodies taking such decisions. The decision by the FSA not to take action to protect the interests and/or reasonable expectations of potential policyholders was without doubt such a decision.

133 The FSA were under an obligation generally to act in accordance with established principles of good administration. In fulfilling this obligation, I would expect the FSA, acting on behalf of the prudential regulators, to have kept proper and appropriate records as evidence of their activities, including a record of the reasons for their decisions.

134 The failure by the FSA to record the reasons for their decision at, or shortly after, the time that it was taken constituted a departure from the applicable standard. Given the potential consequences of the decision for those affected by it, I consider that this fell far short of acceptable standards of good administration.

135 **I consider that the failure by the FSA, acting on behalf of the prudential regulators, to record their decision to permit the Society to remain open to new business, following its loss of the *Hyman* litigation, constitutes maladministration. I therefore make such a finding of maladministration against the FSA.**

136 But what of the basis on which I have been told that the FSA took this important decision? The prudential regulators had a range of intervention powers conferred on them by the provisions of the 1982 Act. The FSA, acting on behalf of those regulators, were under a general public law duty to give proper consideration to the use of their powers of intervention where the circumstances had or may have arisen which gave grounds for the use of such powers.

137 The FSA were also under an obligation generally to act in accordance with established principles of good administration, including by taking reasonable decisions having regard to all relevant considerations and leaving out of account irrelevant ones.

138 The question before me is whether the rationale for this decision, as it has been explained to me, demonstrates that the FSA took their decision on a proper legal and factual basis, having regard to all relevant considerations, leaving irrelevant considerations out of account, and balancing relevant considerations appropriately.

139 I am not persuaded that such a proper basis informed that decision. The FSA left out of account a number of relevant considerations, such as the nature of the Society's business and the fact that it was not only potential policyholders who might be adversely affected by the Society being permitted to remain open.

140 In addition, none of the legal powers available to the prudential regulators (or as to the other actions they could have taken) appears to have been taken into account by the FSA at the time they took their decision. Those powers or other actions were not given any consideration as part of the FSA's decision-making process.

141 I consider that those deficiencies both in the way in which the FSA took its decision to permit the Society to remain open to new business – and also in respect of the basis on which that decision was taken – meant that this decision was both unreasonable in the circumstances and fell far short of acceptable standards of good administration.

142 **I consider that the unsound basis on which the decision was taken by the FSA, acting on behalf of the prudential regulators, to permit the Society to remain open to new business, following its loss of the *Hyman* litigation, constitutes maladministration. I therefore make such a finding of maladministration against the FSA.**

Information provided by the FSA in the post-closure period

143 I turn finally to the acts and omissions of the prudential regulators in respect of the information that they provided to policyholders and others during the period after the Society had closed to new business (and before my jurisdiction ended on 1 December 2001) concerning the financial position of Equitable and its conformity to the regulatory obligations to which the Society was subject.

144 The prudential regulators were under an obligation generally to act in accordance with established principles of good administration. In fulfilling this obligation, I would expect the prudential regulators to have provided, where it was appropriate to provide such information, information which was clear, accurate, complete and not misleading.

145 I have found that the information provided by the FSA during the post-closure period was misleading, in that this information gave unqualified assurances both that the Society was and always had been solvent in regulatory terms and that it was and always had met its other regulatory requirements. However, the FSA should have known that those assurances had no sound basis. The provision of this misleading information therefore constitutes a departure from the applicable standard.

146 In determining whether the provision of this information constitutes an unreasonable departure from that standard, it seems to me that there are a number of matters which I should take into account.

147 On the one hand, I recognise that it would not have been reasonable to expect those exercising regulatory functions, and privy to sensitive commercial information about the position of one of the entities which they regulated, to provide confidential information to the public and others about the discussions that those regulators were having with that company. Nor do I think it appropriate generally to regulate by public statements or press releases.

148 In addition, I recognise the force of the argument that public statements during the post-closure period by the prudential regulators to the effect

(i) that the solvency position of the Society at that time was questionable, (ii) that the Society might have been in breach of the regulatory required minimum solvency margin for some of this period, and/or (iii) that the Society had (or might have) failed to comply with other regulatory requirements in the past would have added to the difficulties faced by the Society and might have encouraged a run on its with-profits fund.

149 On the other hand, I have found it difficult to reconcile the actions of the FSA in this respect with their view that the regulatory regime which existed at this time did not entail a 'zero-failure' position. The primary concern of the prudential regulators in such a regime was not the survival of an insurance company, but the protection, partly through the provision of certain information, of the interests of existing and potential policyholders.

150 Nor have I been able to reconcile those actions with one of the fundamental premises of the applicable regulatory regime, namely 'freedom with publicity'. That an insurance company might be in serious financial difficulty and might fail was a central feature of the applicable regime. Information that a particular company was in such difficulty could hardly have been seen as inappropriate in that context. Indeed, under the regulatory regime, it might have been expected that such information would be available.

151 Citizens are entitled to expect that the information provided to them by public bodies does not mislead them as to the true position. That is particularly so, it seems to me, when the central role of such public bodies is to protect the interests of those citizens at least in part through ensuring the disclosure of accurate and complete information about the entities they regulate.

152 The relevant regulatory regime was said and recognised at the time to be predicated in part on the concept of 'freedom with publicity'. The provision of accurate information to policyholders and potential policyholders (and their advisers) about the financial position of life insurance companies was one of the cornerstones of the United Kingdom's approach to prudential regulation.

153 The system was designed to enable consumers (and their advisers) to make their own choices using information that was produced in a prescribed manner and which was sufficient to enable such choices to be made (and such advice to be given) on a sound basis.

154 Yet, when things got difficult for the Society, the FSA failed to bear this approach out and instead provided unqualified assurances that all was well. Such information also contrasted with the clearer information that the Society gave during this period about the fundamental uncertainties and financial difficulties it faced – in, for example, the material it published as background to the Compromise Scheme or within its 2001 returns.

155 I consider that no prudential regulator, acting reasonably, would have given the assurances that the FSA gave during the post-closure period. The information before them should have led the FSA to realise that the assurances that they were routinely providing were unsustainable on the facts and were misleading.

156 That does not mean that the FSA should have opened up the regulatory discussions they were having about the serious nature of the Society's financial difficulties to public scrutiny. Nor does it mean that nothing useful could have been said by the FSA to citizens who enquired about the financial position of the Society.

157 It is one thing to set out impartially a range of options available to a policyholder or to signpost them to sources of independent or specialist advice. However, it is quite another thing to provide assurances which no prudential regulator, acting reasonably, could have given – especially in circumstances where it was plain that those contacting the FSA were deeply concerned about their own financial future and about the uncertain position of the Society.

158 I consider that the information provided by the FSA in this period was inaccurate and misleading and, as such, departed significantly from the standard of information that it is reasonable to expect a prudential regulator to have provided. It was also in sharp contrast to the standard of information that the FSA, acting as conduct of business regulator, expected insurance companies themselves to provide to consumers.

159 The provision of inaccurate and misleading information by the FSA constituted a departure from the applicable standard that was both unreasonable in the circumstances and which fell far short of acceptable standards of good administration.

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

Conclusion

161 I have made ten findings of maladministration – one against the DTI, four against GAD, and five against the FSA. I now turn to determine whether any injustice resulted from that maladministration and, if such injustice did result, to consider what an appropriate remedy might be for that injustice. I do this in Chapters 12 and 13 of this report.

Chapter 12 – Determinations: Injustice?

Introduction

1 In this Chapter, I summarise the findings of maladministration that I have set out within Chapter 11 of this report. I also set out my determinations as to whether that maladministration resulted in injustice to those who have complained to me.

2 Before doing so, I outline the nature of the concept of 'injustice' as it applies to the work of my Office.

The nature of injustice

3 The concepts of maladministration and injustice were not defined in the Parliamentary Commissioner Act 1967 and Parliament has left it to me, as it did with my predecessors, to develop those concepts – which I and my predecessors have done over the last 40 years.

4 However, it is clear that Parliament did not intend, when using the term 'injustice', to limit the concept to narrow legal definitions. Nor did Parliament intend simply to replicate the remedies that were available to citizens through proceedings in the courts.

5 The Minister who piloted what became the 1967 Act through Parliament, when explaining what was intended by the use of this term, said[1]:

> *We have not tried to define injustice by using such terms as "loss or damage". These may have legal overtones which could be held to exclude one thing which I am particularly anxious shall remain – the sense of outrage aroused by unfair or incompetent administration, even where the complainant has suffered no actual loss.*
>
> *We intend that the outraged citizen who persuades his Member to raise a problem shall have the right to an investigation, even where he has suffered no loss or damage in the legal sense of those terms, but is simply a good citizen who has nothing to lose and wishes to clear up a sense of outrage and indignation at what he believes to be maladministration...*
>
> *We have left both words – maladministration and injustice – undefined in the Bill. We believe that the meaning of the words will be filled out by the practical processes of case work...*

6 The courts have recognised that to be the correct approach in considering the concept of injustice as it applies to the work of my Office and to that of other Ombudsmen in the public sector:

(i) in the first 'Balchin' case[2], the court held that *'the question whether any given set of facts amounts to maladministration – or by parity of reasoning, to injustice – is for the* [Ombudsman] *alone'*;

(ii) in the same case, the court held, in relation to the differences between court proceedings and Ombudsman investigations with regard to injustice, that *'the defence familiar in legal proceedings, that because the outcome would have been the same in any event there has been no redressible wrong, does not run in an investigation by the* [Ombudsman]';

[1] The Rt Hon. Richard Crossman, *Hansard:* 18 October 1966 (col. 51).
[2] *R v Parliamentary Commissioner for Administration, ex parte Balchin* [1997] CCD 146.

(iii) in the second Balchin case[3], the court held that *'the meaning of injustice is... equally capable of being limited to* [financial loss] *or importing considerations which are wider than financial loss';* and

(iv) in *R v Commissioner for Local Administration ex parte S*[4], the court held that *'it must be established that there has been some prejudice to the complainant before a finding of injustice can properly be made. That prejudice may be no more than the loss of an opportunity... and certainly it is not required that any particular damage be established. Indeed, it is quite plain that the word "injustice" was used with a view to indicating something wider than is covered by the concept of damage, and also perhaps to avoid the need to delve into questions of causation which might otherwise arise in certain cases'*.

7 In the more than 40 years since my Office was established, Ombudsmen have found that the concept of injustice is capable of covering:

(i) financial loss caused by official acts or omissions;

(ii) damage deriving from other causes but which has been exacerbated or prolonged by official acts or omissions;

(iii) the loss of opportunities to take remedial action or to pursue a course of action that might benefit a citizen or protect his or her position;

(iv) the frustration of such courses of action embarked upon by a citizen which prevent those courses of action from achieving the desired or another reasonable outcome;

(v) inconvenience or distress;

(vi) a sense of outrage;

(vii) the frustration of legitimate expectations; and

(viii) the expenditure of unnecessary effort or money in the pursuit of an appropriate outcome.

Summary of the maladministration I have found

8 I have made ten findings of maladministration in respect of the acts and omissions of GAD and/or the prudential regulators:

- my first finding is that the failure by the DTI, as prudential regulators, (i) to insist, when approving the appointment in June 1991 of a new Chief Executive, that he should demit office as the Society's Appointed Actuary, and (ii) during the period from 1 July 1991 to 31 July 1997, when one person held the position of the Society's Chief Executive simultaneously with the position of its Appointed Actuary, to consider the use of their powers to seek to remove that person from such a 'dual role' constituted maladministration;

- my second finding is that the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1990 to 1993, related to (i) the valuation rate of interest used to discount the Society's liabilities and (ii) to the affordability and sustainability of the Society's bonus declarations, constituted maladministration;

[3] *Ex parte Balchin (No. 2)* (1999) 2 LGLR 87.
[4] (1998) 1 LGLR 633.

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

- my fourth finding is that the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1994 to 1996 – related to (i) the valuation rate of interest, (ii) the affordability and sustainability of bonus declarations, apparently arbitrary changes to the assumed retirement ages, and (iii) the holding of no explicit reserves for the liabilities associated with prospective liabilities for capital gains tax, for pensions mis-selling costs, and for guaranteed annuity rates – constituted maladministration;

- my fifth finding is that the failure by GAD (i) to ask for the information GAD needed in respect of the Society's 1995 returns to enable them, as part of the scrutiny process, to be sure that the Society had produced a valuation that was at least as strong as the minimum required by the applicable Regulations, and (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society constituted maladministration;

- my sixth finding is that the failure by the FSA, acting on behalf of the prudential regulators, (i) to ensure that the financial reinsurance arrangement was not taken into account within the Society's 1998 returns without an appropriate concession being given, and (ii) to ensure that the credit taken by the Society within its returns for 1998, 1999 and 2000 properly reflected the economic substance of that arrangement constituted maladministration;

- my seventh finding is that the failure of the FSA, acting on behalf of the prudential regulators, to pursue the issue of the proper disclosure, within the Society's regulatory returns for 1998 and 1999, of the potential impact on the Society of it losing the *Hyman* litigation constituted maladministration;

- my eighth finding is that the failure by the FSA, acting on behalf of the prudential regulators, to record their decision to permit the Society to remain open to new business, following its loss of the *Hyman* litigation constituted maladministration;

- my ninth finding is that the unsound basis on which the decision was taken by the FSA, acting on behalf of the prudential regulators, to permit the Society to remain open to new business, following its loss of the *Hyman* litigation constituted maladministration; and

- my tenth finding is that the misleading information – about the Society's solvency position and its record of compliance with other regulatory requirements – that was produced by the FSA, acting on behalf of the prudential regulators, during the period after the Society closed to new business constituted maladministration.

9 When determining in general terms whether or not any maladministration has resulted in injustice to those who have complained to me, I first identify what were the consequences of that maladministration and then I assess whether those consequences constitute an injustice for which no, or no sufficient, remedy has been provided. This I now turn to do.

The consequences of the maladministration I have determined occurred

10 What were the consequences of the ten findings of maladministration that I have determined occurred? I will set out what I consider to be both the specific consequences of each finding and also the general consequences of those findings when they are taken together.

The specific consequences of each finding

The consequences of the first finding of maladministration

11 My first finding relates to the failure by the DTI, as prudential regulators, (i) to insist, when approving the appointment in June 1991 of a new Chief Executive, that he should demit office as the Society's Appointed Actuary, and (ii) during the period from 1 July 1991 to 31 July 1997, when one person held the position of the Society's Chief Executive simultaneously with the position of its Appointed Actuary, to consider the use of their powers to seek to remove that person from such a 'dual role'.

12 One consequence of that failure was that the prudential regulators and GAD became overly reliant on the information provided by one person within the Society – through his completion of the returns and through the meetings that those regulators and GAD, at which the Society was only represented by that person.

13 Another consequence was that the Society was not prompted and/or invited by the prudential regulators to address the unsatisfactory nature of the 'dual role', which was unacceptable in terms of the prudent management of the Society and for regulatory reasons.

14 A further – and important – consequence of this failure was that the system of prudential regulation, designed on the basis that the Appointed Actuary (with operational independence from the executive management of a life insurance company) would play a central role, instead operated in a dysfunctional manner during this period in respect of the Society.

15 The maladministration which I have found resulted in the effective operation of the system of prudential regulation in respect of the Society, and the governance of the Society, being compromised. There was effectively no 'whistle-blower' within the Society during this period to the detriment of the proper governance of the Society and of the prudential regulation of the Society.

The consequences of the second finding of maladministration

16 My second finding relates to the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1990 to 1993, related to (i) the valuation rate of interest used to discount the Society's liabilities and (ii) to the affordability and sustainability of the Society's bonus declarations.

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

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

19 That maladministration led to lost opportunities to seek further understanding as to whether the Society's business model was inherently prudent or whether that model exposed the Society's members to unnecessary risks.

The consequences of the third finding of maladministration

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

21 One consequence of this failure was that the prudential regulators, to whom GAD had not disclosed the introduction of the new policy, were disabled from discharging their duties. Another consequence of that failure was that the Society was not asked by the prudential regulators and/or GAD to justify its approach in the light of the reasonable expectations of its existing policyholders and/or of the contents of its advertising, which did not draw to the attention of potential policyholders (or existing policyholders, especially those considering making further contributions to policies which did not contain guaranteed annuity rates) that such a policy existed.

22 Had the prudential regulators raised the matter with the Society, in a context in which the Society was receiving complaints which challenged its application of the differential terminal bonus policy, it seems likely that the Society would have taken legal advice.

23 Had the Society done so at that time, I see no reason to conclude that the legal advice it would have received would be different from that which the Society received later in 1998. That in itself would not have changed events, although I recognise that it is possible that, having received such advice and having to deal with complaints about the differential terminal bonus policy at that time, the Society would have decided to test that policy in the Courts much sooner.

24 That, in my view, would have been all the more likely had the prudential regulators also insisted on full disclosure of the existence of the differential terminal bonus policy within the Society's literature, which might have led to more people realising that such a policy was being applied.

25 Whatever may be the case as to that, the taking by the Society of legal advice at a much earlier stage might have had significant consequences. It might have brought a large number of people who were not eligible for compensation for mis-selling within the scope of such compensation.

26 A further consequence of the failures I have identified in this respect was that the Society took its decisions, such as not to ring-fence new entrants into a different fund, rejecting certain approaches that it received from those interested in acquiring the Society's business and/or as to the validity of its general practices, in a context in which the Society could reasonably believe that it had secured regulatory approval – albeit tacit approval – for its new bonus policy and associated practices.

27 That maladministration resulted in the loss of a number of critical opportunities. Such lost opportunities included opportunities to test the appropriateness of the differential terminal bonus policy, to ensure that the illustrations and advertisements provided to existing and potential policyholders explained the Society's policy and practice, and to take decisions about the future direction of the Society in full knowledge of the reserving requirements to which it was subject and to which the prudential regulators and GAD would eventually draw attention.

28 The Society was not constrained to make provision gradually over time for the costs arising each year from those requirements as those costs accumulated.

29 Maladministration also resulted in the problems which caused the Society eventually to close to new business being obscured until July 1998 and to the loss of opportunities for the Society and for the prudential regulators and/or GAD to begin to address these issues much earlier than they all eventually did.

The consequences of the fourth finding of maladministration

30 My fourth finding relates to the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1994 to 1996, related to (i) the valuation rate of interest, (ii) the affordability and sustainability of bonus declarations, (iii) apparently arbitrary changes to the assumed retirement ages, and (iv) the holding of no explicit reserves for the liabilities associated with prospective liabilities for capital gains tax, for pensions mis-selling costs, and for guaranteed annuity rates.

31 One consequence of this failure was that an early opportunity was lost to address the issue of the Society's practice as to reserving for guaranteed annuity rates. Another consequence was that the Society's liabilities were considerably understated.

32 That maladministration reinforced that which I have found in relation to the introduction of the differential terminal bonus policy, in that the problems which caused the Society eventually to close to new business were further obscured and opportunities were lost to address those issues earlier than eventually happened.

The consequences of the fifth finding of maladministration

33 My fifth finding relates to the failure by GAD (i) to ask for the information GAD needed in respect of the Society's 1995 returns to enable them, as part of the scrutiny process, to be sure that the Society had produced a valuation that was at least as strong as the minimum required by the applicable Regulations, and (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society.

34 One consequence of this failure was that those reading the Society's returns during this period were capable of being misled as to the strength of the Society's true financial position.

35 Another consequence was that those who used the information and conclusions drawn from the returns by rating agencies and other third parties – including financial advisers, industry publications, and those briefing Ministers – were led to rely on information that did not contain a complete and accurate assessment of the Society's true position. They were thus actively misled.

36 A further consequence was that GAD were unable, with respect to the Society's 1995 returns, to verify the financial position of the Society, as they were not able on that occasion reasonably to be satisfied that the Society's chosen valuation method had produced a result at least as strong as the minimum prescribed in the Regulations as they lacked the information needed to be so satisfied.

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

The consequences of the sixth finding of maladministration

38 My sixth finding relates to the failure by the FSA, acting on behalf of the prudential regulators, (i) to ensure that the financial reinsurance arrangement was not taken into account within the Society's 1998 returns without an appropriate concession being given, and (ii) to ensure that the credit taken by the Society within its returns for 1998, 1999 and 2000 properly reflected the economic substance of that arrangement.

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

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

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

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

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

The consequences of the seventh finding of maladministration

44 My seventh finding relates to the failure of the FSA, acting on behalf of the prudential regulators, to pursue the issue of the proper disclosure, within the Society's regulatory returns for 1998 and 1999, of the potential impact on the Society of it losing the *Hyman* litigation.

45 One consequence of the acts and omissions of the FSA in this regard was that they could not be certain that the Society's policyholders and those potential policyholders considering investing or continuing to invest in the Society were being given complete and accurate information about what were the extent and nature of the possible effects should the House of Lords deliver a judgment that was adverse to the Society. Existing and potential policyholders were thus denied information about their potential exposure to significant risk, which was an integral part of informed decision-making as to their financial options.

46 Another consequence of those acts and omissions was that both the Society and the FSA lost an opportunity to consider, either separately or together, whether the scenario planning and other work either had undertaken as preparation for managing the possible outcomes of the *Hyman* litigation was sufficient to address the full range of factors which had exposed the Society to the range of problems which it faced during this period.

47 The maladministration which I have found meant that the prudential regulators could not be certain that the reality that an adverse House of Lords' judgment would crystallise for the Society was not being distorted. Any such distorted reality might inform the published returns and the other publications that the Society produced during this period. The prudential regulators could not be sure that existing and potential policyholders had the full information necessary to take informed decisions.

The consequences of the eighth finding of maladministration

48 My eighth finding relates to the failure by the FSA, acting on behalf of the prudential regulators, to record their decision to permit the Society to remain open to new business, following its loss of the *Hyman* litigation.

49 The consequence of that failure is that no proper and contemporaneous record exists as to the basis for that decision. The maladministration which I have found resulted in an absence of documentary evidence to support the basis for an important decision taken by the FSA.

The consequences of the ninth finding of maladministration

50 My ninth finding relates to the unsound basis on which the decision was taken by the FSA to permit the Society to remain open to new business.

51 One consequence of the failure of the FSA to give proper consideration to the range of their powers to protect the interests of both existing and potential policyholders is that those policyholders lost any opportunity to receive the benefit of the sound and robust exercise of the discretionary powers that Parliament had conferred on the prudential regulators in order to protect the interests of such policyholders.

52 Another consequence of this failure was that those who invested for the first time during this period – which could not have occurred had certain intervention action such as the withdrawal or suspension of the Society's authorisation to write new business been taken – or who bought annuities, or who made further contributions to existing policies where there was no contractual requirement to do so, made those decisions in an environment in which accurate and complete information about the financial position of the Society was not available to them.

53 No warning had been given by the prudential regulators, as would have been provided by the exercise of intervention powers such as the withdrawal of authorisation, of the seriousness of the financial position that the Society was in.

54 A further consequence of this failure was that compensation for mis-selling, if any were provided, became an additional liability falling to be met by those existing policyholders.

55 That maladministration resulted in those 'late joiners' and certain other existing policyholders making decisions about their financial affairs without the accurate and complete information necessary to make those decisions on an informed basis.

The consequences of the tenth finding of maladministration

56 My tenth finding relates to the misleading information – about the Society's solvency position and its record of compliance with other regulatory requirements – that was produced by the FSA, acting on behalf of the prudential regulators, during the period after the Society closed to new business.

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

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

The general consequences of the findings taken together

59 I have set out above the consequences which I consider flow from each specific finding of maladministration which I have found to have occurred. In my view, three general consequences flow from the maladministration I have found:

- the first was that the Society's published returns were unreliable;
- the second was that there were lost opportunities to address critical issues earlier; and
- the third was that regulatory decisions were taken on a basis which had insufficient regard to the range of powers that the prudential regulators possessed.

The published returns were unreliable

60 The first general consequence of the maladministration I have found is that the Society's published **returns for each year from 1990 to 2000 were in important respects an unreliable source of information** about the financial position of the Society – about its exposure to guarantees, about the effects of its bonus policies, and about the solvency position which resulted from the determination of its liabilities and the valuation of its assets in a manner required by the applicable law.

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

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

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

64 The extent of the failure to verify the Society's financial position as shown in its returns began to become critical in the mid-1990s. Anyone reading the Society's published returns for 1993 would not have been able from reading those returns to understand the implications of the fact that the Society had changed its bonus policy. Those reading later published returns did so without the benefit of adequate disclosure of the relevant issues which it was the responsibility of the prudential regulators and/or GAD to secure.

65 The failure by the Society and the prudential regulators and/or GAD to address relevant issues at this time was to have serious ramifications for the solvency position of the Society and for the reasonable expectations of its existing and potential policyholders.

66 From the second half of 1996 onwards, the Society's published returns should also have – but did not – disclose that the Society was in a very weak financial position. Had the Society been required at that time by the prudential regulators and/or GAD adequately to reserve for its guarantees, which were 'biting' by the time that the 1995 returns were submitted, the financial position of the Society would have looked very different to those considering investing in it.

Lost opportunities to address critical issues earlier

67 The second general consequence of the maladministration which I have found is that the Society and the prudential regulators, acting with the advice and assistance of GAD, **lost opportunities to address critical issues much earlier than they eventually addressed those issues**.

68 In relation to the widely accepted causes of the Society's closure to new business – a low free asset ratio, a policy of full distribution, a failure to reserve for generous and flexible guarantees, and the differential terminal bonus policy – these were all matters which the prudential regulators and/or GAD could have addressed through the scrutiny process in earlier years than 1998.

69 The Society disclosed information about those matters, although on occasion such disclosure was incomplete. Had the prudential regulators raised concerns with the Society at an earlier date, the resulting problems might have crystallised earlier and before they became so acute – thus mitigating or forestalling the impact of those problems on those who invested in the Society afterwards.

70 Some of those factors might have been ameliorated by earlier action but such action was not taken due to maladministration by the prudential regulators and/or GAD. Instead, they developed over time to become intractable. The postponed consideration of those factors and of the options open to the Society enabled the Society to continue to grow and to attract new business.

Decisions taken with insufficient regard to the powers available to the prudential regulators

71 The third general consequence of the maladministration which I have found is that, when critical decisions were taken about the Society – about whether to permit one person to hold the posts of Appointed Actuary and of Chief Executive, about the declaration of a bonus in March 1999, about the solvency position published within the Society's returns for 1998, 1999 and 2000 (in the light of a financial reinsurance arrangement), and about whether to permit the Society to remain open to new business in the period after the House of Lords' judgment – those **decisions were taken on a basis which had insufficient regard to the range of powers that the prudential regulators possessed** and which they had an obligation to consider when coming to those decisions.

72 A failure to give sufficient regard to the powers available to them led to the prudential regulators permitting a situation where, at the heart of the governance of the Society, a cornerstone of the system of prudential regulation was not in place – a situation which continued to exist for more than six years.

73 The failure to take action in respect of the 'dual role' meant that the normal system of checks and balances that existed within insurance companies to mitigate the risk of imprudent business strategies was absent for the whole of the period during which were sown many of the seeds of the financial problems that the Society finally had to face.

74 When the prudential regulators and GAD did initiate appropriate action in 1998, that was negated by maladministration by the FSA in relation to the financial reinsurance arrangement entered into by the Society, with its consequent effects on the decisions by the FSA to permit the declaration of a bonus in March 1999 and in respect of the published solvency position of the Society contained within the returns that were published by 1 May 1999.

75 The weak financial position of the Society, once action was taken by the FSA and GAD to ensure that Equitable made provision for all of their liabilities, was masked by the inclusion by the Society, without a reporting concession, within the reported position for 1998 of an offset for a financial reinsurance arrangement whose principal terms had not been agreed by the valuation date.

76 Any prudential regulator, acting reasonably, would have recognised that, if the economic substance of the financial reinsurance arrangement were assessed, no credit at all could legitimately have been taken for that arrangement within the Society's returns in any case. Even if that were not so, the credit taken had no rational basis and was inconsistent with the arrangement into which the Society had entered. Such a regulator would also have insisted that the Society's returns were appropriately corrected and resubmitted.

77 The Society was permitted by the FSA to declare a bonus and to continue writing new business well beyond a time when, had no maladministration taken place, the weakness of the Society's financial position and deep-seated problems would have been made public.

78 The failure by the FSA adequately to consider what could be done to protect those policyholders who joined the Society in the period after the House of Lords' judgment meant that those people who invested in the Society in that period lost the opportunity to be afforded the protection that the regulatory regime envisaged and may have led to them incurring financial loss due to the fundamental imbalance inbuilt into the Society's with-profits fund about which the prudential regulators and GAD should have known.

79 The reassurances that were given by the FSA to policyholders about the financial condition of the Society during the period following closure to new business gave them comfort which the FSA, acting reasonably, could not have provided.

80 All of the above were consequences which impacted on the policyholders and annuitants of the Society. However, those consequences also impacted on the Society itself and on third parties such as the other users of the returns.

81 Those consequences are relevant to my determination of whether injustice resulted from the maladministration that I have found. I now turn to consider that question.

Did injustice result from maladministration?

82 Do the consequences which I have determined flowed from the maladministration I have found constitute injustice to those who have complained to me?

83 I will deal in turn with each of the specific consequences of the maladministration which I have identified but, when doing so, I will consider together the specific consequences of the findings which relate to the content of the Society's returns in the period prior to 20 June 1998. I will address my other findings separately.

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

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

Do the specific consequences constitute injustice to those who have complained to me?

The 'dual role'

86 Do the specific consequences that I have identified as being the result of my finding of maladministration in relation to the 'dual role' – the simultaneous holding by one person of the two posts of Appointed Actuary and Chief Executive of the Society – constitute injustice to those who have complained to me?

87 I consider that I am unable to determine this question. Such a judgement necessarily involves making findings about the actions of bodies or individuals who are not in my jurisdiction. In order to identify whether anything of substance changed once the dual role was ended, I would have to embark on an assessment of the relative merits of the persons who held the relevant posts at the Society. But I have no power to do so. I would also need to examine the commercial affairs of the Society. That I also cannot do.

88 **In that context, I make no determination of this question.**

The Society's regulatory returns for 1990 to 1996

89 Do the specific consequences that I have identified as being the result of my findings of maladministration concerning the scrutiny of the returns for 1990 to 1993, the scrutiny of the returns for 1994 to 1996, and the acts and omissions of GAD in relation to the Society's presentation of two valuations within its returns – which all relate to the unreliability of the information published within those returns for 1990 to 1996 – constitute injustice to those who have complained to me?

90 I consider that my determination of this question must turn on the purpose of the returns and the nature of the maladministration I have found in respect of the contents of those returns.

91 In Chapter 9 of this report, I have concluded that the purpose of this mechanism was thus twofold: to enable the prudential regulators to monitor the financial position of insurance companies and to provide those considering investing in such a company with accurate and complete information about each company, on which those investors could base their investment decisions.

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

93 All of those matters were central to any assessment of the financial condition of the Society. I have also found that the actions of GAD in relation to those matters constituted maladministration.

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

95 In determining whether a particular individual has sustained injustice in this context, I would normally expect to see three things:

- first, that the individual had relied on the information in question;
- secondly, that such reliance had been reasonable in the circumstances; and
- finally, that loss (either of a financial kind or the loss of an opportunity) had resulted.

96 By reliance, I do not mean that it should be expected that an individual policyholder or annuitant should now, perhaps twenty years after the relevant events, be expected to produce copies of the information or advice on which they relied. Nor do I consider that the principal means through which policyholders would have been influenced by the information contained within the Society's regulatory returns was through them reading the returns at Companies House.

97 In the context that I have outlined in this report, I consider that the reliance that an individual (or his or her advisers) placed on the information contained with the Society's returns when considering their financial options could have been as a result of the comparative analyses of life insurance companies, company profiles, ratings produced by agencies, or advice derived by actuarial consultants and others from their reading those returns.

98 Any such reliance, given the purpose of the regulatory returns and the nature of the system of prudential regulation was, in my view, reasonable.

99 The only questions, therefore, are whether an individual relied on the information and did so to their detriment. That can only be determined at an individual level.

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

The intimation of the Society's differential terminal bonus policy

101 Do the specific consequences that I have identified as being the result of my finding of maladministration related to the failure by GAD when they noted its introduction to inform the prudential regulators about the Society's differential terminal bonus policy, or to raise the matter with the Society, or to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders constitute injustice to those who have complained to me?

102 The biggest impact of the failure to act when the differential terminal bonus policy was introduced derived from the lost opportunity to look back and to establish what problem that policy was designed to address.

103 I have no doubt that an opportunity was lost to engage the Society in discussion about the rationale for the introduction of this new policy, about whether that policy met the reasonable expectations of the Society's policyholders, and about whether those policyholders were being properly informed about that new policy.

104 But what effect did this have? I consider that my determination of this question must focus on what would have happened had the maladministration not occurred. Absent that maladministration, would things have been the same?

105 Had no maladministration occurred, I consider that it is, on the balance of probabilities, likely that the Society's growing exposure to guaranteed annuity rates would have been understood much earlier, as would the Society's related reserving practices.

106 The requirements of the prudential regulators were not made clear to the Society at an early and appropriate stage. Instead, the Society was faced in the period after July 1998 with a position in which those regulators were insisting that it established in one go reserves of approximately £1.5 billion in respect of the liabilities arising from those guarantees.

107 Had the prudential regulators and/or GAD insisted, at the time that the differential terminal bonus policy was introduced, on full reserving for the liabilities arising from those guarantees, the financial effect on the Society of such a requirement was not likely to have been as onerous as it had become by 1998.

108 During the period from 1994 to 1996, reserving for those guarantees would not have been difficult for the Society to accommodate over that period, as those guarantees were not always deeply 'in the money'.

109 During that period, the amount of the liabilities associated with those guarantees was still likely to have been manageable within the resources of the Society as, at that time, it still had open to it the possibility of using (or using to a greater extent) various methods to mitigate the impact of any reserving requirement.

110 The Society could have considered changing its investment strategy as part of its planning process or could have sought to secure the reinsurance of the relevant risks, or could have used a future profits implicit item for a higher amount. Those alternatives were not available to the Society in later years when this issue finally crystallised, as many of them had by then already been used to address other issues.

111 Had no maladministration occurred, the Society would have been required to establish the required reserves over time and would have then had time to plan for the onset of the considerable liabilities with which they would be faced as the business which contained those guarantees matured.

112 The other options open to the Society could then have been explored sufficiently early for them still to have been available and viable. Decisions taken by the Society – such as in relation to overtures from other companies interested in the de-mutualisation of the Society – would have been taken in a much changed environment.

113 This had an effect on those considering investing in the Society in the period between 1990 and 1998. Those investors took decisions as to whether to invest in the Society in a context which would not have existed had maladministration not occurred.

114 If the maladministration had not occurred, the financial position of the Society, as published in its returns, would have indicated the potential exposure of the Society to the growing liabilities that those guarantees produced. This would have been a critical factor for any potential investor to take into account when balancing the advantages and the risks of such an investment as part of taking an informed decision about their financial affairs.

115 That the Society's returns did not provide such an indication prevented potential policyholders from ascertaining the Society's true position.

116 Had the Society been required to establish reserves and had it, as a consequence, been required to take the other steps available to the Society to mitigate the growing liabilities that it faced, the picture presented of the Society's affairs to existing and potential policyholders might also have been further transformed.

117 An earlier or more extensive use of a future profits implicit item within the Society's returns would have been a clear indication of the weakness of its financial position. Changing investment strategy would have directly affected the returns on the Society's assets that were available to fund bonuses. Traditional reinsurance would have been costly, thus further reducing the assets available to fund policyholder proceeds.

118 That the Society was not required to consider those options meant that existing and potential policyholders were unable to consider all the options, with the impact that those options would necessarily have had on the Society's financial position, when considering whether to invest further or for the first time in the Society or to purchase an annuity from it with their pension fund.

119 Existing and potential policyholders lost the opportunity to take informed decisions about their affairs in full knowledge of all the factors related to the Society's financial position that were relevant to such decisions.

120 I do not consider that it is possible to conclude that financial loss resulted from this aspect of the maladministration which I have found. I am unable on the balance of probabilities to make findings about what policyholders would or might have done differently had the Society been constrained, as a result of regulatory attention at the time of the introduction of the differential terminal bonus policy, to address at an earlier date the issue of reserving for the liabilities arising from these guarantees. I therefore make no finding of injustice in the form of financial loss to policyholders in relation to this maladministration.

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

Financial reinsurance

122 Do the specific consequences that I have identified as being the result of my finding of maladministration related to the failure by the FSA to ensure that the financial reinsurance arrangement was not taken into account within the Society's 1998 returns without an appropriate concession being given, and to ensure that the credit taken by the Society within its returns for 1998, 1999 and 2000 properly reflected the economic substance of that arrangement, constitute injustice to those who have complained to me?

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

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

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

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

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

128 Once that financial position became known, I consider that many fewer new prospective policyholders, acting reasonably, would have taken out with-profits policies with the Society. The Society's financial position would have become known shortly after the Society announced, as it would have had to do, that it was not declaring a bonus. If in fact it did declare a bonus, its financial position would have become known by 1 May 1999, when the Society's 1998 returns were published.

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

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

131 Under the applicable regulatory regime, whether to declare a bonus or to make arrangements for the reinsurance of risks were matters for the Society in the first instance. However, under that regime, how reinsurance arrangements were to be treated within the regulatory returns for the purposes of demonstrating the solvency of an insurance company – or whether the declaration of a particular bonus put the solvency position of such a company at risk – were matters of direct concern to the prudential regulators, who were under an obligation to verify the financial position of life insurance companies such as the Society.

132 Such an insurance company was entitled to seek to protect their position. Commercial considerations would have been influential when they did so. The role of the prudential regulators was different. Their role was to protect the interests and expectations of existing and potential policyholders and to ensure that such companies acted prudently and in accordance with the obligations to which they were subject.

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

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

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

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

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

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

139 This ran the risk of causing additional damage to the value of the Society if it had been viewed, as a result, as a 'distressed seller'[5]. A move to a more defensive investment portfolio would also have further weakened the Society's marketing message. This would not have mitigated the public relations impact on the Society; indeed, it would have reinforced it.

140 Given that, I consider that, on the balance of probabilities, had no maladministration taken place and had no credit been permitted – as it should not have been – for the financial reinsurance arrangement within the 1998 returns, the Society would have been very publicly in such a parlous position that its ability to attract new investments would have been greatly constrained. That this did not happen had a significant impact on subsequent events.

141 In order to put the Society's finances on a footing that would permit it both to declare a bonus and to report a solvency position that would not alarm existing policyholders and potential investors, immediate and significant action needed to be taken.

142 It should be remembered, however, that the full extent of the issues was not, at that time, being addressed and that, had that not been so, the scale of the action required would have been considerably greater.

[5] That is, someone who is under severe pressure to dispose of an asset, usually because of a dire financial position.

143 A full assessment of the Society's financial position, had such been undertaken, would have established that the Society was using a 'quasi-zillmer adjustment'. As a result, the Society's liabilities were also being understated by what was subsequently, in respect of the Society's 1999 returns, calculated by the then auditors of the Society to be £950 million. This would have been a further issue to address.

144 I am satisfied that 1 May 1999, by which time the Society's precarious position would have been made fully public had no maladministration occurred, is a critical juncture – and that the acts and omissions of the prudential regulators in respect of the financial reinsurance arrangement played a central part in the ability of the Society to continue to attract business after that date.

145 I consider that the prudential regulators failed to fulfil their obligations in respect of the way in which the financial reinsurance arrangement was treated within the Society's returns for 1998, 1999 and 2000. Had those regulators acted properly, the attractiveness of the Society as a potential investment vehicle would have been wholly undermined. The investments which were made were undertaken in a context which was distorted as a result of maladministration.

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

147 I will address questions as to whether individuals have sustained actual financial loss which has not been remedied when I address questions of remedy in Chapter 14 of this report.

The potential impact of losing the Hyman litigation on the Society

148 Do the specific consequences that I have identified as being the result of my finding of maladministration related to the failure of the FSA to pursue the issue of the proper disclosure, within the Society's regulatory returns for 1998 and 1999, of the potential impact on the Society of it losing the *Hyman* litigation constitute injustice to those who have complained to me?

149 Given my finding about the injustice which flowed from the maladministration I have found in respect of the financial reinsurance arrangement, it is not necessary to determine this question, as anyone affected by this maladministration would already be covered by the finding of injustice that I have made in relation to that financial reinsurance arrangement.

150 **I make no further finding on this question.**

The failure to record the decision to permit the Society to remain open to new business

151 Do the specific consequences that I have identified as being the result of my finding of maladministration related to the failure by the FSA to record their decision to permit the Society to remain open to new business, following its loss of the *Hyman* litigation constitute injustice to those who have complained to me?

152 While the failure to record the decision constituted maladministration, no consequences flowed from that maladministration for those who have complained to me.

153 **In those circumstances, I find that this maladministration did not lead to injustice.**

The basis on which the decision to permit the Society to remain open to new business was taken

154 Do the specific consequences that I have identified as being the result of my finding of maladministration related to the unsound basis on which the decision was taken by the FSA to permit the Society to remain open to new business, following its loss of the *Hyman* litigation, constitute injustice to those who have complained to me?

155 Given my finding about the injustice which flowed from the maladministration I have found in respect of the financial reinsurance arrangement, it is not necessary to determine this question as anyone affected by this maladministration would already be covered by the finding of injustice that I have made in relation to that financial reinsurance arrangement.

156 **I make no further finding on this question.**

The information provided by the FSA after closure

157 Do the specific consequences that I have identified as being the result of my final finding of maladministration – which relates to the misleading information, about the Society's solvency position and its record of compliance with other regulatory requirements, that was produced by the FSA during the period after the Society closed to new business – constitute injustice to those who have complained to me?

158 I consider that the maladministration which I have found in relation to this official information meant that such information was unreliable as a guide to the true financial position of the Society and to its record of compliance with the regulatory requirements to which it was subject. Such unreliable information, given its source and the context in which it was given, was undoubtedly capable of causing injustice to those who received it if they acted on that information to their detriment.

159 I have explained above that, when considering whether unreliable information has led to injustice to an individual, I would expect to see that such an individual had relied on the information in question, that such reliance had been reasonable in the circumstances, and that either financial loss or the loss of an opportunity had resulted.

160 I consider that those factors should guide my consideration as to whether injustice resulted from the inaccurate and misleading information given by the FSA during the post-closure period.

161 There is, however, one difference in the context from that which pertained in respect of the unreliable information contained in the Society's returns for 1990 to 1996 and I have had regard to this difference when considering this question.

162 In my view, anyone who had regard to the information provided by the FSA in this period could not be said to have acted reasonably if they, without further enquiry, relied on this information alone when making any decision about their financial affairs.

163 Unlike in the earlier period covered by this report, the Society was at this time widely known to be in financial difficulty. It had closed to new business and was reporting a very weak solvency position. The Society was issuing information as background to its Compromise Scheme which set out the fundamental uncertainties that it faced.

164 Widely publicised policy value cuts had been imposed by the Society in July 2001. The Society's returns for 2001 were later to underline the weakness of its financial position and the doubts that it had met the regulatory solvency margin at all times throughout 2001 if certain unresolved reserving issues had been taken into account.

165 In this context, whatever the information provided by the FSA, it was widely known that the Society was in deep difficulty and that one way of balancing the competing demands on its with-profits fund was by reducing the payouts that the Society was making.

166 I recognise that the FSA was seen as an authoritative and impartial source of information about the financial security of insurance companies. Given their role, that was entirely reasonable. However, the FSA did not, and did not purport to, give tailored or specific advice to individuals about their own circumstances and options.

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

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

The injustice claimed on behalf of complainants

169 But what of the injustice claimed by those representing complainants – that financial loss in the form of the July 2001 policy value cuts was a direct consequence of regulatory failure?

170 I would first record my conclusion that an argument that maladministration alone caused the policy value cuts is not one that could be sustained.

171 There is no basis for determining that the maladministration which I have found to have occurred caused, and was the sole cause, of the particular financial losses that those representing complainants say have been sustained, when regard is had to the effects of stock market movements or other commercial factors on the decision taken by the Society to make those policy value cuts.

172 Nor can the wider economic context – and the falls in the value of the stock market during 2000 and 2001 – be ruled out as being a contributory factor to the need for the Society to consider how best to stabilise its financial position.

173 All that suggests that the maladministration that I have found that was specific to the regulation of the Society cannot alone be seen to have caused the policy value cuts.

174 It is impossible to ignore the industry-wide reductions in with-profits payouts which occurred some time after the Society's own cuts. Those cuts demonstrate the wider impact of the economic context. The also demonstrate that the Society's particular position influenced the timing of those reductions, which will itself have affected the impact on some individual policyholders.

175 However, that does not mean that the maladministration which I have found to have occurred is wholly irrelevant when considering the factors which led to the creation of the situation in which the Society's new Board decided that it was prudent and/or necessary to make those policy value cuts.

176 It seems to me that a fundamental premise behind the policy value cuts was the need to rebalance the Society's finances due to the natural consequences of the events which led to the closure and which were in due course compromised through the Companies Act scheme of arrangement.

177 The responsibilities of the prudential regulators to verify the solvency of insurance companies and to protect the reasonable expectations of policyholders gave the prudential regulators a unique role.

178 Those regulators also considered, at the time that the Society closed to new business approximately eight months prior to the policy value cuts, that the Society was unique among the life insurance industry and that this distinctiveness had played a central role in its closure to new business.

179 As I have explained in Chapter 1 of this report, Treasury officials at that time had explained to the Tripartite Standing Committee their view that the problems faced by the Society had been caused by a unique set of circumstances. The four most important factors identified in that discussion were:

- first, that Equitable had for many years operated a policy of full distribution of any surplus through bonuses to their with-profits policyholders and a policy of not building up a free estate, leaving the Society with a comparatively low level of free assets;
- secondly, that Equitable, being a mutual, had no access to additional, shareholder capital;
- thirdly, that Equitable had offered relatively generous and flexible guarantees on certain types of policy; and
- finally, that the proportion of the Society's business to which those guarantees applied was much higher than was the case for other companies.

180 What the prudential regulators recognised at the time were the root causes of the Society's closure to new business were matters about which those regulators had – or could have had – information many years before the consequent relevant events occurred. All of that must have had an impact on the Society.

181 Given the nature and extent of the maladministration I have identified, it seems to me that it is not possible to say that regulatory issues are unrelated or merely incidental to this question.

182 If I were to accept that such a fundamental failure of the system of prudential regulation as this report has identified would have had no impact whatsoever on the fate which befell the Society, it would, it seems to me, beg the question as to what the purpose of such a system of regulation was.

183 Indeed, it is my view that the maladministration I have found to have occurred played a contributory role in the creation of the circumstances that led to the decision to cut the policy values of the Society's policyholders. While

the external context and matters unrelated to the acts and omissions of the prudential regulators and/or GAD did have a direct impact on the *creation* of the situation, part of the reasons why the Society's options were limited was a direct result of regulatory failure.

184 Other companies faced difficult market conditions and reduced the proceeds paid to policyholders as a result of reduced investment returns. What made the Society different was that the methods available to it were constrained by the nature of the financial position in which the new Board found itself.

185 I consider that it would be impossible for me definitively to determine to what extent the losses claimed on behalf of complainants in the form of the July 2001 policy value cuts were unique to Equitable and, moreover, a direct consequence only of regulatory failure in respect of the particular supervision of the Society.

186 That would require me to go beyond the terms of reference of this investigation, to enter territory over which I have no jurisdiction, and to speculate rather than determine questions about the evidence before me.

187 But in any case, I do not need to do so. I am satisfied that maladministration was a contributory factor in the creation of the circumstances which led to the decision that it was prudent and/or necessary to make those policy value cuts.

188 **I therefore find that any losses associated with the July 2001 policy value cuts are not exclusively attributable to the maladministration which I have found to have occurred but that such maladministration was one among many contributory factors to those losses.**

189 Having determined whether maladministration led to injustice, I now turn to set out my disposal of each complaint within the terms of reference for the investigation which led to this report. I do this in Chapter 13 of this report.

Chapter 13 – My disposal of the complaints

Introduction

1 In this Chapter, I set out whether or not I uphold in full or in part each head of complaint contained within the terms of reference for the investigation which led to this report. Those heads of complaint were set out in Chapter 4 of this report.

2 This Chapter is structured in the following way:

(i) in paragraphs 3 to 15, I explain my approach to the determination of complaints at the end of any investigation;

(ii) in paragraphs 16 to 136, I set out my disposal of each of the specific heads of complaint contained within the terms of reference for the investigation which led to this report; and

(iii) in paragraphs 137 to 180, I set out my disposal of the general complaint contained within those terms of reference.

My approach to the determination of complaints

3 In order to be able to uphold any complaint that I consider, four conditions have to be satisfied. Those conditions are:

- first, that the complaint is **not misconceived**;
- secondly, that the complaint **has a sound basis in fact**;
- thirdly, that the relevant acts or omissions constitute **maladministration**; and
- finally, that any such maladministration led to **injustice** to those who have complained to me for which no remedy or no sufficient remedy has already been provided.

Identifying whether a complaint is misconceived

4 A complaint that is misconceived is one which has no prospect of being upheld whatever the outcome of any investigation. Such a complaint can belong to this category because, after closer examination, it turns out that it relates to action that is not within my remit, or that no injustice was ever sustained, or that any injustice sustained has since been remedied.

5 It can also belong to that category because, even if the allegations which underpinned the complaint were found, after investigation, to have a sound basis in fact, there would be no basis on which I could make any finding of maladministration.

6 That would generally be the case where the complaint was predicated on a view of the obligations of the relevant public body which was inconsistent with the obligations that were in fact imposed on that body, which I would establish, as part of an investigation, after identifying the general and specific legal and administrative obligations which such a body had at the relevant time.

Identifying whether a complaint has a sound factual basis

7 Whether a complaint is soundly based in fact is the core question that I consider during the course of any investigation. This I do by verifying, through consideration of the documentary and other evidence available to me, what actually happened in relation to the subject matter of the relevant complaint or complaints.

Determining maladministration

8 In Chapters 5 and 11 of this report, I have explained my approach to determining whether maladministration has occurred. Having established the facts and the overall standard which applies to the events which form the basis of the complaints made to me, I then assess those facts against that overall standard.

9 In particular, I assess whether or not an act or omission on the part of the body complained about constituted a departure from the applicable standard. If so, I then assess whether that act or omission was so unreasonable in the particular circumstances, when regard is had to the specific legal or administrative context of the case, as to constitute maladministration; and/or whether any such act or omission otherwise fell so far short of acceptable standards of good administration as to constitute maladministration.

Determining injustice

10 In Chapter 12 of this report, I have explained my approach to injustice. When determining in general terms whether or not any maladministration which I have determined has occurred resulted in injustice to those who have complained to me, I first identify what were the consequences of that maladministration and then I assess whether those consequences constituted an injustice for which no, or no sufficient, remedy has been provided.

Disposing of complaints

11 Where all four of the above conditions are satisfied, I would uphold the specific complaint in full.

12 Where a specific complaint contains more than one alleged act or omission which is the subject of that complaint, and where all four conditions are satisfied only in respect of one or more (but not all) of those allegations, then I would uphold the specific complaint in part.

13 Where none or not all of those conditions are satisfied in respect of any of the allegations, then I would not uphold the specific complaint and would dismiss it.

14 As I explained in Chapter 4 of this report, the terms of reference for this investigation contained eighteen specific heads of complaint and one general complaint. The general complaint was that *'the public bodies responsible for the prudential regulation of insurance companies ... and GAD failed for considerably longer than a decade properly to exercise their regulatory functions ... and were therefore guilty of maladministration'*. The specific heads of complaint contained, in most cases, more than one allegation. Many of those allegations overlapped with or duplicated other such allegations within different heads of complaint.

15 I will now set out my disposal of each of those specific heads of complaint and also of that general complaint.

The specific complaints

Complaint A – the prudential regulators had not been sufficiently resourced, and had not all possessed the necessary skills, to contribute effectively to the overall regulatory process and to responsibly exercise their discretionary powers as intended by Parliament and by the European Union.

16 Complainants alleged that the prudential regulators and/or GAD were not sufficiently resourced and did not possess the necessary skills to contribute effectively to the regulatory process.

17 Having reviewed all of the evidence before me, I have seen nothing to suggest that the prudential regulators and/or GAD were insufficiently resourced to undertake their responsibilities appropriately. Nor have I seen any evidence that would sustain a finding that those regulators and/or GAD were not sufficiently skilled to undertake their statutory functions.

18 My attention has been drawn to the view of Lord Penrose that insufficient resources or skills had played a part in the way in which the Society was regulated. I would respectfully suggest that his remarks were predicated on his view that a different system of regulation should have existed, when it did not in fact exist. I can derive no assistance from such a view.

19 In any event, there is no factual basis for this allegation. I therefore dismiss this head of complaint.

Complaint B – that the prudential regulators had failed to liaise and to co-operate effectively with those responsible for the regulation of the conduct of business by insurance companies.

20 Complainants alleged that the prudential regulators failed to liaise and to co-operate effectively with those responsible for the regulation of the conduct of business by the Society, particularly in respect of its communications with its policyholders.

21 Having considered the applicable statutory and administrative framework which governed the discharge by the prudential regulators of their functions during the period covered by this report, I find this complaint to be partly misconceived.

22 The conduct of business regulators and the prudential regulators had discrete spheres of responsibility. It was the responsibility of the conduct of business regulators to oversee how the Society was (and how other insurance companies were) interacting with customers and whether the information given to those customers conformed to the requirements of the conduct of business rules about information that was true, fair and not misleading.

23 I can make no finding about the acts or omissions of the conduct of business regulators in this, or any other, respect – as they are not within my jurisdiction.

24 That said, the prudential and conduct of business regulators had in April 1991 entered into an agreement concerning the information that they would pass to each other in certain specified circumstances.

25 This agreement provided that the prudential regulators would pass information to the conduct of business regulators where there were grounds for concern about the integrity or competence of those directing or managing an insurance company; where otherwise there were grounds for doubt about the financial soundness of the company – and where consideration was being given to the instigation of a formal investigation; where consideration was being given to the use of other powers of intervention; or where consideration was being given to the withdrawal of authorisation.

26 That agreement also provided that information would be passed by the prudential regulators to the conduct of business regulators where a company's margin of solvency either had fallen or where it was anticipated that it would fall below the required minimum margin.

27 Indeed, as the detailed chronology of events set out within Part 3 of this report shows, once the prudential regulation of the Society was undertaken by the FSA, which coincided with the onset of the significant problems that the Society faced in the period after July 1998, those regulators regularly were in contact with their colleagues within the FSA who were responsible for conduct of business regulation. Such liaison grew in intensity throughout the post-closure period.

28 But what of the earlier period, when the two sets of regulators operated within different public bodies? While there were isolated occasions in that earlier period where it might be arguable that liaison pursuant to the agreement between the two regulators was called for, those occasions were few and far between, were about matters which did not evidence any pattern that would have indicated that such liaison was necessary, and related to peripheral issues that were not the focus of the prudential regulatory regime.

29 In any case, in so far as PRE is concerned, as I explain in this report the prudential regulators were required, if information came to their attention, to take their own action with respect to such matters.

30 It was not liaison with the conduct of business regulators which was necessary when grounds arose for the consideration of the need to act to protect PRE. However useful such liaison might also have been, the prudential regulators were under an obligation to consider the use of their own powers in such circumstances.

31 As it is based on an understanding of the relevant regulatory regime which is misconceived, I therefore dismiss this head of complaint.

Complaint C – that the prudential regulators had not operated the regulatory regime as it was intended to be implemented by Parliament and in conformity with European Directives. Those regulators instead had chosen to regulate Equitable with a 'light touch' – a concept not evident from or provided for under the Insurance Companies Act 1982 and the European Third Life Directive, nor one consistent with those statutory provisions.

32 Complainants alleged that the approach to the regulation of the Society was exceptionally and unjustifiably lenient, when compared to that adopted with other companies, and that the prudential regulators had applied a 'two-tier' standard of regulation.

33 To the extent that this allegation contends that there was a conscious decision by the prudential regulators to apply a different standard of regulation to the Society than for other similar companies of a similar size and writing similar business, I have seen no evidence that would support such a contention. There is no sound basis in fact for that allegation.

34 Furthermore, there were objective and entirely proper reasons for the differential treatment of certain insurance companies that were grounded both in the statutory and administrative elements of the applicable regulatory regime.

35 First, the provisions of the 1982 Act applied different standards of oversight and scrutiny and wider powers of intervention to newly authorised companies than those standards and powers which applied to existing companies. Similarly, companies where there had been a change of control were subject to a more intrusive regulatory regime, which included more frequent reporting and the need to submit and have a business plan approved. Those additional requirements also continued to apply to newly authorised companies for specified periods.

36 Secondly, there were administrative systems operated by the prudential regulators and by GAD when advising and assisting those regulators which were relevant to the standard of regulation applied in individual cases. Those systems included the system of priority ratings used by GAD, when considering the order in which the scrutiny of the annual returns of insurance companies would be undertaken, and administrative mechanisms, which enabled the prudential regulators to monitor companies that were giving grounds for disquiet.

37 The prudential regulators, acting with the advice and assistance of GAD, applied a closer level of scrutiny to insurance companies which, in their view, were demonstrating trends that might lead to them becoming a cause for concern.

38 In the light of the nature of the regulatory regime that I have described in Chapter 5 of this report, it seems to me entirely reasonable for the prudential regulators to have developed guidance or administrative systems to enable them, in the words of the Minister who piloted the Insurance Companies (Amendment) Act 1973 through Parliament, to take or to require *'suitable corrective action in time to avert the consequences of imprudent or misguided policies'*. That the prudential regulators did.

39 I consider that it was wholly consistent with the regulatory regime relevant to this investigation for the prudential regulators to have applied differential levels of scrutiny to the affairs of insurance companies where the decision to do so was based on objective criteria or was appropriate to enable or assist them in the discharge of their statutory functions.

40 To that extent, this complaint is also misconceived. Having no sound basis in fact and being partly based on a misunderstanding of the relevant regulatory regime in place at the time, I therefore dismiss this head of complaint.

Complaint D – that the prudential regulators and GAD had allowed successive chief executives or managing directors of the Society simultaneously to hold the post of appointed actuary, despite recognising the potential for conflict of interest. This had not been compatible with the basis of the regulatory regime.

41 Complainants alleged that the prudential regulators and GAD permitted one person to hold the dual roles of the Society's Chief Executive and Appointed Actuary and that this had been incompatible with the basis of the regulatory regime.

42 I have found that maladministration is established in respect of this head of complaint. But I have been unable to determine whether any injustice resulted from that maladministration, because to make such a determination would require me to consider matters which I have no power to consider. However, equally, I cannot determine that no injustice resulted from that maladministration.

43 I therefore find myself unable to determine this head of complaint.

Complaint E – that the prudential regulators and GAD had failed to keep pace with developments in the pensions and life insurance industry and to assess and adapt their methods to reflect those developments.

44 Complainants alleged that the prudential regulators and/or GAD failed to keep pace with developments in the pensions and life insurance industry and to assess and adapt their methods to reflect those developments.

45 Having reviewed the evidence before me, I am satisfied that there is no evidential basis for the contention that the prudential regulators and/or GAD failed to keep pace with the developments in the pensions and life insurance industry during the period covered by this report.

46 I have seen evidence that considerable work was put into updating the systems and processes that those regulators and GAD utilised to discharge their functions. Many developments in the regulatory framework occurred during the period covered by this report. These include those developments to which the public bodies whose actions were the subject of complaint have drawn attention within their initial response to those complaints, which is set out within Part 4 – and which is summarised in Chapter 4 – of this report.

47 It may be that what is implied by this complaint is that the regulatory framework – the primary legislation and associated delegated legislation – had become unwieldy or out-of-date. If that is so, such a complaint is misconceived.

48 In any event, it is not within my jurisdiction to consider the discharge of legislative functions. I cannot therefore review the legal framework which governed the acts and omissions which I have investigated. My role is to identify whether those operating that framework discharged their functions with or without maladministration.

49 All that being so, I dismiss this head of complaint.

Complaint F – that GAD had recommended Equitable as a pension plan or additional voluntary contribution scheme provider in its advice to the administrators of the Principal Civil Service Pension Scheme and to other public sector pension schemes. This had led to a lack of proper separation of its responsibilities and to a clear conflict of interest between GAD's role in providing advice to government bodies in relation to public sector pensions and in assisting the prudential regulators of the Society. This conflict of interest had compromised the proper discharge of GAD's regulatory functions.

50 Complainants alleged that a conflict of interest existed because of the role GAD played within the system of prudential regulation, when they also had a role in advising the administrators of the Principal Civil Service Pension Scheme.

51 Having reviewed the evidence before me, I am satisfied that there is no basis for the allegation that GAD had a conflict of interest because of its roles within the system of prudential regulation and as adviser to the administrators of the Principal Civil Service Pension Scheme.

52 There is no dispute that GAD acted both as adviser to the prudential regulators of insurance companies and also as adviser to the Civil Service scheme, although in relation to the latter role this ended at the end of 1995.

53 I have examined all of the relevant files held by the administrators of the Principal Civil Service Pension Scheme. Having done so, I am satisfied that there was no conflict of interest, as alleged, on the part of GAD.

54 Indeed, I note that when the Treasury, then acting for the pension scheme administrators, contacted the prudential regulators on 1 October 1991 to establish what the financial condition of the Society was and whether there were any issues of contention between the Society and its regulators of which they should be aware, the DTI replied on 17 October 1991, after having taken the advice of GAD, and stated that they were not in principle able to provide such information and drew attention to the published regulatory returns

instead. This was a proper approach and was the approach that the prudential regulators and GAD adopted to all such enquiries.

55 For completeness, I also asked the bodies whose actions were under investigation to obtain declarations of any financial or employment interests that those of its current or former staff with any direct role in the prudential regulation of the Society during the relevant period might have had. I received such declarations from all the relevant individuals – none disclosed any actual or apparent conflict of interest in terms of personal or financial links to the Society.

56 As there is no legal or factual basis for the conflict of interest alleged, I therefore dismiss this head of complaint.

Complaint G – that, from the mid-1980s until 1997, the prudential regulators had failed to evaluate the potential effect of guaranteed annuity rates on the solvency of Equitable in a context where current annuity rates were falling steadily, in line with the Bank of England's base rate, to below contracted guaranteed annuity rates.

57 Complainants alleged that the prudential regulators failed to deal appropriately with the Society's exposure to the risks associated with the guaranteed annuity rates contained within the Society's older policies.

58 I have found that this allegation has a sound basis in fact and that the failures of the prudential regulators in this respect constitute maladministration. I have also found that injustice resulted from that maladministration.

59 I therefore uphold this head of complaint in full.

Complaint H – that, from about 1990 onwards, the prudential regulators and GAD had failed to give sufficient consideration to the fact that some of the measures used to bolster Equitable's solvency position were predicated on the emergence of a future surplus. As a consequence, the prudential regulators and GAD had not properly assessed the overall impact and adequacy of those measures.

60 Complainants alleged that the measures used to bolster the Society's solvency position were predicated on the emergence of a future surplus and that the prudential regulators and/or GAD did not properly assess the overall impact and adequacy of those measures.

61 The phrase *'emergence of future surplus'* is broad and, in the context of this head of complaint, I have limited it to the use by the Society in its returns of future profits implicit items. To the extent to which the emergence of future surplus was a factor in other matters (for example, the credit taken for financial reinsurance), that is considered under the relevant heads of complaint which cover those other matters in this report.

62 I consider that this complaint, so limited, is misconceived – as it is premised on a view of what methods were appropriate for a life insurance company to improve its published solvency position which is inconsistent with the provisions of the applicable legislation which pertained at the relevant time.

63 The European Directives permitted (and still permit) the use of future profits implicit items by insurance companies. Those provisions were transposed into the domestic legislative framework of the United Kingdom through inclusion within the provisions of the valuation Regulations.

64 My attention has been drawn to the fact that this allegation reflects a view expressed by Lord Penrose in his report that such methods were inappropriate. I would respectfully suggest that Lord Penrose based his assessment of the relevant events on an entirely different basis from that on which I must base my assessment.

65 The Penrose Report was not produced on a basis which accepted the regulatory regime of the day as a given. Indeed, Lord Penrose made it very clear that his assessment had had little regard to the standards which applied at the relevant time. His role was as a reporter, aiming to identify lessons that could be learned for the future, and I derive no assistance from his view.

66 I must have regard to the applicable general and specific legal and administrative framework which pertained at the relevant time. I must assess the acts and omissions of the prudential regulators and/or GAD against that framework.

67 As the measures utilised by the Society were lawful and properly granted, there is no basis for making any finding of maladministration. I therefore dismiss this head of complaint.

Complaint I – that, from 1990 onwards, the prudential regulators had allowed Equitable to publish financial results and projections that were misleading in that they had not reflected the Society's true position.

68 Complainants alleged that the prudential regulators allowed the Society to publish projections, illustrations, and bonus notices that were misleading in that they did not reflect the Society's true position. Those complainants also alleged that the financial results contained in the Society's regulatory returns were published in a misleading form.

69 To the extent that this head of complaint deals with the Society's projections, illustrations, and other bonus notices, that complaint I find to be misconceived.

70 How the Society interacted with its policyholders and potential policyholders as part of the sales process or in relation to how it conducted or illustrated its business is not a matter over which I have any jurisdiction. The regulatory framework that was in place at the time covered in this report did not enable the prudential regulators to intervene in those matters, unless questions of PRE arose.

71 While my review of the evidence in the light of the specific complaints that have been made about PRE has had regard to the submissions I have received on this issue, it is not for me to make findings in respect of the Society or of the conduct of business regulators, whose role it was to ensure that information provided by insurance companies to their customers was true, fair, and not misleading.

72 To the extent, however, that this complaint deals with the Society's returns, I have found in this report that one of the general consequences of the maladministration that I have determined occurred was that the prudential regulators could not reasonably have been satisfied, at any time covered by this report, that those returns were a reliable statement of the Society's true financial position. I have also found that injustice, in the form of lost opportunities to take informed investment decisions, resulted from that maladministration.

73 That being so, this aspect of the complaint is substantiated and I therefore uphold this head of complaint in part.

Complaint J – that, during the period under investigation, the prudential regulators and GAD had failed to act when Equitable had adopted what Lord Penrose described as practices of 'dubious actuarial merit'.

74 Complainants alleged that the prudential regulators and/or GAD had failed to act when the Society had adopted what Lord Penrose had described as practices of *'dubious actuarial merit'*.

75 I find this complaint to be misconceived in so far as it is based on a view that certain practices which were permissible within the regulatory regime at the time should not have been permitted because they were inappropriate. Such practices included the mortality assumptions that the Society used and the subordinated loan capital that it issued.

76 It is not my role to make findings that practices which were permissible should not have been permitted.

77 I have not found that maladministration is established in relation to the acts and omissions of the prudential regulators and GAD in respect of the 'quasi-zillmer' adjustment. While clues were present, it was not unreasonable, in the particular context, for those bodies not to have identified that practice at the time.

78 However, in respect of the failure to reserve for guaranteed annuity rates and the financial reinsurance arrangement, I have found maladministration is established in both respects. I have also found that injustice resulted from the maladministration associated with both of those matters.

79 That being the case, I uphold this head of complaint in part.

Complaint K – that ... the prudential regulators and GAD had ignored or failed to act on information that might have led to formal or informal regulatory action against Equitable, thus also failing to alert new investors to the risks of investing. Those occasions included when the Society's board papers were sent to GAD by the appointed actuary on 11 June 1991, and when information was provided to GAD on 10 September 1992 which showed that, for the years 1989 to 1991, the aggregate policy values had very significantly exceeded the value of the underlying assets.

80 Complainants alleged that the actions of a particular GAD actuary were inappropriate in that, when he was sent certain of the Society's Board papers on 11 June 1991, he did not pass those papers to the prudential regulators.

81 Having reviewed all of the evidence before me, I am satisfied that there is no sound basis on which an adverse finding should be made concerning the receipt of certain of the Society's Board papers by an individual GAD actuary.

82 That GAD actuary was sent those Board papers by the Appointed Actuary of the Society on a confidential basis. Those papers are reproduced in full in Part 4 of this report and are also summarised within the chronology entry for 11 June 1991 in Part 3 of this report.

83 It is common ground that the GAD actuary did not forward a copy of those papers to the DTI. That was perhaps unwise, as it left the GAD actuary open to precisely the type of allegations that have since been made.

84 That failure was also a technical breach of the obligations that were placed on GAD by paragraph 36 of the 1984 Service Level Agreement, which required that *'any correspondence between GAD and an insurance company or its advisers and notes of any meetings held with them will be copied at the time to* [the DTI]'.

85 While I consider that it was unwise for the GAD actuary to refrain from copying the papers to the DTI and also that, in so doing, he was not acting in accordance with the terms of the Service Level Agreement, there are two considerations which lead me, on balance, to come to the view that, while the facts bear the allegation out, there is no basis for the making of an adverse finding in all the circumstances of the case.

86 The first is that, on 19 December 1990, the GAD actuary had already informed the DTI of the existence of these and other Board papers (see the entry for this date in Part 3 of this report). The second is that the GAD actuary did pass the documents to his colleague who was responsible for the regulation of the Society.

87 Both of those being the case, I dismiss this aspect of this head of complaint.

88 However, I have found that GAD did not raise or seek to resolve with the Society as part of its scrutiny of the Society's regulatory returns for every year from 1990 to 1996 the questions which arose from the information within those returns – and that those failures constituted maladministration.

89 I have also found that injustice resulted from the unreliable nature of the Society's returns during this period.

90 That being the case, I uphold this aspect of the head of complaint and, accordingly uphold the head of complaint in part.

Complaint L – that, over a period of many years, the prudential regulators and GAD had permitted Equitable to operate an unsound business model, of which those regulators and GAD had been aware.

91 Complainants alleged that the prudential regulators and/or GAD had permitted the Society to operate an unsound business model of which they had been aware.

92 I consider this complaint to be partly misconceived. In Chapter 5 of this report, I have set out the key obligations that the prudential regulators and/or GAD had at the relevant time, in terms of the general and specific duties and powers which they possessed within the applicable regulatory framework.

93 I also explained that this system was based on a number of cornerstones, one of which was 'freedom with publicity'. That is, that an insurance company was given considerable commercial freedom to act, so long as it conformed to the statutory requirements to which it was subject and provided complete and accurate information about its financial position in a prescribed manner.

94 The prudential regulators and/or GAD were entitled to have regard to the information they possessed about a particular business model deployed by any insurance company. Indeed, where doubts arose about the Society's compliance with the requirements imposed on it, this would have been a necessary part of the background to regulatory consideration of the Society's position.

95 However, within the regulatory regime which pertained at the time covered by this report, it was not for the prudential regulators to approve or to monitor an insurance company's business model or to act as a 'shadow director'.

96 That said, where information came to the attention of those regulators, acting with the advice and assistance of GAD, that a particular company was acting imprudently, without regard to the interests and/or reasonable expectations of its existing or potential policyholders, or in contravention of any statutory requirements to which it was subject, the prudential regulators were required to consider whether that information meant that grounds had arisen for intervention action to be taken to protect policyholders and, if so, whether it was appropriate to take such action.

97 A complaint about any failure to take information about a particular business model into account in the discharge of those obligations which the relevant regulatory regime imposed on the prudential regulators and/or GAD would thus not be misconceived. However, approval of such a model was not part of the applicable regulatory regime.

98 In relation to the scrutiny of the Society's returns for every year from 1990 to 1996, I have found that GAD, in giving advice to the prudential regulators, failed to satisfy themselves that the way in which the Society had determined its liabilities and had demonstrated that it had sufficient assets to cover those liabilities accorded with the requirements of the applicable Regulations. I have also found that those regulators were consequently unable to verify the solvency position of the Society, as they were under a duty to do.

99 I have also found that the respects in which the Society's returns raised questions included the valuation rate of interest used to discount the liabilities and the affordability and sustainability of the Society's bonus declarations. Those were both aspects of the Society's business model, about which GAD had sufficient information. That information did not feature in the scrutiny of the relevant returns.

100 That aspect of this head of complaint is thus not misconceived and has a sound basis in fact. I have found maladministration in respect of the scrutiny of the relevant returns and that injustice, in the form of lost opportunities to take informed investment decisions, resulted from that maladministration.

101 I therefore uphold this head of complaint in part.

Complaint M – that the prudential regulators had failed to ensure any satisfactory correlation between the total of declared policy values and the Society's admissible assets in a context where Equitable, uniquely in the industry, had declared total policy values that had included terminal bonuses and had, without exception, always paid all claims (both contractual and non-contractual) in accordance with those declarations.

102 Complainants alleged that the prudential regulators and/or GAD failed to ensure any satisfactory correlation between the total of declared policy values and the Society's admissible assets.

103 In relation to the scrutiny of the Society's returns for every year from 1990 to 1996, I have found that GAD, in giving advice to the prudential regulators, failed to satisfy themselves that the way in which the Society had determined its liabilities and had demonstrated that it had sufficient assets to cover those liabilities accorded with the requirements of the applicable Regulations. Those regulators were consequently unable to verify the solvency position of the Society, as they were under a duty to do.

104 I have also found that, among the respects in which the Society's returns raised questions, were the valuation rate of interest used to discount the liabilities and the affordability and sustainability of the Society's bonus declarations.

105 I have also found that GAD had information before it, through the analysis they undertook as part of the annual report on the industry which GAD provided to the prudential regulators, that raised questions as to whether the Society was routinely paying out more than the asset share for individual policies.

106 On the other hand, I have seen considerable evidence that this was a more general problem which did not just affect the Society at the relevant time.

107 While this phenomenon begged the question as to its prudence and sustainability, I do not think that those facts are capable of sustaining an adverse finding in relation to the specific supervision of the Society.

108 GAD's analysis showed that the Society was not in this regard at the extreme end of the spectrum among life insurance companies. Furthermore, I am not persuaded that, had GAD raised the issue, a reasonable explanation would not have been provided which might have referred to the fact that most equivalent companies were engaged in this practice.

109 It is not clear what any subsequent action by the prudential regulators would have been aimed at or what it would have secured for the Society's policyholders. Had those policyholders known about the Society's practice and decided to invest elsewhere, they would have invested in another company which might well have been doing the same as the Society or have been paying sums further above the asset share.

110 While I have found this complaint to have a sound basis in fact, in that the prudential regulators and/or GAD took no action on this matter when they had information before them, I make no finding of injustice resulting from maladministration. I therefore dismiss this head of complaint.

Complaints N and O – the protection of policyholders' reasonable expectations.

111 Complainants alleged that Ministers had decided that consideration of PRE was to be based solely on the scrutiny of the returns and that the prudential regulators and/or GAD had, as a result, failed to determine the reasonable expectations of the Society's existing and potential policyholders.

112 I consider that this complaint is partly misconceived in so far as it suggests that the prudential regulators and/or GAD were under an obligation to consider PRE questions in a particular way, such as the constant monitoring of PRE or the proactive assessment of the marketing material of insurance companies. I have explained why in Chapter 9 of this report.

113 It was open to Ministers to take a decision to discharge in a particular way their functions in relation to the protection of PRE, so long as that decision was compatible with the key obligations that the prudential regulators and GAD had during the relevant period, which I have described in Chapter 5 of this report.

114 While the scrutiny of the returns was the prime mechanism through which prudential regulation was undertaken, I have found that, where information came into the possession of the prudential regulators and/or GAD through any other source, they were required to consider it and to act in accordance with the obligations to which they were subject.

115 Those obligations included a duty to consider the use of their powers where the circumstances had or might have arisen which gave grounds for the use of such powers.

116 I have found that, in relation to the scrutiny of the Society's returns for every year from 1990 to 1996, issues arose which appeared to raise questions about the PRE of the Society's existing policyholders. Those issues were the valuation rate of interest used to discount the Society's liabilities and the affordability and sustainability of the bonuses that were declared by the Society during this period.

117 I have also found that insufficient regard was had to the PRE of both existing and potential policyholders when the FSA took its decision to permit the Society to remain open to new business in the period after the decision of the House of Lords in the *Hyman* case.

118 I have determined to this extent that maladministration is established in connection with these findings and that injustice resulted from that maladministration.

119 I therefore uphold this head of complaint in part.

Complaint P – preparation for, and follow-up to, the House of Lords' judgment.

120 Complainants alleged that the prudential regulators failed to protect the interests and reasonable expectations of the Society's existing and potential policyholders during the *Hyman* litigation and in the period between the decision of the House of Lords in July 2000 and the Society's closure to new business in December 2000.

121 With regard to the FSA's actions in relation to the *Hyman* litigation and the associated scenario planning, I have seen no evidence on this matter which would make me depart from my conclusion, set out in my first report, that no maladministration occurred in this respect.

122 Therefore, while I have reconsidered this question, I find no basis for an adverse finding with respect to this aspect of this head of complaint.

123 However, I have found that, in so far as this head of complaint relates to the acts and omissions of the prudential regulators in relation to the decision to permit the Society to remain open to new business in the period after the *Hyman* judgment in the House of Lords, those regulators failed to record that decision and took it on an unsound basis.

124 I have also determined that maladministration was established in respect of both those findings and that injustice flowed from the basis on which that decision was taken but not from the failure to record the decision.

125 That being so, I find this complaint to be substantiated to the extent that it relates to this aspect of the actions that were subject to complaint.

126 All of the above being so, I uphold this head of complaint in part.

Complaints Q and R – the bonus and policy value cuts in the period following the closure to new business.

127 Complainants alleged that the prudential regulators permitted the Society to declare a bonus for 2000 and an interim bonus for 2001, which were subsequently withdrawn and which were both inappropriate and unjustifiable given the state of the Society's finances at that time. They also alleged that those regulators failed to protect PRE by permitting the policy value cuts that were made in July 2001.

128 In so far as this head of complaint relates directly to the acts and omissions of the prudential regulators in respect of those matters, I find that there is no factual basis on which I could uphold this aspect of the complaint and that, in any case, it is partly misconceived.

129 As can be seen from Part 3 of this report, the FSA received and considered the Society's board papers setting out the background to the policy value cuts, which discussed at some length the various options that were open to the Society to manage the fundamental financial uncertainties that it faced.

130 I have already explained that I have found no basis for any suggestion that the regulatory regime at the time required or permitted the prudential regulators to act as 'shadow directors' or to intervene in the commercial freedom granted by Parliament to insurance companies. Such a suggestion represents a misconception about the nature of the relevant regime in place at the time covered by this report.

131 The FSA had information before it which showed that the Society had carefully examined the position it was in, had set out and discussed the available options, and had considered in some detail the potential impact on the Society's policyholders and the need to balance a range of competing interests. The FSA also gave consideration as to whether any of that information required them to consider the use of any of their powers of intervention.

132 Given both of those things, I find that there is no factual basis for any criticism of the FSA in these respects. This aspect of the head of complaint should thus be dismissed.

133 However, I consider that these complaints are essentially linked to the injustice claimed by those representing policyholders – financial loss sustained through reductions in bonus and cuts in policy values. Those aspects of the matters within this head of complaint have been addressed when making my determinations of injustice.

134 I have found that the consequences of all the maladministration that I have determined occurred was one contributory factor in the creation of the situation in which the policy value cuts had to be made by the Society. To that extent only, I find this head of complaint to be made out.

135 There were other contributory factors. For example, the falls in the equity and property markets would also have contributed to that situation.

136 To the extent alone that maladministration was a contributory factor in the creation of the situation in which the policy value cuts were made, I uphold these head of complaints in part.

The general complaint

137 But what of the general complaint? Did the prudential regulators and GAD fail *'for considerably longer than a decade properly to exercise their regulatory functions in respect of the Equitable Life Assurance Society'*?

138 In determining this general complaint, I need to address two separate questions. The first is whether the maladministration which I have determined occurred substantiates that complaint; the second is whether, if so, any injustice resulted from it.

Is the general complaint substantiated?

139 I would first note that, with respect to the Society's regulatory returns throughout the period covered by this report, the prudential regulators and GAD could never properly have been satisfied that the true financial condition of the Society, in terms of its compliance with the regulatory requirements and of its presentation of its solvency position, was being disclosed through the publication of those returns.

140 As a result of maladministration on their part and on the part of GAD, the prudential regulators were not able to verify the financial condition of the Society throughout this period. The Society's regulatory returns were published without amendment while serious questions about the Society's true position remained unresolved.

141 The information available to investors and potential investors and their advisers on which those investors could base their financial decisions throughout the period covered by this report was, in the specific ways that I have found, consequently incomplete, possibly inaccurate, and thus misleading.

142 The nature of the failings on the part of the prudential regulators and GAD which I have determined occurred differed over the time periods which I have considered in this report.

143 I consider that the prudential regulators and GAD in the period prior to the closure of the Society to new business in December 2000 failed properly to undertake their responsibilities in a number of respects.

144 In consequence, those regulators did not verify the solvency of the Society, failed to satisfy themselves that the Society's returns were accurate and complete, and failed to consider appropriate action to protect the interests of existing and potential policyholders, when such consideration should have been given as questions about the Society arose.

145 There was a comprehensive failure by the prudential regulators and GAD to identify issues of potential concern within the returns when they first arose – and in some cases ever. Those issues were significant either because they potentially had a fundamental impact on the solvency of the Society or because they appeared to demonstrate questions concerning compliance with the applicable law.

146 Moreover, when matters of concern <u>were</u> identified, little or no consideration was given by the prudential regulators, acting with the advice and assistance of GAD, as to whether that information merited the use of any of the powers of intervention which Parliament had conferred on them. Nor were the Society's returns required to be amended and resubmitted on any occasion during the period covered by this report.

147 As I have explained in Chapter 9 of this report, there is no evidence that there existed a generally applied policy that inaccuracies or other deficiencies in the regulatory returns submitted by insurance companies would be left unchallenged by the prudential regulators.

148 Indeed, such a policy if it existed would have been inconsistent with the obligations which those regulators had – which might in itself have constituted maladministration. Moreover, as I have also explained in Chapter 9 of this report, the evidence on this question that I have seen points the other way.

149 Furthermore, certain matters were not pursued appropriately and to a conclusion which enabled the prudential regulators to be satisfied that the Society was acting in accordance with the provisions of the statutory regulatory framework

or the administrative provisions set out in the relevant guidance.

150 Assurances given by the Society that it would undertake certain actions were often not followed through, reasonable concerns were rebuffed and not pursued further, and practices which should have raised questions in the minds of prudential regulators, acting reasonably, went undetected or were left unchallenged.

151 There was also a series of missed opportunities. The great respect in which the Society was generally held and the reputation it had developed over many years are the only rationalisations that I have been able to find which might explain the **passive, reactive** and **complacent** approach to the supervision of the Society that is evident from the acts and omissions of the prudential regulators and GAD during the period prior to 20 June 1998.

152 Once the supervision of the Society took on a heightened intensity in the period after 20 June 1998, when the prudential regulators and GAD had become aware of the significance of the guaranteed annuity rate issue and while the *Hyman* litigation was underway, those regulators and GAD initiated appropriate discussions with the Society, sought to insist that the requirements to which the Society was subject had to be fulfilled, and entered into extended dialogue with the Society to seek to ensure that those obligations were discharged. All that seems perfectly proper.

153 However, the prudential regulators permitted the Society to take impermissible credit within its returns for a financial reinsurance arrangement, when the terms of that arrangement were not concluded and also not capable of permitting such credit to be taken as the arrangement had no economic substance. On that basis, the Society was permitted to declare a bonus in March 1999. The amount of credit taken, in the returns for 1999 and 2000, was also unreasonable.

154 The prudential regulators also failed properly to consider whether to take action to protect the Society's existing and potential policyholders once the *Hyman* judgment had ended the basis on which the Society had managed its affairs in relation to guaranteed annuity rates, through the use of its differential terminal bonus policy.

155 I have no doubt as to the severity of the situation which faced the prudential regulators and GAD (and the Society) in the period between 20 June 1998 and the closure on 8 December 2000 of the Society to new business. Nor do I consider that those regulators failed to *initiate* action in the difficult circumstances that the Society faced at that time.

156 But once such action was initiated appropriately, it was then negated by the subsequent acts and omissions of the prudential regulators and GAD. On the whole, those acts and omissions in this period were **largely ineffective** and **often inappropriate**.

157 Those bodies acted in a way that was inconsistent with the regulatory regime they were responsible for operating and they departed unreasonably from compliance with the obligations to which those regulators and GAD were subject.

158 In the post-closure period which I have considered, a considerable amount of activity was undertaken by the prudential regulators across a wide range of issues, many of which were of a seemingly intractable nature and which raised serious questions about the future survival of the Society. That the Society was able eventually to weather the storms that it faced during this period must, it seems to me, to be due, at least in part, to this considerable effort by the prudential regulators.

159 The actions of the prudential regulators in the post-closure period were **largely effective** but, when giving information to the Society's policyholders and to others about the situation Equitable was in, the FSA **provided information which was inaccurate and misleading**.

160 That is particularly unacceptable, given the nature of the regime that the FSA were operating – which permitted the Society commercial freedom in return for accurate and complete information, information which the prudential regulators were supposed to ensure was provided. It was also unacceptable given the obvious and understandable concern felt by the Society's policyholders about its stability and their own financial security when they contacted the FSA for such information.

161 Although I have made findings of maladministration within this report, such findings should not be taken as being based on a view that the prudential regulators and GAD were in any sense guilty of acting in bad faith. Similarly, in so far as the period covered in this report from July 1998 onwards is concerned, I do not suggest through my findings that those regulators and GAD gave inadequate attention to, or put insufficient effort into, the supervision of the Society.

162 Nevertheless, I have found there to have been three general consequences of the maladministration which I have determined occurred, namely:

- that the Society's returns were an unreliable source of information;
- that both the prudential regulators and the Society lost opportunities to address at an earlier date issues which were to become critical; and
- that regulatory decisions were frequently taken on a basis which had insufficient regard to the powers available to the prudential regulators.

163 Those consequences of the extensive maladministration which I have determined occurred in this case demonstrate failings which all go to the heart of the responsibilities and obligations which the prudential regulators and GAD had at the relevant time.

164 I consider that, accordingly, the maladministration that I have identified pervades the exercise by the prudential regulators and GAD of their functions over the period covered by my investigation. I also conclude that my findings are of such individual and cumulative significance that they demonstrate a failure by the prudential regulators and GAD to discharge their statutory functions and other obligations in a proper and effective manner.

165 But does all this substantiate the general complaint? **I consider that the maladministration which I have found substantiates the general complaint that the prudential regulators and GAD failed properly to exercise their regulatory functions in respect of the Society during the period prior to its closure.**

166 I consider, however, that the one finding of maladministration that I have made in respect of the inaccurate and misleading information provided by the FSA during the post-closure period does not substantiate the general complaint in relation to that period. Such a finding does not outweigh the substantial and sustained efforts that the prudential regulators put into the supervision of the Society during this period in very difficult circumstances.

Did injustice result from these failings?

167 But did any injustice further to that which I have identified in Chapter 12 of this report result from the failings which have caused me, when those failings are taken together, to find that the general complaint is substantiated with respect to the period prior to 8 December 2000?

168 I have considered whether any further injustice has resulted from the maladministration I have found in respect of the general failure of those operating the system of prudential regulation during the period when the Society was still open to new business. In doing so, I was struck by one theme which ran throughout every one of the referred complaints and throughout every one of the considerable number of letters that I have received from those complainants.

169 The particular circumstances of each complainant vary enormously – in terms of their age, their involvement with the Society, the amount that they claim to have lost as a result of that involvement, and the degree of reliance that they have now, or had in the past, on income derived from their investments with the Society. However, one thing unites all those complainants.

170 That is a sense of outrage that those complainants feel at the failure of those operating the system of prudential regulation, which the complainants believe that events relevant to the Society demonstrate – and which, by way of findings of maladministration, in respect of some of their complaints at least, I have vindicated.

171 In determining whether this sense of outrage is justifiable and thus constitutes injustice, I have had regard to the purpose of the regulatory regime which on this occasion was operated with maladministration. I have also had regard to the prospectus held out at the time by those operating that regime about their responsibilities and the degree to which an existing or potential policyholder could rely on that regime.

172 In Chapter 5 of this report, I found that the stated aim of this system of prudential regulation was to protect the interests of policyholders and potential policyholders. Securing this aim was to be done in such a way as to balance the need to take such action as was necessary to protect those interests without interfering in the business of insurance companies to such an extent as would stifle competition and prevent innovation.

173 That regime was predicated on four cornerstones – freedom with publicity, the central role of the Appointed Actuary in the system of prudential regulation, the protection of the reasonable expectations of existing and potential policyholders, and the fulfilment of the criteria of sound and prudent management.

174 In the case of the Society during the period covered by this report prior to the closure of the Society to new business in December 2000, none of those features of the regulatory regime operated as Parliament intended they should operate. That was a result of maladministration by those charged with operating that regime.

175 Furthermore, the prospectus held out to existing and potential policyholders gave the impression that those operating the system of prudential regulation would undertake their responsibilities in such a manner as would enable those investors, when making investment decisions, to rely on the information about the Society which was published in its annual returns. As a result of maladministration, that information was unreliable throughout the period covered by this report.

176 **In light of the above, I consider that this serial regulatory failure, which the maladministration I have found in respect of the period prior to the Society's closure to new business represented, has caused further injustice to those who have complained to me.**

177 **Such injustice takes the form of a justifiable sense of outrage that those operating the system of prudential regulation so comprehensively failed, when those complainants had been told that this system would protect their interests and would ensure that adequate information in prescribed formats about the activities of insurance companies would be published to enable informed investment decisions to be made.**

178 I find that maladministration permeated the discharge by the prudential regulators of their statutory functions – functions which were discharged with the advice and assistance of GAD. This occurred throughout the period covered by this report. The consequences of that maladministration were both significant and serious for those who have complained to me. I also find that injustice resulted from that maladministration.

179 That maladministration substantiates the general complaint made to me in respect of the period prior to the closure of the Society to new business. Injustice – in the form of a justifiable sense of outrage – resulted from that maladministration.

180 **I therefore uphold the general complaint that the prudential regulators and GAD failed properly to exercise their regulatory functions in respect of the Society during the period prior to 8 December 2000 that is covered in this report.**

181 In the previous Chapter of this report and in this one, I have made five determinations that injustice resulting from maladministration has been sustained. Those are:

(i) that injustice was sustained by any policyholder who can show that they relied on the information contained in the Society's returns for 1990 to 1996 and who suffered either a financial loss or a lost opportunity to take an informed decision about their financial affairs as a result of such reliance;

(ii) that policyholders sustained injustice in the form of the loss of opportunities in the period between July 1991 and April 1999 to take informed decisions about their financial affairs in full knowledge of the exposure of the Society to guaranteed annuity rates and of the risks that such exposure generated;

(iii) that all those who joined the Society or who paid a further premium that was not contractually required in the period after 1 May 1999 have sustained injustice in the form both of any financial loss they may have suffered and also in the form of lost opportunities to take informed decisions about their financial affairs;

(iv) that those individuals who can show, having regard to their particular circumstances, that they relied on deficient information provided by the FSA in the post-closure period, that such reliance was reasonable in the circumstances, and that it led to a financial or other loss have sustained injustice; and

(v) that all those who have complained to me have sustained injustice in the form of a justifiable sense of outrage at the failings of the system of prudential regulation that are epitomised by my findings of maladministration relating to the prudential regulation of the Society during the period prior to its closure to new business.

182 I now turn to consider what would be an appropriate remedy for the injustice that I have found resulted from maladministration. I do this in Chapter 14 of this report.

Chapter 14 – Remedy and recommendations

Introduction

1 In this Chapter, I set out the consideration that I have given as to what remedy, if any, it would be appropriate for me to recommend in the light of my determinations that injustice resulted from the maladministration I have found. That consideration has been informed by representations on this question that I sought and received from the parties to the complaints.

2 I also set out the recommendations that I am making in the light of that consideration. Before doing so, I will explain my approach to remedying injustice resulting from maladministration.

My approach to remedy

3 In October 2007, I published a document, *Principles for Remedy*[1], which sets out my views on the Principles that should guide how public bodies provide remedies for injustice or hardship resulting from their maladministration and confirms my own approach to recommending remedies.

4 Those Principles flow from my *Principles of Good Administration*, referred to in paragraphs 8 to 12 of Chapter 5 of this report. The provision of fair and proportionate remedies is an integral part of good administration, so the same principles apply.

5 My underlying principle is to seek to ensure that the relevant public body restores the complainant to the position he or she would have been in, had the maladministration not occurred. If that is not possible, the relevant body should compensate them appropriately.

6 As with my *Principles of Good Administration*, these Principles are not a checklist to be applied mechanically. Judgement should be used when applying the Principles to produce reasonable, fair, and proportionate remedies in the circumstances of each case.

7 The Principles that I have identified as being most relevant to this case are 'getting it right', 'being customer focused', 'acting fairly and proportionately', and 'putting things right'.

8 'Getting it right' means quickly acknowledging and putting right cases of maladministration or poor service that have led to injustice or hardship and considering all relevant factors when deciding the appropriate remedy, ensuring fairness for the complainant and, where appropriate, for others who have suffered injustice or hardship as a result of the same maladministration.

9 'Being customer focused' means, among other things, apologising for and explaining the maladministration and providing remedies that take account of people's individual circumstances.

10 'Acting fairly and proportionately' means, among other things, offering remedies that are fair and proportionate to the complainant's injustice or hardship and providing remedies to others who have suffered injustice or hardship as a result of the same maladministration.

11 'Putting things right' means, if possible, returning the complainant – and, where appropriate, others who have suffered similar injustice or hardship – to the position they would have been in, had the maladministration not occurred. If that is not possible, the complainant and such others should

[1] Available at: http://www.ombudsman.org.uk/improving_services/remedy/index.html

be compensated appropriately. It also means considering fully and seriously all forms of remedy (such as an apology, an explanation, remedial action or financial compensation) and providing the appropriate remedy in each case.

12 In considering what an appropriate remedy might be in any particular case, I would expect a public body to consider the wishes and needs of the complainant in deciding an appropriate remedy and to consider all the circumstances of the case, trying, wherever possible, to offer a remedy that is calculated fairly and impartially but is still appropriate.

Representations made to me

13 In line with my normal practice, in February 2008, when I sent a copy of the revised draft of this report to the public bodies, to those representing complainants and to other interested parties, I asked those representing the lead complainants to tell me what they, on behalf of those complainants, considered would be an appropriate remedy for the injustice which I have found resulted from maladministration.

14 In May 2008, I received submissions on this question from those acting on behalf of the lead complainants. I also received submissions from the public bodies, whom I had also asked for their views on this question.

The submissions by EMAG on behalf of complainants

15 EMAG made submissions concerning both the broad principles which should govern any scheme for compensation and suggested an approach towards the quantification of such compensation. Those submissions are reproduced in full in Part 4 of this report.

16 With regard to the principles which should govern a compensation scheme, EMAG submitted that:

> *... an FSA-style compensation scheme, such as applied to various forms of mis-selling, could take another eight years. In eight years most Equitable Life policyholders will be beyond caring. They need and deserve, having suffered 'outrageous' treatment at the hands of the Treasury and the regulators, a redress package that:*
>
> 1. *Is rapid in payment.*
> 2. *Is simple to administer.*
> 3. *Is not administered by either the Treasury, or the FSA or any of their offshoots or by Equitable Life.*
> 4. *Does not require an extensive and complicated claims system.*

17 EMAG further submitted, with respect to an approach to the quantification and delivery of compensation, that:

> *The approach EMAG suggests ... is as follows:*
>
> 1. *Take the areas where* [I have] *found maladministration leading to injustice and make a broad brush estimate of the total loss arising to policyholders at 16 July 2001.*
> 2. *Add an estimate of the 'removal costs' in respect of those that have subsequently moved their funds elsewhere. This would include Market Value Adjustments, other penalties and re-investment charges.*

3. *Apply a series of appropriate discounts for things like the proportion who were not influenced by published data and those who would not have invested elsewhere and apply those percentages to the total to arrive at a compensation sub-total as at that date.*

4. *Add something for outrage and interest to the resulting sum to arrive at a current compensation 'pot', which the Treasury should pay immediately to an appropriate independent scheme administrator.*

5. *Distribute that compensation 'pot' upon a policy by policy basis in accordance with a sliding scale based upon values immediately before the big cut of 16 July 2001.*

18 EMAG continued by saying:

The benefit of this approach is that once the compensation pot is agreed and transferred to the scheme administrators, calculation could be handled mechanically from the information held upon Equitable Life's computers, now in the possession of Halifax Financial Services. The downside is a lack of sophistication to deal with all possibilities.

EMAG sees it as vital for the fair treatment of Equitable Life policy holders as a whole that compensation can be calculated, apportioned and distributed without undue delay, even if it involves the acceptance of some rough edges to the calculations.

19 EMAG told me that they had calculated the '*losses incurred by policyholders investing after 1990 at £3.2bn if they would have remained with Equitable or £4.6bn if they would have invested elsewhere*'.

My assessment of the submissions by EMAG

20 The principles that EMAG set out do not seem to me to be controversial. If it is decided to establish a compensation scheme, given the length of time that it has taken to determine the relevant complaints and the history of this case, it seems to me that it would be fair, just and reasonable for such a scheme to operate independently, flexibly, openly, and speedily – and with the acceptance of some '*rough edges*'.

21 As for EMAG's suggested method of compensation, I am aware that there is more than one means of calculating compensation in circumstances such as this.

22 One method is that chosen by EMAG – the identification of quantifiable amounts which are then set at a global level, with the resulting amount shared out to those deemed eligible by some pre-determined formula. Another is that used by the Financial Ombudsman Service which, on an individual level, makes a comparative assessment of the performance of the company in question against an average-performing competitor. I have no concluded view on the relative merits of such proposals, which are a matter for others to determine.

23 Before I would make a recommendation for financial compensation in any individual case, I would need to be satisfied that those who had complained to me, and those who had been affected in the same way by the same maladministration, had sustained injustice in the form of financial loss as a result of that maladministration.

24 The injustice that I have found on this occasion to have been sustained by those who have complained to me was summarised in Chapter 12 of this report, and is:

- financial loss, where that has occurred, or lost opportunities to take informed decisions as a result of reliance on the information contained in the Society's returns for 1990 to 1996;

- the loss of opportunities in the period between July 1991 and April 1999 to take informed decisions in full knowledge of the exposure of the Society to guaranteed annuity rates and of the risks that such exposure generated;

- financial loss, where that has occurred, to anyone who joined the Society or who paid a further premium that was not contractually required in the period after 1 May 1999 and lost opportunities to take those decisions on an informed basis;

- financial or other loss, where that has occurred, to those individuals who can show, having regard to their particular circumstances, that they relied on misleading information provided by the FSA in the post-closure period, that such reliance was reasonable in the circumstances, and that it led to any such losses; and

- a justifiable sense of outrage on the part of all those who complained to me at the failings of those operating the regulatory system during the period prior to the Society's closure to new business.

25 It is my normal practice, where someone has been inconvenienced or made to feel a justifiable sense of outrage at the way that they have been treated, to recommend that an apology is made and that consideration is given to whether that apology should be accompanied by a tangible recognition of such inconvenience or outrage.

26 Where financial loss is established, I would normally expect that, where appropriate, such a loss should be remedied in full, with an appropriate payment of interest where that is relevant.

27 In that context, there are four questions that I need to address in this case before making any recommendations designed to remedy the injustice that I have found has been sustained on this occasion, namely:

- whether complainants have suffered a financial loss in absolute terms – that is, have they suffered an identifiable or quantifiable loss at all?;

- if so, whether complainants have suffered a financial loss in relative terms – that is, have they suffered a loss that they would not otherwise have suffered had they invested or saved elsewhere than the Society?;

- if so, whether there is a sufficient link between the maladministration found and that relative loss; and

- if there is, what it would be appropriate in all the circumstances of this case to recommend by way of a remedy.

  If I were to find no financial loss, or were to conclude that any such loss sustained was not sufficiently linked to maladministration, or were to consider that it would not be appropriate to recommend a remedy for any such loss, I would then need to consider whether it would be appropriate to recommend a remedy for the opportunities that I have found were lost as a result of maladministration.

28 I also need to consider whether any injustice has already been remedied by other means. Where that is so, I would not expect a further remedy to be provided, as it is an important principle – one set out within the detail of my *Principles for Remedy* – that any recommendation I make should not lead to a complainant making a profit or gaining an unreasonable advantage.

29 As for **absolute loss**, I am very far from concluding that everyone who has complained to me about the prudential regulation of the Society has suffered a financial loss. Still less do I conclude that everyone who has saved with, or invested in, the Society during the period covered by this report has suffered financial loss.

30 It seems to me that it is a natural and unavoidable consequence of one of the basic premises of the complaints that have been made about the events covered in this report – namely, that distribution took place of the resources of the Society in what is said to be an imprudent manner which it could not afford – that some people have gained from saving and investing with the Society more than they would have done had any such distribution not occurred.

31 That said, there is no avoiding the fact that those who are, or were at the relevant time, members of the Society underwent the series of policy value and bonus cuts during the period after it closed to new business that are set out within Chapter 2 of this report.

32 That is sufficient evidence in my mind to persuade me to conclude that, for many people at least and in a context where those people had reasonable expectations concerning their policy values and bonuses, financial loss has been sustained. In coming to this conclusion, I have also borne in mind the acceptance, which appears to be common ground among all the parties, that such losses were suffered across the with-profits industry at the relevant time.

33 That brings me to **relative loss**. Did those who have complained to me, and those in a similar position to those complainants, suffer a loss that they would not have suffered had they saved or invested elsewhere?

34 I explained above that the approach that the Financial Ombudsman Service takes to the question of remedying financial loss is a comparative approach. For example, such an approach is illustrated in their determination of the case of Ms E[2]:

> *The compensation due to Ms E should put her in the position she would have been in if she had not invested with Equitable Life. The value of her funds, like those of nearly all funds invested in the stock market, fell during this period. But it would be unfair to order Equitable Life to compensate Ms E for losses due to falls in the stock market that would have affected all with-profits funds and which she would have suffered if she had invested with a different firm instead of Equitable Life.*
>
> *Therefore, compensation is to be assessed by comparing the return Ms E received on the money she put into a with-profits pension with Equitable Life and the return she would have received from a similar product with an alternative provider. Since I have been unable to identify which particular alternative provider Ms E would have chosen, I have decided that the comparison should be made with the average return achieved by comparable with-profits funds.*

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[2] Whose complaint to the Financial Ombudsman Service about mis-selling by the Society was upheld: http://www.financial-ombudsman.org.uk/faq/pdf/Equitable_GAR_final_decision.pdf

35 The Society has dealt with many types or categories of mis-selling complaints, or claims based on breach of contract. However, the most analogous category of complaint to the maladministration on the part of the prudential regulators and GAD that I have found to have occurred on this occasion was those complaints which were made due to the Society's failure to disclose the existence of guaranteed annuity rates.

36 I sought information from the Society as to what the outcome had been to the cases of those people in a similar position to Ms E who, not being caught by the effects of the Compromise Scheme, had complained to the Financial Ombudsman Service about such alleged mis-selling on the part of the Society – and whose case had been assessed using the approach outlined above in relation to Ms E.

37 That information shows that relative loss was established in 1,072 cases. In a further 233 cases, a complaint of mis-selling was upheld but the comparative assessment resulted in a determination that no loss had been sustained. That is, that approximately 60% of those who had made complaints of the type made by Ms E were found to have suffered a relative loss, there having been 1,796 such cases in total.

38 I understand that the cases dealt with by the Financial Ombudsman Service followed on from a review conducted by the Society, at the request of the FSA, of any mis-selling which related to the failure to disclose the existence of guaranteed annuity rates. In the course of that review, the Society also adopted an analagous comparative approach to assessing loss, although I understand that it imposed a ceiling or cap on the remedy provided.

39 Under that review, a total of 7,253 cases were considered. Relative loss was established in 5,636 of those cases. No loss was found in 601 cases and no liability for mis-selling or loss in 1,016 cases. That is, that approximately 78% of those with mis-selling complaints of types other than that made by Ms E were found to have suffered a relative loss.

40 Those who have complained to me are in substantially the same circumstances as those who complained to the Society or to the Financial Ombudsman Service, with the exception that they were caught by the effects of the Compromise Scheme and thus could not pursue such complaints.

41 When the above information is considered together, it seems to me that this demonstrates that, for many of those covered by my recommendations, it could be established that a loss has been sustained, relative to what would have transpired had those individuals saved or invested with a comparable with-profits fund.

42 I therefore conclude that it would be difficult to sustain an argument that no person affected by '*the Equitable affair*' had suffered a relative loss. I also conclude that the individual circumstances of each complainant and other people similarly affected are key to establishing whether those people are in the category of those who have suffered relative loss. Accordingly, whether relative loss in a particular case has been sustained has to be determined at an individual level.

43 I now turn to consider whether there is a **sufficient link** between the acts and omissions of the bodies whose actions have been investigated and found to be deficient with any relative loss that is established.

44 I explained in Chapter 5 of this report that the aim of the system of prudential regulation was to

protect the interests of policyholders through the supervision of the affairs of insurance companies, in the manner in which Parliament intended and using the means that Parliament provided.

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

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

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

48 I am satisfied that there is a sufficient link between the actions of the prudential regulators and GAD and any relative loss that may be established occurred in individual cases. That also goes for the opportunities to invest elsewhere than the Society which I have found that complainants have lost.

49 I now turn to what it might be **appropriate to recommend** to remedy the injustice that I have found resulted from maladministration on the part of the prudential regulators and/or GAD.

50 This I would normally do in line with the basic principle that I have outlined above, namely that the relevant public bodies should restore complainants to the position they would have been in, had maladministration not occurred or, where that is not possible, those bodies should compensate the complainants appropriately.

51 However, I have received submissions from the public bodies that question whether it would be appropriate, in the specific context of this case, to apply the approach that I would normally apply to questions of remedy and redress.

52 I consider those submissions below and then go on to address the question of what it would be appropriate to recommend on this occasion.

The submissions by the public bodies

53 The public bodies in their submissions questioned whether, in principle, it would be appropriate for me to recommend financial compensation, in the light of my findings and determinations. Those submissions were made, those bodies said, '*without prejudice*' to a '*central submission*' on their part that no maladministration had occurred and that, in any event, no injustice had resulted.

54 Those bodies first told me that they accepted that my '*jurisdiction is wider than that of the courts*' and that I applied '*different tests to* [my] *approach to maladministration and injustice*'.

55 However, the public bodies submitted that:

> *... in any consideration of a possible recommendation of a remedy involving compensation being paid by any of the bodies under investigation, they contend that there are compelling reasons of policy as to why it is contrary to the public interest or otherwise*

inappropriate to recommend financial redress to "remedy" any maladministration. Amongst these reasons are those that have led the English courts to shy away from imposing a duty of care on regulators.

56 The public bodies continued by saying:

It is important to note that, even now, Equitable has not failed. Essentially, the complainants in this investigation seek redress not for the collapse of Equitable, but to compensate for the fact that, following the events that were brought about by the decision of the House of Lords in the Hyman litigation, the non-guaranteed element of their policy values has fallen relative to what they were expecting.

57 It was submitted by the public bodies that:

There are many sound public policy reasons for not recommending that a regulator such as the bodies under investigation should provide financial recompense even if negligent regulation (and, by analogy, maladministration) is established. Prominent among these reasons are that such a recommendation would:

(a) tend to result in an over-cautious or excessively risk-averse regulatory approach, for example the distortion of decision-taking in favour of those most likely to sue;

(b) if accepted, result in the diversion of scarce public resources;

(c) be illegitimate in circumstances where the regulator does not exercise sufficiently immediate day to day control over the primary wrongdoer;

(d) obscure the fact that the immediate and material cause of the loss in this case was Equitable itself, coupled with the combined impact of external factors which were beyond the control of the prudential regulator;

(e) be inconsistent with the broader role of regulation; [and]

(f) be incompatible with the statutory scheme in place during the relevant period covered by the ... Report.

58 The public bodies continued by saying:

Effective regulation entails the careful weighing of competing objectives and the exercise of judgement as between a range of possible courses of action. The Courts have consistently recognised this, in cases such as Yuen Kun Yeu[3] *v Attorney General of Hong Kong; Davis v Radcliffe*[4]*; and Three Rivers DC v Bank of England*[5]*.*

As the Court observed in the last of these three cases, "... the exercise of the powers and duties of a supervisor in this field involves the balancing of many different factors in the interests both of the public generally and of both existing and future depositors. The interests of these and other different groups may conflict so that it makes no real sense to hold that a duty of care or a statutory duty is owed to only one or some of those groups ...".

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[3] [1988] AC 175.
[4] [1990] 1 WLR 827.
[5] (Commercial Court) 1 April 1996.

59 It was further submitted by the public bodies that:

> *In the present context, the prudential regulator had to make judgements in the context of a need to weigh up competing considerations of investors and potential investors, the interests of the financial services sector and the wider public interest in fostering competition and innovation.*

60 The public bodies continued:

> *The Courts have on many occasions, in a number of different contexts*[6]*, recognised that to impose a liability to provide financial redress on regulators would result in over-cautious or excessively risk-averse regulatory decisions. In the particular context of financial regulation, in Yuen Kun Yeu the Court considered that there was "much force" in the argument that the imposition of a duty of care on a banking regulator in respect of losses suffered by depositors would have a seriously inhibiting effect on the work of the regulator.*
>
> *This is because a sound judgement would be less likely to be exercised if the regulator were to be constantly looking over its shoulder at the prospect of claims against it, and its activities would be likely to be conducted in a detrimentally defensive frame of mind. The result of this, the Court decided, was that the effectiveness of the regulator's functions would be at risk of being diminished: consciousness of potential liability could lead to distortions of judgement*.

61 The public bodies then submitted that:

> *Any acceptance of a recommendation to make financial compensation would potentially expose the public purse to liability to an unlimited number of claimants comprising existing depositors or investors and potential depositors or investors.*
>
> *This was a powerful factor which weighed with the Court in Davis v Radcliffe, where it commented that a consideration militating against the existence of the alleged duty of care on the regulator was that "it is said to be owed to an unlimited class of persons including not only the depositors of money with [the regulated entity] but also those considering whether to deposit their money with [the regulated entity]".*

62 It was further submitted that:

> *This leads to the related point that any acceptance of a recommendation to pay compensation from the public purse as a result of defective regulation would inevitably result in the diversion of scarce public resources provided by the taxpayer away from important social programmes such as education or health.*

63 The public bodies then set out a '*further fundamental objection to the making or acceptance of any recommendation for financial compensation*', that being:

> *... that this would entail, in effect, making the regulator liable for the defaults of the regulated entity.*

[6] In cases such as, for example, *X v Bedfordshire CC* [1995] 2 AC 633 and *Hill v Chief Constable of West Yorkshire* [1989] AC 53.

As a matter of principle, it is only legitimate to seek to impose liability on a body for the wrongdoings of another to the extent that the body can exercise a high degree of control over the latter, as was emphasised by the Court in Davis v Radcliffe and in Yuen Kun Yeu.

Both these cases were cited by the High Court in Three Rivers District Council v Bank of England. In considering whether the Bank of England owed a duty of care in its regulatory capacity in respect of losses suffered by depositors following the collapse of BCCI, the Court (having referred to Davis v Radcliffe and Yuen Kun Yeu) highlighted the significance of the fact that the Bank of England did not exercise day to day control in its regulatory functions. The judge stated:

> *"... in each case it was held that the supervisor had no day to day control of the supervised institution. ... the same is true here. ... none of [the Bank's powers] gave the bank the kind of control which the Privy Council had in mind as potentially giving rise to a duty of care or statutory duty to depositors ... In my judgment the Bank cannot fairly be regarded as having day to day control of BCCI or any other supervised institution."*

64 It was then submitted by the public bodies that:

This reasoning is, the bodies under investigation contend, applicable to the respective positions of the bodies under investigation on the one hand and Equitable on the other. The regulation of life insurance companies such as Equitable is in principle similar to the regulation of banks with which the Yuen Kun Yeu, Davis v Radcliffe and Three Rivers cases were concerned.

65 The public bodies then set out a '*further reason why it would be quite inappropriate to recommend any financial remedy*', that being:

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

66 The public bodies then submitted that:

> *A broader reason for coming to the same conclusion is that the purpose of the regulatory system in force at the material time was not to provide a warranty to investors.*
>
> *Moreover, any recommendation for a financial remedy would not be in accordance with the specific statutory scheme in place during the relevant period. In Yuen Kun Yeu the Court declined to impose a duty of care on the regulator because the Court is "unable to discern any intention on the part of the legislature that in considering whether to register or deregister a company the commissioner should owe any statutory duty to potential depositors. It would be strange that a common law duty of care should be superimposed upon such a statutory framework."*
>
> *Similarly, there is nothing in the regulatory regime with which the ... Report is concerned which suggests that Parliament intended any common law duty of care to be superimposed on that framework.*

67 The public bodies then concluded by submitting that:

> *Any recommendation for a financial remedy would be tantamount to a recommendation that the State should accept by the back door a very similar obligation to that which Parliament has declined to impose via the front. Such a recommendation, in the circumstances of the present case, would not be an appropriate use of the Ombudsman's powers.*

and that:

> *Moreover, it is not necessary for there to be financial redress to provide for the full accountability of regulators. Public bodies are held accountable for their acts and omissions in a number of ways: through Parliamentary and press scrutiny, by bodies such as the National Audit Office and by public opinion.*

My assessment of the submissions by the public bodies

Preliminary matters

68 Before setting out my assessment of those submissions by the public bodies, I would first note, as a preliminary point, that this statement of principle by those bodies – that it would never be appropriate for me to recommend financial compensation in, or following, a report in which I had upheld complaints that injustice had been sustained in consequence of maladministration on the part of financial regulators – is a surprising submission.

69 I say that it is surprising for three reasons. First, I would note that I am being invited to adopt, without regard on each occasion to the relevant circumstances of the case, a blanket approach to the question as to whether or not it would be appropriate, in the context of all complaints about financial regulation, to recommend financial compensation for any injustice which I identify has been sustained.

70 However, I do not consider that the adoption of such an approach would be permissible. I may not fetter my discretion. I am required to consider each case on its merits. The adoption of a rigid policy, such as is here proposed by the public bodies, would not, in my view, be lawful or appropriate. Nor either, in my view, would it be appropriate if public bodies adopted such a rigid policy when responding to my reports, for similar reasons.

71 Secondly, if I were required as a matter of principle to adopt such an approach, this would constitute a fundamental constitutional principle, one which was not articulated by Parliament within the legislative framework which governs my role.

72 There are many examples within the 1967 Act of qualifications to, or restrictions on, the type of action taken in the exercise of administrative functions that I am empowered to investigate. Specific exclusions from such action, which relate to individual bodies among those which are listed in Schedule 2 to the 1967 Act as being bodies to which that Act applies, are set out by way of Notes to that Schedule.

73 It seems to me that, had it wished to do so, Parliament could have excluded through this method action taken as part of the discharge of the functions of particular financial regulators such as the DTI or the Treasury from the scope of my jurisdiction. Indeed, when Parliament brought GAD

within my jurisdiction to enable me to conduct the investigation which led to this report, Parliament limited the actions by GAD that I could investigate by way of such a Note.

74 The bringing into my jurisdiction of GAD was, it seems to me, itself an indication of the Parliamentary intention that I should consider the actions which I have investigated in this case – and apply the tests that I would normally apply, once I had considered those actions and had determined whether the complaints I have received about those actions were justified.

75 Furthermore, Schedule 3 to the 1967 Act lists types of action taken in the exercise of the administrative functions of all the bodies within my jurisdiction that I am not permitted in any case to investigate.

76 Had Parliament intended that the actions of all financial regulators should be treated differently from those of the other bodies in my jurisdiction, including certain regulators in other fields, it could have removed as a class the actions of financial regulators from my investigative reach by listing those actions within that Schedule.

77 Yet Parliament did not do so – not even on the many occasions on which the 1967 Act was amended after the then Government had indicated, in response to my predecessor's report on Barlow Clowes, that the Government believed that financial regulators were, in the context of my remit, a special case – in respect of which the normal approach adopted by the Ombudsman should not apply.

78 In the absence of express authorisation by Parliament, I consider that it would be inappropriate for those whose actions are subject to investigation to seek to bypass the scheme established by Parliament through the creation of my Office, merely by the assertion that their particular position is different to that of other public bodies.

79 If I were to accept that a public body, through such assertions, was entitled to take itself outside the scope of the remedies that can be provided through my work, this would potentially have significant ramifications on a wider scale.

80 This, it seems to me, is even more the case when regard is had to the purpose of the scheme established by Parliament, which is precisely to enable remedies to be provided for justified complaints that injustice has resulted from maladministration on the part of those bodies within my jurisdiction.

81 That brings me to the third and final reason why I have found the submissions of the public bodies on this point to be surprising.

[7] As is well known, the initial response of the then Government to my predecessor's report on the collapse of Barlow Clowes was that, while, out of respect for my Office and in recognition of the special circumstances which pertained in that case, compensation would be paid to those who had lost as a result of that collapse, the findings that maladministration had occurred were contested. Moreover, the then Government set out its view, in its published response to that report, as to the role of regulators in the financial sector and as to whether it would be reasonable for such regulators ever to be held liable for negligence in the performance of their functions. However, that initial response did not constitute the Government's final view on whether maladministration had occurred in relation to the regulation of Barlow Clowes. On 7 July 1995, in the DTI inspectors' report concerning Barlow Clowes, those inspectors concluded that *'in our view, the DTI did not demonstrate, in relation to Barlow Clowes, the characteristics of a competent regulatory authority'.* And the then Secretary of State for Trade and Industry, Lord Young, had earlier conceded, in an interview shown as part of a Channel 4 documentary on Barlow Clowes, that the regulators had probably been to blame for licensing at least the domestic operation of that company, saying, as regards my predecessor, that *'I suspect he was right'* in that respect – see *The Barlow Clowes Affair* – Lawrence Lever (1992: Macmillan).

82 The initial position of the then Government in respect of the Barlow Clowes report changed over time[7]. Despite this, that position – namely that recommending financial compensation to remedy injustice resulting from maladministration on the part of financial regulators would always be inappropriate – is now put forward again as an important principle that should guide my consideration of what recommendations I should make in this case.

83 But such a fundamental principle is surely one that the public bodies in this case could have clearly and publicly stated before now.

84 At no time have the public bodies made such a statement that, whatever I might find at the end of the investigation which led to this report, it was an important matter of principle that no compensation would ever be payable in any circumstances. That has only been submitted to me since I issued the first draft of this report to those bodies.

85 The terms of reference for my investigation stated plainly that, at the end of that investigation, I would recommend appropriate redress for any injustice I found had been caused by maladministration on the part of those bodies whose actions were subject to complaint. Yet such a principle as is now put forward was not articulated within the initial response of those bodies to the complaints within those terms of reference.

86 Nor was such a principle stated in the response of the Government to the Penrose Report, or during the consultation process that I undertook prior to deciding to launch the investigation which led to this report, or at any of the other opportunities to make such a submission that have arisen during my investigation, or in evidence given by the public bodies before the European Parliament Committee of Inquiry.

87 It seems to me that those who have complained to me therefore have a legitimate expectation that I will consider what it would be appropriate to recommend by way of remedy, without imposing constraints which have no grounding in the legislative scheme governing my role.

88 Those complainants – and others, including Parliament – would, it seems to me, be entirely justified in asking what had been the purpose of my investigation, or of the other inquiries which have been undertaken in respect of the Society, if I were simply to suggest now, at the invitation of the public bodies, that there had never been any possibility of an appropriate remedy at the end of this process.

Do these submissions provide an adequate basis for concluding that no remedy for maladministration should be forthcoming?

89 While, for the reasons I have explained above, I am surprised by the nature of the submissions made by the public bodies, I recognise that those submissions constitute a clear statement of principle which I am invited to adopt. I also recognise that the adoption of such a principle would have a profound effect on what I might consider it appropriate to recommend in this report.

90 I accept, therefore, that the substantive merits of those submissions should be assessed. This I now turn to do.

91 The public bodies have told me that they accept that, '*my jurisdiction is wider than that of the courts*' and that I apply '*different tests to* [my] *approach to maladministration and injustice*'. At the same time they submit that, '*there are compelling reasons of policy as to why it is contrary to the public interest or otherwise inappropriate to recommend financial redress to*

"remedy" any maladministration.' They say that, '*amongst these reasons are those that have led the English courts to shy away from imposing a duty of care on regulators.*'

92 The underlying premise of these submissions by the public bodies, their acceptance that my jurisdiction is wider than that of the Courts notwithstanding, is that I should take into account the same considerations as would the Courts when considering negligence claims against public authorities. In other words, that the work of the Courts in relation to negligence claims is directly analogous to my work. I do not accept that underlying premise for the following reasons.

93 First, I am aware that the Courts have held that only in exceptional cases would they accept that the interests of justice justified an extension of the law of negligence to new categories of public body, such as financial regulators; and that this has normally been on the basis that to do so would create a novel category of negligence liability.

94 A classic example of the caution that I understand the Courts would adopt in such a situation appears in the case of *Reeman v Department of Transport* [1997], where Phillips LJ said[8] that: '*When confronted with a novel situation the Court does not* [consider whether to impose a duty of care] *... in isolation. It does so by comparison with established categories of negligence to see whether the facts amount to no more than a small extension of a situation already covered by authority, or whether a finding of the existence of a duty of care would affect a significant extension to the law of negligence. Only in exceptional cases will the Court accept that the interests of justice justify such an extension of the law*'.

95 However, the rationale for the establishment of my Office was to provide a mechanism for complaints that are not actionable in the Courts to be considered by an independent and impartial officer and to assist Parliament to provide remedies that the Courts could not provide for injustice – a wider concept than those which underline matters which are actionable in the Courts.

96 Indeed, that no remedy exists before the Courts, as is the case here according to the submissions of the public bodies, does not preclude me from conducting an investigation or from treating such a case in line with my normal practice – the position is quite the opposite.

97 Section 5(2)(b) of the 1967 Act provides that I shall not conduct an investigation in respect of any action where the person aggrieved has or had a remedy by way of proceedings in any court of law, unless I am satisfied that, in the particular circumstances of the case, it is not reasonable to expect that person to resort (or to have resorted) to such a remedy.

98 Situations where there is no legal remedy, or where there is such a remedy but I do not consider it reasonable to expect a complainant to exercise that remedy, thus constitute the staple diet of the work of my Office.

99 This is perhaps best exemplified by the case of Mr and Mrs Reeman, to which I have in paragraph 94 above referred.

100 Mr and Mrs Reeman had bought a fishing vessel called *Cornelis Johanna*, which had received a certificate issued by the Department of Transport certifying that the ship complied with the relevant statutory provisions designed to ensure that it was seaworthy.

[8] Phillips LJ in *Reeman v Department of Transport* [1997] 2 Lloyd's Rep 648, CA.

101 Mr and Mrs Reeman relied on that certification as demonstrating that the vessel's design and construction rendered it fit for service as a fishing vessel. Unfortunately, the surveyor who had issued that certificate had failed to carry out his duties when so doing with due skill and care.

102 After stability tests found that, in fact, the vessel did not meet the minimum requirements of the legislation and was thus not permitted to take to sea, Mr and Mrs Reeman initiated a legal action against the Department of Transport, claiming damages for breach of the common law duty of care which they alleged was owed to them by that Department.

103 That litigation concluded when the Court of Appeal held, on 26 March 1997, that it would not be fair, just and reasonable to impose a duty of care on a body, such as the Department of Transport, charged with the regulatory duty of certifying ships with a view to promoting safety at sea. Mr and Mrs Reeman's claim for damages thus failed[9].

104 However, that was not the end of the matter. Mr and Mrs Reeman complained to my predecessor, who decided to conduct an investigation. In his report on that investigation[10], my predecessor upheld their complaint, having found injustice in the form of financial loss resulting from maladministration on the part of the surveyor who had acted on behalf of the Department.

105 The Department of Transport, as a result, agreed to make an *ex gratia* payment to Mr and Mrs Reeman to compensate them for the injustice they had sustained and that Department subsequently made an interim payment of more than £215,000 to Mr and Mrs Reeman, with the final amount paid amounting to approximately £750,000[11].

106 That case underlines the fact that there is no direct or close analogy between the standards which apply to the consideration by the Courts of negligence claims against public authorities and those which apply to my consideration of complaints about injustice resulting from maladministration by those same authorities.

107 There is a difference, rightly accepted by the public bodies in this case, between legality and maladministration. As has been held elsewhere[12], although there is a substantial element of overlap between maladministration and unlawful conduct, those concepts are not synonymous.

108 There is no reason in principle why the considerations which determine whether there has been maladministration should, necessarily, be the same as those which determine whether conduct has been unlawful.

109 There is therefore no reason why, when exercising my powers to conduct investigations and to report on complaints of maladministration, that I should necessarily be constrained by the legal principles which would be applicable were the different task being carried out of determining whether certain conduct is lawful.

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9 *Reeman v Department of Transport* [1997] 2 Lloyd's Rep 648, CA.

10 Case No. C.557/98, *Selected Cases and Summaries of Completed Investigations: April – September 1999*, pp. 29-45. Mr and Mrs Reeman at that time asked that our normal practice of anonymisation within published reports should be disapplied in their case.

11 See our Annual Report for 1999-2000 (HC 593), page 37.

12 In *R v Local Commissioner for Local Government for North and North East England, ex parte Liverpool City Council*, [2001] 1 All ER 462. See also my report, *A Debt of Honour*, 4th Report, Session 2005-2006, (HC 324: 13 July 2005), at paragraphs 132-3.

110 For the reasons given above, I reject the submission that there is a direct analogy, which I should follow, between the approach adopted by the Courts, when considering the liability of certain public authorities for negligence, and the approach that I should adopt, when considering remedies for injustice resulting from maladministration by financial regulators.

111 Nonetheless, it seemed to me that I should, in any event, consider the public policy reasons put forward by the public bodies for not providing financial recompense in this case. Those reasons are set out at paragraph 57 above. I am not persuaded by them, with one exception. I explain why below.

112 I would first emphasise that I fully accept that, when considering what an appropriate remedy might be for the injustice sustained in this case, the public interest is a consideration to which I should have regard.

113 I also accept that, when doing so, it would be appropriate to consider the potential impact on the public purse of any payment of compensation in this case. That one group of taxpayers might have to underwrite the payment of compensation to another group is something that cannot be left out of all account.

114 To that extent, I accept the submissions of the public bodies. I agree that the diversion of scarce public resources is a relevant consideration which should be taken into account and weighed in the balance along with other relevant considerations.

115 I also accept that it is a matter of record that the Courts have not imposed a common law duty of care on financial regulators[13].

116 In that context, the public bodies in their submissions have argued that I should have regard to certain matters of public policy. Those submissions raise the following four questions:

- would any recommendation for financial redress in this case result in an over-cautious or excessively risk-averse regulatory approach?;
- would such a recommendation be illegitimate because the regulators in this case did not exercise sufficient control over the '*primary wrongdoer*' or because it would '*obscure the fact that the immediate and material cause of the loss in this case was Equitable itself, coupled with the combined impact of external factors*'?;
- would such a recommendation be inconsistent with the broader role of regulation?; and
- would such a recommendation be incompatible with the statutory scheme that was in place during the relevant period?

117 I am not persuaded by the answers to those questions provided by the public bodies in their submissions.

118 When considering the above questions, I have borne in mind two central facts about the wider context of this case. The first is that the system of regulation which has been under consideration in this report no longer exists. The events recounted in this report belong to an historical era.

119 As I noted in Chapter 1 of this report, there has been, since 1 December 2001, a wholly new system of financial supervision in place pursuant to the terms of the Financial Services and Markets Act 2000. When that new regime was introduced, it was

[13] This has normally been on the basis that to do so would create a novel category of negligence liability.

said to have strengthened and made more effective the regulatory regimes it replaced through consolidation and a move to a principles-based supervisory approach.

120 Secondly, as I also explained in Chapter 1 of this report, those operating that new regime, the FSA, are not within my jurisdiction and so there is unlikely to be any further occasion on which I will be able to consider complaints made about their actions.

121 It is therefore unclear to me on what basis a specific recommendation now – designed to remedy a purely historic injustice which arose within a regulatory framework which no longer exists and which has been the subject of complaints that could never again be considered – would reasonably lead to any detrimental impact on the actions of financial regulators exercising different powers in another context.

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

123 In my view, a recommendation to remedy injustice would be entirely consistent with the broader role of regulation, and would not, as has been suggested by the public bodies, be equivalent to the creation of a warranty for current and future investors. Such a recommendation would also be compatible with the statutory scheme for prudential regulation that was in place during the relevant period, considered in the context of the further statutory scheme created by the 1967 Act.

124 When considering whether it would be appropriate to make a recommendation for financial compensation – or for any other remedy – the statutory regime to which I must have regard is that which governs my work. That is the approach I have followed.

125 While the facts of each case are matters to be taken into account in any investigation, the appropriateness of the contents of my report, including what remedies might be appropriate, will be determined by consideration of my role and remit as that is prescribed in the 1967 Act.

126 There is no inconsistency between the recommendation of a financial remedy in this case and the provisions of the legislative framework within which I must work.

127 Even if that were not so, I do not accept that a recommendation for financial compensation in this case would be incompatible with the statutory scheme in place at the time governing the prudential regulation of insurance companies. Indeed, I consider that those who promoted that legislation would be surprised by the contention that the application of my normal approach to complaints about the prudential regulation of insurance companies would be inconsistent with that regime.

128 In 1973, when Parliament was considering what became the Insurance Companies (Amendment) Act 1973 – which was subsequently consolidated with other relevant legislation into the Insurance Companies Act 1982 – concern was expressed about certain of the powers granted to the prudential regulators by those legislative proposals.

129 Such concerns primarily related to the authorisation process and to the 'fit and proper' powers to be granted to the prudential regulators, which together were designed to enable those regulators to control entry to the insurance industry. Particular concerns arose regarding the lack of independent appeal mechanisms in cases where those regulators decided not to authorise a company or not to permit an individual to hold a controlled position.

130 The Ministers promoting that legislation expressly relied on the ability of those with complaints about the actions of the prudential regulators of insurance companies to come to my Office through their Member of Parliament[14]. That ability persuaded Parliament to agree to the proposals and to reject amendments aimed at building into the legislation additional appeal mechanisms.

131 Given this clear intention on the part of Parliament and the lack of any express qualification on my ability to apply our normal tests when considering complaints about the functions of the prudential regulators, I see no basis for accepting the proposition that any recommendation that I might make would be incompatible with the scheme of the insurance companies' legislation.

132 I have explained above why, even were I to accept that the considerations to which the Courts have regard are directly applicable to my consideration of this case, the submissions of the public bodies are unpersuasive. I would, moreover, note that the Courts have held[15], in the context of negligence claims against public authorities, that:

> *... it would require very potent considerations ... to override the rule of public policy which has first claim to the loyalty of the law: that wrongs should be remedied.*

133 I too would need to be satisfied that '*very potent considerations*' existed before I would decide that no remedy should be recommended where one was properly due. I consider that having regard to that rule of public policy would be in the public interest on this occasion. The submissions of the public bodies do not, in my view, constitute such potent considerations.

My recommendations

134 For all the reasons given above, I have concluded that the submissions by the public bodies – that I should be constrained in this case from adopting the normal approach that I would adopt in other cases, when considering what an appropriate remedy would be for the injustice which I have found resulted from maladministration – are unpersuasive. It is open to me to recommend financial compensation if that is appropriate.

135 I do not accept that I should adopt the approach of the Courts to these questions and I am entirely unpersuaded that I should depart from my normal approach in that way. I now turn to set out my recommendations.

[14] See, for example, the Earl of Limerick in the House of Lords on 8 February 1973 and on 22 February 1973.
[15] Sir Thomas Bingham MR in *X v Bedfordshire County Council* [1995] 2 AC 633. This view has been cited with approval by the House of Lords in *Gorringe v Calderdale Metropolitan Borough Council* [2004] 1 WLR 1057 at [2] and by the Court of Appeal in *Brooks v Commissioner for Police of the Metropolis* [2002] EWCA Civ 407.

First recommendation

136 **My first recommendation is that, in recognition of the justifiable sense of outrage that those who have complained to me feel about the maladministration in the form of the serial regulatory failure identified in this report, the public bodies should apologise to those people for that failure.**

137 As I explain in *Principles for Remedy*, apologising is not an invitation to litigate or a sign of organisational weakness. It can benefit the public body as well as the complainant, by showing its willingness to acknowledge when things have gone wrong, accept responsibility, learn from maladministration, and put things right.

Second recommendation

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

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

140 Addressing relative loss in this way would remedy any financial loss that has occurred and also the loss of opportunities to invest elsewhere than the Society. It is thus the most appropriate remedy for the injustice that I have found resulted from maladministration.

141 The scope of such a scheme should, in line with my *Principles for Remedy*, cover all those who have suffered similar injustice to those who have complained to me. That should include not just residents of the United Kingdom but all those who have sustained the injustice that I have found resulted from maladministration.

142 I consider that it would be reasonable to expect such a scheme to be established within six months of any decision by Government and Parliament to do so.

143 I recognise that there are likely to be practical difficulties in establishing and operating such a scheme. There may be an inherent conflict between the speed and simplicity of delivery on the one hand, and fairness both to those affected and to taxpayers generally on the other.

144 I began this investigation by addressing, in my July 2004 report to Parliament, arguments that complexity of the subject matter or practical operational difficulties were a relevant factor to be taken into account in any decision to conduct an investigation. I said that those were not compelling arguments in that context. I similarly do not accept now that such difficulties mean that an appropriate remedy should not be delivered.

145 I also recognise that how such compensation should be calculated will need to be carefully considered, not just in terms of how best to design any scheme but also in the context of the principles of regularity, propriety, and accountability for the use of public money that are set out in *Managing Public Money*[16].

[16] This document, which replaced *Government Accounting* in 2007, contains cross-Government guidance on the use of public money. It is available at: http://www.hm-treasury.gov.uk

146 While different approaches might be taken to the calculation of compensation in such circumstances, the existence of those approaches – such as that proposed by EMAG on behalf of complainants or that adopted by the Financial Ombudsman Service in considering mis-selling complaints – indicates that any difficulties that may be encountered are not insuperable.

147 All those considerations are relevant to how any compensation scheme should be organised and delivered. While recognising that the creation of such a scheme would not be straightforward by any means, such difficulties as are likely to arise are not, in my view, sufficient to negate the prime consideration to which I consider regard should be had – namely that, where wrong has been suffered, a remedy for that wrong should be provided.

148 I recognise that the decision as to how best to establish and administer any compensation scheme is a matter for Government and Parliament. However, I would offer, as a contribution to that debate, my view of the principles which should govern any such compensation scheme.

149 It seems to me that such a scheme:

- should be **independent** and constituted along the lines of a tribunal or adjudication panel, with three members – one broadly representing the interests of citizens and one representing those of the relevant public bodies, with an independent chair;

- should operate in a **transparent** manner, with the basis being made public of the decisions as to how compensation is to be calculated, as to what procedure will govern the consideration of individual cases, and as to the criteria which will be taken into account when considering those cases. Those decisions should only be made after appropriate consultation is undertaken, including with those directly affected;

- should be **simple**, not imposing undue burdens, whether evidential or procedural, on those making claims to the scheme.

150 The above principles would, I hope, be accepted widely as being an appropriate and effective mechanism of decision and delivery of the remedy that I have recommended should be provided.

151 I hope, also, that it would be accepted that this mechanism has to have, as its guiding principle, the need to deliver as speedy a remedy as is possible in the circumstances, consistent with recognising the complex issues that would need to be addressed and resolved. In my view, the scheme should take no longer than two years from the date of its establishment to complete its work.

Conclusion

152 I recognised above that the public interest is a relevant consideration and that it is appropriate to consider the potential impact on the public purse of any payment of compensation in this case. Furthermore, I am acutely conscious of the potential scale of what I have recommended and that acceptance of my central recommendation might entail opportunity costs elsewhere through the diversion of resources.

153 I also acknowledge that the public bodies have raised an issue of principle which, if accepted, would potentially have a much wider significance for my work and thus for the remedies available to Members of Parliament to enable them to assist their constituents.

154 In that context, **I invite Parliament to consider the issues that have been raised in this report and the recommendations that I have made and to further reflect on what its response to my report should be.**

155 Having alerted Parliament to the injustice that I have found was sustained in consequence of maladministration, I would be very happy to assist Parliament in its deliberations in any way that I can.

Chapter 15 – Conclusion

1 At the very beginning of this report, in its Foreword, I explained that the issues raised within this report go to the heart of some current debates about the nature of financial regulation and what citizens might reasonably expect from such regulation.

2 Of course, it is an objective shared by all that it would be preferable to avoid, where that is possible, situations where many hundreds of thousands of citizens find themselves in financial difficulties not of their own making.

3 Financial regulation exists to make a contribution to achieving such an aim. However, as successive Parliaments have recognised, such regulation cannot prevent all company failures or financial loss arising therefrom.

4 In my first report on the prudential regulation of the Society, I reported that I had found there to be a:

> *... fundamental mismatch between the nature and expectations of the prudential regulatory regime under which* [the regulators] *were required to operate during the period in question, and the understanding and expectations that policyholders and others appear to have had of that regulatory system*[1].

5 In terms both of what it is reasonable generally to expect from the system of financial regulation and of what standard should be applied by me to the review of the actions of those operating that system in this particular case, a minority of complainants certainly hold views which would suggest that such a mismatch continues to exist.

6 However, in considering the various submissions that I have received from the public bodies whose actions have been the subject of this investigation, I have also been struck by another fundamental mismatch.

7 Those submissions demonstrate a huge gulf between the duties and powers that Parliament in fact conferred on those operating the system of prudential regulation and the responsibilities in relation to those functions that the relevant regulators and their advisers are now prepared to accept were imposed on them.

8 I have explained in Chapter 5 of this report that one of the four cornerstones of the system of prudential regulation which existed at the time of the events recounted in this report was regulatory reform in the wake of high-profile insurance failures or other such problems. Indeed, the regulatory regime for the prudential regulation of insurance companies was largely established through legislation in 1973 that was a direct response to the failure of Vehicle & General.

9 The tribunal that was established by the Government of the day to inquire into the circumstances which had led to that failure concluded that the regulators had taken an overly restricted view both of the powers which Parliament had bestowed on them and of the circumstances in which the use of those powers should be considered[2]. That tribunal found that, for almost four years, there had existed grounds for intervention action in respect of the company, action which should have been taken but which was not even considered.

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[1] 4th Report, Session 2002-03, *The prudential regulation of Equitable Life* (HC 809), Part 1, paragraph 10.

[2] *Report of the Tribunal appointed to inquire into certain issues in relation to the circumstances leading up to the cessation of trading by the Vehicle and General Insurance Company Limited*, (HC 133), 15 February 1972.

10 That system of regulation, as it was supplemented and amended over time, was replaced on 1 December 2001 by the system which is now operational and which is contained within the Financial Services and Markets Act 2000. However, while the two regimes are governed by different legislation and informed, perhaps, by different approaches, difficulties continue to be experienced by financial firms. The contribution of those responsible for regulating those firms, in terms of the prevention or mitigation of those difficulties, also continues to be the focus of attention.

11 In the report of its internal inquiry into the supervision of Northern Rock during the period prior to its nationalisation, which was published at the end of April 2008, the FSA concluded that it could not provide assurance that the prevailing framework for the assessment of risks had been appropriately applied in respect of Northern Rock. The FSA also identified other failings which were described as '*the most significant combination of shortcomings*'[3]. It was found that the risk '*assessment of Northern Rock ... as "low probability" was key to many elements of the subsequent supervision of the firm*'.

12 I have not investigated either the historical regulation of Vehicle & General or the more recent supervision of Northern Rock, although my attention has been drawn to both cases on a number of occasions towards the end of the investigation which led to this report. For current purposes, I take the findings of both the tribunal and the FSA at face value.

13 Nevertheless, it seems to me that there are parallels between these other cases and the conclusions to which I have come within this report in respect of the prudential regulation of the Society.

14 I have found that, in relation to the Society, grounds existed on many occasions for the use of the powers of intervention which the prudential regulators possessed. However, little or no consideration was given by those regulators to whether it might be appropriate to use those powers. That echoes the findings of the Vehicle & General tribunal.

15 I have also found that, despite the information before the relevant regulators, any concerns which should have been raised by that information did not materialise in relation to Equitable. The Society was seen by those regulators as low risk, because of its long history and central place in actuarial tradition, because of its market position, and because of its good reputation. Such an assessment was, as appears to have been the case with Northern Rock, key to the way in which the regulation of the Society was undertaken.

16 There are other ways in which those other cases resonate with my findings in relation to the prudential regulation of Equitable – such as the apparent failure by the FSA to record the content of meetings with Northern Rock – but those are perhaps matters for others – and perhaps history – to consider.

17 It seems to me that the central lesson that can be learned from those cases – and perhaps the only way to address the fundamental mismatches that I have found on the part both of some complainants and of the relevant public bodies – is the need for absolute clarity as to what can and cannot be expected from the system of financial regulation.

[3] *The supervision of Northern Rock: a lessons learned review*, FSA Internal Audit Division, March 2008.

18 Key to achieving such clarity are three things: a clear Parliamentary intention, systems and processes that are designed to deliver that intention, and a shared understanding as to the limits to the protection that the system offers to investors both before and after problems arise, as they inevitably will.

19 I make no suggestion as to what is the appropriate or optimal form of, and approach to, financial regulation. That is a matter for Parliament.

20 Nevertheless, whatever form or approach is adopted should be clearly articulated both within the relevant legislative framework and in any information provided about the system of regulation as to what it can or cannot deliver. Such information should be available to those – whether as investors, as regulated entities, or simply as legislators and taxpayers – who are potentially affected by such regulation.

21 Devising policies and approaches to implement the policy underlying the system of regulation – whatever that policy is – is critical to the success of such a system. The development of principles or philosophies, and of administrative systems of verification and oversight, will doubtless aid such effective delivery of Parliament's intention.

22 However, such approaches to regulation should be consistent with what Parliament intended. It would be entirely unsatisfactory if Parliament were to legislate for a particular form or level of protection that was negated or reduced by the adoption of restricted and narrow interpretations of the duties and powers that Parliament has imposed in order to see its intention properly administered and effectively discharged.

23 Moreover, all those participating in – or with responsibilities for supervising from without – the financial system, including those investing or considering making such investments, should understand their own rights and responsibilities and thus be enabled to take appropriate action to mitigate those risks which cannot be removed by a system of regulation.

24 It seems to me that market stability and confidence in financial services can only be harmed where problems arise in a context in which no general understanding exists as to whether or not the system of regulation aims to prevent such problems from arising or as to whether a safety net exists to remedy any financial losses sustained.

25 I am aware of the views of others who believe that deficiencies in the system of regulation, and not the way in which that system was operated in the particular case of the Society, are more to blame for the circumstances which led to the Society to close to new business in December 2000.

26 However, I have found little evidence that would support such an assessment. The aim of the system of regulation that was in force under the Insurance Companies Act 1982 was clear enough. The means afforded by Parliament to the prudential regulators in order to deliver that aim were robust and could have been used, but were not used, in relation to the Society.

27 In reviewing the development of this regulatory regime, I was struck by a recurring theme in the Ministerial explanations to Parliament as to the basis for the powers that it was being asked to provide to the relevant regulators.

28 Sir Geoffrey Howe (as he then was), the Minister introducing what became the Insurance Companies (Amendment) Act 1973, told the House of Commons on 21 May 1973 that:

> *The purpose of the Bill is to improve the protection given to insurance policy holders. It is another example of the measures being introduced by the Government under the general heading of consumer protection. It is clear that we must do all we sensibly can not only to protect the policy holder but also to maintain the name and reputation of our insurance industry which does so much for our invisible earnings.*

29 When the Policyholder Protection legislation, which established a scheme to provide compensation where insurance companies failed, was introduced, the then Secretary of State for Trade, the late Peter Shore, told the House, on 18 June 1975, that the legislation had:

> *... one central purpose and justification – to see to it that policyholders do not suffer major loss and hardship when an insurance company fails. Let me say straight away that I consider that my main objective, in supervising the industry, is to see that insurance companies do not fail ... But the fact is that insurance companies have failed over many years, and in the past two years, in particular, a number of companies have got into difficulties as a result of the deterioration in the general economic situation and particularly the fall in stock market values and the decline in the property market.*
>
> *I shall do my utmost to prevent failures in the future, but, if and when they occur, my major concern, and I believe that of this House, must be for the victims of such failures. Life insurance is the major form of saving in this country. For many people a life insurance policy represents their only substantial investment. The average citizen relies very heavily indeed on his insurance policies.*

30 On 2 February 1981, in introducing legislation to implement the provisions of the first European Directive, subsequently to be consolidated within the 1982 Act, Sir Reginald Eyre, the then Minister responsible for prudential regulation, explained the approach to insurance regulation within the UK as being based on the doctrine of 'freedom with publicity' – like membership of the European Communities, another of the cornerstones of the system of prudential regulation covered in this report – and said:

> *Quite properly, the freedom I have referred to has its limits; the Secretary of State has a clear duty to intervene if it appears that all is not well. The need for supervision of the insurance industry is one of record. There have been cases in the past where failures of insurance companies have done policyholders and interested third parties great harm, and, indeed, done the industry no good. Although no system of supervision can avoid completely all risks of difficulty or failure of an insurance company, Government responsibility for a systematic approach is to be found not just in the United Kingdom, but throughout the countries of the developed world and in many others.*

31 Ample means to deliver the central aim of regulation, as articulated by all those Ministers – the protection of policyholders – were given by Parliament to those responsible for regulating the insurance industry.

32 The central story of this report is that this robust system of regulation was not, in respect of the Society, implemented appropriately – that is, consistently, fairly, and with proper regard to the interests of those directly affected – by the prudential regulators and those providing assistance and advice to those regulators.

33 Assessing the risks relevant to a particular insurance company cannot be appropriately achieved through relying on its longevity or reputation. Verification of the financial position of such a company is not achieved if clear indications of difficulty or other warning signs are ignored or not followed through to a proper resolution. Ensuring that current and potential investors have sufficient information to enable them to make informed choices about their finances requires the published information about companies to be accurate and complete.

34 My findings in this report show that the prudential regulation of the Society during the relevant period failed – and failed comprehensively. That was not a system failure, but a failure properly to implement in the particular case of the Society the system of regulation that Parliament had enacted.

35 Shared understandings as to the purpose of, and limits to, financial regulation and as to the relevant rights and responsibilities of all those affected by such a system depend on the proper implementation of Parliament's intention. That did not happen in this case.

36 As I noted in Chapter 4 of this report, on behalf of complainants EMAG submitted that:

> *Policyholders have lost large sums of money as a result of the maladministration by the Regulators to the extent that it is questionable whether they might not have been better served by no regulation at all.*

37 The comfort taken by investors that a system of regulation exists to protect their interests cannot be lightly dismissed – but it should have a realistic basis. Ensuring that such comfort is realistic requires clarity as to what regulation is for, as to how it will be undertaken, and as to its limits.

38 This report deals with events and a regulatory framework that are both in the past. It is for Parliament to consider whether any lessons for the present – or for the future – can be drawn from the story that has been told in this report.

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Report enquiries
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Fax: 020 7217 4061

Email: equitable.investigation@ombudsman.org.uk

General enquiries
Tel: 0845 015 4033
Fax: 020 7217 4000

Email: phso.enquiries@ombudsman.org.uk

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Contents

Introduction

Background

1 In this Part of my report, I set out the work we have done to establish how the regulatory regime relevant to the prudential regulation of Equitable and other insurance companies developed over time. The structure of my report is explained in Chapter 1 of Part 1 of this report.

2 The complaints which were contained within the terms of reference for the investigation are set out in Chapter 4 of Part 1 of the report. In summary, these complaints contended that the public bodies responsible for the prudential regulation of insurance companies and the Government Actuary's Department (GAD) '*failed for considerably longer than a decade properly to exercise their regulatory functions in respect of* [Equitable] *and were therefore guilty of maladministration*'[1].

3 Specific complaints relate to organisational issues, general operational issues, supervision of regulatory solvency, payment of excess bonuses and the adequacy of procedures to safeguard the reasonable expectations of policyholders and (implicitly) of potential policyholders (PRE[2]).

4 I explained in Chapter 5 of Part 1 of this report that an essential factor in the consideration of these complaints is the nature of the regulatory functions which pertained at the relevant time. Within Chapter 5 of Part 1 of this report, I also set out in broad outline the key aspects of the regulatory regime relevant to this investigation and the obligations to which the prudential regulators and GAD were subject.

5 This Part of the report describes in more detail how the regime for the prudential regulation of life assurance companies such as Equitable developed over the period from approximately 1970 until December 2001. As is noted elsewhere in this report, 'prudential regulation' is primarily concerned with the solvency of insurance companies and the soundness and prudence of their management. Since 1973, the legislation has included the concept of PRE and the protection of PRE as a basis for regulatory intervention.

6 The rest of this Part of the report explains the main duties and powers of the regulators and the mechanisms available to them and outlines the role of GAD in relation to the regulation of life insurance companies. It summarises the relevant primary legislation and statutory instruments that were in force in the United Kingdom, the European directives, some of the professional guidance produced for appointed actuaries and the 'service level agreements' entered into by bodies within my jurisdiction.

Bodies within my jurisdiction

7 The government departments primarily concerned with the prudential regulation of insurance companies over the relevant period were the Department of Trade and Industry (the DTI) and its predecessor departments and Her Majesty's Treasury (the Treasury).

8 Chronologically, responsibility rested with and/or administrative functions were undertaken by the Board of Trade (the BT) (1870-1970)[3], the DTI (1970-74), the Department of Trade (the DoT) (1974-1983),

[1] Complainants alleged that this maladministration had resulted in injustice to them and sought redress for the injustice they claimed to have sustained.

[2] Where appropriate to the context, the acronym 'PRE' should be taken to refer to the reasonable expectations of potential policyholders as well as those of existing policyholders in the following text.

[3] In 1970, the functions of the BT under the relevant legislation were transferred so as to be exercisable concurrently by the Secretary of State and the BT. On the coming into force of section 54(2) of the Insurance Companies Amendment Act 1973, the powers and duties under the relevant legislation were to be exercisable by the Secretary of State alone.

the DTI (1983-98) and, as from 5 January 1998[4], the Treasury. GAD, one of the Chancellor of the Exchequer's departments, was created in 1919 to provide actuarial advice to all government departments.

9 Under section 5 of the Parliamentary Commissioner Act 1967 (the 1967 Act), I have power to investigate action taken in the exercise of administrative functions by or on behalf of the government departments and other public bodies listed in Schedule 2 to that Act. The listed bodies over time included the BT, the DoT, the DTI and the Treasury.

10 Through an amendment to the 1967 Act which came into force on 15 November 2004, GAD has been brought within my jurisdiction, but only in respect of its actions in advising on or before 26 April 2001 in relation to the exercise of certain functions relating to the regulation of insurance companies[5].

11 The actions of the Financial Services Authority (FSA) fall within my jurisdiction only in so far as they relate to functions contracted out[6] to it by the Treasury in respect of the prudential regulation of insurance companies under arrangements which were in place between 1 January 1999 and 1 December 2001 and its actions are deemed to be those of the Treasury.

12 The actions of the Securities and Investments Board Limited (SIB), the Personal Investment Authority Limited (PIA), those of the FSA prior to 1 January 1999 and those of Equitable and its appointed actuary are not within my jurisdiction. This report accordingly does not address the regime for conduct of business regulation[7] for which the SIB, PIA, and FSA were responsible.

13 This Part of the report also refers to the professional guidance which was available to appointed actuaries during the relevant period, in particular that issued by the Faculty of Actuaries and Institute of Actuaries (F&IA), as a relevant factor for GAD and the prudential regulators. The actuarial profession is not within my jurisdiction[8].

Legal identity of Equitable

14 The treatment of various undertakings which carry on insurance business under the legislation (and the implications of certain provisions) differs in some respects dependent upon the legal status of the undertaking concerned. Information about Equitable is provided in Chapter 2 of Part 1 of this report.

Appendices to this Part of the report

15 This Part of my report has a number of appendices[9]. Appendix A shows the derivations of the relevant provisions of the Insurance Companies Act 1982. Appendix B contains information about the frequency of exercise of powers of

4 See the Transfer of Functions (Insurance) Order 1997 SI No. 2781, which transferred functions of the Secretary of State for Trade and Industry under the Insurance Companies Act 1982 and other specified insurance legislation to the Treasury, or in some instances to the Treasury and the Secretary of State concurrently.

5 See the Parliamentary Commissioner Order 2004 SI No. 2670. The advice by GAD which may be the subject of an investigation by me is that given on or before 26 April 2001 which relates to the exercise of functions under Part II of the Insurance Companies Act 1982, or any other enactment relating to the regulation of insurance companies within the meaning of that Act.

6 See the Contracting Out (Functions in Relation to Insurance) Order 1998 SI No. 2842, empowering the Treasury to authorise another person or its employees to exercise specified functions on behalf of the Treasury.

7 'Conduct of business regulation' primarily concerns the marketing and sale of insurance companies' products and the provision of related advice to current and potential investors.

8 References to the actuarial profession and its publications are made only to set the account of the prudential regulation in context.

9 At pages 266 to 321.

intervention under the Insurance Companies Act 1982. Appendix C contains specimen forms from the regulatory returns which life insurance companies were required to submit to the prudential regulators during the time covered by this report.

16 Appendix D contains the annex to the Service Level Agreement between the prudential regulators and GAD, which set out the priority order ratings for the scrutiny of those regulatory returns. Finally, appendix E contains a Government paper on '*the regulatory regime pursuant to which Equitable Life was regulated during the period 1973 to 2001*'[10].

Early history of the legislation and organisation of information

17 Specific legislation in relation to life assurance companies dates back to 1774[11]. Rudiments of the current regulatory regime were contained in the Life Assurance Act 1870, which was enacted following a high incidence of failure of life assurance companies[12] and included requirements for the establishment of a separate long-term fund, actuarial investigation at specified intervals and annual returns to the BT, with returns to be made available to policyholders on request and powers for policyholders to petition for winding up.

18 The promoters of that legislation described the aim of regulation as being '*perfect freedom with perfect publicity*'[13], with limited government intervention in the affairs of insurance companies, an approach which has survived (with some adaptation) in modern times.

19 Over the late nineteenth and early twentieth centuries the legislation continued to develop, to cover more classes of insurance and eventually to include powers for the BT to appoint inspectors for companies of dubious solvency and (with leave of the court) to petition for their winding up. In 1946[14], following further incidents of failure of insurance companies[15], former requirements for such companies to deposit money with the court were replaced with a 'solvency margin' requirement for companies conducting general business, with the aim of anticipating and preventing insolvency arising. The Insurance Companies Act 1958 (the ICA 1958) was then enacted to consolidate the Assurance Companies Acts 1909 to 1946.

20 The Companies Act 1967 (the CA 1967), Parts I and II of which were introduced in the light of concerns about fraud in non-life areas of insurance business and a perceived need for greater disclosure by companies generally, provides a convenient starting point for my account. A summary of the main provisions of Part II of that Act provides a 'base

10 This was one of two documents which together comprised the initial response of the public bodies to the complaints set out within the terms of reference for the investigation. The other, which is summarised within Chapter 4 of Part 1 of this report, is reproduced in full in Part 4 of the report.

11 When the Life Assurance Act of that year prohibited all such insurance unless the policyholder had an 'insurable interest' in the life or death of the person insured.

12 In particular, the failure of the Albert Life Assurance Company in 1869, which had taken over the business of twenty other societies. Concern had also been expressed that UK companies would be 'shut out' of overseas countries where more stringent legislation applied (notes for the Jubilee Lecture of the Institute of Actuaries Students' Society on 18 January 1977 by a senior official of the DTI).

13 Recorded in the notes referred to in footnote 12.

14 Under section 3 of the Assurance Companies Act 1946. The required solvency margin was the greater of £50,000 or one-tenth of the general premium income of the company in its preceding financial year. For the purposes of other legislation concerning the winding up of companies by the court, a company conducting general business was to be deemed to be unable to pay its debts if its assets did not exceed its liabilities by that amount.

15 The notes referred to in footnote 12 mention 34 such failures between 1919 and the promotion of the 1946 Act.

line' from which to assess the evolution of the prudential regulation regime for insurance companies since the 1970s.

21 The prudential regime is described as it applied over the following phases:

Phase 1:	1967 - 1972
Phase 2:	1973 - 1980
Phase 3:	1981 - 1990
Phase 4:	1991 - 1993
Phase 5:	1994 - 1999
Phase 6:	2000 - 2001.

Phase 1: 1967 – 1972

The Companies Act 1967

Introduction and overview

22 Part II of the CA 1967 amended the ICA 1958 and introduced new and stricter controls over the establishment and activities of insurance companies carrying out specified classes of insurance business, including ordinary long-term insurance business.

23 'Ordinary long-term insurance business' was defined by section 59(6)(a) of the CA 1967 (and its successor provisions) to include '*effecting and carrying out contracts of insurance on human life or contracts to pay annuities on human life*'. Long-term business was (and is) treated distinctly from 'general business' for many purposes under insurance legislation[16]. 'Insurance business' was not defined in the legislation at this time[17].

24 The government department responsible for regulation under the CA 1967 (as under the ICA 1958) was the BT. The CA 1967:

- extended the classes of insurance business subject to statutory regulation to include all identified classes;
- introduced requirements for entities to obtain authorisation from the BT to conduct new classes of insurance business, based on criteria relating to initial resources, adequacy of arrangements for reinsurance and 'fit and proper persons';
- introduced powers for the BT to direct or require action by the company of specified kinds in specified circumstances, in particular to avert prospective insolvency; and
- imposed additional requirements in relation to insurance company accounts and the audit of accounts.

25 The impact of the CA 1967 was described as leaving the basic concepts of supervision essentially as before, namely, that each enterprise would be left free to determine the scope of its business, its relations with policyholders (including the terms of contract) and the management of its funds, subject only to the interplay of competition and to the final tests of maintenance of a proper degree of solvency[18]. In relation to the powers to intervene to avert insolvency, these were later described in an internal paper prepared for the Secretary of State in relation to proposed legislation to replace the CA 1967 as '*hastily grafted on to the earlier power to petition for winding up when insolvency had occurred*'[19].

26 The criterion of 'policyholders' reasonable expectations' as a 'sweeping-up' ground for intervention appears to have been proposed by officials of the DTI as early as 1971 (by means of insertion of a new clause in the CA 1967), although it was not pursued at that time[20].

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16 Ordinary long-term insurance business and industrial assurance business were together defined as 'long-term business'. Long-term business was excluded from the definition of 'general business' in section 33 of the ICA 1958 (as amended by Schedule 5 to the CA 1967).

17 It was first defined in section 34 of the Insurance Companies Act 1981.

18 National Report from Great Britain to the 19th International Congress of Actuaries, referred to in the Journal of the Institute of Actuaries (JIA) 101 (1974) at paragraph 7, page 54.

19 See the Report of the Equitable Life Inquiry led by the Right Honourable Lord Penrose ordered by the House of Commons to be printed on 8 March 2004 (the Penrose Report), Chapter 13, paragraph 16.

20 See the Penrose Report, Chapter 13, paragraph 19.

27 The origins of this expression are obscure, but appear to pre-date the 1967 legislation[21]. The expression had been used in 1966 by RS Skerman, in a paper published in the Journal of the Institute of Actuaries entitled 'A Solvency Standard for Life Assurance Business'[22] in a particular context. In considering exactly what income and outgoings should be taken into account when testing solvency he described, as one of the three main problems, the issue of policyholders' participation in profits under with-profits policies. He noted[23]:

> *Although an office is not under a contractual obligation which can be quantified in relation to the benefits which its policyholders will derive from future profits, it would be unsatisfactory not to take account of the policyholders' reasonable expectations when determining the value of its liabilities.*

In identifying five suggested principles for a solvency standard for life assurance business he rejected the use of a gross-premium basis of valuation as being appropriate only if 'solvency' was understood to mean '*no more than fulfilling contractual obligations*'. He considered that in order to fulfil policyholders' reasonable expectations, it was necessary to use a net-premium[24] or other valuation basis which would produce stronger reserves.

Authorisation to conduct additional classes of insurance business

28 Under the CA 1967, companies[25] which immediately before 3 November 1966 were properly[26] carrying out a relevant class of insurance business were authorised to continue to do so, but those wishing to extend their businesses into additional classes required express authorisation from the BT (sections 60 and 61). Before issuing such an authorisation, the BT was required to be satisfied that the company fulfilled minimum financial requirements concerning the excess of the value of its assets over the amount of its liabilities and that where necessary, adequate arrangements for reinsurance of risks had been or would be made (sections 62 and 63).

29 No authorisation could be issued if it appeared to the BT that an officer of the company, its parent company or a person who controlled the company was not a 'fit and proper person' to be associated with the company (section 64). On issuing an authorisation, the BT was empowered to impose requirements regarding the initial conduct of business by the company, including restrictions on investments made by the company, the custody of

[21] A report on PRE prepared by a working party of the F&IA in 1993 (referred to below) suggests that the origins of the expression may date back to the 19th Century and describes the ideas behind PRE as being *'deeply embedded in actuarial thought in concepts such as equity'* but with consumerist overtones added in recent years.

[22] JIA 92 (1966) 75-84.

[23] Ibid, at page 77.

[24] RS Skerman described the net-premium valuation method as being one under which: *'the premiums valued exclude any amounts included in the with-profits office premiums which would provide profits to policyholders. Thus, these amounts receivable in the future are not capitalized so as to reduce the amount of the liabilities and, if solvency is demonstrated using a net-premium method, then, broadly speaking, the amounts included in future premiums which should provide profits for policyholders will, in fact, emerge as surplus from year to year in the future and be available for this purpose'.* This was intended to do a good deal more than achieve solvency in terms of ensuring the fulfilment of contractual liabilities, it was intended as a *'standard of good conduct'* so far as with-profits policies were concerned, linked to Skerman's concept of the need to fulfil the reasonable expectations of with-profit policyholders: JIA 92 (1966) at page 79.

[25] I use the term 'company' throughout this Part of the report although the provisions of the CA 1967 and subsequent legislation also applied to certain unincorporated bodies. As noted, Equitable is a private unlimited company.

[26] i.e. without contravention of section 2(1) of the ICA 1958, which prohibited any person from carrying on life assurance or other specified kinds of insurance business unless that person was incorporated (under the Companies Act or otherwise) and held a paid-up share capital of at least £50,000 (subject to certain exceptions).

assets and the supply of specified information for a period of up to five years, with supplementary provisions which rendered certain mortgages or charges created in contravention of the statutory requirements void against the liquidator and any creditor of the company (sections 65 and 66).

Restrictions on entering into new contracts of insurance

30 By section 68 of the CA 1967 the BT was empowered, in specified circumstances, to give directions which imposed restrictions on the carrying on of insurance business. Those circumstances included those where the BT was not satisfied about the solvency of the company[27], as well as those where statutory obligations were not being satisfied by the company; reinsurance arrangements were not considered to be adequate; it appeared that the 'fit and proper person' criterion under section 64 for authorisation would not be fulfilled if an application were to be made; or where it appeared to the BT that misleading or inaccurate information had been supplied when authorisation had been sought.

31 In the case of a company conducting ordinary long-term insurance business, the appropriate form of the restriction was to prohibit the company effecting further contracts of insurance on human life or contracts to pay annuities on human life. Companies were given the opportunity to make representations and the BT was required to consider any such representations before a direction was given. Notice of a direction was required to be published in the London and Edinburgh Gazettes. Criminal sanctions applied to a company which contravened a restriction imposed by a direction given by the BT under these powers. The BT could withdraw a restriction if it appeared to it that the restriction was no longer necessary.

Accounts, audit, documents and actuarial valuations

32 The former provisions of section 4 of the ICA 1958 which required the accounts and balance sheets of insurance companies to be in a prescribed form were replaced with a power for the BT to make regulations to specify the contents of the accounts and the documents to be annexed to them (section 71 of the CA 1967). The Insurance Companies (Accounts and Forms) Regulations 1968 were made under the amended provisions of the 1958 Act (and are referred to under a separate heading below).

33 The rules prescribed for the audit of accounts of insurance companies were extended to all such companies whether or not they were also governed by the Companies Acts; the BT was empowered to prescribe by description the person who should audit the accounts and the manner in which they should be audited (section 72).

34 The BT was also empowered to vary the length of an insurance company's financial year (section 73). The requirements for signature of the accounts by specified officers of the company were slightly reduced in order to minimise delay in the deposit of accounts with the BT (section 75).

35 Requirements for companies to prepare an annual 'statement of business' under section 7 of the ICA 1958 (which had formerly applied only to those conducting accident insurance business) were extended to apply to companies conducting business of other prescribed classes (section 74 of the CA 1967).

[27] In the case of a company carrying on long-term business the test regarding solvency in the CA 1967, section 68(1)(b) was expressed as being that the BT *'are not satisfied that the value of its assets exceeds the amount of its liabilities (including all prospective and contingent ones, but excluding those in respect of share capital)'*.

36 By Regulation 14 of the Insurance Companies (Accounts and Forms) Regulations 1968, ordinary long-term insurance business became a class prescribed for this purpose and those Regulations prescribed the form of the statement (described as a 'Summary of Changes in Long-Term Business').

37 The BT, as an 'appropriate authority', was empowered to exempt an insurance company from the normal requirements of disclosure to shareholders and policyholders[28] of statements and reports annexed to the accounts if, in its opinion, disclosure '*would be harmful to the business of the company or of any of its subsidiaries*' (section 76).

38 The maximum interval for actuarial investigation of the financial condition of an insurance company (including a valuation of liabilities) under section 5(1)(a) of the ICA 1958 for a company conducting ordinary long-term business was reduced from five years to three years (section 78 of the CA 1967).

39 The maximum interval of five years for the preparation of the statement of business under section 5(2) of the ICA 1958, in cases where an annual actuarial investigation was made, was not changed. Schedule 5 to the Insurance Companies (Accounts and Forms) Regulations 1968 set out the prescribed form of statement of ordinary long term business for the purposes of section 5(2) of the ICA 1958. It required considerable detail to be provided in relation to separately distinguished categories of contract in order to enable an independent assessment of the company's liabilities to be made (see further paragraph 51 below).

Insolvency and winding up

40 Sections 79-81 of the CA 1967 amended the provisions of the ICA 1958 regarding insolvency and winding up of insurance companies. The solvency margin requirements for companies conducting general insurance business (i.e. non-life business) were strengthened.

41 The BT as an 'appropriate authority' was empowered to impose requirements on insurance companies which were conducting business in a way which created a risk of insolvency. These requirements were framed in similar terms to those which might be imposed under section 65 when authorisation for a new class of business was to be issued, such as restrictions on the making of new investments of a specified class and the realisation of investments of that class[29], with the addition of a requirement through which the maximum amount of premiums received during a specified period could be limited (section 80).

42 The powers under section 15 of the ICA 1958, for the BT to petition for the winding up of an insurance company, were extended to include failure by the company to comply with specified requirements of the legislation. The former requirement that leave of the court should be obtained before a petition was presented was removed (section 81 of the CA 1967).

Notification of changes in officers and changes in control of the company and penalties for non-compliance with the legislation

43 Insurance companies were required to give written notification to the BT of any changes in officers or in the persons controlling the company, and of similar changes in respect of its holding company. Any person acquiring or relinquishing control of an

[28] Section 8(6) of the ICA 1958 required an insurance company to provide a printed copy of the accounts, balance sheet, abstract or statement last deposited with the BT under section 8 of that Act to any shareholder or policyholder who applied for the document.
[29] As well as maintenance of assets of a minimum value in the UK and provision of information verified in a specified manner.

insurance company (or its holding company) was required to give written notification to the company of that fact. A criminal sanction was imposed for non-compliance with the latter requirement (sections 82 and 83).

44 Various related criminal offences were created, for example in respect of the supply of false information in purported compliance with certain requirements of the CA 1967 and the ICA 1958. By section 89 of the CA 1967, individual officers of a company could be personally liable for any offence committed with their consent or connivance, or through their neglect (see sections 84-91 regarding penalties and legal proceedings).

Miscellaneous

45 The BT was empowered to exempt individual companies from certain provisions of the ICA 1958 where compliance would be unduly onerous or inappropriate, and was empowered to make the application of those provisions less stringent (section 92 of the CA 1967). The BT was required to make an annual report to Parliament about insurance matters in place of the former obligation (under section 10 of the ICA 1958) to lay before Parliament the accounts and related documents deposited with the BT during the proceeding year (section 98).

The Insurance Companies (Accounts and Forms) Regulations 1968

46 From 1969 onwards, the accounts of insurance companies incorporated under the Companies Acts[30] were subject (in addition to the requirements of companies legislation) to the more detailed requirements of insurance companies legislation, initially, the Insurance Companies (Accounts and Forms) Regulations 1968[31] (the ICAF Regulations 1968) which came into operation on 1 January 1969.

47 In view of the particular requirements of the ICAF Regulations 1968, it was possible that the figures provided by a company in order to comply with those Regulations would differ from the figures shown in the company's profit and loss account and balance sheet produced to comply with general companies legislation.

48 The ICAF Regulations 1968 applied to all insurance companies (other than those conducting only industrial assurance business) and included a set of prescribed forms specifically for those conducting long-term business. The returns to be made in respect of long-term business under the five Schedules to the ICAF Regulations 1968 were:

Schedule 1	Balance sheet and profit and loss account
Schedule 2 (Parts 1 and 2)	Revenue account and premium analysis
Schedule 3 (Part 4)	Summary of changes in business and new business
Schedule 4	Valuation report
Schedule 5	Statement of business.

49 The primary objective of the returns was to provide the supervisory authorities with sufficient information to determine that a company was solvent and was not following a policy which could lead to future insolvency[32].

[30] Such as Equitable.
[31] SI 1968 No. 1408.
[32] Paper prepared for the Institute of Actuaries on 26 November 1973 by A Ford, FIA, FSA: JIA 101 (1974) 53–87.

50 They were also a means by which policyholders might obtain information about the state of the company's affairs, although it was noted that it was not widely known that the returns were available for public scrutiny and were not reasonably intelligible to an educated layman[33].

51 In respect of the contents of the statement of ordinary long-term business of the company (under Schedule 5 to the ICAF Regulations 1968) it was specified that the statement must contain '*such particulars as are sufficient to enable an independent assessment of the liabilities of the company's ordinary long-term business to be made*'.

52 From this it appeared that, at minimum, the returns should permit an independent actuary, with no other knowledge of the company than that contained in the statutory returns, not only to assess the valuation basis but also to perform a valuation on a different basis or bases in order to gauge the effect that the use of different assumptions would have on the value of the assets and liabilities[34].

53 The ICAF Regulations 1968 required that the accounts prepared under section 4 of the ICA 1958 and all the statements, certificates and reports to be annexed to the accounts gave a 'true and fair' view of the affairs of the company as at the end of its financial year and of the profit or loss of the company for the financial year (regulation 2(1)).

54 However, the accounts and other documents were not to be deemed to fail to give a true and fair view '*by reason only of the fact that the amount at which any asset of the company has been included in the balance sheet is less than the full value of that asset*'. The effect of this proviso was obscure, as there was no requirement to show the difference between the full value and the balance sheet value.

55 Furthermore, the meaning of 'full value' was itself unclear[35]. The application of the general company law requirement for the accounts to show a 'true and fair view' in relation to the accounts of insurance companies and the valuation of long-term liabilities were to become major issues between auditors and actuaries[36].

56 The most important of the prescribed documents were considered to be the balance sheet and valuation report. For a company which had carried out long-term business during the financial year, a certificate signed by the actuary (see paragraph 57) was to be annexed to the balance sheet stating whether or not, in his opinion, the aggregate amount of the liabilities of the company in relation to its long-term business as at the end of the financial year exceeded the aggregate amount of those liabilities shown in the balance sheet (Regulation 5). However, no minimum was prescribed for the excess of the life fund over the actuarial liabilities.

57 Regulation 15 prescribed the qualifications required[37] of the company's actuary as being either a Fellow of the Institute of Actuaries or of the Faculty of Actuaries or such other person having

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33 Report referred to in footnote 18.
34 Paper referred to in footnote 32.
35 Ibid.
36 See the Penrose Report, Chapter 11, paragraph 13 in relation to the practice of actuaries being to include *'over-prudent margins in liability valuations'* and auditors taking the view that this practice undermined the possibility that the accounts could show a true and fair view. The relationship between actuaries and company auditors was eventually the subject of a Guidance Note: GN7, first issued with effect from 1 January 1980.
37 For the purpose of the interpretation provisions of section 33 of the ICA 1958, which defined an 'actuary' as an actuary who possessed prescribed qualifications (subject to a limited exception).

actuarial knowledge as the BT might, on the application of the company, approve.

The Finance Act 1971

58 Section 20(3) of the Finance Act 1971 amended section 226 of the Income and Corporation Taxes Act 1970 so as to enable a policyholder under a contract approved by the BT to take part of the policy benefit as a cash lump sum rather than as an annuity. That lump sum could be no greater than three times the annual amount of the remaining part of the annuity (and the election by the policyholder to take a lump sum was required to be made at or before the time the annuity first became payable to him or her).

59 This change gave policyholders greater flexibility. It enabled them (or their advisers) to assess whether the cash lump sum might be used to purchase a more beneficial annuity from another insurer on the open market. Later changes made to section 226 of the Income and Corporation Taxes Act 1970 by section 26 of the Finance Act 1978 made it possible for the policyholder to require that the entire cash sum representing his or her policy benefits be paid to another life insurance company, facilitating the introduction of what became known as the 'open market option'.

The European Communities Act 1972

60 The European Communities Act 1972 (the ECA 1972) received Royal Assent on 17 October 1972 and had effect on 1 January 1973 when the United Kingdom (the UK) joined the Community.

61 On joining the Community, the Community Treaties and legislation became binding on the UK at an international level. The ECA 1972 was designed to give effect to the Community Treaties and legislation 'internally'.

62 By section 2(1) of the ECA 1972, rights, powers, liabilities, obligations, restrictions, remedies and procedures from time to time created, arising from or provided for under the Community Treaties (as defined by section 1(2) of that Act) were given direct effect in the UK if the Treaty provided for the provision to have effect without further enactment in the UK.

63 By section 2(2), provision was made for certain rights and obligations under Community law to be implemented in the UK by means of subordinate legislation. This could either be through an Order in Council or by regulations made by a designated Minister or department, but in either case the form of the measure must be a statutory instrument approved by each House of Parliament, or subject to annulment by either House.

64 Following on from the various European Economic Community (EEC) and European Community (EC) Directives on insurance referred to below, subordinate legislation was made on a number of occasions to give effect to the Directives, in some cases amending the primary legislation.

65 It was plain that the aims of the Treaty of Rome would have a considerable impact on insurance business once the UK joined the Community. In general the UK regulatory regime, particularly for long-term business, was seen as being less interventionist and having less stringent rules than the regimes which applied in other EC countries.

66 The fundamental aims of the Treaty in terms of freedom of establishment and to provide services, the free movement of persons, services and capital and fair competition within the Community, were bound to have considerable implications for the

regulatory regime in the UK. The process of harmonisation of the legislation to facilitate the aims of the Treaty was expected, at the least in the short-term, to lead to stricter rules in the UK.

67 However, it was suggested by the Minister for Trade (in a talk given on 1 November 1972) that, once the UK joined the Community, the Commission would welcome the liberalising influence of the UK in the preparation of the insurance directives, as such an approach accorded with the general philosophy of the Commission.

68 The twelve-year general programme for the progressive establishment of the Common Market included a specific, five-stage, timetable for the introduction of the principles of freedom of establishment and freedom of services in respect of insurance transactions. This timetable was subject to substantial delay.

69 By the time the UK joined the Community, no Community rules had been promulgated in relation to direct insurance business[38]. The First Non-Life Directive (representing the second step in the five-stage process of transition in the original timetable) was almost finalised, subject to the contributions of the countries (including the UK) who were about to join[39]. The First Life Directive (or Establishment Directive) was at an early stage of preparation. It was anticipated that reaching agreement with other member states on solvency regulations was likely to be a difficult issue in view of the less stringent supervisory approach adopted in the UK.

Background to the role of the Government Actuary's Department

70 Before GAD was formally created in 1919, actuaries who were to form part of that Department provided advice to the BT on life assurance matters[40]. In a letter written in 1916, the actuary who was to assist the BT recorded that his duties for the Board were to include:

(a) reporting generally on returns sent in by individual companies and occasionally to advise as to the meaning of legislation from an actuarial point of view; and

(b) in the event of new legislation, to advise on proposals made.

71 With the creation of GAD in 1919, the arrangements between government departments and GAD were formalised. GAD had its own source of finance from a Parliamentary vote, so other departments were not expected to pay for its services at least until 1989[41].

72 In addition to the matters referred to above, over the years GAD became involved in the liquidation of life assurance companies and participated in government committees of inquiry to address issues of concern in the field of life assurance.

73 By the 1930s, the role of GAD had gradually widened to include advising the BT on possible action to improve the position of policyholders and to make published information more transparent and informative. GAD was also asked to

[38] An EEC Council Directive 64/225/EEC of 25 February 1964 had abolished restrictions on the freedom of establishment and on the free supply of reinsurance and retrocession within the Common Market. (A further directive had been issued in relation to motor insurance.)
[39] Talk by Minister for Trade at a seminar on 'Corporate Insurance and Risks Today', 1 November 1972.
[40] According to a paper by the Government Actuary: JIA 119 (1992) 313–343.
[41] Since 1989 when a management review was undertaken, GAD has been expected to recover almost all of its costs from fee income from its clients.

become closely involved in consideration of cases of suspected insolvency. GAD appears to have played a part in encouraging the BT to consult informally with the then insurance associations: the Life Offices Association and the British Insurers Association. Eventually GAD (and the Government Actuary) became involved in international life assurance issues and the emerging single European market for insurance business.

74 The role of GAD is not referred to in the legislation which creates and governs the regime for prudential regulation of life assurance companies. However, GAD's services in scrutinising returns and seeking clarification of technical issues and its advice on problem areas, emerging legislation and guidance have been essential components in the scheme of prudential regulation. The experience GAD had built up over the years must have been of particular significance prior to any valuation regulations being introduced. In 1991, the Government Actuary described the role of GAD as follows:[42]

> *From 1984 GAD has operated a major part of life insurance supervision as a delegated responsibility, under the terms of a written contract with the DTI, which lays down the respective responsibilities of DTI officials and of GAD. It is the responsibility of GAD to monitor the financial position of each life company, including examination of annual returns, quarterly returns (where applicable) and other information, to discuss matters with the company and, in particular, with the Appointed Actuary, to clear up any uncertainties or to resolve any disagreements, and then to report to DTI with an assessment of the situation, including any recommendations for further action.*

The Government Actuary went on[43] to emphasise that responsibility for supervising insurance companies rested with the Secretary of State supported by the Insurance Division of the DTI and that GAD was in no sense the supervisory authority:

> *However, as actuarial advisers to the DTI, GAD has a major contribution to make to the supervisory process. Insurance is a complex and technical business, which is not easily understood by generalist administrators and executive staff at the DTI...*

75 The '*written contract*' was a 'service level agreement', first made in 1984 between the DTI (Insurance Division) and GAD in respect of the role to be played by GAD in the examination of statutory returns made by insurance companies carrying out long-term business, and is referred to below.

76 The meaning of 'appointed actuary' and the significance of that role are explained in paragraphs 95 and 96 below. The series of letters sent by the Government Actuary to appointed actuaries of insurance companies from 1985 onwards, known as 'Dear Appointed Actuary' or 'DAA' letters, giving information on the working standards applied by GAD and its view of good practice in the actuarial profession, are also mentioned below. In practice, DAA letters were considered to set a minimum acceptable standard for appointed actuaries in determining provisions for particular risks in the valuation of liabilities[44].

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[42] In paragraph 14.23 of the paper referred to in footnote 40.
[43] In paragraph 16.10 ibid.
[44] Memorandum produced by the F&IA for the House of Commons Treasury Committee Inquiry into Equitable and the Life Assurance Industry, dated February 2001 (paragraph 8.2). See further paragraph 280, regarding the intended function of DAA letters.

77 In April 2001, staff of GAD who had been involved in the prudential regulation of insurance companies transferred to the FSA in order to provide the FSA with 'in house' actuarial advice.

Phase 2: 1973-1980

The Insurance Companies Amendment Act 1973

Introduction and overview

78 Shortly after the CA 1967 and the ICAF Regulations 1968 had come into force, consideration began to be given within the DTI and the actuarial profession to the need for still further revision of insurance legislation. The actuarial profession debated[45] the level and nature of supervision which applied in the UK and compared it to that which applied in other countries. It was suggested that the UK system was '*probably the cheapest in the world*'.

79 The relative roles of the DTI, GAD and company auditors and actuaries in the UK system were considered. Debate surrounded the respective roles of insurance company auditors (who were prohibited, by general companies legislation, from being an officer or servant of the company) and actuaries (who usually were company employees[46]) in reporting on the financial condition of the company and some auditors had approached external actuaries to comment on the company actuary's valuation (although the ICAF Regulations 1968 did not require the auditor to audit the certificate required to be given by the appointed actuary under those Regulations in relation to the aggregate amount of the company's long-term liabilities).

80 Consideration was also given to whether the ICAF Regulations 1968 fulfilled the 'publicity' element of the '*freedom with publicity*' objective (and what that objective meant), as those Regulations addressed the position from the standpoint of the DTI rather than that of policyholders, shareholders or the public.

81 Following the collapse of the Vehicle and General Insurance Company in 1971 leaving one million motorists without insurance cover, a Tribunal of Inquiry had been set up to consider the circumstances which had led to its failure, including the role played by the DTI and Ministers in failing to foresee and avert its collapse. Whilst this Inquiry related to the non-life field, it was seen as highlighting the ineffectiveness of the then existing powers of intervention in general.

82 In 1971 the Scott Committee was formed by the DTI to consider the need for new safeguards in respect of property bonds and equity-linked life assurance.

83 Although it was not required to consider the whole of the life assurance business, some of the areas that Committee addressed, such as the role of the actuary in relation to the issue of solvency, were of wider significance.

84 Before the publication of the Scott Report in 1973, the Bill which led to the enactment of the Insurance Companies Amendment Act 1973 (the ICAA 1973) was introduced in the House of Lords. There had been close liaison within the DTI between those preparing the Bill and the Scott Committee secretariat[47]. The Government accepted, in principle, all but one of the recommendations made by the Scott Committee[48], although most of the recommendations were provided for in powers to make regulations rather than within the body of the Act.

[45] Notes of a Sessional Meeting of the Institute of Actuaries held on 24 April 1972: JIA 98 (1972) 233-250.
[46] A paper presented to the Institute of Actuaries in 1988 by the then Government Actuary suggested that some 20% of 'appointed actuaries' were appointed as consultants rather than as employees of the insurance company: JIA 116 (1989) 27–100 (paragraph 5.1).
[47] Discussion on the Report of the Committee on Property Bonds and Equity-Linked Life Assurance: Transactions of the Faculty of Actuaries (TFA) 34 (1973–1975) 23–48 (page 28).
[48] The exception was the Committee's recommendation that, to enable the DTI to act in urgent cases, the one month minimum period of delay whilst representations from the company were considered under the CA 1967, section 68 should be repealed.

85 In promoting the new legislation it was said that experience had shown that the powers of intervention under the CA 1967 were too inflexible and narrow and that wider discretion was required as it was '*impossible to foresee all the circumstances in which an insurance business might run into trouble*'[49].

86 The doctrine of '*freedom with publicity*' was again referred to. The approach to government regulation adopted in other countries which encompassed premium rates, policy conditions[50] and choice of investment was rejected in favour of leaving these matters, as a general rule, '*to the free play of competition*'.

87 The comparatively less prescriptive approach adopted in the UK was seen as a benefit in terms of allowing innovation in the insurance industry, keeping costs down and encouraging healthy overseas earnings. However, it was acknowledged that there were circumstances in which the government should intervene '*to react quickly and appropriately in order to protect the interests of policyholders*'[51]. It was noted that '*although we have almost certainly tried to supervise insurance too cheaply in the past, there is a point at which returns for increased expenditure must diminish sharply*'. The stated objective of new legislation was '*not primarily to penalise post facto dishonest or incompetent managements, but to protect policyholders by taking or requiring suitable corrective action in time to avert the consequences of imprudent or misguided policies*'. The intention was to '*strike a proper balance between, on the one hand, allowing the industry so much freedom that it can be exploited by rogues, and on the other hand, creating for the industry such shackles that it cannot give efficient, competitive and forward looking service to consumers here and abroad*'[52].

88 In July 1973, the ICAA 1973 was enacted, with most of its provisions coming into force on subsequent dates. The Act gave new powers to the Secretary of State, refined existing powers and imposed new obligations on insurance companies. Important features of the 1973 legislation included:

- the reformulation and strengthening of powers of intervention (now expressed as being exercisable by the Secretary of State, rather than by the government department);

- an explicit statement of the grounds on which the Secretary of State might exercise his powers of intervention including (in section 12(1)(a)) that he considered it desirable for protecting policyholders or potential policyholders against the risk that the company might be unable '*... in the case of long term*[53] *business, to fulfil the reasonable expectations of policy holders or potential policy holders*[54]';

[49] Hansard Debates, House of Lords 8 February 1973, column 1158.
[50] Under the UK system, in the main, these matters were to be considered by the 'appointed actuary'. See further below in relation to the guidance given to actuaries of long-term insurance businesses in GN1 as from 1975 (paragraphs 172 et seq) and the role of GAD in scrutinising the valuation methods and assumptions being used, once policies had been written (paragraph 205).
[51] Hansard Debates, House of Lords 8 February 1973, column 1156.
[52] Hansard Debates, House of Commons 21 May 1973, column 118.
[53] In the ICAA 1973 and subsequent legislation, in most cases, the hyphen in ***'long term'*** was dropped, other than in the expression *'ordinary long-term business'*.
[54] For the purpose of the ICAA 1973, 'policy holder' was defined by section 33 (1) of the ICA 1958 to mean the legal holder of the policy and in relation to life assurance business, included an annuitant. 'Policy holder' was defined in similar terms in the primary legislation up to and including the Insurance Companies Act 1982. Although the legislation mainly refers to ***'policy holders'*** as two words, I have not followed this elsewhere in the text except where quoting from the legislation.

- an explicit role for the actuary appointed by the insurance company within the statutory regime;
- provision for separate identification of long-term assets and liabilities;
- power to make valuation regulations (arising from the Vehicle and General Report);
- provisions for continuation of long term business in liquidation; and
- the introduction of what might be described as greater 'consumer protection measures' such as a 'cooling off period' for prospective policyholders, powers to regulate advertising and offences in relation to misleading statements (following recommendations of the Scott Committee).

Exercise of powers following the commencement of the ICAA 1973 and the making of regulations and orders

89 The powers under the ICAA 1973 were expressed to be exercisable by the Secretary of State rather than by the BT or its successor government department, the DTI. Prior to the enactment of the 1973 Act the functions of the BT had been transferred so as to be exercisable concurrently by the BT and the Secretary of State[55]. Section 54(2) of the 1973 Act provided that the functions of the Secretary of State under the ICA 1958 and the CA 1967, Part II should cease to be exercisable concurrently by the BT, so that they became exercisable by the Secretary of State alone.

90 Many of the provisions of the ICAA 1973 were dependent upon subordinate legislation being made. Regulations made for the purpose of the ICAA 1973 were to be made by the Secretary of State by statutory instrument subject to annulment in pursuance of a resolution of either House, as under the ICA 1958 (the negative procedure). However, the power to make orders under sections 1 and 28 (to amend earlier primary legislation in relation to the margin of solvency) were subject to the affirmative procedure, requiring a statutory instrument to be laid in draft and approved by resolution of each House.

Authorisation of insurance companies

91 The Secretary of State was given greater flexibility in relation to authorisation of insurance companies through new powers to vary the minimum financial standards under section 62 of the CA 1967 by order (section 1 of the ICAA 1973).

92 The provisions prohibiting the issue of authorisation to a company on the basis of the involvement of 'unfit persons' under section 61 of the CA 1967 were extended to include directors, 'controllers' and managers of an insurance company, with 'controller' being defined to include managing directors, chief executives and those in accordance with whose directions or instructions the directors of the company (or its parent company) were accustomed to act, or who controlled at least one third of the voting power at a general meeting of the company (or its parent) (section 2).

Actuarial valuation and the appointed actuary

93 The requirements for periodic investigation of the financial condition of the company and valuation of liabilities by an actuary for companies conducting life assurance (and certain other kinds of business) under section 5(1) of the ICA 1958, were to be construed as relating only to the long-term business of the company, as was the required

[55] The Secretary of State for Trade and Industry Order 1970 SI No. 1537.

statement of business under section 5(2) of the ICA 1958 (section 3(1) of the ICAA 1973).

94 The valuation of assets and the amount of any liabilities in respect of the long term business were to be determined in accordance with regulations[56] (section 3(3)). The maximum intervals for actuarial investigation and valuation of liabilities (three years) and for the statement of long term business (five years) were not amended. The Secretary of State was empowered to require the company to carry out a special actuarial investigation (under section 18).

95 Every insurance company subject to the ICA 1958 which carried on long-term business was required to appoint an actuary to the company to carry out the investigations required under section 5 of the ICA 1958. Whenever an actuary was appointed the company was required, within fourteen days, to give written notice to the Secretary of State of the name and qualifications of the person who had been appointed and notice was also to be given when their appointment ended (sections 3(5) and 3(6) of the ICAA 1973)[57]. The actuary appointed under this requirement, and equivalent subsequent provisions, became known as the 'appointed actuary' (although the expression did not appear in the primary legislation).

96 The brevity and simplicity of the requirements in section 3 of the ICAA 1973 belie the considerable discussion which had taken place between the actuarial profession and the DTI about the role the company's own actuary was intended to play in the overall regime for prudential supervision of companies conducting long-term insurance business.

97 It has been suggested that the system of prudential regulation of life insurance companies since the mid-1970s has been only partly one of government supervision, containing elements of self-regulation, with (it was said) the F&IA standing in the place of a self-regulating organisation[58], although this view was not universally accepted.

Accounts and statements

98 Requirements for the deposit of accounts and other documents with the Secretary of State under section 8 of the ICA 1958 were updated and were required to include any report of the company's auditor prepared under section 9 of the ICA 1958 (section 4 of the ICAA 1973).

99 The normal timing for the deposit of those documents (within six months after the close of the period to which they related) could be accelerated (under section 19). The Secretary of State was

[56] Section 32 provided for regulations to be made in relation to the valuation of assets and the determination of liabilities. In relation to the valuation of assets, the initial regulations made under the equivalent provision of the ICA 1974 were the Insurance Companies (Valuation of Assets) Regulations 1974 SI No. 2203.

[57] The Insurance Companies (Changes of Director, Controller or Manager) Regulations 1975 SI No. 959 (made under the regulation making powers of the Insurance Companies Act 1974) prescribed the information to be supplied when a person ceased to be or became a director, controller or manager.

[58] See the paper by the then Government Actuary on 'The Appointed Actuary': JIA 116 (1989) 27-100 (paragraph 1.1). During the discussion which followed the presentation of the paper other actuaries challenged this analogy. The view was expressed that the F&IA *'are not, and never should be, SROs regulating insurance companies'* and that '[a]*ny attempt to use the profession to regulate insurance companies is unacceptable'* (F.B. Corby at page 82). Concern was expressed about extending the Institute's guidance as a self-regulating authority if this led to a downgrading of the responsibility of the board (R. Brimblecombe and F.B. Corby at page 90). One actuary described the analogy as *'not altogether happy'*; whilst accepting that in extremis the appointed actuary would have a duty to report concerns about the company to the DTI he stressed the responsibilities of a company's management team as a whole and not solely those of the appointed actuary in the normal operations of a company, *'... the 'big stick' of statutory responsibility and the requirements of the Guidance Notes are simply part of the framework of good practice within which the team as a whole operates'* (T.J. Palmer at page 94). See further, footnote 92 regarding a later Government Actuary's view of the historical role of the appointed actuary and footnote 539 regarding his view of the actuary's role as at 1994.

empowered to require an insurance company which conducted business of a prescribed class to provide periodic statements of its business in a prescribed form, accompanied by prescribed certificates, to enable a closer watch over its affairs (section 5 of the ICAA 1973). The timing of the provision of such statements could be accelerated by the Secretary of State (section 19).

100 The Secretary of State was empowered to prescribe classes of transaction which he considered likely to be undesirable in the interests of policyholders, in respect of which he was to be given prompt notification by the company (section 6).

Separation of assets and liabilities attributable to long term business and other measures to safeguard long term policyholders

101 All companies carrying out long-term business were required to maintain a specific account in relation to that class or those classes of business, with receipts being carried to a separate appropriately named insurance fund for each class of long-term business. The company was to maintain such books of account or other records as were needed to identify the assets representing that fund or funds. It was also to make arrangements to identify the assets and liabilities of the company attributable to its long-term business as at the last day of the financial year, in accordance with regulations made for this purpose[59] (section 7).

102 Section 8 prohibited the use of the assets representing the long-term business fund for any purpose other than that business, except in respect of any surplus in the value of the assets over the amount of the liabilities. A mortgage or charge created in contravention of this prohibition was void. Insurance companies were prohibited from declaring a dividend at any time when the value of the assets representing the long-term fund was less than the amount of the liabilities attributable to that business.

103 Where long-term policyholders of any class were entitled to participate in an established surplus (and an amount had been allocated to them in respect of the last preceding surplus), a 'relevant minimum' amount was required to be allocated to those policyholders before any part of the surplus could be applied for purposes other than the long-term business[60] (section 9).

104 The Secretary of State was empowered to prescribe a limit on the value of transactions conducted by the insurance company or any of its 'subordinate companies'[61] with persons connected[62] with it (calculated by reference to a percentage of the credit on the long-term fund). The effect of this provision was not to render any transaction unenforceable between the parties to it (section 10). However, contracts entered into by an insurance company which created a liability of an amount which was uncertain at the time the contract was entered into were rendered void by section 11, unless exempt by regulations.

Powers of intervention and the introduction of PRE

105 Sections 12-25 of the ICAA 1973 contained provisions intended to expand and make more effective the powers of intervention given by the CA 1967 which, by that time, were considered to be too narrow and inflexible to address the wide variety of circumstances which could arise.

[59] The Insurance Companies (Identification of Long Term Assets and Liabilities) Regulations 1973 SI No. 2064 were made for the purpose of this provision.
[60] Part of the debate in the lead up to the ICAA 1973 had surrounded the balance of interests between shareholders and policyholders.
[61] Defined in section 10(4) of the ICAA 1973.
[62] Defined in section 10(5) of the ICAA 1973.

106 The intervention powers under the 1973 legislation fell into two categories: first those, as under the CA 1967 but expanded, which were designed to address readily foreseeable circumstances; and second a 'sweeping-up' provision intended as a safety net to enable the Secretary of State to intervene in any other circumstances where the interests of policyholders required it but which could not be identified in advance[63].

107 As a basis for the sweeping-up provision, DTI officials involved in the preparation of the Bill had 'commandeered' an expression which had been used in an actuarial context (and apparently with a different purpose in mind[64]).

108 As noted above, the expression 'policyholders' reasonable expectations' had been suggested for inclusion in a clause to be inserted in the CA 1967 in 1971, but the proposal was not pursued at that time[65]. The expression was included in the instructions to Parliamentary Counsel and found its way into the Bill which preceded the ICAA 1973. The interests of future policyholders were also drawn within the net of protection in the drafting of the 1973 legislation.

109 There had been some debate between GAD and the DTI about the practical implications of incorporating what was seen as a wide-ranging test for government intervention, in terms of the capacity and resources which would be required to monitor the need for reliance upon it, as well as concern among Ministers that there would be grounds for increased criticism of them when the inevitable failure of an insurance company occurred notwithstanding its existence.

110 However, I have not traced any record of detailed consideration having been given, prior to the enactment of the 1973 Act[66], to whether the expression would be difficult to interpret or apply in practice, or what implications (if any) this test might have if the interests of various classes of long-term policyholder were to conflict, although it was acknowledged that the action needed to protect future policyholders as opposed to present ones might differ[67]. It was, as the government official proposing the clause indicated, an expression suggested '*notwithstanding lawyers' objections to lay competition*'[68]. It is conceivable that some benefit was perceived in its imprecision in terms of providing wide discretion for the regulator should it wish to intervene[69], but presenting difficulties for anyone seeking to compel it to do so.

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63 See the quotations from the internal paper prepared for the Secretary of State to send to other ministers in December 1972, set out in the Penrose Report, Chapter 13, paragraphs 16 and 17.
64 See paragraph 27 above regarding the paper by RS Skerman published in 1966 on a solvency standard for life business and the underlying valuation basis to be used.
65 See paragraph 27.
66 In the course of the 'clause stand part' debate on what was by then clause 12 of the Bill, one Member (Dr John Gilbert MP), drew attention to the lack of any definition of PRE in the drafting, but it does not appear that he received any response on behalf of the government. Some time after enactment, at a Sessional Meeting of the Faculty of Actuaries in 1976, the Under-Secretary of State stated that what expectations might be reasonable in any particular case would have to be determined in the light of the circumstances, but it was the government's expectation that companies that charged large premiums, loaded for bonuses, would in fact make profits to be shared with their policyholders. However, the government did not envisage general intervention in the amount of surplus to be disclosed by companies or the manner in which it was distributed between policyholders of different classes or of different generations, which would be left to the directors, acting on the advice of appointed actuaries: TFA 35 (1975-1977) 113 – 136 (at page 115).
67 Earl of Limerick moving a drafting amendment to clause 20 during the Lords Committee stage. (The original drafting of *'the reasonable expectations of policyholders **and** potential policyholders'* was changed to *'... policyholders **or** potential policyholders'*.)
68 DTI memorandum dated 3 November 1971; also referred to in the Penrose Report at chapter 13, paragraph 19.

111 PRE were built into the drafting of the ICAA 1973 in two ways. First, as one of the grounds on which any of the specific powers of intervention under sections 13-21 might be used (section 12(1)(a)); and second, as an integral part of the most wide-ranging of the intervention powers under which the Secretary of State could require the company to take '*such action as appears to him to be appropriate ...*' (under section 21), if the specific measures in the preceding sections of the Act could not, alone, appropriately achieve the statutory objective of section 21.

112 The notes on clause 11 of the Bill when introduced in the Lords (subsequently renumbered as section 12 of the ICAA 1973) explained that the reference to PRE took account of the extensive participation of with-profit policyholders in modern long-term insurance profits.

113 It was suggested that with-profits policyholders might pay double the premium of non-profit policyholders in order to participate in the future profits of the company. It was stated that, whilst it was reasonable to expect that the proceeds under the policy would be considerably greater than the basic sum assured under the contract (unless the policyholder died shortly after the policy was taken out), it was not reasonable to expect that the current bonus rate would be maintained come what may, although it would seem odd if only trivial bonus increases were awarded in return for substantially increased premiums. It was noted that companies issuing with-profits policies typically allocated with-profits policyholders nine-tenths[70] or more of the profits but that the company normally retained discretion to vary the proportion.

Section 12 – grounds for intervention under sections 13-21

114 Section 12 dealt with the grounds on which the intervention powers conferred on the Secretary of State in sections 13-21 could be exercised and imposed limitations on reliance on section 21 (which related to PRE). In summary the grounds under section 12(1) were:

(a) that the Secretary of State considered the exercise of the power to be desirable for protecting policyholders or potential policyholders against the risk that the company might be unable to meet its liabilities, or (in the case of long term business) to fulfil the reasonable expectations of policyholders or potential policyholders;

(b) that the company (or a parent or subsidiary) had failed to satisfy specified statutory obligations under the ICA 1958, Part II of the CA 1967 or the 1973 Act;

(c) that the company had provided misleading or inaccurate information to the Secretary of State for any purpose under the ICA 1958 or Part II of the CA 1967;

(d) that the Secretary of State was not satisfied with the company's reinsurance arrangements; or

[69] In a Presidential Address to the Institute of Actuaries made many years later, the Government Actuary expressed the view that *'Part of the strength of the relevant DTI power lies in the uncertainty – the actuary can use this to good effect in adopting a professional approach to ensuring equity and value for money for the policyholders'* (BAJ 1, 5-36).

[70] Apparently a reference to proprietary life companies (rather than to mutual companies) for which it has been common, but not universal, practice to allocate surpluses in the proportion 90:10 as between policyholder and shareholder funds.

(e) that a ground existed which, under section 2 of the ICAA 1973 relating to the involvement of 'unfit persons' in the company, would prohibit authorisation being issued if it were to be applied for.

115 A further ground for intervention was specified in section 12(2). In the case of a company carrying on long-term business, the Secretary of State was empowered to intervene if he was not satisfied that the value of the assets representing the long-term fund exceeded the amount of the liabilities of its long-term business, with the value of assets and the amount of any liabilities to be determined in accordance with regulations[71].

116 In respect of the power to require the company to produce documents under section 20 of the ICAA 1973, an additional ground for exercise was specified: that the Secretary of State considered it desirable in the general interests of those who were or might become policyholders (section 12(3)).

117 The Secretary of State was given greater flexibility in exercising his powers of intervention in relation to insurance companies which had only recently obtained authorisation. In respect of companies which had obtained authorisation within the preceding five years (or those for which there had been a change of control within that period), the powers under sections 13-18, 20(1) or 21 were exercisable whether or not any of the grounds summarised in paragraph 114 above existed, but any restriction imposed could last for no more than ten years (section 12(4)).

118 An express limitation was imposed on the wide 'safety net' power under section 21 concerning PRE: that this power could only be used if its purpose could not be appropriately achieved by relying on one of the specific powers under sections 13-20, or could not be so achieved by reliance on those powers alone.

119 There was an express requirement (in section 12(6)) for the Secretary of State to state the grounds on which he was exercising any of the powers under sections 13-21, unless he had given notice of the proposed exercise of the power under section 22 (in relation to section 13, restrictions on new business) or section 23 (unfit persons).

Section 13 – restrictions on new business

120 The intervention power under section 13, to impose restrictions on effecting new contracts of insurance or varying existing contracts, was said to permit the Secretary of State a more discriminating means of restricting new business than under the former provisions of section 68 of the CA 1967. A restriction under section 13 might apply to only part of an insurance company's business, through specifying by description the contracts to which it was to apply.

Sections 14, 15 and 16 – requirements about investments, maintenance of assets in the United Kingdom and custody of assets

121 Section 14 gave power to the Secretary of State to require a company not to make investments of a specified class or description and to realise assets of a specified class or description. This was intended to give greater flexibility to apply such a requirement to a particular investment if necessary. Such requirements could be framed so as to apply only to assets representing the long-term fund (or only to other investments).

122 Section 15 empowered the Secretary of State to require that the company hold in the UK assets of equal value to the whole or a specified proportion

[71] The various regulations made under these requirements are referred to below. In the event, only regulations relating to the valuation of assets and not in respect of the determination of the amount of liabilities were made under the ICAA 1973 or the ICA 1974.

of its UK liabilities. Unlike the former provisions of section 80 of the CA 1967 the grounds for exercise of this power were not limited to cases of threatened insolvency, but included all the grounds listed in section 12 (in common with other intervention powers under the ICAA 1973 summarised below).

123 Where a requirement had been imposed by the Secretary of State under section 15 for the maintenance of assets in the UK, he could impose an additional requirement that the assets be placed in the custody of a person approved by him. The custodian was to hold the assets as trustee for the company (section 16).

Section 17 – limitation of premium income

124 Section 17 elaborated on the former requirement of the CA 1967, section 80(1)(d) to enable the Secretary of State to impose a limitation on the new business taken on by the company, by restricting the aggregate amount of premiums it was to receive during a specified period. Separate restrictions could be imposed as regards life and general business. The limitation could be applied to premiums net of reinsurance costs.

Section 18 – special actuarial investigations

125 A further form of intervention relied upon the appointed actuary. The Secretary of State could require any company which carried on long term business to cause its actuary to make an investigation into its financial condition (including a valuation of its liabilities) in respect of the whole or any part of its long-term business, as at a specified date; to cause an abstract of the appointed actuary's report of the investigation to be made and to prepare a statement of all or part of its long term business as at the date specified.

126 The valuation was to be conducted in accordance with '*any applicable valuation regulations*'[72]. The form and content of any abstract or statement were to be the same as those required under section 5 of the ICA 1958 (namely, as prescribed in the ICAF Regulations 1968).

Sections 19 and 20 – acceleration of accounting information and production of documents

127 The Secretary of State could require that the accounting documents which were to be deposited with him under section 8 of the ICA 1958 should be submitted up to three months earlier than their due date, provided at least one month's notice was given to the company. Periodic statements required under section 5 of the ICAA 1973 could be required earlier than the originally specified date.

128 Section 20 empowered the Secretary of State (or a person authorised by him) to require the company (or any person appearing to him to be in possession of them) to furnish him with such books and papers[73] as the Secretary of State might specify, and authorised the Secretary of State to take copies of them. The Secretary of State could also require the person in possession of the documents or any director (present or past), controller or auditor employed by the company to provide an explanation of any item or, if any items were not produced, to state (to the best of the person's knowledge and belief) where those items were. Statements made in compliance with these requirements could be used in evidence against the person who made them.

[72] This appears to be a reference to valuation regulations made for the purpose of section 32, first made under the equivalent provisions of the ICA 1974 in relation to the valuation of assets (but not liabilities) in the Insurance Companies (Valuation of Assets) Regulations 1974 SI 1974 No. 2203.

[73] The term 'books and papers' was to be construed in accordance with the Companies Act 1948. Section 455 of that Act (the interpretation provision) defined the term as *including* accounts, deeds, writings and documents (i.e. it was not intended to be an exhaustive definition).

Section 21 – residual power to impose requirements for the protection of policyholders

129 This short section provided:

> *The Secretary of State may require a company to take such action as appears to him to be appropriate for the purpose of protecting policy holders or potential policy holders of the company against the risk that the company may be unable to meet its liabilities* ***or, in the case of long term business, to fulfil the reasonable expectations of policy holders or potential policy holders****.* (Emphasis added.)

130 As noted, this was a power of 'last resort'. The Secretary of State's powers under section 21 could only be relied upon if the purposes of the section could not be appropriately achieved through reliance on the powers in sections 13-20 or by reliance on those powers alone.

Notice of proposed exercise of powers

131 Under section 22, the Secretary of State's power to impose a restriction on entering into new business under section 13 could only be exercised if he had given the company written notice that he was considering exercising that power and of the ground on which he was considering exercising the power and had invited the company to make written representations to the Secretary of State and (if the company so requested) oral representations to an officer of the DTI appointed for this purpose.

132 Section 22 did not apply if the proposed ground for exercising the power was that under section 12(1)(e) (involvement of an unfit person in the company), unless that person was a controller of the company, in which case the controller was also to be served with notice.

133 Section 23 provided for prior notices in cases where the proposed ground for exercising any of the intervention powers under sections 13-21 was that under section 12(1)(e) and the person being considered under the unfitness requirements was a person *other than* a controller of the company.

134 Notice was to be served first on the person concerned, setting out the grounds on which such action was being considered and inviting them to make representations and (unless the Secretary of State decided, having considered those representations, not to exercise intervention powers), an equivalent notice was then required to be served on the company, identifying the grounds, inviting representations and specifying the powers proposed to be exercised.

Power to rescind or vary requirements imposed and obligation to publicise

135 Under section 24, the Secretary of State was given power to rescind or vary at any time a requirement imposed by sections 13-21. Five years after its imposition, a requirement could only be relaxed through variation.

136 Notice of imposition, rescission or variation of a requirement under section 13 (debarring a company taking on new business) was to be published in the London and Edinburgh Gazettes and in such other ways as the Secretary of State considered expedient for notifying the public. Written notice of a requirement in respect of the custody of assets by an approved person under section 16 (or its variation or rescission) was to be served on the registrar of companies.

Power to bring civil proceedings

137 Section 25 extended the general power of the Secretary of State under section 37 of the CA 1967 to bring civil proceedings on behalf of a body corporate where it appeared to him that such proceedings ought, in the public interest, to be brought. In relation to insurance companies, this power also arose in relation to information or documents obtained under the ICA 1958 or the CA 1967 (and not just in respect of the information and documents specified in section 37 of the CA 1967 which applied to bodies corporate generally).

Transfer of long term business

138 Sections 26 and 27 updated the provisions of section 11 of the ICA 1958 in so far as it applied to the transfer of long-term business between insurance companies. In the absence of these statutory provisions, the consent of every policyholder would be required before any transfer could be effected. Section 26 provided for either the transferor or the transferee company to petition the court[74] to sanction a transfer scheme and prohibited the scheme being carried out unless an order was made. The petition was required to be accompanied by a report from an independent actuary on the terms of the scheme.

139 Publication and notification requirements had to be fulfilled, including a requirement to provide long-term policyholders with a summary of the independent actuary's report indicating the likely effects of the scheme for them. The court was prohibited from making an order sanctioning the scheme unless satisfied that the transferee company was, or immediately after the making of the order would be, authorised to carry on long-term business of a class or classes to be transferred under the scheme.

140 Both the Secretary of State and any person '*who alleges that he would be adversely affected by the carrying out of the scheme*' were entitled to be heard on the petition. In making an order under section 26, the court could make provision for the transfer of the whole or any part of the transferor's undertaking and liabilities, the allocation or appropriation of shares etc. by the transferee, the continuation of legal proceedings, the dissolution (without winding up) of the transferor company and incidental and consequential matters. Office copies of the court order were to be deposited with the Secretary of State by the transferee company.

Insolvency and winding up

141 Sections 29-31 were intended to improve the procedures for winding up insurance companies, with particular reference to the position of long-term policyholders.

142 Section 28 expanded on the provisions relating to the margin of solvency under section 13 of the ICA 1958 which applied to companies conducting general business, by empowering the Secretary of State to amend section 13 by order to substitute amounts specified or determined in accordance with that section. Specific provision was made for the assessment of the margin of solvency for insurance companies which carried on long-term business in addition to general business, by specifying how the amount of its long-term business liabilities was to be calculated (section 28(5)).

143 Sections 29-31 contained new winding-up provisions. The Secretary of State was empowered to present a petition for the winding up of an insurance company subject to the ICA 1958 where it appeared to him that it was '*expedient in the*

[74] The High Court in England or the Court of Session in Scotland.

public interest that the company should be wound up ... if the court thinks it just and equitable for it to be so wound up'. This power did not apply if the company was already being wound up by the court. Where the petition for winding up had been presented by another person, a copy of the petition was to be served on the Secretary of State who was entitled to be heard on the petition. Provision was made for the general rules about winding up under section 365 of the Companies Act 1948 to include rules relating to the determination of the amount of an insurance company's liabilities to policyholders of any class or description.

144 Section 30 applied specifically to the winding up of companies subject to the ICA 1958 which conducted long-term business and prohibited such a company from being wound up voluntarily. In general, the assets representing a long-term fund could only be made available to meet the company's liabilities in respect of its long-term business (section 30(3)(a)). Rules, additional to those under section 365 of the Companies Act 1948, could be made to provide for such matters as the identification of assets and liabilities attributable to the long-term and other business of an insurance company.

145 Where money or property had been recovered by the company through an order under section 333 of the Companies Act 1948 (misappropriation by directors) in respect of its long-term business, the court was to include in the order a direction that the money, property or contribution be treated as assets of the long-term fund.

146 Section 31 introduced a new measure to provide for the continuation of the long-term business of an insurance company in liquidation. The liquidator was required to carry on that business with a view to its being transferred as a going concern to another insurance company (either existing or specially formed) unless the court ordered otherwise.

147 The liquidator was empowered to apply to the court to appoint a special manager of the long-term business if the liquidator was satisfied that the interests of the creditors required it. If it thought fit, the court was empowered to reduce the amount of the contracts made by the company in the course of carrying out its long-term business[75]. On the application of the liquidator or of a special manager or of the Secretary of State, the Court could also appoint an independent actuary to investigate the long-term business of the company and to report on the desirability or

[75] The expression 'the amount of the contracts made by the company' which the court was empowered to reduce under section 31(5) of the ICAA 1974 was not defined in that Act. However, it was defined by the court in *Re Capital Annuities Limited* [1978] 3 All ER 704 as meaning 'the sum or sums payable under the contract'. In essence, section 31(5) provided a means by which the court could reduce the magnitude of an insurance company's liabilities. This provision was re-enacted as section 48(5) of the ICA 1974 (and later, as section 56(5) of the ICA 1982). Under section 50 of the ICA 1974 (section 58 of the ICA 1982), the court was empowered to reduce the amount of the contracts of an insurance company which was unable to pay its debts as an alternative to making a winding up order. The extent of the court's powers under section 50 of the ICA 1974 was considered in the *Capital Annuities* case, in which it was held that section 50 applied to sums prospectively payable under the company's current policies as at the date of presentation of the winding up petition. Thus:

(a) the court was empowered to reduce sums prospectively payable by the company under its insurance contracts as at the date of the order effecting the reduction;

(b) the court could also reduce sums which had been prospectively payable under those contracts as at the date of presentation of the winding up petition, but which had 'ripened' into presently payable debts between the date of presentation of the petition and the date of the court order;

(c) but the court did not have jurisdiction to reduce debts which had accrued due by the date on which the winding up petition had been presented.

otherwise of that business being continued and on any reduction in the contracts that might be necessary for its successful continuation.

Valuation regulations

148 Under section 32, provision was made for the value of assets and the amount of liabilities to be determined in accordance with valuation regulations (made by the Secretary of State). Such regulations could make different provision in relation to different cases or circumstances. The regulations made under these provisions for the purpose of valuing assets are referred to below. No regulations for the determination of liabilities were made under the ICAA 1973. This was first addressed in the Insurance Companies Regulations 1981[76] (ICR 1981), Part VI.

Changes of director, controller or manager

149 Before appointing a managing director or chief executive an insurance company was required to serve the Secretary of State with written notice stating that it proposed to appoint a person to the position and providing prescribed particulars.[77]

150 The Secretary of State was given a three month period to give notice of his objection to the appointment on the grounds that the person concerned was not a '*fit and proper person to be appointed to the position in question*'. The effect of such a notice served by the Secretary of State within the three month time limit was to debar the company from making the appointment[78].

151 The Secretary of State was not obliged to disclose to the company or to the person concerned any particulars of the ground on which he was considering service of notice of objection. Provision was made for representations to be made by the company or the person concerned in respect of a notice of objection given by the Secretary of State (section 33).

152 Section 34 made similar provision to that in section 33 in respect of persons who were proposed to become a 'controller' of an insurance company other than as the managing director or chief executive. This applied to the third category of 'controller' defined in section 2, namely, a person in accordance with whose directions or instructions the directors of the company (or its parent company) were accustomed to act or a person who alone or in association with others was entitled to exercise, or controlled the exercise of, one third or more of the voting power at a general meeting of the company or its parent.

153 A person who became, or ceased to be, a controller of an insurance company was required to give the company seven days' written notice of that fact and of such other matters as might be prescribed. Those who became a director or manager of an insurance company were to notify the company in writing of such matters as might be prescribed. The company was required to give the Secretary of State written notice of anyone becoming or ceasing to be a director, controller or manager of the company (section 35).

[76] SI 1981 No. 1654 (see paragraphs 248 et seq).
[77] The Insurance Companies (Changes of Director, Controller or Manager) Regulations 1975 SI No. 959 were made later under the ICA 1974.
[78] Section 33(1) stipulated that no insurance company subject to the ICA 1958 should appoint a person as managing director or chief executive of the company unless (a) the company had served the required notice of its proposal on the Secretary of State containing prescribed particulars and (b) the Secretary of State had either given written notice to the company within three months that he had no objection to the person being appointed or the three month period had elapsed without the Secretary of State giving written notice of objection.

154 The involvement of a person in an insurance company whom the Secretary of State considered was not a fit and proper person to be a director, controller or manager of the company was one of the grounds on which the Secretary of State's powers of intervention were exercisable (section 12(1)(e) of the ICAA 1973, see paragraph 114(e) above).

Miscellaneous provisions (sections 36-38 and 42-47)

155 Section 36 required the Secretary of State to deposit with the registrar of companies certain of the documents which had been deposited with him by an insurance company under the requirements of the ICA 1958 and the ICAA 1973.

156 Under section 37 of the ICAA 1973, the Secretary of State was empowered, on the application of an insurance company or with its consent, to treat certain business of the insurance company as either being or not being ordinary long-term insurance business.

157 Section 38 provided the Secretary of State with the power to disapply specified statutory provisions of the ICA 1958 and the ICAA 1973 or to modify those provisions through a direction made by order. (Comparable powers had been given to the BT under sections 92 and 93 of the CA 1967.)

158 In consequence of recommendations made by the Scott Committee, section 42 of the ICAA 1973 provided that a person making a misleading statement, promise or forecast to induce a person to enter into a contract of insurance would be guilty of an offence[79]. Sections 44 to 46 dealt with the new 'cooling-off' period provisions. They required an insurance company to provide a statutory notice, by post, to any proposed long-term policyholder containing prescribed information.

159 A notice of cancellation was required to be annexed to the statutory notice, stating the person's right to withdraw from the transaction within a specified period. A new power to make regulations was included in section 47 in respect of 'linked long-term policies' (i.e. those under which the benefits were wholly or partly determined by reference to the value of, or income from, property).

Offences and penalties

160 Section 52 provided for (and extended previous provisions in respect of) offences for non-compliance with the requirements of the insurance legislation, including the new requirements relating to the separation of assets and liabilities attributable to long-term business and the application of the assets of a company with such a business under sections 7-9.

The First Non-Life Directive 73/239/EEC

161 Two days before the ICAA 1973 received Royal Assent, an EEC directive on insurance was made (73/239/EEC, 23 July 1973, the First Non-Life Directive). Although this Directive expressly excluded life assurance, it provided a 'foretaste' of the extent to which UK legislation on insurance would be affected by the need to remove restrictions on the establishment of insurance providers from other member states and to harmonise supervisory legislation.

162 One of the main features of the First Non-Life Directive was the requirement for insurance companies to possess a supplementary reserve, known as the 'solvency margin', represented by free assets in order to make provision against business

[79] Contracts of insurance were excluded from the application of the Prevention of Fraud (Investments) Act 1958 by section 48 of the ICAA 1973.

fluctuations, and for this solvency margin to be calculated on a uniform basis throughout the EEC.

163 The First Non-Life Directive was implemented through a series of statutory instruments made in 1977 to amend the Insurance Companies Act 1974 in respect of non-life business and its application to companies from other EEC member states. It was not until 1979 that a comparable directive was made in relation to life assurance (79/267/EEC, 5 March 1979, referred to below).

The Insurance Companies Act 1974

164 The Insurance Companies Act 1974 (ICA 1974) came into force, subject to 'transitory' provisions[80], on 31 August 1974. It was a consolidating Act to amalgamate almost the whole of the ICA 1958, the relevant provisions of the CA 1967 and the ICAA 1973, and to repeal the earlier insurance legislation.

Subordinate legislation following on from the Insurance Companies Amendment Act 1973 and Insurance Companies Act 1974

Identification of long-term assets and liabilities

165 To give effect to the requirements of sections 7(3) and (4) of the ICAA 1973, the Insurance Companies (Identification of Long Term Assets and Liabilities) Regulations 1973[81] were brought into force on 1 January 1974. They included an obligation on the company to deposit a certificate with the Secretary of State indicating that the required arrangements had been made.

Valuation regulations

166 Section 32 of the ICAA 1973 (section 78 of the ICA 1974) provided for regulations to be made in relation to the determination of the value of assets and the amount of liabilities, in any case in which the value or amount was required by any provision of the Act to be determined in accordance with 'valuation regulations'.

167 The first set of valuation regulations made for this purpose were the Insurance Companies (Valuation of Assets) Regulations 1974[82] which were brought into operation on 1 February 1975. As their name suggests, they dealt solely with the valuation of assets. They made provision for the manner or basis on which such items as shares in dependent companies, debts and other rights, land, equipment and other shares, investments and assets were to be valued.

168 The value of certain assets was to be reduced or disregarded in the asset valuation. These regulations were revoked and replaced in 1976 and the replacement regulations were then amended to introduce various refinements, for example to impose limitations on the extent to which the value of certain descriptions of asset could be brought into account[83].

169 In relation to the determination of the amount of liabilities, it appears that despite attempts to draft such regulations[84], no such regulations were made under the 1973 or 1974 Acts. As noted, valuation regulations in relation to liabilities were eventually included in ICR 1981.

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[80] Contained in section 89 of that Act, which preserved the effect of various requirements, directions and other forms of action under the legislation which was being repealed and provided for transition to the new primary legislation.
[81] SI 1973 No. 2064.
[82] SI 1974 No. 2203.
[83] See the Insurance Companies (Valuation of Assets) Regulations 1976 SI No. 87, the Insurance Companies (Valuation of Assets) (Amendment) Regulations 1976 SI No. 2039 and the Insurance Companies (Valuation of Assets) (Amendment) Regulations 1980 SI No. 5.
[84] It appears that draft regulations relating to long-term liabilities were prepared before those for assets, but the Institute of Actuaries (although not the Faculty) objected to them (letter from GAD to DTI dated 9 October 1973).

Changes of Director, Controller or Manager

170 In 1975, regulations were made under the ICA 1974 to prescribe the information to be supplied to the Secretary of State regarding any person proposing to become a 'controller', director or manager of an insurance company and when any person ceased to be in such a position[85]. The 1975 Regulations were superseded in 1978[86], to require additional information to be provided and in the light of exceptions to the legislation on rehabilitation of offenders, which required spent convictions to be disclosed.

Amendments to the Insurance Companies (Accounts and Forms) Regulations 1968

171 The ICAF Regulations 1968 were amended in 1975[87] to take account of the requirements for the separate identification of assets and liabilities attributable to long term business (by that time, included in section 23 of the ICA 1974) and for assets to be valued in accordance with any applicable valuation regulations, such regulations having by then been made at least in relation to the valuation of assets[88]. The ICAF Regulations 1968 were amended on four further occasions to take account of updated valuation regulations and other changes in the related legislation[89] before they were revoked[90] with effect from 1 January 1981.

Guidance for Appointed Actuaries – the first version of GN1

Introduction

172 Actuaries had played an important part in the management of life assurance companies in the UK long before the enactment of the ICAA 1973[91]. It has been noted that the underlying approach of the legislation, that insurance companies should be free to manage and develop their businesses as they thought fit provided that the financial condition of the company satisfied certain financial standards, placed considerable reliance on the work of actuaries, since those standards had largely to be actuarially determined[92].

173 It has been said that the regulatory system in the UK was not fully codified in legislation, but instead it relied, in significant part, on the professional responsibilities of actuaries. It has been suggested that in doing so it could be '*more flexible, less onerous on management, and cheap to run*'[93].

85 The Insurance Companies (Changes of Director, Controller or Manager) Regulations 1975 SI No. 959.
86 By the Insurance Companies (Changes of Director, (Controller or Manager) Regulations 1978 SI No. 722.
87 By the Insurance Companies (Accounts and Forms) (Amendment) Regulations 1975 SI No. 1996.
88 SI 1974 No. 2203, made for the purpose of section 78 of the ICA 1974, see paragraph 166.
89 The further amendment regulations were the Insurance Companies (Accounts and Forms) (Amendment) Regulations 1976 SI No. 549, the Insurance Companies (Accounts and Forms) (Amendment) (No.2) Regulations 1976 SI No. 869, the Insurance Companies (Accounts and Forms) (Amendment) (No.3) Regulations 1976 SI No. 2040 and the Insurance Companies (Accounts and Forms) (Amendment) Regulations 1978 SI No. 721.
90 By the Insurance Companies (Accounts and Statements) Regulations 1980 SI No. 6: see paragraphs 235 et seq.
91 In a paper – 'The Supervision of Life Insurance Business in the United Kingdom' – prepared for a summer school of *Le Groupe Consultatif des Associations d'Actuaires des Pays des Communautés Européennes* in 1990, the Government Actuary noted (at paragraphs 1.4 and 1.5) that, historically, actuaries had enjoyed a respected position in UK life assurance. Their technical ability, high standards of ethical behaviour, professional discipline and broad view of their responsibilities made them invaluable in the commercial environment. As a result, actuaries had become dominant in the management of life assurance companies; '*the early attempts at supervisory legislation accepted a central role for the actuary, not just in valuing the liabilities but in monitoring the overall financial strength of the company*', paving the way for the much more recent introduction of their '*formal position*' (under the ICAA 1973).
92 See the paper by the then Government Actuary for the Institute of Actuaries on 'The Appointed Actuary' at JIA 116 (1989) 27–100 (paragraph 1.3).

174. The status of the appointed actuary within a life office varied considerably between individual companies[94]. There was no requirement that the appointed actuary should or should not hold any particular post in the company[95] and some appointed actuaries were consultants rather than company employees. Later, the appointed actuary might also have been the 'reporting actuary' for the purpose of the company's accounts prepared to comply with the Companies Acts when the relevant requirements were introduced in 1993[96].

175. It appears that GAD's initial reservations about the resource implications for GAD of introducing such a wide ranging test for intervention as that in relation to PRE were at least partially resolved in practice by leaving the detailed ongoing responsibility for considering PRE with the appointed actuary (eventually as an explicit matter to be taken into account in preparing valuations), with GAD continuing to base its scrutiny (undertaken on behalf of the DTI) on the regulatory returns and identifying issues relating to PRE in that way.

176. Prior to the enactment of section 3 of the ICAA 1973 (which required insurance companies to appoint an actuary and to notify the DTI of the appointment), companies had only to produce actuarial valuations at three yearly intervals[97]. Even under the 1973 Act there was no requirement for the continuous involvement of an actuary.

177. However, following the insolvency or threatened insolvency of several life offices during 1974[98] despite the introduction of the ICAA 1973, further action was considered necessary. In part, this took the form of the Policyholders Protection Act 1975. But as far as supervision of insurance companies was concerned, no new primary legislation was implemented at this stage. Instead, following discussion within the actuarial profession, the F&IA agreed to issue additional guidance to actuaries on the role of the appointed actuary in relation to long-term insurance business.

178. The guidance in GN1 (which described the general duties and responsibilities of the appointed actuary) and the later guidance in GN8 (on the technical basis of actuarial valuations) were seen as key elements in the regulatory framework which '*buttressed*' the regulations[99] made under the various Acts, albeit that they did not amount to 'statutory guidance'. In later years, the appointed actuary was required to certify, as part of the annual returns, whether the practice standard

93 The paper referred to in footnote 92, at paragraph 1.9.

94 In the case of Equitable, the company's chief executive was also the appointed actuary for the period 1991-1997. In December 2000, the Society's Appointed Actuary was nominated by the company to act as chief executive, following the resignation of the incumbent chief executive. The roles were again split in January 2001, with the Society appointing a new appointed actuary.

95 The Corley Report (at paragraph 68) recommended that Guidance Notes issued by the F&IA should require that an actuary resists holding the dual role of chief executive and appointed actuary or any role which compromises his or her ability to fulfil the duties of the appointed actuary.

96 See paragraph 550. The expression 'reporting actuary' is used to refer to the actuary responsible for calculating the 'long term business provision' in respect of a company's accounts prepared for the purposes of the Companies Acts pursuant to requirements introduced by the Companies Act 1985 (Insurance Companies Accounts) Regulations 1993 SI No. 3246.

97 Section 78 of the CA 1967.

98 Nation Life became insolvent in 1974 and three other companies were at risk of insolvency during 1974.

99 As later described in Annex 1 to the Insurance Division's (internal) Policy Guidance Notes, Guideline 6.2. Paragraphs 6 and 7 of the Policy Guidance Note explained that regulations 50-64 of ICR 1981 were couched in very broad terms requiring the appointed actuary, for example, to determine long-term liabilities on '*actuarial principles*' and to make '*proper provision for all liabilities on prudent assumptions*' and went on to explain that: '*In other words, the regulations do not prescribe precise ways of valuing long term liabilities. The actual amounts to be placed on a company's long term business, therefore, is for the judgement of the Appointed Actuary in the light of his professional skills, subject to the criteria set out in the 1981 Regulations and further guided by the professional guidance notes issued by* [the F&IA in GN1 and GN8]'.

guidance notes had been fully complied with[100]. Compliance with GN1 (and in later years GN8) was 'mandatory' which meant that departure from the guidance without good reason could lead to disciplinary action against the actuary, including dismissal from the profession[101].

Guidance Note 1: Actuaries and Long-term Insurance Business

179 The first version of this guidance note, known as 'GN1', was issued by the F&IA on 1 May 1975. It stressed the importance of the role of the appointed actuary in ensuring the financial soundness of a company '*and the reputation of the profession*'. Whilst stating that it was '*no more than a guide*', it was made plain that it outlined a framework within which the appointed actuary was expected to work at all times and that failure to do so without justification would be regarded as prima facie evidence of unprofessional conduct.

Roles of the person appointed as actuary

180 The contents of GN1 illustrate the complex position in which an appointed actuary must have found himself[102]: owing duties to his profession ('*upholding its standards... in the public interest*'), to the company which appointed and paid him, and as the guidance put it, to the DoT[103] '*by reason of his statutory duties, which arise from the Department's supervisory functions aimed at the protection of policyholders*'.

181 The guidance accepted that the appointed actuary might have a separate, executive, role within the company, but indicated that in his capacity as appointed actuary he would have no executive authority. The appointed actuary would, however, have an advisory role and should have direct access to the board of directors '*having regard to the paramount importance of his advice in the context of long-term business*'.

182 If the appointed actuary was concerned at a course of action being pursued by the company which was likely to lead to him withholding a certificate in a normal form, he was first obliged to advise the company; but if the company persisted notwithstanding his advice, he was then required to advise the DoT, having so informed the company[104]. It is implicit that the appointed actuary's position would become more complex and difficult in a situation where the company was running into difficulties[105].

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100 Regarding the consultation paper issued by the DTI in 1990 on strengthening the role of the appointed actuary), see paragraphs 401 et seq.

101 The later versions of GN1 and GN8 were classified as 'Practice Standards' by the F&IA (see versions 6.2 and 7.1 respectively, the final versions of the guidance to be overseen by the F&IA). According to the F&IA's Professional Conduct Standards (version 2.3, paragraph 4.2), a material breach of a practice standard is a ground for referral under disciplinary schemes and strong *prima facie* evidence of misconduct.

102 For simplicity I have referred to 'him' and 'his' in this section as stated in GN1.

103 The relevant Government Department between 1974 and 1983.

104 A footnote to the guidance stated that this duty applied to '*Fellows of the Institute of Actuaries notwithstanding Basic Principle 2 of its Memorandum on Professional Conduct and Practice*'. Other sources indicate that this Basic Principle was entitled 'Relationship with the Principal' and introduced a fundamental concept that an employed actuary should advise his or her employer, who might then pass on that advice to the ultimate client (JIA (1980) 107 441-486 at page 475). In subsequent versions of GN1, updated references to professional conduct standards appear which, by 1998 (version 5.1), stated that the duty applied '*notwithstanding the normal requirement of the Memorandum on Professional Conduct of the Faculty and Institute to maintain the confidentiality of the company's affairs*'.

105 See further paragraphs 193 et seq in respect of the position of appointed actuaries who were also directors of their company.

Creation of a continual duty of the appointed actuary

183 Under section 14 of the ICA 1974 the appointed actuary's responsibility was to carry out and report upon the financial condition of the life office (including a valuation of its liabilities) at specified intervals, but the guidance imposed a greater obligation on the actuary. It stated that it was the appointed actuary's duty '*to take all reasonable steps to ensure that he is, **at all times**, satisfied that if he were to carry out such an investigation, the position would be satisfactory*' (emphasis added).

Obtaining information and data from the company and issues to be considered

184 The guidance in GN1 dealt with the information the appointed actuary would need to fulfil his task and stressed the need for him to ensure that the company provided him with correct and complete data, including obtaining written assurances from the company if necessary. It noted that the company's financial position was particularly affected by:

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

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

(c) the existing investments and the continuing investment policy;

(d) the marketing plans, in particular the expected volumes and costs of sales;

(e) the current and likely future level of expenses; and

(f) the extent of the company's free estate[106].

185 A reference to reinsurance arrangements was added to the above list of factors particularly affecting a company's financial position in paragraph 4.2 of version 1.1 of the Guidance Note issued for the period 1978-1979.

Premium rates and terms of contracts

186 A '*prime responsibility*' of the appointed actuary was to satisfy himself that the premium rates being charged for new business were appropriate in terms of being sufficient to enable the company in due course to meet its emerging liabilities[107].

187 It was stated that the appointed actuary '*may need to have regard to the provisions of section 28(1)(a) of the Insurance Companies Act, 1974*[108]', a reference to the first ground on which the Secretary of State's intervention powers under the legislation would be exercisable, namely where he considered it desirable for protecting policy holders or potential policyholders against the risk

106 There is no universally agreed or statutory definition of the term 'free estate'. In simple and general terms the 'free estate' is the company's uncommitted reserves. One definition is the excess of assets held within the long-term fund over and above the amount required to meet liabilities. The liabilities, for this purpose, include the present value of amounts that are expected to be paid in respect of discretionary benefits, including terminal bonuses, consistent with policyholders' reasonable expectations. The free estate, which will generally have accumulated over many years, acts as working capital of the business. It is used to support the business by, for example, providing investment flexibility and protection against adverse stock market conditions, facilitating the smoothing of bonuses, generally providing a cushion of extra security against unanticipated events, and supporting the sale of new business. If not required for such purposes, distributions can be made from the free estate and shared between policyholders and (in the case of proprietary life companies) shareholders.

107 An area which was the subject of government regulation at this time in certain countries outside the UK.

108 Which by then had re-enacted section 12(1)(a) of the ICAA 1973.

that the company may, in the case of long-term business, be unable to fulfil the reasonable expectations of policyholders or potential policyholders (the PRE ground).

188 It was acknowledged that a statement that a premium rate would be sufficient could not be an absolute statement as it would inevitably be dependent on future events. However, it was stated that the required judgment would need to be based on the use of sound techniques and that attention should be specially drawn to (among other things) '*contracts involving various options*'.

Actuarial investigations

189 In relation to actuarial investigations, the appointed actuary was to satisfy himself as to the existing business by considering the liabilities, the corresponding assets and their interrelationship. He was to use liability valuation methods that were appropriate to the contract in question taking into account not only the principal benefits, but any ancillary guaranteed benefits such as surrender and paid-up values and any options.

Role in respect of investment policy (and balance sheet)

190 The guidance made clear that the responsibility for investment policy rested with directors of the company, as did the decision as to the value to be placed on the assets in the balance sheet (GN1 version 1, paragraph 6.4). However, the appointed actuary was to decide whether, in his judgment, the investment policy pursued by the directors was, or could become, inappropriate having regard to the nature and term of the company's liabilities. If that was the case, the actuary was required to advise the company of the constraints on investment policy necessary to protect the position of policyholders.

Insolvency

191 In relation to insolvency, whilst noting that the problems with which the appointed actuary was to be concerned were again matters of judgment rather than being capable of precise assessment, the guidance stressed that in issues which affected the solvency of the company much more rigorous standards should be applied when exercising that judgment.

192 The guidance noted that the possibilities of insolvency or intervention by the Secretary of State on PRE grounds could arise either from factors within the control of the company or those which were not. If within the control of the company, the appointed actuary's duty was to assess the limits within which the company must act and advise the company of the necessity for these limits. In relation to external factors which might lead to insolvency, the actuary was required to consider all external factors outside the control of the company and then take whatever action he considered appropriate. It was noted that '[t]*he profession requires that any appointed actuary should pay the most scrupulous regard to prudent judgment in these matters*'.

Appointed actuaries as directors of their company

193 The final section of GN1 dealt with the situation where the appointed actuary was also a director of the insurance company (version 1, paragraph 8). In describing the position of appointed actuaries who were also company directors, GN1 stated (version 1, paragraph 8.0):

> *It is clearly in the public interest that actuaries should be available to act as directors of insurance companies, particularly those transacting long-term insurance, where by their professional training they are especially fitted to make a useful contribution. The actuary should, however, recognise that the*

public, and his fellow directors, will assume that he is satisfied as to the way in which the affairs of the company are likely to be conducted whilst he is a member of the Board.

194 GN1 did not comment on the possibility that the appointed actuary might also be the chief executive of an insurance company. This combination of roles was addressed in a paper on the appointed actuary presented to the Institute of Actuaries on 28 November 1988 by the Government Actuary at that time[109]. He noted that in '*small proprietary offices*' this combination of roles was more common than combining the roles of actuary and marketing executive.

195 The then Government Actuary considered that the combination had a number of obvious disadvantages, observing that '[t]*he Actuary is needed as a check and balance; these functions cannot be combined in one person*' and that all the problems of combining the actuarial function with that of marketing would be present[110], but more strongly.

196 The then Government Actuary suggested that it might be supportable to combine the positions of chief executive and appointed actuary while an office was at level (i)[111] and all seemed to be going well, but the strains inherent in this double role would show up at level (ii). He considered it would seem to become almost impossible and certainly profoundly unsatisfactory at level (iii). He suggested that the combination of these roles should be regarded as a last resort and the use of consultants should always be carefully considered[112]. He noted that this combination of the roles of chief executive and actuary was also found in a number of leading mutual offices, but indicated that whilst his remarks might still apply in theory:

... the practical situation contains important safeguards. These offices have a well established tradition of actuarial involvement in management at the highest level. The Deputy Actuary, on whom much of the Actuary's responsibilities will fall, is usually an important figure in the management. While there are of course marketing pressures, the extreme pressure from shareholders for results which may be found in a small and (hopefully) expanding office is not present. The ultimate purpose of supervision, and hence of the Appointed Actuary system, is to protect policyholders, and in a mutual office the Board to which management answers is itself responsible to with-profit policyholders. In spite of these points, though, I feel that the arguments against the combination is strong, and the responsibilities have in fact been separated in several cases in recent years.

197 In the debate which followed the presentation of this paper it was suggested that (in relation to the then Government Actuary's comments regarding small proprietary companies) a combination of these roles was preferable to the situation where the appointed actuary was well down the pecking order[113].

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109 JIA 116 (1989) 27-100 at paragraphs 4.2.6-4.2.8.

110 Paragraph 4.2.5 ibid referred to those problems as including under-pricing, the inclusion of improper options or under-reserving in order to attract high sales.

111 These 'levels' are explained in paragraph 1.14 of the paper. Level (i) relates to what is needed when things are going reasonably well for a company; level (ii) when things are going badly; and level (iii) where there are really serious difficulties.

112 Ibid, paragraph 4.2.7.

113 Ibid, R.E. Brimblecombe at page 80.

198 Another member noted that the author had expressed more concern about the situation where the two roles were combined in a small proprietary office rather than in a mutual office. He observed:

> *Although no mutual office which has its Chief Executive as its Appointed Actuary has got into difficulties it is a less than satisfactory situation. This concentration of power in the hands of one person is akin to the situation where the Chief Executive is also the chairman of the board. The relationship between the Appointed Actuary and the investment management is referred to* [in paragraph 3.3.8 of the paper]. *It would be preferable to have regular, frequent and documented meetings between these two. This is perhaps an area where GN1 could be expanded.*[114]

Subsequent revisions of GN1

199 During the period under consideration, which runs until December 2001, twelve further versions of GN1 came into force. The revisions to GN1, where relevant, are referred to in chronological sequence below.

The role of the Government Actuary's Department

200 The then Government Actuary had been actively involved in discussions with the DTI when the Bill which preceded the ICAA 1973 was being prepared, notably in relation to the resource implications of the PRE provisions.

201 One of the effects of the collapse or threatened collapse of a number of insurance companies in 1974 was to highlight the need for effective supervision by the DTI with support from GAD. The size of the team involved in insurance work at GAD began to expand at this time and it has been suggested that a more active approach to supervision began[115].

202 Following the introduction of the appointed actuary system under the ICAA 1973, each new appointed actuary was invited for an informal discussion with the Government Actuary once the DTI had been notified of the appointment. This was said to provide an opportunity to establish personal contact and discuss the appointed actuary's relationship with the company's board and senior executives.

203 Issues discussed included GN1 and the arrangements in place to ensure compliance, product design, premium setting, investment policy, valuation, data systems and the influence the appointed actuary brought to bear on these matters. It was also said that appointed actuaries were encouraged to get to know the individuals at GAD who would be examining returns and to contact them informally to sound them out or give advance warning of developments[116].

204 Speaking about the role of GAD[117] (many years after the introduction of the appointed actuary system) the Government Actuary said:

> *The most important item in a life insurance company's returns to the DTI is the report by the Appointed Actuary. Only another actuary*

[114] Ibid, A. Spedding at page 88.
[115] Paper by the Government Actuary: JIA 119 (1992) 313–343, paragraph 14.20.
[116] Ibid, paragraph 14.21. It is to be noted that the 1984 service level agreement referred to in paragraphs 355 et seq indicates that (at the time of that agreement and '*in relation to the scrutiny of returns*') there was intended to be a fairly structured approach to any direct contact with appointed actuaries which, '*at least in the first instance*', was not to be made by GAD.
[117] Paragraph 5.3 of the paper given in 1990 referred to in footnote 91.

can form a proper appreciation of what is going on in the company and whether there are developments which could become serious. The process of examining the returns of life insurance companies is, therefore, delegated[118] *to GAD. This delegation extends to entering into a dialogue with the company and the Appointed Actuary over any points which need to be clarified in order to understand fully the valuation report and the returns.*

205 According to the Government Actuary, although the DTI did not approve individual contracts or products written by insurance companies, the DTI or GAD was sometimes approached by an insurance company to give guidance on how a new form of contract should be classified or to establish whether GAD was satisfied with the way in which the appointed actuary proposed to value that contract. Once contracts had been written, GAD would scrutinise the valuation method and assumptions used by the actuary to ensure that they were prudent. GAD monitored the impact of certain products on the development of the company's financial position and warned the DTI if it was likely that the company's margin of solvency would be eroded in the near future[119].

206 There was no specific power within the statutory regime for the statutory regulator (or GAD) to object to the appointment of an appointed actuary (in that capacity) on grounds of fitness or otherwise. It was simply required that the actuary should hold prescribed minimum qualifications (or have been approved by the BT/DTI) and that the Secretary of State should be notified of the appointment and of the name and qualifications of the person concerned.

The Policyholders Protection Act 1975

207 The Policyholders Protection Act 1975 (the PPA 1975), although not part of the prudential regime, is relevant to its overall context. The Act was introduced following the failure or threatened failure of several insurance companies during 1974. Its introduction entailed an acknowledgment that the principle of *caveat emptor* was not appropriate in relation to decisions concerning the purchase of insurance policies because the information needed to make an informed choice simply was not available to the public[120].

208 The PPA 1975 was designed to make provision to protect policyholders in the event that an insurance company carrying on business in the UK was unable to meet its liabilities under an insurance policy. The Act established the Policyholders Protection Board (the PPB) whose functions were to indemnify or otherwise assist policyholders in such circumstances. The PPB was empowered to impose levies on insurance companies and others engaged in the insurance industry[121] in order to finance its expenditure (section 1). The five members of the PPB (and five alternate members) were appointed by the Secretary of State[122] (Schedule 1), who was empowered to give guidance to the PPB from time to time (section 2).

118 See paragraphs 355 et seq regarding the first of the service level agreements entered into between the DTI and GAD.
119 Paragraphs 11.1 and 11.2 of the paper referred to in footnote 91.
120 Statement by the then President of the Board of Trade, quoted in the notes referred to in footnote 12.
121 In particular, under section 19 of the PPA 1975, the PPB could impose levies on 'accountable intermediaries', i.e. those who had received income from a company in liquidation for procuring long-term business for that company.
122 Initially, the Secretary of State for Trade.

209 The main powers of the PPB applied to companies permitted to carry on insurance business under the ICA 1974 ('authorised insurance companies') and came into play when a winding-up order was made by the court or when a resolution for voluntary winding up was passed in relation to an authorised insurance company, provided either such event occurred after 29 October 1974 (section 5).

210 Sections 10-12 dealt with the protection of long-term policyholders on a liquidation (for this purpose, 'policyholders' included annuitants: see section 32(2)(a) of the PPA 1975 and section 85(1) of the ICA 1974.) The PPB was under a duty to secure that a sum equal to ninety per cent of the amount of any liability to a long-term policyholder of a company in liquidation was paid to the policyholder as soon as reasonably practicable after the beginning of the liquidation.

211 The PPB was also under a duty to make arrangements for securing continuity of future benefits under long-term policies, either by transferring the insolvent company's long-term business to another authorised insurance company or by arranging for substitute policies to be issued by another authorised insurer. Where it was not reasonably practicable for the PPB to make arrangements to secure continuity, it was under a duty to pay the policyholder ninety per cent of the value attributed to the person's policy for the purpose of any claim under the winding up as soon as reasonably practicable after the claim was admitted. Where the benefits under the policy appeared to the PPB to be excessive, the matter was to be referred to an independent actuary.

212 As well as intervening in the case of insolvency, the PPB was given powers to assist authorised companies which were in financial difficulties. The PPB could assist by taking measures to secure the transfer of all or any part of the company's business to another authorised insurer. The PPB also had power to give the company assistance to enable it to carry on business, with power to impose conditions requiring future liabilities and premiums due under a long-term policy to be reduced to ninety per cent of their former amounts (sections 16 and 17).

213 The amount of the levy payable by an insurance company was calculated by reference to its net premium income and was subject to a maximum of one per cent of the income for the previous financial year. The levy (and income in respect of) general business and long-term business were dealt with separately (section 21 and Schedule 3). The levy began to be payable with effect from the financial year commencing on 1 April 1976.

214 The PPA 1975 was amended by the Policyholders Protection Act 1997, although many of the amendments were not brought into force before the 1975 Act was repealed on 1 December 2001[123] (and the revisions were instead embodied in the Financial Services and Markets Act 2000 (the FSMA 2000)).

Guidance for actuaries – GN1 version 1.1: 1978

215 Amendments and additions were made to the guidance for actuaries on long-term business in 1978.

216 A comment was included in the introductory section advising appointed actuaries to seek help and advice from their professional body by approaching the Honorary Secretary[124] if the

123 By article 3(1)(a) of the Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001 SI No. 3649.
124 Apparently a reference to the Honorary Secretary of the Faculty of Actuaries or of the Institute of Actuaries, dependent on the body to which the actuary belonged.

actuary became doubtful as to the proper course to adopt in relation to a potentially significant problem.

217 A paragraph regarding conflicts of interest was added in the context of considerations affecting an actuary's decision as to whether to accept an appointment, making it plain that an appointment should not be accepted if the actuary's financial interests in the company were such that a conflict would arise. However, it was indicated that if '*temporarily in a special situation*' a conflict of interest arose, the appointed actuary should ask the company to obtain a report from another actuary (who had no such conflict of interest) before the actuary made his or her own report.

218 References to reinsurance arrangements were added to the list of matters to which the appointed actuary would need to have regard in assessing the financial position of the company and in conducting actuarial investigations. The actuary was to advise the company on any necessary modifications to such arrangements to protect the position of policyholders.

219 In relation to the actuary's required assessment of premium rates and policy conditions, mention was made of the need for the actuary to be satisfied that if a premium basis involved a significant new business strain, the company was able to set up the necessary reserve and the actuary should indicate any limit on new business which might prudently be accepted.

First Life Directive 79/267/EEC

220 In 1979 the First Life Directive (79/267/EEC of 5 March 1979: the **First Life Directive**) was issued. Although many of the requirements under the Directive were already reflected in some form in the UK legislation, certain aspects were entirely new to the UK. This Directive was also known as the 'Establishment Directive'. In essence it was aimed at facilitating freedom of establishment and the harmonisation of rules across the EEC. In particular, it sought to co-ordinate the financial requirements imposed on companies[125] carrying on long term business under the prudential regulation regimes of member states. The Directive contained a definition of the long-term insurance business to which it applied[126], which included life assurance (as further defined) and annuities. Long-term and general business were to be separately managed and the authorisation of new composite companies was prohibited.

221 The Directive permitted insurance companies incorporated anywhere in the EEC to establish a head office, branches or agencies in respect of their long term business in any other EEC country, provided that the company obtained 'official authorisation' from the member state in question[127].

222 In the UK legislation, this requirement was provided by means of authorisation issued by the Secretary of State (and eventually required more detailed provision to be included in the legislation to deal with authorisation of insurers from other EEC countries and those from outside the EEC). A company which wished to operate in several member states would require authorisation from each country. Withdrawal of authorisation by the

[125] The EEC Directives refer to 'undertakings' rather than 'companies'.
[126] Article 1.
[127] Article 6.

state in which the company's head office was based would lead to withdrawal of authorisation in other countries.

223 The requirements for an undertaking which was seeking authorisation were set out in article 8. One requirement for authorisation which was new to the UK was that the company should limit its activities to the business of insurance and operations arising directly therefrom. A company seeking authorisation was required to show that it possessed the minimum of the **guarantee fund** and to submit a **scheme of operations** (and in some cases, provide proof that it possessed the **minimum solvency margin**).

224 The Directive required that precise reasons should be given by the regulators in cases where authorisation was refused or withdrawn and there was an explicit requirement that there should be an opportunity for an aggrieved company to apply to the Court[128].

225 One important feature of the Directive was that companies were required to maintain specified reserves and margins of solvency calculated in accordance with the Directive.

226 Technical reserves (sufficient to meet the company's underwriting liabilities), including mathematical reserves[129], were required to be covered by equivalent **matching assets**[130] localised in the country where the activities were carried on, subject to the power of a member state to relax the rules on matching and localisation[131]. Regulations made by the member state in which the activities were carried on were to determine the nature of the assets which could be used to cover the technical reserves (including the mathematical reserves) and where appropriate, the extent to which those assets could be so used. Domestic regulations were also to deal with the valuation of assets. Member states could choose to provide for 'on the spot' verification of whether the assets representing the reserves complied with their regulations.

227 The required solvency margin could be represented by explicit items, such as capital, free reserves and surpluses in the company's balance sheet or (to a specified degree and with the consent of the prudential regulator) by implicit items such as a percentage of the present value of future profits, **zillmerising** and other hidden reserves[132]. In the UK, the regulator was to give consent to reliance on implicit items by means of an order made by the Secretary of State under section 57 of the ICA 1974[133].

228 Articles 19 and 20 provided for, respectively, the calculation of the 'minimum solvency margin' and the 'guarantee fund' (one third of the minimum solvency margin, at least half of which was to be represented by explicit items).

229 Where a company was unable to cover its required minimum solvency margin, the prudential regulator was to require the submission of a **plan for**

128 Articles 12 and 26.3.

129 i.e. reserves in respect of long-term liabilities specially calculated for regulatory purposes, intended to be determined on a prudent basis (see paragraph 265 and footnote 431 regarding the definitions used in the UK regulations).

130 'Matching assets' was defined for this purpose as '*the representation of underwriting liabilities which can be required to be met in a particular currency by assets expressed or realisable in the same currency*' (article 5(b)).

131 Article 17.2. Technical reserves were not defined in the Directive, but are taken to mean amounts an insurer must have in place to meet liabilities under policies.

132 Article 18.

133 Or later, under the equivalent provisions of section 68 of the ICA 1982 (see paragraph 337).

restoration of a sound financial position for its approval[134]. If the margin fell below the level of the guarantee fund, the regulator was to require the submission of a **short-term finance scheme** for its approval (and could also restrict or prevent free disposal of assets by the company) [135].

230 Article 21.2 of the Directive prohibited member states from restraining the **free disposal of assets** by an insurance company except in limited specified circumstances. Exceptions applied in relation to the requirement to establish technical reserves covered by matching assets and the localisation of those assets[136], where the company had failed to comply with provisions envisaged in article 17 (which included rules and regulations made by member states in connection with the establishment of technical reserves, including mathematical reserves)[137]; in the event that the solvency margin fell below the 'guarantee fund'[138]; and in the event that authorisation of the company was withdrawn[139]. (The extension of these exceptions by the Third Life Directive is referred to in paragraph 497 below.)

231 Article 23 obliged member states to require insurance companies with a head office in their territory to produce an annual account of their financial situation and solvency, covering all types of operation.

232 The First Life Directive harmonised some aspects of insurance regulation and kept them under the control of the member state in which the company's head office was based[140], whilst other aspects were to be dealt with in *every* member state in which the company wished to do business[141]. Certain aspects of insurance regulation were not harmonised, or were not completely harmonised, by this Directive. The amount of the technical reserves (including mathematical reserves) were to be determined according to rules fixed by the member state and regulations made by the country in which the activities were carried on were to determine the nature and value of assets[142]. Member states were to continue to have power to enforce provisions of their 'domestic' legislation regarding approval by their supervisory authorities of policy conditions and to prescribe the technical bases for calculating premium rates and technical reserves (including mathematical reserves) and to apply provisions such as those requiring approval by the supervisory authorities of the technical qualifications of directors and the memorandum

134 Article 24.2.
135 Article 24.3.
136 Article 17.2.
137 Article 24.1.
138 Article 24.3.
139 Article 26.1.
140 The 'head office state' was responsible for such matters as receipt of annual accounts; verifying that the company's balance sheet showed the necessary technical reserves in respect of liabilities in *all* states in which the company operated; certifying matters to other member states in which the company sought authorisation (such as the existence of the guarantee fund or margin of solvency if higher); ensuring the adequacy of solvency margins in respect of the company's *entire* business; responsibility for taking action in the event that the company's solvency margins or guarantee fund did not comply with the minimum requirements; the power to restrict the free disposal of assets by the company where the technical reserves were not sufficient; and the duty to notify other member states in which the company operated if authorisation was withdrawn, leading to withdrawal of authorisation in other countries (articles 23, 17.4, 10.1(b), 18, 24 and 26.1).
141 Every member state in which the company operated (including the head office state) was responsible for giving and withdrawing authorisation to operate in its country; ensuring the sufficiency of the technical reserves localised in its country in respect of the business carried on there; receipt of periodic returns; and some supervisory responsibility in the form of the power to restrict free disposal of assets by the company if the technical reserves were not sufficient, but only after informing the supervisory authorities in the head office state (articles 6-12, 26, 17, 23.2 and 24).
142 Article 17.

and articles of companies seeking to become established in their country[143]. (As noted elsewhere, the legislation in the United Kingdom did not impose direct controls on premium rates).

233 Member states were given a period of 18 months from notification of the First Life Directive to amend their national provisions in order to comply, and the amended national provisions were to be applied within 30 months of notification (article 40). As noted below, the provisions of the Directive were implemented in the UK by the Insurance Companies Act 1981 by means of amendments to the ICA 1974 and those amended provisions were subsequently consolidated within the Insurance Companies Act 1982.

Insurance Companies Act 1980

234 The Insurance Companies Act 1980 (the ICA 1980) was enacted to extend the provisions of the ICA 1974 to Northern Ireland, where similar but separate legislation had formerly applied. In order to achieve this, various consequential amendments were made to the ICA 1974 and to other legislation (including the PPA 1975) listed in Schedule 3 to the ICA 1980. The statutory instruments made under the ICA 1974 and earlier legislation listed in Part I of Schedule 2 to the ICA 1980 were also extended to Northern Ireland.

The Insurance Companies (Accounts and Statements) Regulations 1980

235 The Insurance Companies (Accounts and Statements) Regulations 1980[144] (the ICAS Regulations 1980) came into force on 1 January 1981 and applied to accounting years which commenced after that date. Those Regulations substantially revised the format and content of the accounts and returns to be made annually to the DoT[145] pursuant to section 13(1) of the ICA 1974 by insurance companies operating in the UK. They amounted to a full scale revision of the earlier regulations and prescribed some 65 forms for life and non-life business. The objectives of the changes included:

(a) to consolidate the numerous amendments made to the ICAF Regulations 1968;

(b) to correct inadequacies in the ICAF Regulations 1968 and to incorporate the margin of solvency requirements for non-life business arising from the EEC requirements on solvency in the First Non-Life Directive;

(c) to take account of new thinking on the forms required by long-term business;

(d) to increase the information to be provided by the actuary in his or her valuation summary for long-term business; and

(e) to add a number of new items of information considered likely to be of use in arriving at an assessment of a company's position.

236 The ICAS Regulations 1980 prescribed the form and content of the statement of long-term business to be prepared by a company under section 14(3) of the ICA 1974 and of the abstract of the appointed actuary's report prepared following an investigation under section 14(1). They also made provision for audit, and specified that the auditor must be a person qualified to audit accounts for the purpose

143 Articles 10.3 and 8.3.
144 SI 1980 No. 6.
145 The relevant government department between 1974 and 1983.

of the Companies Acts 1948 to 1976. However, the auditor was not required to audit or report on the abstract of the appointed actuary's report or related prescribed forms (regulation 19 and paragraph 8 of Schedule 6 to the ICAS Regulations 1980).

237 The appointed actuary was required to give a certificate, to be annexed to the accounts, stating (if it was the case) that in the opinion of the actuary the company had kept proper records, adequate for the purpose of valuing the long-term liabilities; that the actuary was satisfied that the aggregate long-term liabilities did not exceed the value of the assets identified as representing the long-term business; and that the actuary had taken due account of the nature and term of assets and the nature and term of the liabilities in making the statement (regulation 18(b) and Schedule 6, Part II.)

238 Regulation 20 of the ICAS Regulations 1980 prescribed the qualifications required of an 'actuary' for the purpose of the ICA 1974[146] and of an appointed actuary under section 15 of that Act. An appointed actuary was required to be a Fellow of the Institute of Actuaries or of the Faculty of Actuaries and to be at least 30 years old. Actuaries who immediately before the ICAS Regulations 1980 came into force held an appointment by virtue of Regulation 15 of the ICAF Regulations 1968 were permitted to continue in their appointment (this applied to any actuary who was not a Fellow of the Faculty or Institute but who came within the former category of '*such other person having actuarial knowledge as the* [BT] *may, on the application of the company, approve*').

239 The ICAS Regulations 1980 revoked the ICAF Regulations 1968 and other regulations relating to insurance company accounts and forms (Regulation 23 and Schedule 7). At the time the ICAS Regulations 1980 were made it was known that further revision would be necessary once the First Life Directive was implemented in the UK. The ICAS Regulations 1980 were treated as continuing in force after the enactment of the Insurance Companies Act 1982[147] and were later amended under that Act.

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146 Pursuant to the definition of 'actuary' in section 85(1) of that Act.
147 By virtue of section 17 of the Interpretation Act 1978 and/or a general saving provision in paragraph 22 of Schedule 4 to the ICA 1982.

Phase 3: 1981 – 1990

The Insurance Companies Act 1981

240 The Insurance Companies Act 1981 (ICA 1981) and ICR 1981 made four months later were designed to put into effect the changes required by the First Life Directive and to incorporate the various changes made as modifications to the ICA 1974 by statutory instruments during 1977 to implement the First Non-Life Directive[148].

241 Section 21 of the ICA 1981 inserted new sections 26A-26D into the ICA 1974 to provide for the margin of solvency requirements arising from the EEC Directives.

242 The new section 26A of the ICA 1974 required insurance companies which had their head office in the UK (or whose UK business was restricted to reinsurance) to maintain a margin of solvency '*of such amount as may be prescribed or determined in accordance with regulations made for the purpose of this section*'. (Provision was also made for the margin of solvency for companies based in other countries which operated in the UK.)

243 The margin of solvency for the purpose of the ICA 1981 for a company with a UK head office was defined as the excess of the value of its assets over the amount of its liabilities, with the value and amount being determined in accordance with any applicable valuation regulations. If the company failed to maintain the required margin of solvency, the Secretary of State was to request the company to submit a plan to him for the restoration of a sound financial basis.

244 Section 26B dealt with the maintenance of a 'minimum margin' and required the company, at the request of the Secretary of State, to submit a short-term financial scheme if its margin of solvency fell below the amount prescribed or determined in accordance with regulations made for this purpose (reflecting the 'guarantee fund' requirements of the Directives).

245 Section 26C made provision for the requirements in relation to companies supervised in other member states. Section 26D gave power for regulations to be made regarding the situation and form of assets, having regard to the currency in which liabilities might be required to be met.

246 Section 17 of the ICA 1981 amended section 14 of the ICA 1974, reducing the interval between the required actuarial investigations from three years to twelve months.

247 The Insurance Companies Act 1982 (the ICA 1982) received Royal Assent in the following year, consolidating the ICA 1974, the ICA 1980 and the ICA 1981. Since the section numbers in the ICA 1982 are of longer-term significance, the provisions of the legislation as revised in the ICA 1981 are not further described here. However, a table showing the main derivations of relevant provisions of the ICA 1982 is attached as Appendix A.

The Insurance Companies Regulations 1981

248 Most of the provisions of ICR 1981 came into effect on 1 January 1982, with certain regulations coming into operation on later dates during 1982[149]. ICR 1981 continued in force after the commencement of the

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[148] The Insurance Companies (Classes of General Business) Regulations 1977 SI No. 1552 and the Insurance Companies (Solvency: General Business) Regulations 1977 SI No. 1553, made under section 2(2) of the ECA 1972.

[149] For companies authorised to transact long-term business on 31 December 1981, the margin of solvency provisions did not apply until 15 March 1984 (section 99(1) and paragraph 4 of Schedule 4 to the Insurance Companies Act 1982).

ICA 1982 and was subsequently amended under that Act.

249 ICR 1981 was primarily made in connection with the amendments introduced under the ICA 1981 in relation to the EEC Directives, but they also consolidated with amendments the earlier regulations made under the ICA 1974, other than those dealing with accounts and statements (which had been provided for in the ICAS Regulations 1980) and those dealing with Lloyd's.

250 Parts II and III and Regulations 25 to 30 implemented the provisions of the First Non-Life Directive and the First Life Directive. Part II dealt with the margin of solvency requirements (and Part III regulated the making of deposits by companies whose head office was not in a member state).

251 Part VI included, for the first time, provisions on the determination of the amount of long term liabilities. These regulations followed on from a very long period of negotiation and consultation between the DoT, GAD and the F&IA, based on proposals initially put forward by the DTI in 1974[150], which in turn were based on six principles for a good standard of conduct outlined in a paper submitted to the Institute of Actuaries by RS Skerman in 1973[151]; eventually they were the subject of the joint actuarial working party formed in 1981 referred to below.

252 It has been noted[152] that until 1981, responsibility for ensuring that a prudent value was placed on the liabilities of long-term insurance business was left to the appointed actuary. Prior to the introduction of the solvency margin requirements of the First Life Directive, there were no requirements in the UK legislation regarding the level of free assets held by life insurance companies[153].

253 As the solvency margin was based on the excess of assets held over the amount of the technical reserves, it has been suggested that the solvency margin requirements created an incentive for insurance companies to keep the technical reserves to a minimum in order to demonstrate a healthy margin of solvency. In addition, the exercise of certain of the Secretary of State's powers of intervention became linked to a breach of the new margin of solvency requirements.

254 For these reasons, a more clearly defined minimum standard for the valuation of liabilities was needed. It has been said that providing for this (in Part VI of ICR 1981) strengthened the position of the appointed actuary, who might otherwise have come under increasing pressure from shareholders to weaken the valuation basis.

Margin of solvency

255 Regulations 4 to 8 were made for the purpose of the new section 26A of the ICA 1974[154] in connection with the margin of solvency requirements, in order to prescribe how the margin was to be determined. (Regulations 5 to 8 dealt with the required calculations in respect of various classes of long term business.)

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150 According to a paper entitled 'Statutory Regulation of Long Term Insurance Business' prepared for the F&IA by William M Abbott and revised by Nick C. Dexter in 2000.

151 JIA 100 (1973) 35-69 at paragraph 18. The principles proposed by Skerman included a net premium method of valuation (or some other method producing reserves at least as strong); partial allowance to be made for the expenses of new business; and actuarial reserves of no less than the guaranteed surrender values or the values of other options available under the policy (paragraphs 18.1–18.6).

152 Observations made by the Government Actuary in paragraphs 6.1-7.3 of the paper prepared for *Le Groupe Consultatif* summer school referred to in footnote 91.

153 Although there had been requirements for an initial minimum margin of solvency as a prerequisite to authorisation under, for example, section 62 of the CA 1967 and section 1 of the ICAA 1973.

154 See paragraph 242 above.

256 Regulation 9 set out the *minimum* margin for the purpose of section 26B of the ICA 1974[155] and created the concepts of a 'guarantee fund' of one third of the required margin of solvency as well as a 'minimum guarantee fund' calculated in accordance with Schedule 3 to the Regulations.

257 Regulations 10(4) and 11 to 13 made provision for the valuation of implicit items in respect of:

(a) future profits;

(b) zillmerising; and

(c) hidden reserves.

Implicit items were amounts which were not assets available to meet a company's liabilities, but which Article 18.3 of the First Life Directive permitted to be counted towards meeting the required margin of solvency with the agreement of the supervisory authority, up to specified limits (see paragraph 227).

258 In the UK, implicit items were to have no value except in accordance with an order made by the Secretary of State under section 57 of the ICA 1974. In the event of such an order being made, as regards long-term business, implicit items were to be valued in accordance with Regulations 11-13 (Regulation 10(4)).

259 Under Regulations 11-13:

(a) an implicit item relating to future profits was to be valued at not more than 50% of the full amount of the future profits calculated in a prescribed manner (Regulation 11);

(b) an implicit item in respect of zillmerising was to be valued at no more than a maximum amount calculated in accordance with Regulation 12. Zillmerising was defined in Regulation 3 as meaning the method known by that name for modifying the net premium reserve method of valuing a long term policy by increasing the part of the future premiums for which credit is taken so as to allow for initial expenses; and

(c) hidden reserves resulting from the under-estimation of assets and over-estimation of liabilities (other than mathematical reserves) might, in so far as the reserves were not of an exceptional nature, be given their full value (Regulation 13).

Valuation of assets and determination of liabilities

260 Regulations 37-49 (Part V) made provision for the valuation of companies' assets and reproduced, with amendments[156], the law previously in force (see paragraph 167). Essentially, assets were to be valued at their current market value, although there were limits on the extent to which certain assets could be taken into account in demonstrating that the technical reserves and margin of solvency were covered[157].

155 See paragraph 244 above.

156 The amendments included changes in relation to the valuation of dependants of life companies so as to increase their liabilities by an amount approximating to the solvency margin (Regulation 40(2)); to allow debentures or shares which were suspended at the valuation date to be included in the valuation within limits (Regulation 46(2)); amendment to the definition of 'long term business amount', to bring it into line with the definition of 'general business amount' (Regulation 49) and to apply limits on the extent to which all assets of a proprietary life company could be taken into account in the valuation (only the life fund had previously been subject to such limits) (Regulation 49).

157 In practice, those rules were considered to have a significant impact on insurance companies' investment policies (paragraph 10.1 of the paper prepared by the Government Actuary referred to in footnote 91).

261 Regulations 50-64 (Part VI) which set out principles for the determination of liabilities were new. Those Regulations were of particular importance in relation to the required annual actuarial valuation[158] and the determination of the solvency margin[159].

262 Subject to the detailed requirements of subsequent regulations in Part VI of ICR 1981, the basic requirement in Regulation 52 was that the amount of the liabilities of a company conducting either long term or general business should be determined '*in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies*', taking account of all contingent and prospective liabilities (other than liabilities in relation to share capital).

263 Regulation 54 required that actuarial principles be used for the determination of the amount of the long term liabilities other than those which had fallen due for payment before the valuation date (and, where Regulation 54 applied, actuarial principles would, in the event of any inconsistency, take precedence over the generally accepted accounting and other methods).

264 There were no financial reporting standards specifically for insurance contracts until 2004. An International Financial Reporting Standard for Insurance Contracts (IFRS 4) was issued in March 2004 and the (UK) Accounting Standards Board issued a Financial Reporting Standard for life assurance business (FRS 27) in December 2004, the latter in response to criticisms made in the Penrose Report. These standards still left certain aspects for further consideration.

265 'Long term liabilities' were defined in Regulation 50 as meaning '*liabilities of an insurance company arising under or in connection with contracts for long term business*'. The term 'mathematical reserves' was defined in Regulation 2 as meaning '*the provision made by an insurer to cover liabilities (excluding liabilities which have fallen due) arising under or in connection with contracts for long term business*'. The latter definition was not explicitly linked to the required calculations under Part VI of ICR 1981, although for certain purposes the figure for the mathematical reserves was to be '*not less than those required by Part VI*'[160], and it appears to have been intended that this should generally be the case[161].

266 Regulation 54 specified that the determination of the amount of long term liabilities (other than those due for payment before the valuation date) should be made on actuarial principles and make proper provision for all liabilities on prudent assumptions in regard to the relevant factors, and that the aggregate amount should be no less than that calculated in accordance with Regulations 55-64, which made specific provision for the calculation of long term liabilities. Thus, if any alternative methods of valuation were used to those stipulated in Regulations 55-64, the resulting figure was to be tested against the amount produced by following those regulations. At this stage the Regulations did not state that the determination of the liabilities should take account of PRE[162].

158 Under section 14 of the ICA 1974 as amended by section 17 of the ICA 1981.
159 Under section 26A of the ICA 1974 inserted by section 21 of the ICA 1981.
160 Regulation 12(1)(b) on zillmerisation.
161 C.D. Daykin: JIA 119 (1992) 313 –343 at paragraph 15.2.
162 Reference to PRE was included later: see regulation 64 of the Insurance Companies Regulation 1994 SI No. 1516, which specified that the actuarial principles used to determine liabilities must have *'due regard to the reasonable expectations of policy holders'*. It has been suggested that, even before this change was made, the requirement to use (as a minimum) a net premium valuation method for certain long term contracts amounted to an implicit requirement to take account of PRE in respect of those contracts.

267 The determination of the amount of the liabilities was required, by regulation 55, to take account of the nature and term of the assets which represented the long term fund and the value placed upon them was required to include '*appropriate provision against the effects of possible future changes in the value of the assets on their adequacy to meet the liabilities*'.

268 The process of establishing whether a life company's reserves were sufficient to meet the liabilities after a change in external conditions e.g. a change in returns on investments or in rates of mortality, became known as '**resilience testing**', with monies set aside to address such changes being known as a '**resilience reserve**'.

269 The method of valuation of future premiums in regulation 57 was referred to as being a net-premium method of valuation[163] for certain contracts, although that expression was not used in the regulation itself. Regulation 57 provided:

(1) Where further specified premiums are payable by the policy holder under a contract (not being a linked long term contract) under which benefits (other than benefits arising from a distribution of profits) are determined from the outset in relation to the total premiums payable thereunder, then, subject to regulation 58 below–

(a) where the premiums under the contract are at a uniform rate throughout the period for which they are payable, the premiums to be valued shall be not greater than such level premiums as, if payable for the same period as the actual premiums under the contract and calculated according to the rates of interest and rates of mortality or disability which are to be employed in calculating the liability under the contract, would have been sufficient at the outset to provide for the benefits under the contract according to the contingencies upon which they are payable, exclusive of any additions for profits, expenses or other charges;

(b) where the premiums under the contract are not at a uniform rate throughout the period for which they are payable, the premiums to be valued shall be not greater than such premiums as would be determined on the principles set out in sub-paragraph (a) above modified as appropriate to take account of the variations in the premiums payable by the policy holder in each year;

save that a premium to be valued shall in no year be greater than the amount of the premium payable by the policy holder.

(2) Where the terms of the contract have changed since the contract was first made (the terms of the contract being taken to change for the purposes of this paragraph if

[163] Regulation 57(1) provided for a net premium method of valuation in cases where further specified premiums were payable under the contract and benefits were determined from the outset in relation to the total premiums payable. Regulation 57(3) related to contracts under which each premium paid increased benefits or the amount of a premium payable in the future was not determinable until it was paid, and in this case allowed both the future premiums and the corresponding liability to be left out of account so long as adequate provision was made against any risk that the increase in the company's liabilities resulting from payment of future premiums might exceed the amount of those premiums. By virtue of Regulation 54, if any alternative method of valuation to that in Regulation 57 was used (or if any alternative methods of calculation to those in Regulations 55, 56 or 58-64 were used) to determine the amount of the long term liabilities, it was required that the alternative method should result in liabilities (or provision for liabilities) of no lesser amount, in aggregate, than the amount calculated in accordance with Regulations 55-64. See also footnote 24 regarding the aims of a net premium method of valuation in terms of providing for more than contractual liabilities.

the change is indicated in an endorsement on the policy but not if a new policy is issued), then, for the purposes of paragraph (1) above it shall be assumed that those changes from the time they occurred were provided for in the contract at the time it was made.

(3) Where under a contract (not being a linked long term contract)–

(a) each premium paid increases the benefits (other than benefits arising from a distribution of profits) provided under the contract, or

(b) the amount of a premium payable in future is not determinable until it comes to be paid[164]*,*

future premiums and the corresponding liability may be left out of account so long as adequate provision is made against any risk that the increase in the liabilities of the company resulting from the payment of future premiums might exceed the amount of the premiums.

270 Regulation 59(1) specified that in determining the rates of interest to be used in calculating the present value of future payments or receipts regard should be had to the yields on existing assets attributed to long term business and, to the extent appropriate, to the expected yields on sums to be invested in the future.

271 Regulation 59(2) specified that the assumed yield on an asset should not exceed the actual yield, calculated in the prescribed way and reduced by 7.5%. Zillmerisation was permitted, but not required, under Regulation 58, allowing the maximum annual premium valued under Regulation 57 to be increased by no more than 3.5% of the relevant capital sum under the contract. In making provision for expenses under Regulation 61, some credit could be taken for the difference between the fraction of future premiums left out of account pursuant to Regulation 57(1).

272 Regulation 62 required provision to be made to cover any increase in liabilities caused by policyholders exercising options under their contracts.

The intended relationship between the IC Regulations 1981 and the professional guidance (and the DAA letters issued by GAD)

273 The development of the regulations relating to the determination of liabilities contained in Part VI of ICR 1981 had been the subject of a Joint Actuarial Working Party (JAWP) established in 1981 consisting of representatives of the F&IA and GAD and attended by officials from the DoT[165].

274 In October 1983, the F&IA issued for the first time an additional guidance note for appointed actuaries on the determination of liabilities and solvency margins under ICR 1981 known as 'Guidance Note 8' or 'GN8'.

164 Certain of the contracts entered into by Equitable came within sub-paragraphs (a) and (b) of paragraph (3) of regulation 57.

165 The then Government Actuary stated in 1988 that the JAWP was chaired by the Government Actuary, with representatives of the F&IA and GAD and 'an observer' from the DTI. The JAWP was supported by a 'Valuation Research Working Party' which developed valuation methods and assumptions and reported on technical questions. The then Government Actuary indicated that the JAWP offered a means of close cooperation between the supervisors (represented by GAD) and the profession (through the F&IA). The JAWP had been set up as a means of formal consultation with the F&IA when the valuation regulations were first drafted, but was '*retained as a permanency*', which (in addition to developing and amending the regulations) considered such matters as methods of valuation and tests to be applied by GAD, for example, to mismatching reserves (JIA 116 (1989) 27-100 at paragraph 2.15).

275 Speaking at a meeting of the Faculty of Actuaries in 1982 to discuss an exposure draft of the additional guidance notes for appointed actuaries[166], a directing actuary at GAD, who had been involved in the development of ICR 1981, highlighted the extent to which government departments depended upon the support of the actuarial profession in the function of supervision.

276 He noted that it would be impossible to operate the '*uniquely liberal system of supervision*' in the UK, which had no controls over premium rates, policy conditions and almost total freedom of choice of investments '*without the existence of a tightly knit actuarial profession maintaining high accepted standards of professional conduct laid down in part in the specific Guidance Notes.*' Later in his speech, the directing actuary commented that the valuation regulations had been, essentially, a compromise.

277 He also noted that ICR 1981 could not have existed in the form in which it was enacted, '*which in critical respects specify requirements in terms of* '*actuarial principles*' *not defined or with phrases such as* '*where appropriate*' *or* '*to the extent appropriate*' *unless their interpretation was to be spelt out in guidance.*' He considered the guidance notes and the Regulations taken together[167]; explaining that the guidance notes must be:

> *...capable of being justified as flowing from the requirements, even though they may be in general terms, of the Regulations themselves and if the desired standard is felt to go beyond what can properly be required under professional guidance on this basis, it may well be necessary to amend the Regulations. Inevitably however, the more the standards have to be spelt out in detail in the Regulations, the less flexibility that can be achieved.*

Thus, it appears to have been intended that the detail of the standards should be set by guidance notes produced by the profession, provided that the guidance did result in '*the desired standard*'[168].

278 The GAD directing actuary noted that the regulator's powers of intervention hinged on the solvency margin, which in turn depended on an assessment of the minimum basis for the calculation of liabilities in accordance with ICR 1981: '*It is here that the need for the standard to be spelt out as precisely as possible, albeit in actuarial terms, most strongly arises*'.

279 In relation to Regulation 54, concerning the fundamental principles for the determination of the amount of the long term liabilities, the directing actuary explained that it was intended to fulfil two distinct functions, the first of which was as a long-stop provision for topping up reserves calculated on minimum standards prescribed in other regulations:

> *In the first place the regulation unequivocally leaves the responsibility for ensuring an adequate level of appropriate reserves on prudent assumptions with the Appointed Actuary. The regulation thus requires the actuary, where appropriate, to strengthen the*

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166 TFA 38 (1981-1983) 219-243 at pages 235-238.

167 A similar point was made by the Government Actuary in 1990 when describing the UK supervisory regime to a summer school for European actuaries (paragraph 8.2 of the paper referred to in footnote 91).

168 Another actuary present at the meeting expressed concern that a proliferation of professional standards might lead to a reduction in reliance on the professional judgment of actuaries (although he was comforted that the Exposure Draft emphasised judgment) '*I think that we must restrict guidance to the minimum necessary to give comfort to the laity and the authorities and, where possible, rely on professional discussion in this Hall and in Staple Inn, duly reported in our transactions and journals*' (D.D. McKinnon at page 242 ibid).

reserves calculated in accordance with the minimum standards laid down in the other Regulations and also provides justification for him doing so, ... An obvious area where Regulation 54 might result in the strengthening of reserves ... is in regard to with-profits business where the requirement for a net premium valuation, criticised though it has been, goes some way to protecting the interests of with-profits policyholders but may still not result in sufficient provision for future bonus.

He explained that the second function of Regulation 54 was to ensure that prudent standards were applied for each class of business and to each of the elements of the basis of calculations without going into elaborate detail to prescribe how this should be done in each case.

280 As was acknowledged by the Government Actuary in a paper presented to the *Groupe Consultatif* summer school in 1990[169], notwithstanding the existence of the regulations concerning the valuation of liabilities and the professional guidance issued to actuaries by the F&IA, there were still considerable areas in which the appointed actuary was expected to exercise his or her judgment. He noted that:

This is not done in isolation, since the DTI has to be satisfied that what has been done is in accordance with the regulations. On this the DTI accepts the advice of GAD.

The Government Actuary went on to explain that, as a matter of practice, GAD laid down working standards for the interpretation of the regulations which were, in some cases, promulgated to appointed actuaries in a letter from the Government Actuary (i.e. through the series of DAA letters issued from 1985 onwards referred to in paragraph 76 and in subsequent sections of this Part of the report). He explained:

The intention is not to impose particular methods or assumptions on actuaries but to require them to demonstrate that what they are doing is prudent, should it produce lower technical reserves than would be implied by the GAD working standard. In forming its views GAD plays an active role in professional affairs and draws widely on research work being carried out within the profession.

281 ICR 1981 was amended in 1982[170] to enlarge the descriptions of property by reference to which benefits under linked long term contracts could be determined and, in 1983, in relation to insurance advertising[171]. Further amendments are noted below.

The Insurance Companies Act 1982

Introduction and overview

282 As noted, the ICA 1982 consolidated the ICA 1974, the ICA 1980 and the ICA 1981 (the ICA 1981 having been made in order to implement the First Life Directive and to incorporate the changes introduced to implement the First Non-Life Directive[172]). The 1982 Act came into force on 28 January 1983, subject to transitional and saving provisions in Schedule 4.

169 Paragraphs 9.1 and 9.2 of the paper referred to in footnote 91.
170 By the Insurance Companies (Amendment) Regulations 1982 SI No. 675.
171 By the Insurance Companies (Advertisements) (Amendment) (No. 2) Regulations 1983 SI No. 396.
172 Which had been implemented in 1977 by means of regulations made under section 2(2) of the ECA 1972, making modifications to the ICA 1974.

283 The five parts of the ICA 1982 dealt with the following:

Part I	Restrictions on carrying on insurance business and conditions for authorisation of insurance companies
Part II	Regulation of insurance companies which had authorisation, including the new margin of solvency requirements, transfers and winding up
Part III	Conduct of business regulation
Part IV	Special classes of insurers
Part V	Supplementary provisions, including powers to make regulations and orders, criminal offences and interpretation.

284 Schedule 1 set out the classes of business to be treated as 'long term business' for the purpose of the ICA 1982. It included:

Class I — Life and annuity

Effecting and carrying out contracts of insurance on human life or contracts to pay annuities on human life, but excluding (in each case) contracts within Class III below.

Class III — Linked long term

Effecting and carrying out contracts of insurance on human life or contracts to pay annuities on human life where the benefits are wholly or partly to be determined by reference to the value of, or the income from, property of any description (whether or not specified in the contracts) or by reference to fluctuations in, or in an index of, the value of property of any description (whether or not so specified).

Class IV — Permanent health

Effecting and carrying out contracts of insurance providing specified benefits against risks of persons becoming incapacitated in consequence of sustaining injury as a result of an accident or of an accident of a specified class or of sickness or infirmity, being contracts that –

(a) are expressed to be in effect for a period of not less than five years, or until normal retirement age for the persons concerned, or without limit of time, and

(b) either are not expressed to be terminable by the insurer, or are expressed to be so terminable only in special circumstances mentioned in the contract.

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173 The DTI became the responsible government department from 1983 onwards.

285. The main functions in relation to prudential regulation under the ICA 1982 continued to be vested in the Secretary of State, administered by the Insurance Division of the DoT/DTI173 with advice from GAD. As under earlier Acts, many of the provisions were dependent upon subordinate legislation being made by the Secretary of State. The ICAS Regulations 1980 and IC Regulations 1981 (each of which had by then been amended) were continued in force as if made under the ICA 1982.

286 The following concentrates on the provisions of Part II of the ICA 1982 in relation to prudential regulation. Reference is also made to Part I which included the power of the Secretary of State to withdraw authorisation and illustrates the range of change effected by the First Life and First Non-Life Directives. The following centres on provisions of particular significance to insurance companies which conducted long-term business and which were mutual companies (for example, provisions exclusively concerned with general business are not described).

Classification and authorisation of insurance companies

287 For the purpose of the ICA 1982, insurance business was divided into long term business (covering the classes specified in Schedule 1, which included Classes I (life and annuity), III (linked long term) and IV (permanent health)) or general business (the classes specified in Schedule 2).

288 The classes of business specified in the two Schedules to the ICA 1982 reflected those required to be adopted under the First Life Directive and First Non-Life Directive and were intended to cover the entire field of insurance business. The expression 'insurance business' had been defined for the first time in the ICA 1981, section 34.

289 That definition was consolidated in section 95 of the 1982 Act. It did not provide an exhaustive definition of 'insurance business' but rather dealt with 'borderline cases' in order to make it clear that they were within the meaning of the term. Among the specified activities '*the effecting and carrying out of contracts to pay annuities on human life*' was referred to (in section 95(d)).

Authorisation by the Secretary of State

290 The basic rule that only those authorised under the legislation could carry on insurance business in the UK was preserved. Companies authorised to conduct insurance business in the UK of a particular class or classes under the former legislation were to continue to be so authorised. Separate requirements were established for authorisation by the Secretary of State of UK companies, those from other EEC states and for companies from outside the EEC[174], in order to comply with the requirements of the two EEC Directives. Under the Directives, a non-EEC company which maintained its solvency margin in one EEC state could obtain exemption from certain requirements in another and this was reflected in the drafting of the requirements for authorisation of such companies in the UK. The detailed procedures for obtaining authorisation were left to be dealt with in regulations[175].

291 The Secretary of State was required to give written reasons for any refusal of authorisation[176] (implicitly providing a basis for an application to the courts for

174 Sections 7-9 of the ICA 1982.

175 The information to be submitted by applicants was prescribed in regulation 29 of ICR 1981 and Schedules 4 and 5 for long-term and general business respectively.

176 Section 5(2) of the ICA 1982. An application for authorisation was to be determined within six months of the applicant's proposals being submitted. A DTI briefing paper for new ministers dated April 1992 indicated that authorisation was almost never refused by the Secretary of State under section 5(2). Instead, companies were persuaded to modify or withdraw their applications.

an aggrieved applicant by way of judicial review), thereby fulfilling the requirements of the two Directives that precise grounds should be given for any refusal of authorisation and that there should be a right to apply to the courts in the event of a refusal[177]. In relation to the involvement of unfit persons in specified positions in the company as a bar to authorisation, the pre-existing category of persons (director, controller, manager) was extended to include 'main agents' (sections 2-10).

Withdrawal of authorisation

292 The power of the Secretary of State to terminate authorisation to carry on insurance business of a particular class where the company ceased to carry on that class of business or did not commence to conduct it having been issued with authorisation (under section 9 of the ICA 1974) was replaced with more elaborate provisions contained in sections 11-13 of the 1982 Act.

293 On specified grounds, the Secretary of State was empowered to issue a direction withdrawing authorisation in respect of new business. This would allow a company to continue paying claims and only after all its business had been run-off would its authorisation be finally withdrawn under section 13 (the company having ceased to carry on insurance business or business of the particular class).

294 The power to withdraw authorisation arose either where the company requested it or where one of the three grounds in section 11(2) applied. These comprised:

(a) that it appeared to the Secretary of State that the company had failed to satisfy an obligation under the ICA 1982;

(b) that a ground existed which would pose a bar to issuing authorisation; or

(c) that the company had ceased to be authorised in the member state where its head office was located or where it had made a financial deposit under section 9(2).

295 Prior to giving a direction under section 11 (otherwise than at the request of the company) the Secretary of State was required to serve notice on the company stating that he was considering doing so and inviting the company to make written representations to him within one month, with the opportunity for the company to make oral representations to an officer of the DoT (section 12). After giving a direction under section 11, the Secretary of State was required to give written reasons for doing so (again, providing a basis for an application to the courts by way of judicial review)[178].

General effect of Part II of the ICA 1982

296 Part II provided for the regulation of insurance companies and included requirements imposed on insurance companies and powers for the Secretary of State to intervene. The general effect of Part II was to consolidate the amendments and modifications to Part II of the ICA 1974 in respect of the Secretary of State's powers of intervention (described in paragraphs 76 et seq in relation to the predecessor provisions of the ICAA 1973), in order to implement the First Non-Life Directive and the First Life Directive, including new financial requirements, limitations on the Secretary of State's intervention powers and provisions to strengthen to some degree the protection afforded to policyholders.

177 See article 12 of the First Life Directive.
178 Section 11(3) of the ICA 1982 and article 26.3 of the First Life Directive.

Application of Part II of the ICA 1982

297 All insurance companies which carried on insurance business in the UK, whether established within or outside the UK, were subject to Part II, other than four categories of entity which were wholly or partly excluded from its ambit, or excluded in respect of certain activities (friendly societies, trade unions or employers' associations, members of Lloyd's and those conducting banking business). General business contracts of prescribed descriptions under which benefits in kind were provided by the insurer could also be excluded by regulations made under the ICA 1982.

Restriction of business to insurance

298 In response to requirements of the two Directives a new restriction was introduced, prohibiting insurance companies subject to Part II from carrying on any activities otherwise than in connection with or for the purpose of insurance business, whether in the UK or elsewhere. Contravention of this requirement could provide grounds for intervention by the Secretary of State under section 37 of the ICA 1982, but did not constitute a criminal offence (section 16).

Accounts and statements and the appointed actuary

299 Sections 17 to 26 of the ICA 1982 re-enacted the following provisions originally introduced by the ICAA 1973, which had been consolidated in ICA 1974, in respect of insurance companies subject to Part II of the ICA 1982, with modifications in relation to the required frequency of the actuarial investigations and to take account of the position of non-EEC companies:

(a) **annual accounts:** the requirements regarding deposit of annual accounts and balance sheets (and other supporting documents) in prescribed forms[179] were re-enacted (section 17 of the ICA 1982[180]);

(b) **annual actuarial investigation:** the frequency of the compulsory actuarial investigation of the financial condition of a company carrying on long term business was increased from triennially to annually. In addition, where any rights of with-profits policyholders related to particular parts of the company's long-term fund, the actuary was required to determine the excess of assets over liabilities for each part. As under the former provisions, a statement of long term business was to be prepared at least once in every five years and the value of assets and the amount of any liabilities was to be assessed in accordance with any applicable valuation regulations[181] (section 18[182]);

(c) **appointed actuary:** the requirements were re-enacted for the appointment of an actuary by a company carrying on long term business, with written notification to be given to the Secretary of State of the name and qualifications of the appointee (section 19[183]);

(d) **annual statement of business:** the requirement for annual preparation of a statement of business in a prescribed form by companies conducting prescribed classes of insurance business[184] was re-enacted (section 20[185]);

179 At the time of enactment of the ICA 1982, these were contained in the ICAS Regulations 1980.
180 Derived from section 13 of the ICA 1974.
181 The applicable regulations at this time were ICR 1981, Parts V (assets) and VI (liabilities), which continued in force by virtue of section 17 of the Interpretation Act 1978.
182 Derived from section 14 of the ICA 1974 (section 3 of the ICAA 1973) and consolidating amendments made to section 14 of the 1974 Act by section 17 of the ICA 1981.
183 Derived from section 15 of the ICA 1974 (section 3 of the ICAA 1973).
184 The ICAS Regulations 1980 (Regulation 15 and Forms 41-51 related to long-term business).
185 Derived from section 16 of the ICA 1974.

(e) **audit of accounts**: the requirement for the accounts and balance sheet of insurance companies to be audited in the prescribed manner by a person of the prescribed description[186] was re-enacted (section 21[187]);

(f) **deposit of documents with the Secretary of State:** the detailed requirements for the deposit of documents (normally within six months after the close of the period to which the account related), numbers of copies, signature etc., were re-enacted and extended to enable regulations to be made about the signatories of documents deposited with the Secretary of State[188] (section 22[189]);

(g) **rights of shareholders and policyholders**: their rights to receive copies of deposited documents on application to the company were re-enacted (section 23[190]);

(h) **periodic statement of business**: the power to prescribe classes or descriptions of business for which statements of business should be made at such intervals and for such period as might be prescribed[191] was re-enacted (section 25[192]);

(i) **undesirable transactions**: power to prescribe classes or descriptions of agreements or arrangements which appeared to the Secretary of State as '*likely to be undesirable in the interests of policyholders*', with a requirement that the company (or any 'subordinate company'[193]) which entered into such an agreement or arrangement furnish the Secretary of State with a statement of the terms of the agreement or arrangement within a prescribed time limit (section 26[194]); and

(j) **proper accounts and records by non-EEC companies:** section 27 of the ICA 1982 contained a new requirement[195] under which companies with a head office outside the Community were required to keep proper accounts and records of their insurance business carried on in the UK.

300 Detailed requirements for the contents of accounts and statements prepared under sections 17, 18 and 20 were prescribed in the ICAS Regulations 1980 as amended[196], and in respect of the valuations specified in section 18(4), in ICR 1981.

186 Regulation 21 of the ICAS Regulations 1980 (as amended).
187 Derived from section 17 of the ICA 1974.
188 The relevant regulations were SI 1980 No. 6 (see paragraphs 235 et seq) as amended by the Insurance Companies (Accounts and Statements) (Amendment) Regulations 1981 SI No. 1656 in relation to the prescribed signatories, subsequently replaced as described in paragraph 341.
189 Derived from section 18 of the ICA 1974 as amended by section 18(1) of the ICA 1981.
190 Derived from section 19 of the ICA 1974.
191 'Prescribed' was defined in section 96(1) as meaning prescribed by regulations made under the ICA 1982.
192 Derived from section 21 of the ICA 1974 (section 5 of the ICAA 1973).
193 As defined in section 31(4) of the ICA 1982.
194 Derived from section 22 of the ICA 1974.
195 Derived from section 22A of the ICA 1974, introduced by section 18(2) of the ICA 1981.
196 By the Insurance Companies (Accounts and Statements) (Amendment) Regulations 1982 SI No. 305.

Assets and liabilities attributable to long-term business

301 Sections 28 to 31 of the ICA 1982 re-enacted provisions of the ICA 1974 which had been revised and strengthened by the ICA 1981. They were primarily of relevance to proprietary companies or those which conducted general business in addition to long term business.

302 The basic rule was maintained that the assets and liabilities attributable to long-term business were to be separately accounted for, with the assets constituting a fund separated from any general business (section 28). Assets of this separate fund were to be used exclusively to meet liabilities on long term business, protected from transfers within the company, mortgages and charges or use for dividends, unless the funds were adequate to meet the long term business liabilities (section 29).

303 As amended by the ICA 1981, the provisions in relation to allocations to policyholders required that where policyholders were entitled to share in any surpluses (as under with-profits policies), the share of the surplus allocated to policyholders from one year to the next could not be reduced beyond a specified percentage unless notice was first given to the Secretary of State and an approved statement was published in the London, Edinburgh and Belfast Gazettes (section 30). The pre-existing restriction was maintained on the proportion of long term funds invested in shares in subordinate companies, loans to such companies and shares in and loans to connected persons[197], made by the insurance company or a subordinate company. In aggregate such investments etc. could not exceed five per cent of the amount of the long term fund (section 31).

Financial resources and the margin of solvency

304 Sections 32 to 35 dealt with the system of solvency margins required under the First Non-Life Directive and the First Life Directive, which had initially been embodied in primary legislation by amendments to the ICA 1974 as sections 26A-26D, introduced by the ICA 1981 (see paragraphs 240 et seq above).

305 **The margin of solvency:** under section 32, every insurance company subject to Part II of the ICA 1982 with its head office in the UK or whose UK business was restricted to reinsurance[198] was to maintain a margin of solvency of such an amount as was prescribed or determined in accordance with regulations (those regulations being designed, in turn, to give effect to the requirements of the two EEC Directives[199]).

306 The relevant regulations continued to be ICR 1981 (Regulations 3-13 and Schedules 1 and 2; Regulations 5 to 8 related specifically to the determination of the margin of solvency for the various classes of long term business). This margin was known as the 'required minimum margin' or RMM. It is to be noted that section 32 created a continuing obligation to 'maintain' the margin, rather than to demonstrate that it was available at particular times. If the solvency margin was not maintained, the Secretary of State could request the company to submit to him a plan for the restoration of a sound financial position, which was to be modified if the Secretary of State considered it to be inadequate, and then put into effect by the company (section 32(4)).

[197] 'Connected person' was defined for this purpose in section 31(5) as being a person (other than a subordinate company) who or which controlled, or was the partner of someone who controlled, the insurance company; was a company controlled by the insurance company; or a director of an insurance company (or a director's husband, wife or child).

[198] The Directives did not deal with those conducting only reinsurance business, but the UK legislators chose to provide for them.

[199] See article 19 of the First Life Directive in relation to the 'minimum solvency margin' and its determination.

307 Further provision for failure to maintain a *minimum* margin was made in section 33. It has been suggested[200] that in the event of failure to maintain the solvency margin, the powers of the Secretary of State under sections 32(4) and 33 were to be used before his more general powers of intervention under sections 37-45 could be relied upon, although there was no express requirement to this effect. For companies carrying on long-term business before 1 January 1982 which did not thereafter obtain authorisation for any other class of long term business, section 32 (and section 33) did not apply until 15 March 1984 (section 99(1) and Schedule 4).

308 **Failure to maintain the minimum margin**: The 'minimum margin' in section 33 corresponded to the 'guarantee fund' in the EEC Directives[201] (and was described as the 'guarantee fund' in regulation 9 of ICR 1981). Where the margin of solvency fell below the prescribed minimum level, at the request of the Secretary of State, the company was required to submit a short-term financial scheme to him, to which he could propose modifications if he considered it inadequate; the company was then required to give effect to the scheme.

309 **Form and situation of assets**: A basic principle of the EEC Directives was that the assets representing the reserves which an insurance company required to meet its liabilities should be localised in the country where business was conducted and should be in the same currency as the liabilities[202]. Regulations made for the purpose of section 35 gave effect to that principle. The relevant provisions were regulations 25-27 of ICR 1981.

Unlimited liabilities

310 The provisions of the earlier legislation which rendered void any contract entered into by an insurance company under which it assumed liabilities of an uncertain maximum amount unless the contract was exempted by regulations, was maintained in section 36. However, commencement of this provision was postponed until regulations were made under it[203]. It appears that no such regulations were ever made and section 36 was eventually repealed without ever having been commenced.

Secretary of State's powers of intervention

311 Sections 37-48 consolidated the intervention powers of the Secretary of State under sections 28-41 of the ICA 1974[204], which had been amended by sections 22-24 of the ICA 1981. The basic

200 This submission is made in the annotations to section 32(4) of the ICA 1982 published in the Current Year Law Book. The notes compare section 32(4) with section 45(2)(b). Section 45(2)(b) contained one of the three exceptions to the general rule in section 45(2) that the residual power under section 45(1) should not be exercised in such a way as to restrict the company's freedom to dispose of its assets (see paragraph 328). Section 45(2)(b) permitted the section 45(1) intervention power to be used to restrain free disposal of assets in circumstances where the company had failed to satisfy an obligation to which it was subject by virtue of sections 33-35 of 1982 Act (or the equivalent provisions of the ICA 1974). Under section 45(2) as originally enacted, in cases where the only default by a company related to its solvency margin, it was implicit that section 45(1) could not be relied upon *in a way which would restrict asset disposal* unless the company's solvency margin had fallen below the minimum required under section 33 (and possibly, unless it had also failed to provide or implement a short-term financial scheme requested by the Secretary of State under that section). Further, section 45 could not be relied on if its purposes could be achieved by reliance on sections 38 to 44 (section 37(6)). However any wider limitation on reliance on section 45(1) or on sections 37-44 by virtue of sections 32(4) and 33 is not apparent. (The exceptional grounds in section 45(2) were later expanded to include cases where a company had failed to satisfy the solvency margin requirements of section 32, see paragraph 603.)

201 Articles 20.1 and 21.2 of the First Life Directive: the 'guarantee fund' was to consist of one third of the minimum solvency margin, subject to a specified minimum amount.

202 See article 17.2 of the First Life Directive and the definition in article 5(b) of 'matching assets'.

203 Schedule 4, paragraph 6.

204 Initially introduced as sections 12-25 of the ICAA 1973. See paragraphs 114 et seq above.

structure of the intervention powers was maintained (i.e. the grounds for exercise, followed by the measures themselves), although the grounds for exercise were made more elaborate to create distinct grounds for intervention by way of certain of the powers, particularly in the light of the restrictions on member states' powers to intervene by way of restricting free disposal of assets other than in exceptional circumstances.

312 The power for the Secretary of State to intervene by imposing restrictions on new business[205] had been repealed by the ICA 1981[206], which had consequential effects for the remaining intervention provisions.

Section 37 – grounds for intervention under sections 38-45

313 Section 37 consolidated the grounds for intervention under section 28 of the ICA 1974[207], with the following changes which had been introduced by sections 22, 36 of and Schedules 4 and 5 to the ICA 1981.

314 **Limitation on exercise of certain intervention powers:** in order to conform with the Directives[208], limitations were placed on the Secretary of State's powers to intervene by way of imposing requirements for the maintenance of assets in the UK and the custody of assets by a trustee (under sections 39 and 40 of the ICA 1982). By virtue of section 37(3), those forms of intervention could only be exercised where:

(a) the Secretary of State had given a direction under section 11 to withdraw authorisation in respect of new business;

(b) it appeared to the Secretary of State that the company had failed to satisfy the new 'minimum margin' requirements or provisions concerning the value of assets to be maintained in the UK or regarding the form and situation of assets under sections 33-35[209]; or

(c) an account or statement submitted to the Secretary of State showed that the company's liabilities had been calculated otherwise than in accordance with the valuation regulations (or accepted accounting concepts if no such regulations applied).

315 **Two new grounds for intervention**: under section 37(2), the five grounds for intervention listed in section 18(1) of the ICA 1974[210] were supplemented by two new grounds. The additional grounds comprised:

(a) that it appeared to the Secretary of State that there had been a substantial departure from a proposal or forecast submitted to the Secretary of State under section 5 of the ICA 1982 when the company applied for authorisation; and

(b) that the company had ceased to be authorised to effect contracts of insurance generally or of a particular description in a member state

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205 Section 13 of the ICAA 1973, consolidated in section 29 ICA 1974. See paragraph 120 above.
206 Section 23(1) of the ICA 1981 and Schedule 5 to that Act.
207 Derived from section 12 of the ICAA 1973, summarised in paragraph 114 above.
208 See article 21.2 of the First Life Directive, which contained a prohibition on restraining the free disposal of assets of authorised undertakings.
209 Or under the equivalent earlier provisions of sections 26B, 26C or 26D of the ICA 1974 which had been inserted in that Act by the ICA 1981.
210 Derived from section 12(1) of the ICAA 1973 summarised in paragraph 114 above. The original grounds related to: (a) policyholders' reasonable expectations; (b) failure to fulfil obligations under the relevant legislation; (c) furnishing misleading information; (d) inadequate reinsurance arrangements; and (e) existence of a ground which would amount to a bar to authorisation being issued.

where it had its head office or had made a financial deposit under section 9(2).

316 The seven grounds for intervention under section 37(2) applied to the powers under section 38 (requirements about investments); section 41 (limitation of premium income); section 42 (special actuarial investigations); section 43 (acceleration of provision of accounting information); section 44 (power to obtain information and production of documents) and section 45 (the residual power to intervene on solvency or PRE grounds)[211].

317 Section 37(5) of the 1982 Act preserved the provisions of section 12(4) of the ICAA 1973[212], giving the Secretary of State greater flexibility to intervene[213] in relation to recently authorised companies. The additional ground on which the Secretary of State might require a company to produce documents[214], namely where he considered it desirable in the general interests of those who were or might become policyholders, was preserved in section 37(4)[215].

318 **Repeal of ground for intervention**: section 28(2) of the ICA 1974[216] had given a general ground for intervention in respect of concerns regarding solvency, in the case of companies conducting long term business, in circumstances where the Secretary of State was not satisfied that the value of the assets exceeded the amount of the liabilities. Section 28(2) had been repealed by section 22(2)(e) and Schedule 5 to the ICA 1981.

319 **Policyholders' reasonable expectations:** the first ground for intervention, under section 37(2)(a), where the Secretary of State considered the exercise of the intervention power to be desirable for protecting policyholders or potential policyholders against the '*risk that the company may be unable to meet its liabilities, or, in the case of long term business, to fulfil the reasonable expectations of policy holders or potential policy holders*', was repeated from the earlier legislation without amendment (and, as before, no explanation was given of the meaning of 'policyholders' reasonable expectations'). The wide (but residual) power of intervention based on PRE then included as section 45 of the ICA 1982[217] continued to be subject to the general restriction that it could only be relied upon where the intended purposes of intervention could not be appropriately achieved by reliance on other specific intervention powers or by reliance on those powers alone (section 37(6)). (The residual intervention power was made subject to an additional limitation under section 45(2) as described below.)

Repeal of power of intervention by way of restrictions on new business

320 The first of the Secretary of State's powers of intervention under the former legislation, enabling him to require the company not to effect new contracts of insurance[218], had been repealed by the ICA 1981[219].

[211] Section 37(2) did not apply to the intervention powers under sections 39 or 40, for which special provision was made in section 37(3) (as described in paragraph 314).
[212] Paragraph 117 above.
[213] By way of his powers under sections 38, 41, 42, 44(1) or 45, whether or not any of the grounds in 37(2) or (4) existed.
[214] Under section 44(2)-(4) of the ICA 1982.
[215] Section 12(3) of the ICAA 1973, see paragraph 116 above.
[216] Section 12(2) of the ICAA 1973, see paragraph 115 above.
[217] Which had been revised so as to limit the use of the power in such a way as to restrict the company's freedom to dispose of its assets in the light of the EEC requirements, as explained below.
[218] Under section 29 of the ICA 1974 (section 13 of the ICAA 1973).
[219] Section 23(1) of the 1981 Act.

Section 38 – requirements about investments

321 A new limitation was placed on the Secretary of State's power to intervene by way of requiring a company not to invest in or to realise certain investments. In order to conform with the requirements of the two EEC Directives that state control over insurance companies' investments should only extend to the reserves required to meet liabilities and not to 'free reserves'[220], section 38(3) specified that this intervention power would not apply to any surplus of assets over liabilities determined in accordance with the relevant regulations.

Section 39 – maintenance of assets in the UK

322 The provisions enabling the Secretary of State to require that assets of an equal value to the whole or a specified proportion of the company's domestic liabilities was preserved (with the definition of 'domestic liabilities' being slightly revised). As noted above, the grounds on which the Secretary of State was entitled to rely on this power were restricted to those set out in section 37(3).

Section 40 – custody of assets

323 The power of the Secretary of State to require, in conjunction with the exercise of the power under section 39, that assets be placed in the custody of a trustee was also preserved, but subject to restricted grounds for exercise under section 37(3).

Section 41 – limitation of premium income

324 The power to intervene by way of restricting the aggregate amount of premiums to be received by the company in a specified period (thereby placing a limit on new business) was preserved.

Section 42 – actuarial investigation

325 The Secretary of State's power to require a company which carried on long term business to cause a special actuarial investigation[221] to be undertaken by the appointed actuary in respect of all or any specified part of that business was re-enacted with minor revisions.

Sections 43 and 44 – accelerated accounting information and provision of information of documents

326 The powers of the Secretary of State to require a company to deposit accounts and statements (under sections 22 and 25) earlier than their normally required times or to provide specified information or documents were repeated from the earlier legislation[222].

Section 45 – residual power to protect policyholders

327 Section 45(1) repeated the original drafting of the wide power of the Secretary of State to take '*such action as appears to him to be appropriate for the purpose of protecting policy holders or potential policy holders of the company against the risk that the company may be unable to meet its liabilities or, in the case of long term business, to fulfil the reasonable expectations of policy holders or potential policy holders*'[223]; a power which was to be employed only where other powers of intervention (under section 38-44) could not '*appropriately achieve*' those aims (section 37(6)).

328 In order to conform with the prohibition in the EEC Directives[224] on restraining the free disposal of assets by a company, a new limitation was placed on this residual power by section 45(2). The power conferred by section 45(1) could only be exercised

220 See article 21.1.
221 See paragraphs 125 and 126 regarding section 18 of the ICAA 1973 (consolidated in section 34 of the ICA 1974 and later slightly amended by section 36 of and Schedules 4 and 5 to the ICA 1981).
222 See paragraphs 127 and 128 regarding sections 19 and 20 of the ICAA 1973 (consolidated in sections 35 and 36 of the ICA 1974).
223 See paragraphs 129 and 130 regarding section 21 of the ICAA 1973, consolidated in section 37 of the ICA 1974.
224 See article 21.2 of the First Life Directive.

in such a way as to restrict the company's freedom to dispose of it assets in three specified circumstances:

(a) after the Secretary of State had given a direction under section 11 to withdraw authorisation in respect of new business;

(b) where it appeared to the Secretary of State that the company had failed to satisfy the new 'minimum margin' requirements or provisions concerning the value of assets to be maintained in the UK or regarding the form and situation of assets under sections 33-35[225]; or

(c) where an account or statement submitted to the Secretary of State showed that the company's liabilities had been calculated otherwise than in accordance with the valuation regulations (or accepted accounting concepts if no such regulations applied).

(These circumstances were equivalent to the limited grounds on which, by virtue of section 37(3), the intervention powers under sections 39 and 40 (regarding maintenance of assets in the UK and custody of assets) could be exercised.)

Prior notice in cases of involvement of unfit persons

329 Section 46 of the 1982 Act preserved the requirements[226] for the Secretary of State to give written notification to the person concerned and to allow that person to make representations, followed by an equivalent notice served on the company and invitation to make representations, before exercising an intervention power under sections 38-45 based on the ground of the unfitness of a person for the position he or she held[227].

Power to bring civil proceedings on behalf of an insurance company

330 The Secretary of State's power to bring civil proceedings in the public interest was preserved[228] in section 48 with minor consequential amendments.

Transfers of long term business

331 Sections 49 and 50 re-enacted with minor revisions the provisions of the former legislation (described in paragraph 95 in relation to sections 26 and 27 of the ICAA 1973) enabling a transferor or transferee company to apply to the court to sanction a scheme for the transfer of long-term business, without obtaining the consent of all the affected policyholders. This was seen as providing one potential means of averting the worst effects of the liquidation of a business. The provisions were also relied on when an insurance company wished to sell its long term business to another company.

Insolvency and winding up

332 Sections 53-59 re-enacted the provisions of the former legislation on winding up of insurance companies with minor revisions. They came into force in 1985 when rules were made under section 59[229]. They included provisions (in addition to those for the winding up of companies generally under the Companies Acts):

225 Or under the equivalent earlier provisions of sections 26B, 26C or 26D of the ICA 1974 which had been inserted in that Act by the ICA 1981.
226 The former provisions of section 23 of the ICAA 1973 (section 39 of the ICA 1974) are noted in paragraphs 133 and 134 above.
227 Other than as 'controller' of the company.
228 Section 25 of the ICAA 1973; section 41 of the ICA 1974.
229 See section 99 of and paragraph 15 of Schedule 4 to the ICA 1982, which postponed commencement of these provisions until rules under section 59 had come into operation. The Insurance Companies (Winding-up) Rules 1985 SI No. 95 were made for this purpose. Those Rules included a form of reference to PRE in relation to the valuation of non-linked life policies in Schedule 2. Under paragraph 1(2) of that Schedule, the court was to make an allowance in the calculations for the situation where, on the basis of the company's established practice, the policyholder had an expectation of receiving benefits additional to the minimum guaranteed under the contract.

(a) for ten or more policyholders to present a petition for the winding up of an insurance company;

(b) for the Secretary of State to petition for the winding up of an insurance company on three specified grounds[230], namely that:

 (i) the company was unable to pay its debts within the meaning of specified sections of the Companies Act 1948;

 (ii) the company had failed to satisfy an obligation to which it was subject by virtue of the ICA 1982 or predecessor legislation; and

 (iii) the company had failed to keep proper accounts or to produce records as required under section 12 of the Companies Act 1976 and the Secretary of State was unable to ascertain its financial position;

(c) making special provision in respect of the winding up of insurance companies with long-term business, prohibiting voluntary winding up and ensuring that the required separation of assets relating to the long term fund and any general business continued into the winding up arrangements;

(d) requiring the liquidator to carry on the long-term business unless the court ordered otherwise, with a view to that business being transferred as a going concern to another company; with powers for the court to appoint a special manager of the business, to reduce the amount of the contracts made by the company in the course of its long term business and to appoint an independent actuary to investigate and report on that business;

(e) for the winding up of a company from which business had been transferred in conjunction with the winding up of the transferee company, where the transferor (or its creditors) had claims against the transferee; and

(f) in place of winding up in the case of a company unable to pay its debts, the court was empowered to reduce the amount of the contracts of the company on such terms and conditions as the Court thought fit.

Secretary of State approval of managing director or chief executive of an insurance company and of a controller of a company

333 Sections 60 and 61 re-enacted the requirements[231] for the Secretary of State to be notified of the proposed appointment of a managing director or chief executive or of a prospective new controller[232] of an insurance company.

334 This enabled the Secretary of State to object if necessary on the grounds that the person was not a 'fit and proper person' to take up the appointment or become a controller, and potentially provided grounds for intervention under section 37(2)(e)[233].

335 Notice of change of controller, director or manager was also to be given to the company by the person concerned; the company was then required to give

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[230] Section 54(1) of the ICA 1982.
[231] See paragraphs 149 to 154 regarding sections 33 and 34 of the ICAA 1973 (consolidated in sections 52 and 53 of the ICA 1974).
[232] Originally defined in section 7(4) of the ICA 1982 (from 1 July 1994 defined in a new section 96C of that Act, see footnote 413).
[233] See paragraphs 313 et seq regarding section 37 of the ICA 1982 and paragraphs 114 and 170 regarding the predecessor provisions, in particular, of section 12(1)(e) of the ICAA 1973 (consolidated in section 28(1)(e) of the ICA 1974).

written notice to the Secretary of State under section 62[234]. ICR 1981 contained prescribed forms for the notices to be given under these requirements. Sections 63 and 64 made provision for the Secretary of State to be notified of changes of managing director and chief executive of companies from outside the UK and of changes of main agents.

Miscellaneous provisions, section 68 orders and offences

336 Minor ancillary provisions in relation to the obligations of the Secretary of State to deposit documents with the registrar of companies were preserved (section 65). He continued to be empowered to direct, by order, that certain business should be treated as being or not being ordinary long term business (section 67). The Secretary of State was also empowered to extend or shorten any financial year of an insurance company (section 69).

337 Section 68 re-enacted the power of the Secretary of State to modify, by order, certain of the provisions of the primary legislation and related regulations concerning regulation of insurance companies (a section 68 order). This power was important to insurance companies as it provided a mechanism by which the Secretary of State could authorise implicit items, such as the present value of future profits, to be used (to a limited extent) in demonstrating that the required minimum margin was satisfied.

338 Section 71 provided for a number of offences in relation to default in compliance with specified provisions of Part II and was mainly derived from the ICAA 1973 (and ICA 1974).

Part V of the ICA 1982

339 Part V included provisions related to the Secretary of State's wide ranging powers to make subordinate legislation in relation to various provisions of the ICA 1982 (section 97); his power to make valuation regulations (section 90); detailed provisions in relation to criminal proceedings including the criminal liability of directors (section 91); and a number of new defined terms in the general interpretation provision (section 96). As noted, 'policyholders' reasonable expectations' was not defined.

The practical application of the ICA 1982 in later years and the fate of the Act

340 Information about the practical application of the regulatory regime under the ICA 1982 during the early 1990s is included in the first section of Phase 4. Following successive amendments (certain of which are referred to below), the ICA 1982 was repealed with effect from 1 December 2001 by the Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001[235], which was made by the Treasury in exercise of its powers under the FSMA 2000.

The Insurance Companies (Accounts and Statements) Regulations 1983

341 The ICAS Regulations 1980 were amended by a series of statutory instruments between 1981 and 1983 to update the requirements for accounts and statements in the light of changes introduced by the ICA 1981 and the EEC Directives, in relation to such matters as the prescribed signatories of deposited documents[236], to introduce new definitions, to make provision for returns by non-

234 Re-enacting the provisions of section 35 of the ICAA 1973 (section 54 of the ICA 1974), see paragraph 104.
235 SI 2001 No. 3649.
236 SI 1981 No. 1656, referred to in footnote 188.

UK companies[237] and in relation to the margin of solvency requirements[238].

342 The Insurance Companies (Accounts and Statements) Regulations 1983[239] (the ICAS Regulations 1983) came into operation in March 1984 to replace, with modifications, the ICAS Regulations 1980.

343 The principal new requirements under the ICAS Regulations 1983 for deposited documents related to companies carrying on long term business and included a statement of benefits enjoyed by the appointed actuary (such as shares in the company and pecuniary interests in company transactions) and a statement of any arrangements by which management services were received from or provided to another company. In relation to long term business, these Regulations incorporated changes concerning such matters as the margin of solvency, requirements for further analyses of premium income, expenses, assets and new business and a new form for the abstract of the actuary's report. The prescribed qualifications for appointed actuaries and auditors[240] were unchanged.

Guidance for appointed actuaries – revisions to GN1 1979-1985

344 The guidance for appointed actuaries in GN1 was reissued as versions 1.2 (in 1979), 1.3 (1983), 1.4 (1984) and 1.5 (1985). Few significant changes were made other than to update references to the legislation in the light of the enactment of the ICA 1982 and to revise the name of the responsible government department (to refer to the 'Department of Trade and Industry') in the 1983 version. In the version issued in 1985 (1.5), the reference to the failure by an appointed actuary to work within the framework indicated in the guide being regarded as prima facie evidence of unprofessional conduct was removed from the text of the document[241].

Guidance for Appointed Actuaries – the first version of GN8

345 Whilst GN1 dealt with the appointed actuary's general responsibilities in relation to long term business, GN8 focused on the determination of liability regulations in Part VI of ICR 1981 and the actuary's role in relation to solvency margins.

346 As noted above, a number of new requirements had been imposed which had implications for the work of the appointed actuary. Part VI of ICR 1981 had made provision for the determination of long-term liabilities of insurance companies and governed the required valuations when an actuarial investigation was undertaken pursuant to the ICA 1982.

347 One of the required outcomes of such an investigation was for the actuary to provide a certificate that the long-term liabilities of the company did not exceed the value of its liabilities[242]. Part VI of ICR 1981 had introduced a statutory requirement for 'resilience testing' in

237 SI 1982 No. 305, see footnote 196.
238 The Insurance Companies (Accounts and Statements) (Amendment) Regulations 1983 SI No. 1192.
239 SI 1983 No. 1811.
240 In Regulations 28 and 30 respectively. Regulation 29 required the company to annex a statement to the accounts giving prescribed information about the actuary, including particulars of any shares held in the company, any pecuniary interest in company transactions, his or her remuneration and any emoluments as a director.
241 From January 1990, this principle was set out in the general guidance on professional conduct standards issued to actuaries by the F&IA (as it is in the current professional conduct standards for actuaries). See the additional note of Advice on Professional Conduct (APC3) issued by the Institute of Actuaries in January 1990.
242 Regulation 18 and Part II of Schedule 6 to the ICAS Regulations 1980.

Regulation 55, that in determining the amount of the company's long term liabilities account was to be taken of '*the nature and term of the assets representing the long term fund and the value placed upon them and shall include appropriate provision against the effects of possible future changes in the value of the assets on their adequacy to meet the liabilities*'. In addition, the ICA 1982 and Part II of ICR 1981 had made provision for the maintenance of margins of solvency by insurance companies.

348 GN8 was issued by the F&IA in October 1983 to give additional guidance to appointed actuaries in relation to certain aspects of their professional responsibilities when undertaking the required valuations; giving guidance on dealing with the determination of liabilities and solvency margins and in relation to 'resilience testing' under Regulation 55.

349 By the time GN8 was first published, the DTI had indicated that it would require a certificate from the appointed actuary in relation to applications from companies for orders under section 68 (enabling implicit items to count towards the solvency margin), although the form of the certificate had not been announced.

350 The stated aim of GN8 was to draw actuaries' attention to their professional responsibilities relevant to the required valuations, rather than to interpret ICR 1981. The comments made by the GAD directing actuary to a meeting of the Faculty of Actuaries in 1982 suggest that this professional guidance was intended to fulfil a key function in the overall regulatory regime (see paragraphs 273 et seq).

351 The guidance emphasised that the paramount requirement was that in regulation 54 (see paragraph 266 The appointed actuary should use prudent bases determined according to actuarial principles and professional considerations as set out in earlier guidance notes.

352 Paragraph 2.1.3 stated:

> *Actuarial principles require the actuary to pay due regard in his valuation to the future interests of with-profits policyholders notwithstanding the fact that Regulations 55-64 do not specify the point. This may well necessitate his making other investigations to satisfy himself as to the pace of emergence of surplus.*

Thus from 1983 the future interests of policyholders, if not their 'reasonable expectations', were built into the professional guidance for appointed actuaries regarding the required valuations. However, no reference was made to the 'reasonable expectations of policyholders' in the subordinate legislation on valuations until some time later[243].

353 The requirements of Regulations 55-64 were described as '*minimum criteria*' and the actuary was to interpret them in a prudent way, individually and as a whole. Guidance on resilience testing was given only in very general terms: that it was necessary for the actuary to use '*professional judgment*' when applying Regulation 55, cross referring to the guidance in GN1 paragraphs 6.6-6.9 (which again related to general factors), rather than providing any specific hypothetical situations, or

243 Such a reference was included in regulation 64 of the Insurance Companies Regulations 1994 SI No. 1516 on the determination of long term liabilities, in relation to the actuarial principles to be used (which were to have *'due regard to the reasonable expectations of policy holders'* (with no reference to potential policyholders)). From 1992 onwards, GN1 referred to the need for the actuary to have regard to policyholders' reasonable expectations in his or her assessment of the company's long-term liabilities (paragraph 6.3 of GN1 version 3.0, see paragraph 514(g) below).

potential adverse investment conditions, which the actuary should consider.

354 Whilst there was no statutory requirement for the actuary to do so, the guidance in GN8 required the actuary to advise the company of the action required of it to maintain the margins of solvency prescribed in Part II of ICR 1981, and the action the company should take in the event that it was reasonably foreseeable that it would be unable to meet its long term liabilities.

1984 Service Level Agreement between the DTI and GAD and supervision in practice

The 1984 Service Level Agreement

355 In 1984, the arrangements between the DTI and GAD in relation to GAD's role in scrutinising returns submitted by companies carrying on long term business and providing the DTI with related advice were formalised in a 'service level agreement' (SLA) which came into effect on 1 July 1984. The agreement outlined the division of tasks between the DTI and GAD and the basic requirements for the methodology to be used and required progress reports to be given in relation to the scrutiny process. The outcome of the process was for GAD to provide the DTI with a scrutiny report intended to enable the DTI to assess the need for action by the Secretary of State as prudential regulator.

356 The underlying approach stated in the agreement was that formal action on behalf of the Secretary of State should always be taken by the DTI. GAD was permitted to make direct enquiries of companies, but it was not to make enquiries of auditors, nor in the first instance, of appointed actuaries.

357 GAD was given the major share of the responsibility for the examination of returns relating to long term business and pursuing technical questions arising from them with the companies.

358 The DTI was clearly to remain the point of contact for insurance companies under the regulatory regime, covering such matters as new authorisations, directions, notices of requirements, concessionary orders, notifications of change of control and of the appointed actuary and receipt of the statutory returns, and it retained responsibility for scrutinising annual reports and accounts in relation to shareholder matters.

359 Under the 1984 SLA it was agreed that:

(a) the DTI would pass on to GAD copies of returns from the company, reports to policyholders and other relevant documentation and supporting information such as business plans and policies;

(b) on receipt of the annual returns the DTI was to carry out an initial check of the main documents to ensure that they were complete;

(c) some of the forms were then to be computer processed and passed on to GAD;

(d) the DTI was to advise GAD of significant errors and omissions (and GAD was to notify the DTI if it found any such matters in the returns which needed to be taken up urgently) and the DTI was to be responsible for pursuing these with the company concerned;

(e) the DTI was also to pass on the quarterly returns and supporting documents; and

(f) the DTI was to notify GAD if in its view the company should be given a higher priority rating or there were other matters which appeared relevant to the examination of the return in relation to long-term business.

360 The main obligations of GAD under the 1984 SLA included:

Initial scrutiny

(a) as soon as possible after receipt of the annual return from the DTI, GAD was to carry out an initial scrutiny in order to advise the DTI of any serious solvency or compliance problems and to allocate a priority to the case in the range 1-4 as described in Annex A to the agreement, with 1 being the most urgent and those in category 4 seen as a low priority for whom detailed examination would be undertaken at least once in every three years;

(b) GAD was to notify the DTI immediately if it appeared that the company had failed to meet its long term business solvency margin or was otherwise in financial difficulty;

(c) GAD was to examine the various certificates in the returns and notify the DTI of serious cases of non-compliance; examine the non-computerised parts of the returns and notify the DTI of significant errors or omissions; and make an initial examination of the form showing the valuation result and distribution of surplus to ensure that the requirements of section 30 on allocation of surpluses to with-profits policyholders had not been breached;

(d) GAD was to provide the DTI with a quarterly list showing current and previous priority ratings of all companies;

Detailed examination and report to DTI

(e) GAD was to undertake a detailed examination of the annual returns, reporting to the DTI on significant matters arising from the returns or from correspondence or discussion with the companies or their actuaries; the main objective of each examination was to form a view on the company's solvency and margin of solvency as at the date of the return and compliance with statutory requirements and any undertakings given by the company; for 'priority 1' cases the detailed examination was to be carried out '*within days*' of GAD's receipt of the return, for 'priority 3' cases it was '*normally*' to be carried out within ten months;

(f) on completion of the detailed examination GAD was to provide a scrutiny report to the DTI on significant matters which had emerged or been raised by the company, advising the DTI if GAD was of the view that any formal action was required; the SLA gave details of the matters to be addressed in the report to the DTI aimed at identifying major issues, developments or weaknesses which might require some form of action or intervention;

(g) GAD was to provide the DTI with a monthly progress report on the examination of annual returns, completion of initial checks and final reports on outstanding issues.

361 At the stage of the detailed examination, GAD was permitted to contact the company or (with its agreement) the company's appointed actuary to obtain clarification of points relating to the long-term business.

362 However, if the DTI had already been in correspondence with the company following its initial examination of the company's return, GAD was to agree with the DTI which department

should pursue matters further with the company. Any correspondence between GAD and the company or its advisers or notes of meetings were to be copied to the DTI. GAD was to make recommendations to the DTI about any action which should be taken in relation to matters arising from the returns. The SLA made it clear that GAD was not to initiate any such action or commit the DTI to any particular decision in the course of its discussions with companies. Nor was GAD to approach any company's auditors.

363 The 1984 Agreement (clause 45) stated that it was to be reviewed in early 1986 (other sources suggest that this review may not have taken place). A new SLA was agreed between the DTI and GAD in 1995 (see paragraphs 744 et seq below).

Supervision in practice as at 1988

364 A paper presented by the Government Actuary, E.A. Johnston, to the Institute of Actuaries in 1988[244] described the role of GAD in the day-to-day supervision of insurance companies at that time, the relationship between GAD and appointed actuaries and GAD's relationship with the F&IA.

365 In 1988 just over 80 people in the DTI and GAD were working on life and non-life work, including six and a half full time equivalent qualified actuaries dealing with life assurance matters[245]. The costs were recovered through fees charged to insurance companies. At the end of 1987 there were 281 companies writing long-term business and 168 different appointed actuaries (as some were appointed to more than one company).

366 The then Government Actuary explained that a full examination of the returns in a complex case could take more than a week. The objective of the full examination was to monitor that the legislation had been complied with, which entailed checking that the returns had been made out correctly, that the appointed actuary's valuation accorded with the regulations and guidance notes[246], that the solvency margin was held and that other statutory requirements had been met.

367 A further aim of the detailed examination was to look at the company 'dynamically', using the returns and any other available information to assess how the financial state of the company was developing[247] and to seek to identify potential problems or dangerous trends. At the time the paper was written, with-profit companies had been receiving increased attention in order to identify cases where over-distribution might be occurring. It was explained that this work paralleled rather than duplicated the work of the appointed actuary in terms of the actuary's valuation and the financial condition report[248] which the actuary was presumed to make to the board of the company, but which the supervisory authorities did not see.

368 Where the detailed examination and any follow-up queries revealed matters of concern, the procedure moved to a second stage during which '*DTI and GAD work*[ed] *as a team*'. The first step would normally be to seek further information; there might then be discussion with the company, especially if its plans seemed unsuitable or matters were moving in a direction likely to cause difficulty.

244 JIA 116 (1989) 27-100 at paragraphs 2.1-2.17.
245 By 1990, the total staff employed by GAD comprised some 30 qualified actuaries, 12 trainee actuaries and about 25 support staff (according to paragraph 5.1 of the paper referred to in footnote 91).
246 Apparently a reference to GNI and GN8.
247 See further below (paragraphs 825 et seq) regarding the practice of 'dynamic solvency testing' and financial condition reports aimed at assessing the ability of long-term insurance businesses to withstand changes in the economic environment.
248 There was no statutory requirement for such a report to be prepared or considered by the company, but from 1996 onwards it was recommended practice under GN2 that such a report, addressed to the board of the company, should be prepared by the appointed actuary (paragraphs 825 et seq).

369 Ultimately, it might be necessary to consider whether there were grounds for formal intervention. The Government Actuary explained that GAD played a major part at this stage, in terms of internal discussions with the DTI, assisting with correspondence and attending meetings and dealing with the actuary on actuarial issues. Often this type of work arose from events between valuations, such as major restructurings.

370 As regards the relationship between GAD and appointed actuaries, the then Government Actuary said:

> *Contact between GAD and actuaries is crucial to the smooth functioning of the Appointed Actuary system. It is not GAD's function to second-guess the company actuary. That Department's responsibility is to advise the DTI on the state of the company in relation to the legislation. For this purpose, the input to GAD is the finished work of the Appointed Actuary. It would be very unusual for GAD to investigate the condition of an office itself.*

371 He went on to explain that the normal aim of the supervisors was that the management of a company should address any problem. The company's actuary would be expected to carry out any necessary investigation and advise management as required. The DTI expected management to take 'full note' of the results of any actuarial investigations and of the appointed actuary's advice and act accordingly.

372 The then Government Actuary described the F&IA as providing professional backup essential to the system, with responsibility for education, qualification standards, research and professional discipline. He stated that the appointed actuary system called for close co-operation between the supervisors (represented by GAD) and the profession (through the F&IA) and explained that this was achieved both informally and formally through such means as the JAWP[249].

The Financial Services Act 1986

373 The Financial Services Act 1986 (the FS Act 1986) is relevant to conduct of business regulation and is not described here other than by way of background, to explain the extent to which it applied to life assurance business and in order to refer to some of the amendments it made to the ICA 1982.

General background and effects of Part I of the FS Act 1986

374 The FS Act 1986 effected a complete overhaul of the statutory framework for the regulation of investment business. It was enacted some ten years after it had first been proposed that the previous legislation (the Prevention of Fraud (Investments) Act 1958) should be revised to bring it into line with modern conditions.

375 In the wake of the collapse of four licensed dealers in securities in 1981, Professor Gower was appointed by the Secretary of State to undertake a review of the protection needed by investors and to advise on the need for new legislation. Professor Gower recommended[250] the replacement of the former legislation with a comprehensive statutory regime for the regulation of investment business '*based so far as possible on self-regulation subject to government surveillance*'.

[249] See paragraph 273 and the footnote thereto.
[250] Review of Investor Protection, Cmnd 9125 (January 1984).

376 Much of the Government White Paper which preceded the Act and eventually the FS Act 1986 itself, followed Professor Gower's recommendations. The basic model was for the establishment of a practitioner-based body matching criteria specified in the legislation, which would in part operate through a number of self-regulating organisations (SROs) recognised by the new body.

377 The FS Act 1986 provided for the establishment of a new regulatory authority 'the Securities and Investments Board Limited' (SIB). Under section 114, the Secretary of State was empowered to delegate to the SIB (as a 'designated agency'[251]), by order, specified functions under the Act in relation to the regulation of investment business. The SIB began to 'recognise' the SROs with effect from 17 May 1987, when the SIB assumed responsibility for the functions listed in a delegation order[252]. Most of the relevant provisions of the Act came into force on 29 April 1988 (known as 'A Day').

378 Section 4 of the FS Act 1986 made it an offence to carry on investment business without authorisation or exemption under the Act. There were two means of obtaining authorisation: either directly from the SIB or through membership of an SRO[253].

379 Chapter V of Part I of the FS Act 1986 dealt with conduct of business regulation. Criminal offences were created in relation to the making of misleading statements, market manipulation and investment advertising by unauthorised persons.

380 The SIB (following the delegation arrangements) was empowered to make rules and regulations to regulate conduct of business. The provisions included civil remedies by way of actions for damages by those who suffered loss on account of a contravention of the requirements (section 62). Part VI included a number of intervention powers which were to be exercisable by the SIB under the delegation arrangements. Chapter IX provided for the creation of a Financial Services Tribunal to which an appeal against the exercise of those powers could be made.

Impact on the ICA 1982

381 Part II of the FS Act 1986 and Schedule 10 to the Act adapted the investment business regime to life assurance in a way which took account of the regulation of insurance companies under the ICA 1982. The broad effect was that only the life assurance marketing and pension fund management activities fell within the scope of the investment business regime[254].

382 The opportunity was taken within Part II to make a number of amendments to the ICA 1982, including an amendment to the definition of 'controller' in section 7(4)(c)(ii) of the 1982 Act to reduce the specified percentage of voting power controlled from one third to 15 per cent (section 134). This ensured that the definitions of 'controller' in ICA 1982 and the FS Act 1986 were consistent.

383 A new section 21A was inserted in the 1982 Act, designed to facilitate communication between auditors of insurance companies subject to Part II

[251] By virtue of the Financial Services Act 1986 (Delegation) Order 1987 SI No. 942.

[252] Articles 3,5,6,7 and 8 and Schedule 3 to SI 1987 No. 942. Certain functions were subject to the reservation that they were to be exercisable concurrently by the Secretary of State and the SIB. Schedule 1 listed functions which were not to be transferred to the SIB.

[253] Equitable was a member of two SROs: the Life Assurance and Unit Trust Regulatory Organisation Limited (LAUTRO), in relation to its sales activities, and the Investment Management Regulatory Organisation Limited (IMRO) in relation to its fund management. The general manager of Equitable was appointed as the first chairman of LAUTRO.

[254] Equitable's accounts for 1988 stated that the management report included more information than in the past and that the Society supported '*the general thrust of the regulations stemming from the Financial Services Act to require more openness from the life assurance industry*'.

of the ICA 1982 and the Secretary of State. Section 21A provided that no duty to which such an auditor might be subject should be regarded as contravened by reason of the auditor communicating in good faith to the Secretary of State any information or opinion on a matter of which the auditor had become aware in his or her capacity as company auditor and which was relevant to the functions of the Secretary of State under the 1982 Act (section 135). The regulations which were later made by the Secretary of State under section 21A(2) and (3) to impose duties on auditors to communicate certain information are referred to below[255].

384 A new section 31A was also added to the ICA 1982 requiring insurance companies to secure that they had adequate arrangements in force to avoid unfairness between separate insurance funds, said to enshrine in the legislation the '*single most important principle of investment management of dealing fairly between different clients*'[256] (section 136).

385 The funds which were relevant for this purpose were those required to be maintained under section 28 (separating assets relating to the long term business from any relating to general business) and 'identified funds'. 'Identified funds' were defined as assets representing receipts from a particular part of a company's long term business which could be identified as such by virtue of accounting or other records maintained by the company.

386 Section 78(2) of the ICA 1982, relating to linked long term policies and the property and indices to which they could be linked was also amended to allow the Secretary of State to prescribe quantitative limits, expressed in terms of the proportion of the benefits under such policies which could be determined by reference to property of a specified description or a specified index (section 137). It was said that this would enable the range of permitted links to be extended.

Transfer of functions under and repeal of the FS Act 1986

387 On 7 June 1992, many of the functions of the Secretary of State under the FS Act 1986 were transferred to the Treasury, although some were to be exercisable by the Secretary of State and the Treasury acting jointly or concurrently. The relevant transfer order contained express provisions[257] to ensure that the delegations which had been made to the SIB as a designated agency were preserved and that the Treasury could assume the powers from the designated agency in circumstances where the Secretary of State would have been entitled to resume them. The FS Act 1986 was repealed (with minor savings) as from 1 December 2001 by the Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001[258].

Policyholders' reasonable expectations for taxation purposes: the Finance Act 1989

388 An allowance was made for the costs of meeting policyholders' reasonable expectations within section 82 of the Finance Act 1989, which related to the calculation of profits of insurance companies for the purposes of the Income and Corporation

255 The Auditors (Insurance Companies Act 1982) Regulations 1994 SI No. 449, referred to at paragraph 697.
256 Hansard Debates, House of Lords 28 July 1986 Vol 479, col 663.
257 Article 6 of the Transfer of Functions (Financial Services) Order 1992 SI No. 1315.
258 SI 2001 No. 3649 (articles 3(1)(c) and 292).

Taxes Act 1988. Section 82 permitted so much of any surplus as was held by the company to meet the reasonable expectations of policyholders[259] to be treated as a liability of the company for the purpose of the calculation of its profits for tax purposes (thereby reducing the amount of the profits subject to taxation), subject to limited exceptions. Section 82(1)(a) specified that:

> *... if, at the end of the period, the company has an unappropriated surplus on valuation, as shown in its return for the purposes of the* [ICA 1982], *then, subject to subsection (3) below, the closing liabilities of the period may include such amount, forming part of that surplus, as is required to meet the reasonable expectations of policy holders or annuitants with regard to bonuses or other additions to benefit of a discretionary nature.*

389 The exception in subsection (3) related to amounts which had been reserved for policyholders or annuitants before 14 March 1989 but had not been allocated to them or expended on their behalf before that date.

390 Section 82 of the Finance Act 1989 remained in force in this form until it was substituted in respect of accounting periods beginning on or after 1 January 2003 by the Finance Act 2003[260].

Guidance for Appointed Actuaries – revisions to GN1 and GN8 1987-1990 and guidance on resilience testing from GAD (DAA1)

GN1

391 Further versions of GN1 were issued in 1987 (version 1.6), 1988 (version 2.0) and 1990 (version 2.1).

392 Of the changes to GN1 introduced during this period the most significant appear to be those made in 1988 when the new version 2.0 was produced, in which a new section 8 was added giving guidance on the written reports the appointed actuary was required to prepare following an actuarial investigation under section 18 of the ICA 1982.

393 The guidance stated that it was the professional duty of the appointed actuary to report in writing to the directors on the results and implications of the investigation, whether or not any allocation of profits was involved, before providing the statutory report to the DTI. Section 8 went on to give guidance on the approach to be adopted and the matters to be covered in the appointed actuary's report to the company directors, including requirements for the actuary:

(a) to take all reasonable steps to ensure that the directors were in a position to consider a suitable written report from the actuary if there was reason to believe that the company planned to announce a specific allocation of profits in anticipation of the results of the results of an actuarial investigation (paragraph 8.2);

[259] No reference was made in the Finance Act 1989 to 'potential policyholders', suggesting that it was not considered necessary to reserve sums in order to meet the expectations of prospective policyholders.

[260] The replacement provision in section 82B(2) of the Finance Act 1989 now refers to so much of the unappropriated surplus as is required to meet the 'duty of fairness' (to treat its policyholders and annuitants fairly with regard to terminal bonus) being treated as a deduction from profits.

(b) in reporting on and making recommendations in respect of any proposed allocation of profits, to consider specified matters affecting the company's financial position, carry out appropriate financial investigations and provide directors with the necessary information to enable them to judge the appropriateness of the allocation and understand its implications for the future conduct of long term business (paragraph 8.3); and in particular (without prejudice to the generality of this requirement) the actuary was required:

- if the report anticipated the results of an annual actuarial investigation under section 18 of the ICA 1982, to '*indicate and discuss how in the context of the statutory requirements, the allocation will be financed*' (paragraph 8.3.1);

- to discuss the relationship between the proposed allocation and the relevant experience and indicate whether, in the actuary's opinion, the continuance of a distribution policy which (in its relationship to relevant experience) was consistent with the allocation proposed, could lead in due course to an unsatisfactory position and, if so, to explain how this could appropriately be avoided (8.3.2); in the case of with-profit business, the actuary's comments were required to cover '*bonus prospects, with particular reference to the projected development of outgo on and asset cover for unreserved terminal bonus and the like in different investment scenarios'* (8.3.3); and

- to justify his or her recommendations regarding the allocation of profits and its consequences for the conduct of the company's long term business by reference as appropriate to the actuary's appraisal or assessment of (a) relevant experience, (b) the company's financial and business objectives, and (c) the company's continuing ability to meet its statutory solvency requirement, and:

> *... his interpretation of the reasonable expectations of the company's policyholders having regard to* [(a), (b) and (c)]. *He should assume that among the conditions for the fulfilment of those expectations are:*
>
> *(i) that, in the recognition and allocation of profits in accordance with the company's terms of participation in its policy in respect of* [the nature and timing of allocation of profits to policyholders and/or shareholders], *groups of participating policies are appropriately and equitably distinguished having regard inter alia to the terms of the policies, their duration and their relevant pooled experience; and*
>
> *(ii) that the company conducts its affairs, including its new business and investment strategies, with due regard for its financial resources* [Paragraph 8.3.4].

GN8

394 Versions of GN8 were issued for 1984-85 (version 1.1), 1985-86 (version 1.2), in 1988 (version 2.0) and in 1990 (version 2.1).

395 In version 1.2 two paragraphs were added. The first (paragraph 1.4) specified that it was the appointed actuary's duty to report in writing to the company,

at the appropriate level of authority, on the results and implications of any valuation carried out for statutory purposes and to advise on the conditions in which the company might reasonably be expected to be able to maintain current rates of bonus for any with-profits policies, allowing for any changes in rates envisaged as a result of the valuation (this paragraph was removed in version 2.0).

396 The second new paragraph (1.5) stated that it was the actuary's professional duty to make timely and reasoned disclosure to the company and to the DTI if, for some exceptional reason, the actuary was unable to comply fully with the additional guidance notes (in GN8).

Government Actuary's letter to Appointed Actuaries on his 'working rule' for resilience testing (DAA1) and Temporary Practice Note from the F&IA

397 On 13 November 1985 the then Government Actuary wrote to the appointed actuaries of insurance companies indicating the standard or 'working rule' he would be applying for resilience testing when considering the suitability of the actuary's statutory valuations and advising the DTI on the solvency position of each insurance company (DAA1).

398 This entailed comparing the company's reserves with the ability to meet the requirements of ICR 1981 (other than Regulation 55) given an immediate rise or fall of 3% in the rate of interest and a fall of 25% in equity prices (and a similar fall in property values). This working rule was later said[261] to have been '*effectively endorsed*' in Temporary Practice Note No. 2 (TPN2, issued by the F&IA to actuaries in May 1986).

399 Over the years up to 2000 a number of further DAA letters were issued by the Government Actuary to appointed actuaries on the subject of resilience testing in which the tests and hypothetical scenarios evolved and became considerably more complex[262], as mentioned below. The guidelines contained in the DAA letters had no statutory force, but were considered to set a benchmark for a minimum acceptable standard[263] for resilience testing.

400 Resilience testing was considered to play an important part in securing prudent provision for the liabilities of insurance companies. A later working party of the F&IA which investigated resilience reserves[264] noted that numerous working parties had looked at the fundamental valuation regime and most had concluded that their results were heavily dependent upon the resilience regime which was applied to them.

Proposals to strengthen the appointed actuary system and a view of the role of the actuary in the UK supervisory regime as at 1990

Consultation paper on proposals to strengthen the system

401 In March 1990 the DTI consulted on proposals to strengthen the appointed actuary system[265]. Whilst it was noted that generally the system had worked well it was open to question whether '*such an*

[261] In a 'Dear Appointed Actuary' letter sent to appointed actuaries by the Government Actuary dated 31 July 1992 (DAA4).
[262] Eventually reverting to more straightforward tests in 2001, at least on a temporary basis, in guidance issued by the FSA shortly after the transfer to it of functions in relation to prudential regulation of insurance companies.
[263] As noted above, the memorandum produced by the F&IA for the House of Commons Treasury Committee Inquiry into Equitable and the Life Assurance Industry, dated February 2001, states (at paragraph 8.2) that, in practice, DAA letters set a minimum acceptable standard for appointed actuaries in determining provisions for particular risks in the valuation of liabilities.
[264] The Resilience Reserves Working Party report of October 2000 (paragraph 2.10), referred to in paragraphs 995 et seq.
[265] Consultation Paper: 'Strengthening the Appointed Actuary System', Insurance Division of the DTI, 13 March 1990.

important part of the UK's insurance supervision should continue to rest so largely on non-statutory professional rules and custom and practice, without any backing of law'.

402 The DTI had considered whether, in the circumstances, it should take legislative action in relation to the appointed actuary system and set out the essential elements of the professional rules in regulations, but the view had been reached that it was not desirable to take over the role of the profession in this way and that it would destroy the flexibility of the system which was seen as one of its main strengths. The DTI did, however, conclude that '*some reinforcement is necessary to prevent serious problems arising in the future*'.

403 The paper proposed two means to strengthen the system: the first was to introduce into the Regulations a requirement for the appointed actuary to certify compliance with the Guidance Notes issued by the professional bodies, or to identify any departures[266]. The second was that an actuary should not be appointed as an 'appointed actuary' without a practising certificate issued by one of the two professional bodies[267].

Programme of visits to appointed actuaries

404 On 7 November 1990 the Government Actuary wrote to appointed actuaries to inform them that officials from the DTI and GAD were beginning a rolling programme of visits to life insurance companies, intended to cover all authorised life insurance companies in the UK over a three year period. The letter stated that the aims of the visits were:

(a) to strengthen the appointed actuary system by achieving closer contacts between appointed actuaries and senior officials of GAD and the DTI, explaining that GAD wished to be satisfied that the role of the appointed actuary was well understood within the company and that the appointed actuary was well placed to perform his or her professional duties; and

(b) to improve the supervisory process by looking at the company's plans prospectively rather than relying on the retrospective view given in the returns to the DTI made under the ICAS Regulations 1983, indicating that officials would wish to discuss with appointed actuaries and senior management the company's business plans over the next five years with particular reference to solvency aspects and any requirements for additional capital.

405 Although discussion at the meetings was mainly to be about actuarial matters, it was indicated that wider issues would be discussed. The letter explained that in order to maintain effective supervision it was becoming increasingly necessary to understand aspects which were not covered in the DTI returns, for example any group corporate structure, any service agreements between the insurance company and any other companies in a group and the sources of the company's business. It was suggested that it would be necessary for the company's senior management, including its chief executive, to be present for at least part of the visit, particularly when business plans and group structure were to be discussed. (The DTI wrote simultaneously to the chief executives of insurance companies enclosing a copy of this letter.)

266 With effect from 1 January 1994, the certificate to be given by the appointed actuary under Schedule 6 to the ICAS Regulations 1983 was required to include a statement (if it was the case) that guidance notes GN1 and GN8 had been complied with, following an amendment made by the Insurance Companies (Accounts and Statements) (Amendment) Regulations 1993 SI No. 946.

267 This proposal was accepted by the actuarial profession and a system for issuing certificates was introduced at the end of 1992. The requirement for an appointed actuary to possess a practising certificate was first referred to in version 4.0 of GN1 issued in 1994 (at paragraph 2.1).

The Government Actuary's view of the role of the appointed actuary in 1990

406 Speaking at a summer school attended by European actuaries in 1990[268], the Government Actuary placed considerable emphasis on the professional role of the appointed actuary in the system of supervision in the UK. In considering the distinctions between the regimes which applied in the UK and in other parts of Europe he said that in the UK there was '*emphasis generally on certification by professionals rather than prescription of rules by the supervisor and detailed checking to see that they were satisfied*'. He noted that the actuary was responsible for determining the mathematical reserves for life business, for ensuring the continuing financial viability of the company, and that the actuary had a major part to play in safeguarding the reasonable expectations of policyholders. He went on to observe that:

> *The Actuary's responsibilities are seen as going well beyond a simple requirement to report in the annual returns to the supervisory authority on his regular investigations into the financial condition of the company. Clearly the Actuary has responsibilities to the company as his principal, but he is also regarded by his profession as having an overriding obligation to the supervisory authority, by reason of his position, which gives him a clear responsibility to safeguard the rights and interests of policyholders. The Guidance Notes envisage that there could be occasions on which the Appointed Actuary might need to advise the DTI directly of a situation where the company is following a course of action which would lead him to qualify a subsequent actuarial certificate. In practice this has happened only rarely but the threat is important in ensuring that company management takes notice of what the Appointed Actuary says.*

The Second Life Directive 90/619/EEC

407 The Second Life Directive of 8 November 1990 (the Second Life Directive) built on the right of establishment in the First Life Directive and was described as supplementary to it[269]. It was primarily concerned with the next stage in the EEC's programme in relation to the freedom to render services, allowing companies based in one member state to offer their services to customers in other member states.

408 In essence, this Directive permitted an insurer to accept unsolicited business (or 'own initiative business') from residents of another EEC state even though the insurer did not hold authorisation in that country. The Directive's description of 'own initiative business' in article 13 included unsolicited intermediary business, but contained an option which allowed the member state to restrict 'own initiative business' to cases where there had been no contact with the prospective policyholder, even via an intermediary.

409 Article 5 of the Second Life Directive amended article 23 of the First Life Directive. It required member states to ensure that their supervisory authorities had the power to supervise cross-border activities of companies within their country, including the power to carry out 'on the spot' investigations at the premises of the company and to take any measures appropriate and necessary to ensure that the company was in conformity with the laws and regulations relevant to it.

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268 See paragraphs 1.6, 3.2, 4.3 and 4.5 of the paper referred to in footnote 91.

269 Although it had a slightly narrower ambit; for example it did not apply to pension fund management.

410 The limited ability provided by the Second Life Directive for insurance companies throughout the Community to accept business from policyholders in other member states was superseded by the implementation of the Third Life Directive which was issued in 1992. However, provisions of the Second Life Directive regarding the law of contract[270] and cancellation[271] were carried over into the Third Life Directive regime.

411 The Second Life Directive was implemented in the UK mainly through amendments to the ICA 1982 introduced by the Insurance Companies (Amendment) Regulations 1993[272] which came into force on 20 May 1993.

Further amendments to ICR 1981 and other subordinate legislation 1985-1990

412 Miscellaneous amendments were made to ICR 1981 in 1985[273]. Those of substance primarily related to the margin of solvency and valuation provisions and introduced a number of refinements, for example to clarify the relationship between the required margin of solvency and the minimum guarantee fund, to amend the calculation of future profits to enable the average number of years remaining on policies to be weighted by reference to the actuarial value of their benefits, as well as dealing with certain reinsurance issues.

413 In 1988[274], consequential amendments were made to ICR 1981 in relation to references to unit trust schemes in the light of repeals and replacement provisions introduced by the FS Act 1986. Amendments were also made to the ICAS Regulations 1983 for this reason[275]. In 1991[276] ICR 1981 was amended in relation to long-term contracts linked to unit trusts, to prohibit the linking of benefits to anything other than authorised unit trust schemes or recognised schemes within the meaning of the FS Act 1986. Schedule 13 to ICR 1981 was also amended in relation to the securities by reference to which benefits under linked long term contracts could be determined[277].

414 Specific rules for the winding up of insurance companies were made in 1985[278] under section 365(1) of the Companies Act 1948 and section 59 of the ICA 1982, to provide for such matters as the identification of assets and liabilities of the long term business and methods of valuation. In 1986 the rules were amended[279] in the light of the enactment of the Insolvency Act of that year.

270 As regards the law of contract, article 4 of the Directive included a default provision that the law of any insurance contract entered into by parties in different member states was to be the law of the member state in which the policyholder had his or her habitual residence (known as the 'law of the member state of the commitment' and defined in article 2(e)), unless the law of the member state permitted the choice of law of another country or the policyholder was an individual and a national of another member state and the parties agreed to choose the law of another country. In the UK this was put into effect by amendments to the ICA 1982 and the Contracts (Applicable Law) Act 1990.

271 Member states were to ensure that policyholders who entered into own initiative contracts were given a period of between 14 and 30 days to cancel unless the contract was for a period of six months or less (article 15). These provisions were implemented in the UK by SI 1993 Nos. 1327 and 1092.

272 SI 1993 No. 174.

273 By the Insurance Companies (Amendment) Regulations 1985 SI No. 1419.

274 The Insurance Companies (Amendment) Regulations 1988 SI No. 673.

275 By the Insurance Companies (Accounts and Statements) (Amendment) Regulations 1988 SI No. 672.

276 By the Insurance Companies (Linked Contracts) (Amendment) Regulations 1991 SI No. 2511.

277 The Insurance Companies Regulations 1981 (Amendment) Regulations 1991 SI No. 1999.

278 The Insurance Companies (Winding-Up) Rules 1985 SI No. 95.

279 The Insurance Companies (Winding-Up) (Amendment) Rules 1986 SI No. 2002.

415 Section 49 of the ICA 1982 regarding sanction of the court for transfer schemes relating to long term business was amended through subordinate legislation with effect from January 1988[280] in order to implement the Directives[281] on mergers and divisions of public limited liability companies in so far as they applied to life insurance companies. The effect was to make certain mergers or divisions where the transferor was a public company subject to Companies Act provisions on compromises and arrangements, in addition to the provisions of the ICA 1982.

416 The Insurance Companies (Amendment) Regulations 1990[282] implemented the Non- Life Directive 88/357/EEC by introducing amendments to the ICA 1982, ICR 1981 and the ICAS Regulations 1983.

Consideration of PRE 1981-1990 and the first report of the F&IA joint working party on PRE

417 As noted above, there appears to have been only limited debate on the meaning and effects of the phrase *'reasonable expectations of policyholders or potential policyholders'* before it was introduced into the legislation in 1973. However, that debate got under way very shortly after the ICAA 1973 was introduced, as illustrated by a note prepared by the DTI on the policy issues arising from the 1973 Act which explained that the reference to PRE '*may present difficulties of interpretation and policy is likely to evolve from cases*'[283].

418 Nonetheless, it was considered that the reference to 'potential policyholders' was important as it demonstrated '*the forward looking use of the powers which is contemplated and implying the desirability of early intervention to secure recovery rather than merely minimising the effects of expected deterioration*'. Notes prepared by GAD in the period leading up to the preparation of the Bill which preceded the ICA 1982 on the need for amendments to then existing legislation confirmed the view that, in interpreting the PRE ground for intervention in relation to long-term business, the Secretary of State was required to look beyond the fulfilment of contractual liabilities to the satisfaction of the additional expectations of participating policyholders. The note then suggested that '*thinking on the issues of policyholders' reasonable expectations has developed further*'[284].

419 Nonetheless, in sections 37(2)(a), 37(6) and 45 of the ICA 1982 the earlier provisions of the legislation on PRE were simply repeated, subject to the new restriction in section 45(2), arising from the requirements of the First Life Directive, in relation to the prohibition on the exercise of the residual PRE intervention power in a manner which would restrict free disposal of assets by the company (subject to limited exceptions).

420 During the 1980s extensive consideration was given by the DTI to the origins and meaning of the term PRE, most commonly in the context of the balance to be struck between the interests of shareholders and policyholders. For example, in 1986 a major insurance company was proposing to change its articles of association to omit the reference to a

280 By the Insurance Companies (Mergers and Divisions) Regulations 1987 SI No. 2118.
281 78/855/EEC and 82/891/EEC.
282 SI 1990 No. 1333.
283 Quotation from the policy note prepared following the passing of the ICAA 1973 included in an internal DTI memorandum dated 18 April 1986.
284 Note prepared by GAD dated 11 January 1980.

90:10 split between policyholders and shareholders. This led DTI officials to undertake research into what the term meant and its origins, although this failed to produce any precise definition and the simple conclusion was reached that the powers were wide ranging and could be used in a variety of circumstances[285].

421 Counsels' opinions were obtained by the DTI in the latter part of the 1980s, generally in connection with PRE in the context of a proposed restructuring by a proprietary life company and concerns about the balance of interests between policyholders and shareholders.

422 Those opinions confirmed what appeared to be the commonsense reading of the PRE provisions, that they were directed at something wider than enforceable legal or equitable rights and that such matters as the company's statements of previous practice could give rise to expectations which were, objectively assessed, 'reasonable'. It was indicated that one matter which a policyholder might reasonably expect was that the balance between policyholders of different classes (and not just the balance between shareholders and policyholders) would not in any substantial respect be altered in a manner adverse to any class[286].

423 Correspondence between officials in the DTI, GAD and the Solicitor's Office during 1988[287] in connection with a draft submission which was being prepared for the then Parliamentary Under Secretary of State for Corporate and Consumer Affairs, shows that an issue had arisen about whether or not section 45(2) of the ICA 1982 (the prohibition on the use of the PRE intervention power in a manner which would restrict the company's freedom to dispose of its assets save in specified exceptional cases) posed an obstacle to the Secretary of State intervening[288] in cases where a proprietary company was increasing significantly the proportion of profits distributed to shareholders.

424 The officials appear to have concluded that section 45(2) should not be interpreted as presenting such an obstacle (although the issue did not appear in the final version of the submissions to the Parliamentary Under-Secretary of State). A number of arguments were put forward to support this conclusion, mainly based on the officials' understanding of the intended effects of article 21.2 of the First Life Directive (from which section 45(2) was derived) and the way in which that provision had been applied in other parts of Europe. A directing actuary at GAD noted[289] that:

(a) he had always considered that article 21 was concerned solely with investments;

(b) like much of the First Life Directive, article 21 was '*a straight carry-over*' from the Non-Life Directive, but the issue of appropriation of profits did not normally arise with non-life business;

[285] Internal DTI memorandum dated 18 April 1986. A later covering note from the then Head of Insurance at the DTI, dated 21 June 1988, re-circulating the 1986 memorandum to other officials who had wished to know what had been said publicly about PRE in the past stated that it would enable the recipients to *'share equally in the poverty of past reference'* to reasonable expectations. A more informative view about the justifiable expectations of policyholders as an objective of actuarial valuation, rather in terms of the statutory meaning of PRE, was contained in the presidential address given by M.H. Field to the Institute of Actuaries in 1986 (JIA 114 (1987) 1-14) referred to in paragraph 429.

[286] Joint Opinion of Counsel, 8 January 1987, paragraph 8(6), page 8.

[287] Dated 21 June 1988; 27 June 1988; 6 July 1988 and 8 July 1988.

[288] For example by way of issuing a direction to the company as to the allocation of surplus between policyholders and shareholders.

[289] In a note dated 21 September 1987 circulated with the memorandum of 6 July 1988 to the DTI.

(c) '[c]*ertainly, the existence of article 21.2 has not prevented other Member States from prescribing limits to the share of profits that may be allocated to shareholders*'.

An adviser in the DTI's Solicitor's Office considered that it '*seemed both legitimate and necessary, in order to give proper effect to the Directives, to interpret the word "assets" in a reasonably restricted way, that is, so as not to include surplus profits available for distribution*'[290]. He was of the view that a very wide interpretation of section 45(2) would '*all but emasculate the section 45(1) power*'[291]. It appears that the DTI did, on occasion, rely on section 45 to prevent the payment of a dividend by an insurance company[292], but it is not known whether or not any of the exceptional circumstances specified in section 45(2) existed when it did so.

425 By 1988 consideration was being given by the DTI, with advice from GAD, to the need for guidelines to be issued on the policy to be applied by the Secretary of State in using the powers of intervention on PRE grounds, what the criteria for their use should be and what should be said publicly.

426 GAD recognised the need for guidelines but considered that there was also a need for flexibility in the exercise of powers and this could be endangered by '*saying too much in public*'. GAD presumed that, in practice, the DTI would only wish to intervene in extreme cases. GAD suggested that in some cases the powers could only be exercised effectively if more formal responsibilities were placed on appointed actuaries[293].

427 GAD later drew attention to the need for issues relating to fairness between different classes of policyholders to be addressed (and not just those between shareholders and policyholders) and predicted that this could be an area in which there would be an increase in the number of cases where the DTI would be asked to intervene on PRE grounds[294].

428 Those deliberations culminated in a memorandum produced by DTI officials for the then Parliamentary Under-Secretary of State, dated 9 September 1988, concerning the criteria for the use of PRE powers (and whether they should be announced). This memorandum included the following points:

(a) the DTI's powers should be used to ensure that policyholder funds were properly managed in accordance with the interests of policyholders (with an equitable balance between policyholders and any shareholders) and that funds were administered prudently and with the level of skill and competence that did not depart significantly from the range which it would be reasonable to expect from the company in the circumstances of the case;

(b) the DTI did not consider, as a matter of law, that policyholders can or should have

290 Memorandum dated 8 July 1988.
291 A further issue raised in the officials' correspondence regarding the proposed contents of the draft submissions to the Parliamentary Under Secretary of State was whether it would be worthwhile exploring with the SIB and LAUTRO the extent to which those bodies would use powers under the FS Act 1986 to prohibit misleading advertising by insurance companies, rather than the DTI attempting to stop such advertising by giving directions under section 45. In a memorandum of 21 June 1988 a DTI official said that he '*would hope that we can leave this role to the SIB/LAUTRO*'.
292 See paragraph 6 of the Treasury's evidence to a House of Commons Treasury Select Committee on Pension Mis-selling in 1998 referred to in footnote 304.
293 Memorandum from GAD to DTI dated 8 July 1988.
294 Memorandum from GAD to DTI dated 8 September 1988.

reasonable expectations of any particular rate of return as such;

(c) the DTI's powers should be used to ensure insurance companies did not engage in practices which are obviously unfair. The position as between various classes of policyholders was mentioned and the example was given of the concern expressed by the supervisory authorities in Australia at the habit of some companies to gear the generosity of their bonuses to the fierceness of the competition for new types of policy. It was suggested that greater financial awareness among consumers could lead to an increased volume of complaints about 'unfairness' and that the Department should not be over-zealous in the pursuit of possible unfairness. It was said that '*there is a large margin of appreciation between fairness and unfairness and we should only consider intervening when the unfairness is obvious and blatant*';

(d) no comprehensive statement on the criteria for use of the PRE powers should be made but there might be advantage in speaking selectively on certain aspects. It was suggested that if companies were led to believe that certain areas of conduct were not, as a matter of policy, to be patrolled closely this might be considered to give them licence. However, it was noted that there could be advantages in making it clear to policyholders that they could not expect a particular rate of return, that it could fall as well as rise in the light of the general investment climate;

(e) a perceived gap in the legislation should be closed. This related to the situation where the company was demonstrably 'able' to meet PRE but chose not to do so; a problem which was described as arising from faulty drafting in the ICA 1982. The memorandum suggested that the legislation be amended to delete the reference to the company being '*unable*' to fulfil PRE, and that this point might join other proposals for inclusion in the Companies Bill which was then contemplated. However, it was acknowledged that this change was not urgent (and it appears that it was never made).

No legislation was pursued as a result of the memorandum to the Minister; nor does it appear that any ministerial announcement on PRE was made at this time.

429 In his presidential address to the Institute of Actuaries in 1986, M.H. Field considered the justifiable expectations of policyholders as an objective of actuarial valuation (JIA 114 (1987) 1-14). He commented on issues surrounding four 'important and justifiable' expectations of policyholders:

(a) that the company was operated soundly and competently, conformed to proper standards of practice, was free of conflicts of interest and had a negligible risk of fraud;

(b) that the company was financially sound, noting that no regulatory system could be absolutely secure and that imposing high standards of financial soundness entailed a cost to policyholders; that maintaining the required solvency margins, for example, could result in a reduction in investment income to the company;

(c) expectations about what the policyholder would receive in terms of a lump sum or pension, observing that those expectations were shaped by companies and their intermediaries, and noting how far products had moved from their origins (of enabling individuals to cope with risk) and closer towards investment products, questioning whether that was really in the interests of the broad mass of the public; and

(d) that risks would be shared by the general body of policyholders and not borne by individual savers (which was important for the general mass of the public who required the protection which life assurance could bring, but were not generally 'sophisticated investors'). He observed that:

> *I regard the with-profits policy as having the potential to be of continuing valuable service to the community, but with so much of the benefit now being subject to discretionary judgements its simplicity and, perhaps its integrity is in jeopardy. I believe we need to restore the balance.*

As far as the monetary expectations of policyholders were concerned, the President concluded that the concept only had meaning at a given point in time. A number of the other comments in his address showed foresight about issues which were to be considered more extensively much later, including the way in which the costs of meeting guaranteed surrender values should be met in financially deteriorating conditions and his observation that the changes in with-profit policies which had then commenced some 25 years earlier had not been tested in '*violently different economic environments*'.

430 In September 1989 the F&IA set up a joint working party of the Faculty and Institute to consider the issue of PRE at the suggestion of the chairman of the Life Assurance Joint Committee[295]. It was said that the issue of PRE had been especially topical in the preceding few months and it seemed likely to be of continuing general interest and of special interest to companies that demutualised or restructured.

First report of the F&IA joint working party on PRE – 25 April 1990

431 The first of the three reports produced by the Working Party between 1990 and 1993 entitled 'Policyholders' Reasonable Expectations' was dated 25 April 1990[296]. The Working Party had set its own terms of reference which related to how PRE had been used in practice, with recommendations to be made on how PRE should be regarded within the UK actuarial profession and whether or not there should be professional guidance as to its interpretation.

432 Rather than deciding what the expression ought to mean, the Working Party conducted interviews and sought opinions from members of the actuarial profession on how PRE had been interpreted in practice. The interviews were conducted on the basis of complete confidentiality. The Working Party also met with officials from the DTI and from GAD. The first report summarised the results of those interviews and appended a history of PRE, a list of references to PRE in legislation and in actuarial literature and a checklist of matters to be considered in respect of PRE.

433 An issue which emerged repeatedly from the interviews was the level of sophistication which it was appropriate to attribute to policyholders in respect of PRE, it being said that the policyholder generally had '*little understanding of the kinds of technical issue raised by PRE*'.

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295 A steering group overseeing the work of a number of working parties, a role undertaken by the Life Board of the F&IA in more recent years.

296 The 1990 report was published together with the two subsequent reports in a document dated June 1993 (it is not apparent from that document whether the first two reports were published individually before 1993).

434 The general view was that PRE should be interpreted in the context of the professional advisers acting for policyholders, the courts, the press and '*similarly well informed observers of the life insurance industry*'. The strong view was expressed that PRE was not exclusively of relevance to with-profit offices but arose, for example, in relation to a decision to increase charges for non-profit policies. It was noted that proprietary offices raised particular issues with PRE because of the potential for conflict between shareholders and policyholders.

435 No instances were found of the Secretary of State invoking his powers to intervene on grounds of PRE[297], but the Working Party understood that there were a number of occasions on which the DTI had advised companies of the steps to be taken to avoid such intervention. The appointed actuaries involved in these cases were interviewed by the Working Party and seven brief examples were given of situations in which PRE considerations had arisen, mainly relating to some form of transfer, merger or restructuring and issues concerning the allocation of surpluses or compensation on a demutualisation. One case related to the closure to new business of a mutual company which was considered to be unable to maintain its current level of bonuses due to inadequate financial resources and entailed consideration of whether, prior to closing for new business, the company had been giving new policyholders reasonable expectations concerning their bonuses.

436 In relation to the concepts and principles that emerged from the interviews, the points made included the following:

(a) many life assurance contracts included at least one discretionary element; policyholders might reasonably expect that a life company would behave fairly and reasonably in exercising any discretion which was available to it;

(b) asset shares[298] should provide the starting point for determining maturity benefits;

(c) it was reasonable to expect that a company would change its policies only gradually in relation to matters which affect the returns to policyholders such as the degree to which returns are smoothed[299] over time or the extent to which part of the asset share is retained to finance future expansion;

297 See paragraph 444 regarding the contents of a draft briefing note for ministers dated April 1992 which indicated that intervention under the residual power to impose requirements to protect policyholders against the risks of failure to meet liabilities or PRE under section 45 of the ICA 1982 had taken place on 19 occasions during 1990 in relation to change of control or financial difficulties of companies (and a further 28 times on authorisation).

298 The conclusions in the joint report suggested that the use of asset shares was '*almost universal*' and implied a link between the use of asset shares and providing equity and meeting PRE. The working party report on annuity guarantees (paragraphs 857 et seq) confirmed that by the time that report was written in 1997, the use of asset shares by life offices as a means of calculating maturity payments was '*almost universal*'. However, other comments in this and the later joint reports on PRE and in other documents suggest that there was no single or accepted means of calculating 'asset shares'. A letter sent by GAD to appointed actuaries dated 9 July 1993 indicated that at that time GAD considered 'asset shares' to be an undefined term of imprecise meaning (see paragraph 531). An explanation of 'asset shares' in a more recent actuarial paper was '*the accumulation of premiums less expenses incurred, allowing for the investment return earned for a group of similar policies. In making the calculations, the asset share would normally be charged for the cost of accruing guarantees, life cover and any capital charges. The asset share is a guideline or benchmark rather than an absolute constraint. In practice, there may be good reasons why a particular group of policyholders should be entitled to more than just asset shares, or in some circumstances less, for example because of the effect of smoothing.*' (Paper presented to the Institute of Actuaries on 25 February 2002 by M. Shelley, M. Arnold and P.D. Needleman). That paper suggests (at paragraph 4.4.5) that, even by 2002, the systems in some offices to calculate asset shares were 'only rudimentary'.

299 A 'smoothing adjustment' would normally be made to 'smooth out' peaks and troughs in investment returns, or where the value of the asset share was significantly different from the actual value of the underlying assets.

(d) the Working Party concluded that PRE for with-profit policyholders extended beyond the relationship between maturity payments and asset shares, to the factors which determined the asset shares. Unusual investment policies or acceptance of high risk policyholders at ordinary rates would risk failing to meet PRE unless the company published its intention to do so;

(e) policyholders and their advisers normally expected continuity in all areas of a company's operations including its bonus philosophy;

(f) in general, gradual changes were more likely to be acceptable to policyholders than major discrete changes; communication with policyholders during the currency of their policies played an important part in shaping expectations and might help to avoid problems;

(g) for with-profits policyholders gradual change was acceptable, particularly if it was communicated to policyholders, whereas sudden change was not;

(h) the consensus among actuaries interviewed was that policyholders should be consulted about any proposed radical change in the way in which the company operated (for example following a major downturn in the company's prospects) and that they should be provided with clear information about the available options, such as closure to new business or operating as a closed fund; and

(i) any major change in the level of discretionary charges or benefits should be regarded as a break in continuity which would warrant consultation with policyholders (as an example, a reduction in the level of bonuses in excess of that justifiable on grounds of deterioration in investment conditions would amount to a major change).

437 The Working Party stated that '*in the final analysis*'[300] it was for the Secretary of State to decide whether a company might be unable to fulfil policyholders' reasonable expectations. Interviews with the DTI and GAD confirmed that there was no predetermined view of where the line between reasonable and unreasonable behaviour lay; each case was considered on its individual facts and circumstances.

438 The report suggested that lower prominence was given to the issue of PRE by appointed actuaries where no '*special circumstances*' applied. In their conclusions, the Working Party noted that in normal day-to-day management of a life office, PRE was '*virtually synonymous with equity*' and the almost universal method of measuring it was in asset share calculations, and that it was '*naturally, widely accepted that there are different ways of calculating asset-shares*'.

439 The checklist of factors to be considered in relation to PRE, set out in Appendix 2 to the first report, referred to such matters as:

(a) the contents of sales literature, policy documents, illustrations and quotations;

(b) maturity values in comparison with the industry as a whole and the past record of the company;

(c) the consistency of a proposed course of action with the practice and performance of the industry as a whole and the past practice of the company;

[300] This, of course, disregarded the role of the courts, for example, on judicial review.

(d) the company's memorandum and articles of association;

(e) the question of whether appropriate importance was being attached to expectations of a '*minimal or non contractual kind*', such as options to extend or convert and surrender values; and

(f) whether the proposed course of action was sound and prudent by the normal standards of the insurance business and fair to different classes of policyholders (and how fairness was to be defined, for example, whether asset shares should be used).

440 The Working Party recommended that the subject did not warrant a 'full professional paper', but that a Guidance Note of an advisory kind would be helpful, comprising a summary of part of the first report[301] and the checklist of factors to consider in relation to PRE. As some form of guidance to actuaries on the interpretation of PRE was considered desirable, it was recommended that it could be provided by publication of the first report after discussion by the profession and amendment as necessary.

[301] Section 3 of the report, parts of which are summarised in paragraph 436 above.

Phase 4: 1991-1993

Practice regarding exercise of supervisory powers by the DTI in the early 1990s

Draft briefing paper for ministers

441 A 'snapshot' of the practical position regarding the exercise of supervisory powers by the DTI prior to the introduction of the changes which took place during this phase is provided by a draft briefing paper prepared by the DTI for new ministers dated 7 April 1992[302].

442 The stated purpose of the paper was to explain to ministers the action which was taken in the name of the Secretary of State under the ICA 1982 on a regular basis, because ministers might be asked to give advance approval in serious or controversial cases and because there were considered to be some gaps and weaknesses in the powers which ministers were to be asked to remedy, including by way of new legislation.

443 The paper explained that the DTI's fundamental aim was to protect policyholders and identified the two main approaches behind its work as being the monitoring of solvency of insurers and preventing those who were not fit and proper persons from controlling or managing insurance companies.

444 A table annexed to the paper showed how often the different types of main intervention power (encompassing authorisation) had been used in (then) recent years (apparently in relation to all classes of insurance business subject to the ICA 1982). For example, the table showed:

(a) that during 1990 the residual power to impose requirements for protection of policyholders under section 45 had been used 28 times on authorisation[303], 9 times on change of control and 10 times when financial difficulties had been encountered by a company. It was explained that in recent years the section 45 power had been used for temporary withdrawal of authorisation to write new business, as exercise of the power under section 11 of the ICA 1982 resulted in a permanent withdrawal of authorisation[304];

(b) the powers under section 38 to prohibit investments of a particular kind or to require the realisation of investments, the powers to limit premium income under section 41 and those to obtain information under section 44(1) were all said to have been '*routinely used*', but predominantly on authorisation;

(c) the power for the Secretary of State to petition the court for the winding up of an insurance company under section 54 had been used only 9 times since 1979; it was noted that such action was rarely necessary as the company's directors or creditors normally took action in the event of insolvency;

(d) withdrawal of authorisation under section 11 was said to be '*threatened several times a year*'. It was noted that where such action was contemplated in relation to a director who had been found to be unfit, the person usually resigned so the power did not actually need to

302 By an official of Branch 1 of the Insurance Division of the DTI, which was responsible for such matters as authorisation.
303 A handwritten note indicated that this comment related to limiting transactions with connected persons.
304 A supplementary memorandum produced by the Treasury several years later, in 1998, to respond to questions from a House of Commons Treasury Select Committee on Pension Mis-selling, gave further examples of the use of the power as being to prevent a company from paying a dividend and the control of disbursement of assets released from custody. The supplementary memorandum includes the observation that the effect of section 45 was far greater than the formal exercise of the power suggested in that, in practice, companies discussed with the DTI proposed significant changes which might affect policyholders with the result that potentially unacceptable proposals were abandoned or modified, making the actual exercise of the power unnecessary.

be used. It was suggested that the one month delay to allow for representations where such action was contemplated was a handicap in a financial crisis; and

(e) it was explained that where confidential investigations were undertaken in relation to a company, the powers to secure the production of books and papers under section 447 of the Companies Act 1985 were generally preferred to those under section 44(2) of the ICA 1982 (if the insurance company was subject to the Companies Act 1985) as the powers under the Companies Act were wider.

445 The figures given in the table annexed to the draft briefing paper in respect of the year 1990 are consistent with those shown for that year in a table produced by the Treasury in 1998 as part of its evidence to a House of Commons Treasury Select Committee on Pension Mis-selling. The table produced by the Treasury in 1998 shows the frequency of exercise of powers of intervention over the years 1985 to 1997 and is reproduced as Appendix B.

446 In relation to the power to prohibit a company from writing new business (under section 11 of the ICA 1982) it was noted that there was no formal power to suspend underwriting, only permanently to prohibit it, although suspension could be achieved with the agreement of the company concerned. It was said that a power to suspend authorisation would be useful to enable reorganisations to take place or to allow swifter protective action (since this required one month's notice under the statutory procedure).

447 As regards objections to managing directors, chief executives and other 'controllers', the briefing paper stated that there was no power to force divestment of shares or to secure changes in the management of a company. It was said that this could only be achieved by threatening to stop the company from writing any more business, but that this was not an effective mechanism in cases where the company had already had its authority to effect new contracts withdrawn[305].

448 In describing the use of the powers under the ICA 1982 the draft paper stated:

> *It is well known in the UK industry that we do not use these powers lightly or in any way capriciously. But it is equally well known that we are fully prepared to use these powers if circumstances warrant. In taking intervention action we have to balance the danger of damage caused by premature action against the risk of acting too late. Experience in the last few years has tended to swing the balance of advantage towards earlier and more decisive action.*

449 The draft paper stated that the DTI did not normally disclose to the public the action taken in relation to a particular company as to do so could adversely affect the company and make it more difficult for it to restore a sound financial position, which in turn would be contrary to the interests of policyholders. It was said that this approach sometimes led to unjustified criticism of the DTI for inaction.

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305 The involvement of an unfit person in an insurance company as a director, controller, manager or main agent constituted a ground for refusal of authorisation under section 7(3) of the ICA 1982 and for the exercise of certain of the Secretary of State's powers of intervention under section 37(2)(e) of the ICA 1982 (see paragraphs 313 et seq regarding section 37 of the ICA 1982 and paragraph 76(e) regarding the predecessor provisions of section 12(1)(e) of the ICAA 1973).

Policy Guidance Notes

450 From September 1991 onwards, the DTI began to issue a new series of 'Policy Guidance Notes'[306] to its staff at Executive Officer (EO) level and above. Copies of the Guidance Notes were also issued to the DTI Solicitor's Branch B1 (referred to as 'Sols B1') and to GAD.

451 The series of Policy Guidance Notes was produced as a result of recommendations made in a '*DTI Insurance Division Business Review and Information Systems Strategy Study*' which had been carried out in 1990 by an actuarial and management consulting firm. The study had suggested that guidelines should be drawn up to help staff in areas of supervision where significant judgmental decisions were required. The guidance was intended to help staff where '*important and publicly visible decisions*' were required, such as the issue and withdrawal of concessions and requirements and decisions on the admissibility of assets, and to meet a perceived need for greater consistency in decisions made which might affect the operations of individual companies. The stated aim was that:

> *The Department should operate, and should be seen to operate, a firm but fair regulatory regime in respect of UK authorised insurance companies. The "message" to the industry and to the public should be that the Department is watching very carefully and is likely to err on the side of caution rather than adopt a relaxed attitude, particularly toward companies in difficulties.*

452 Individual Policy Guidance Notes (or 'Guidelines') were issued on all the main areas of regulation such as authorisation, annual returns, assets and liabilities, failure to maintain solvency margins, intervention powers, concessions (orders under section 68 of the ICA 1982), disclosure and winding up. In general, each of the guidelines followed a common format which included a summary of the relevant legislation and comments on 'best practice'.

453 A section of the Guidelines[307] dealt with the allocation of responsibilities for policy issues between Branches of the DTI and on obtaining advice from GAD, the Solicitor's Office and 'industry experts' in the DTI. Another section contained Guidelines on the Policyholders Protection Act 1975 and the division of responsibility for parts of that Act within the DTI and the circumstances in which information should be provided to the Policyholders Protection Board established under that Act[308].

454 Section 8 of the Policy Guidance Notes contained Guidelines on the Secretary of State's powers of intervention. It included individual Guidelines which provided a general overview of the intervention powers (Guideline 8.1); general guidance on 'notice of requirements' (8.2); guidance on each of the main intervention powers other than the residual power to protect policyholders under section 45 of the ICA 1982[309] (8.3-8.8) and a Guideline entitled 'Non Statutory Intervention' (8.10). These Guidelines were said to have been based on advice from the Solicitor's Branch or prepared by that Branch.

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306 These replaced an earlier series of Policy Guidance Notes for staff, dating back at least to the time of the ICAA 1973 and were a separate series of documents to the *Prudential Guidance Notes* issued by the DTI to insurance companies (of which those issued from 1994 onwards are mentioned in paragraphs 715 et seq.). Both the internal and external series of notes were, on occasion, referred to in documents as 'PGNs' but in this Part of my report this acronym is used to refer to the Prudential Guidance Notes issued by the DTI externally, to insurance companies.

307 Guidelines 1.1 to 1.6.

308 Guideline 15.1.

309 It appears that an intended Guideline 8.9 on residual intervention powers under section 45 of the ICA 1982 was not issued.

455 Guideline 8.2 explained the legal, procedural and policy requirements in relation to service of 'notice of requirements', which constituted the means by which the Secretary of State's powers of intervention were initiated. Standard draft notices of requirements were included in relation to each of the intervention powers.

456 A Precedents Register was required to be maintained, to include details of unusual requirements which had been imposed, advice received and the background to decisions taken, for reference in subsequent cases. In addition, a record was to be maintained (in a pro forma provided) of the number of occasions on which the powers in sections 38-45 of the ICA 1982 had been used, to enable publication of an Insurance Annual Report.

457 Guideline 8.10 on 'Non-Statutory Intervention' dealt with forms of action which might be taken by the regulator which fell short of the actual exercise of intervention powers under the ICA 1982. The Guideline gave guidance on such action by the DTI as:

(a) accepting undertakings from companies (for example, not to write new business) rather than invoking intervention powers;

(b) suggesting a course of action to a company to alleviate a regulatory concern;

(c) expressing an opinion on the interpretation of legislation (subject to the caveat that only the Courts could decide this);

(d) notifying a new company that its business activities constituted unauthorised insurance business and requesting that those activities cease, rather than mounting a statutory investigation;

(e) requesting information from a company beyond that required to be provided under the Act; and

(f) notifying the appropriate professional body of unprofessional conduct by accountants, lawyers or actuaries.

458 Although described in the Guideline as 'non-statutory' forms of intervention, in the main the examples given might properly be characterised as implicitly authorised under the ICA 1982 (or as being an essential prerequisite to formal action). In some circumstances, certain of these forms of action may have been expressly authorised by the residual power under section 45 of the ICA 1982 to require the company to take action to protect policyholders or potential policyholders.

459 Guideline 10.2, dated July 1992, dealt with disclosure to and liaison with other UK regulators, giving guidance on when and how information or allegations about companies or individuals should be passed on. The principal 'other regulators' were identified as being the SIB and the SROs which, along with the Bank of England and the DTI, participated in a 'College of Regulators'[310]. Guideline 10.2 included the following points:

(a) There was no statutory obligation on the DTI to disclose information to other regulators, but rather there were restrictions under common law[311] and statute[312] (and there were criminal

310 Which provided for co-operation in the supervision of financial conglomerates which were subject to regulation by more than one of the members of the College and nominated a 'lead regulator' (based on the dominant activity of the group concerned) who would call meetings of other members concerned with that group if the need arose.

311 Particularly in relation to confidentiality.

312 See for example paragraph 605 and the footnote thereto regarding section 47A of the ICA 1982. A less extensive restriction on disclosure of information obtained by the relevant government department in relation to insurance companies had formerly been included in section 111 of the Companies Act 1967.

sanctions for disclosure of information in contravention of the statutory requirements).

(b) There were exceptions to the statutory restrictions, but these were 'extremely complex' and advice on disclosure should always be sought from lawyers.

(c) Liaison with other regulators aided the exercise of such functions as supervision of solvency and ensuring that notified persons (i.e. people who had been proposed for or who had recently filled notifiable positions in insurance companies) were fit and proper and that authorisations were properly granted.

(d) The DTI's objectives were to avoid regulatory failures because an issue or company (or group of companies) fell between regulators and to prevent unfit people moving from one regulated area to another.

(e) As 'best practice', when staff in the DTI had adverse information about an individual or a company they were to consider whether there were any circumstances which made it likely that the information would be relevant to other regulators.

(f) The DTI and the SIB had entered into an agreement in April 1991 relating to the exchange of information on investment business (which was annexed to Guideline 10.2), which required both regular and ad hoc exchanges and provided for information to be exchanged between the SIB, SROs and the DTI in such circumstances as doubts about the integrity or competence of management, doubts about the financial soundness of a company in which the regulators had a mutual interest or cases where the use of formal investigation, disciplinary or intervention powers were being considered. The letter from the SIB dated 19 April 1991 annexed to the Guideline, which set out the agreed framework, stated that in relation to a list of named insurance companies[313] the DTI on the one hand and the SIB or the SRO of which the company was a member on the other, would 'normally' inform the other and discuss appropriate action (if any) to protect investors if one of the parties became aware of information *'which appears to it likely to be relevant to the discharge of the supervisory functions of the other'*.

(g) Regular exchanges of information took place about notified persons through a list which was circulated 'widely internally' by the DTI and externally to GAD, the SIB, Lloyd's, the Stock Exchange and the Bank of England.

(h) Where allegations were received about possible improprieties by a person active in the businesses of concern to the regulators, a decision was to be made at or above a specified level (Grade 7) about whether or not that information should be passed on to other regulators.

(i) GAD might be the recipients of allegations which they would pass on to the DTI for action.

(j) Companies would not normally be aware of the exchanges of information which were taking place.

460 The Policy Guidance Notes did not provide instruction or guidance on the examination of annual returns, which was said to be provided in other ways.

[313] Which included Equitable.

Internal teaching material for DTI staff

461 Further insight into the DTI's view of the regulator's powers in the early 1990s is provided in teaching material prepared for DTI staff which was copied to various officials in the DTI in an abbreviated form in 1991[314].

462 The teaching paper contained a commentary on the individual powers under the ICA 1982 and the grounds for their exercise and included a blend of technical and practical advice on the circumstances in which the powers of intervention could be invoked. The paper highlighted distinctions between the use of the powers for life companies and general business companies. It also provides an indication of the regulator's interpretation of the legislation and certain aspects of the policy for applying it in the early 1990s.

463 The paper addressed the Secretary of State's powers of intervention in two categories:

(a) first, those which were exercisable on the (more general) grounds under section 37(2) of the ICA 1982[315], namely the intervention powers relating to investments (section 38); limitation of premium income (section 41); actuarial investigations (section 42); acceleration of annual returns (section 43); supply of information (section 44(1)) and the residual power to take action to protect policyholders (section 45[316]); and

(b) secondly, those which entailed imposing a restriction on the free disposal of assets by a company and were only exercisable on the more restricted grounds under section 37(3)[317], namely intervention in the form of requirements for the maintenance of assets in the UK (section 39) and custody of assets (section 40).

464 In relation to the first group of intervention powers, practical points made in the teaching paper included:

(a) a requirement under section 38 regarding the investment (or realisation of investments) in specified assets was included '*for practically all companies subject to notices of requirement*';

(b) the power under section 41 to limit the amount of premium income a company could receive was considered to be '*imperfect*'; it was difficult to monitor because the drafting of the section did not include a definition of the premium income to which it applied, it was not clear whether a limit could be imposed on both gross and net premium income, and a limit on premium income which was designed to control the growth in liabilities could not take account of price movements (such limits normally being applied for a three year period, during which prices could change considerably);

(c) section 43, under which the Secretary of State could require a company's annual returns and other documents to be submitted earlier than their normally due date was '*not used very often*' and did not feature in the standard notice of requirements; and

314 With a memorandum from an official of I4 Branch of the DTI's Insurance Division dated 16 December 1991.
315 Referred to in paragraphs 315 et seq.
316 Section 45 was included in the first category of powers, although the section itself contained limitations on its use in such a way as to impose a restriction on the free disposal of assets.
317 Referred to in paragraph 314.

(d) the power to require an insurance company to provide specified information under section 44(1) was considered to be extremely useful because it was flexible and covered a very wide range of information. The power was used to require quarterly returns and information to be submitted. It was noted that requests for information had to be 'reasonable' and justifiable, requiring no more and no less than was needed to monitor the company.

In relation to the residual power under section 45, the paper simply outlined the limitations on its use in a manner which would restrict free disposal of assets (under section 45(2)) and its exclusion in cases where other powers could be relied on (by virtue of section 37(6)).

465 In relation to the grounds, under section 37(2), for exercising the first group of powers the paper included the following points:

(a) if reliance was to be placed on the first limb of the ground in section 37(2)(a)[318], '*there should actually be a tangible risk that the company may go broke i.e. there needs to be some evidence pointing to financial failure in the foreseeable future*';

(b) in relation to the second limb of the ground in section 37(2)(a)[319] it was simply said that this criterion of risk was '*even more difficult and intangible*';

(c) the ground in section 37(2)(b)(i)[320] was '*very wide indeed*', covering not only failure to satisfy a requirement of the ICA 1982, but any requirement of the regulations made under the Act or imposed on a company in a notice of requirements;

(d) section 37(2)(c)[321] was also a very wide and flexible provision, enabling the Secretary of State to intervene where a company had supplied misleading or inaccurate information under the ICA 1982, the regulations made under that Act or pursuant to a notice of requirements;

(e) assessment of whether or not any reinsurance programme was adequate or even necessary for the purpose of the ground in section 37(2)(d)[322] could in itself be a difficult question, probably requiring advice from the DTI's industry experts; and

(f) in relation to the ground for intervention based on the involvement of an unfit director or manager under section 37(2)(e)[323] it was stressed that a preliminary notice under section 46 must be served on the director or manager concerned, allowing that person to make written representations (to the Secretary of State) and/or oral representations (to an officer of the DTI); '*this is to allow the unfit person an opportunity to convince us that he is not unfit or, alternatively if he fails in doing so or not does not wish to try, the opportunity to resign*

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318 That the exercise of the power was desirable for protecting policyholders or potential policyholders against the risk that the company might be unable to meet its liabilities.
319 That the exercise of the power was desirable, in the case of long term business, to fulfil the reasonable expectations of policyholders or potential policyholders.
320 Relating to the failure of a company to satisfy an obligation to which it was subject by virtue of the ICA 1982 or the former legislation.
321 The ground concerning instances where it appeared to the Secretary of State that the company had furnished him with misleading or inaccurate information under or for the purposes of the ICA 1982 or the former legislation.
322 That the Secretary of State was not satisfied that adequate reinsurance arrangements were in force or would be made.
323 Described as being the *'most likely'* reason for relying on section 37(2)(e), which was based on a number of specified grounds on which authorisation of a company might be refused if applied for.

without the company necessarily knowing what has happened'. It was pointed out that the subsequent notice required to be served on the company under section 46(2) must contain the same details in relation to the grounds for potential intervention as those which had been given in the initial notice served on the director or manager.

466 The paper noted that the second group of intervention powers were used much more rarely than the first group, but this had not always been the case. Until the limitations had been imposed in the late 1970s (through the First Non-Life Directive), on the use of forms of intervention which had the effect of restricting the free disposal of assets other than in limited circumstances, maintenance of assets and custody of assets requirements had 'invariably' been included in notices of requirements served on newly authorised companies or which had been subject to a change of control.

Proposals for modernisation of insurance legislation outlined by the DTI in 1991

467 A memorandum prepared by an official of I4 Branch of the DTI dated January 1991 to other officials in the DTI and GAD suggests that some of the legislative changes made in later years had their origins almost a decade earlier.

468 In particular, in 1991 it was suggested that there were arguments in favour of taking insurance regulation out of a government department and vesting it in '*a Commission or whatever, probably encompassing Friendly Society regulation as well*' and that there were various options for '*sweeping up the landscape*' of financial regulation which might or might not include insurance regulation. The memorandum explained that it was an attempt to summarise the topics that might be included in future legislation given '*unlimited Parliamentary time and a free policy rein from Ministers*'. Points made in that memorandum included:

(a) there was uncertainty about whether or not new training programmes and a new Branch 1 structure would turn generalist civil servants into professionally competent enough regulators;

(b) when considering the powers the insurance regulator should have, it was necessary first to decide whether the regulator should be a body which was reactive and answerable to Parliament or proactive and answerable to the courts;

(c) a radical modernisation of the ICA 1982 would entail '*tear*[ing] *up the series of express powers exercisable in defined circumstances with a sweep up residual power of limited use*' and replacing them with a discretionary power, under which continued authorisation would be subject to such conditions as the regulator saw fit to protect the interest of investors;

(d) officials had prepared a paper to compare the two approaches, but in the event there had been no prospect of a bill long enough to modernise insurance legislation and the then Minister for Corporate Affairs had ruled out a radical restructuring;

(e) the submission eventually sent to the Minister by officials had proposed far more limited changes (including a power to suspend authorisation, placing assets in trust if the minimum solvency margin was breached, forcing divestment of shares and removing voting rights of shareholder controllers)[324], but

[324] These proposals had been included in a memorandum from the then Head of the DTI's Insurance Division to the Minister dated 10 October 1990.

the Minister had decided against any amendment, his broad approach being that the DTI had adequate leverage against companies and should act robustly;

(f) the DTI had given consideration to tightening up requirements for proper management and control systems in insurance companies, but had decided that existing requirements were adequate;

(g) the DTI was working with auditors to explore ways of improving the quality of audit and it was suggested that auditors should be placed under an obligation to disclose to the DTI any concerns about their clients, or to require them to report to policyholders as well as to shareholders;

(h) it was suggested that the regime for charging fees should be revised so that the DTI could recover all its costs; the Minister wished to see specific fees charged on authorisation and on notification of changes of control.

Other views on the regulatory regime expressed by the Minister in the early 1990s

469 In a letter dated 22 May 1991, the then Minister for Corporate Affairs described the residual power to take action to protect PRE (under section 45 of the ICA 1982) as being:

> *... designed primarily to protect the position of 'with profits' policyholders, a substantial part of whose benefits are payable at the discretion of the company, as a terminal bonus to which they have no contractual right.*

470 At a meeting with officials from the DTI and GAD on 24 July 1991 to discuss the submissions they had made to the Minister in relation to various companies which were then causing concern[325], the Minister emphasised the importance of the DTI operating and being seen to operate a firm but fair regulatory regime.

471 In his view, the message to the industry and to the public should be that the DTI was watching very carefully and would be likely to err on the side of caution, rather than adopt a relaxed attitude to companies in difficulties. It was noted that the system for reviewing annual returns was being revised to make it more effective in identifying likely risks and that one of the priorities was major companies. The Minister welcomed this, but expressed concern that the returns could only provide a historic picture of the company, seven months earlier[326].

472 In a letter from the Principal Private Secretary to the Secretary of State for Trade and Industry to the Permanent Secretary at the DTI dated 9 January 1992 it was said that the Secretary of State and the Minister for Corporate Affairs remained concerned that the regulators were '*still not concentrating*

[325] Recorded in a memorandum from Principal Private Secretary to the Minister dated 2 August 1991.

[326] An issue which GAD was seeking to address through its rolling programme of visits to appointed actuaries (see paragraphs 404 and 405). GAD also stressed the importance of considering the financial position of a company 'dynamically' to identify potential future problems (see, for example, paragraph 366). A paper given by a GAD actuary at a meeting in Brussels on 23 April 1993 described the UK supervisors' role in examining returns to check for compliance with the legislation, the existence of adequate technical provisions and the required margin of solvency at the year end as being only *'part of the story'*. He said that although the supervisors in the UK were not directly concerned with premium rates, they worked with appointed actuaries to examine the impact of factors such as future expenses and assumed levels of sales on the ongoing financial viability of an insurer. Further, the encouragement to companies to use dynamic solvency techniques (paragraphs 825 et seq) was intended to ensure that insurers were themselves looking forward to risks which might emerge in the future and planning how they might react to them.

enough on "detective work", i.e. proper targeted action in that minority of cases where the warning signs are clear'. Citing the Maxwell case as an example, it was said that it was noticeable that no one regulator had accepted responsibility for looking at the whole picture and no one regulator seemed to have reacted quickly or positively enough in another identified area of concern (equity release schemes).

Freedom with publicity

473 In describing the UK regulatory regime, actuaries from GAD and officials from the DTI continued to make reference to the underlying philosophy of 'freedom with publicity' or variations on that theme. Speaking in 1990, the then Government Actuary suggested that in some ways the system might better be described as 'freedom with responsibility'.

474 Within certain constraints, companies were given freedom as to the type of policies they could write, the premiums charged, investments made and the way in which they carried on business. However, information about their business, income and expenditure, assets and solvency had to be provided in their statutory returns to the DTI and was then placed on public record for anyone to refer to.

475 The then Government Actuary explained that '[i]*n principle, the information which is publicly available should be sufficient to permit another actuary to make an evaluation of the financial state of the company and to estimate the probable level of the future profits which could be attributable to policyholders*'. (See further, paragraph 563 in relation to the concept of freedom with publicity or 'freedom with disclosure', as explained to the Minister in 1994.)

The regulator's approach to discounting, financial reinsurance and complex financial arrangements used by some insurance companies

476 Some insight into the general approach the DTI adopted to the regulation of the use by some insurance companies of complex financial techniques is contained in a draft paper prepared for the then Director of the Insurance Directorate at the DTI, for a speech to be given at a meeting of the (American) National Association of Insurance Commissioners in 1992.

477 The draft paper appears to be directed at issues which had been of particular concern in the context of general insurance, but the observations regarding the proper classification and treatment of reinsurance contracts, the need for transparency by insurance companies and for the regulator to understand the reasons behind transactions are of wider significance.

478 The paper sought to acknowledge the commercial reality of insurance business. It referred to the practice of some insurance companies to choose some combination of explicit discounting (where this was permitted) and financial reinsurance (where reserves could be established net of reinsurance), or implicit discounting or simply under-reserving, if the other approaches were not available or were thought to be a sign of financial weakness. The paper went on to address the way in which regulators should respond to the use of such financial arrangements.

479 It was suggested that the regulator should allow companies to operate in the 'real world', permitting them to set reserves which properly reflected the 'time value' of money, but at the same time the regulator should ensure that this freedom was not abused so as to allow companies to present a '*distorted or over-optimistic picture*'.

480 In particular, the regulator should seek to ensure that companies were not encouraged, or forced, into unnecessary and expensive arrangements which left them reliant upon offshore reinsurers whose security could not be properly assessed or which were simply opaque. The paper outlined a concern that too close regulation could be counter-productive, potentially having the effect of driving insurance companies into engaging in more complex (and undesirable) transactions, simply to circumvent the rules.

481 The UK regulator's approach was illustrated by reference to the line the UK had adopted in negotiations over the preparation of the EC insurance companies accounts directive (Council Directive 91/674/EEC of 31 December 1991, referred to in paragraphs 540 et seq).

482 The draft paper noted that in the course of those negotiations, the UK had faced the almost totally unanimous view that discounting was imprudent and should be prohibited, but the UK had managed to overturn that view so that discounting was eventually permitted, subject to safeguards. The UK had argued that a ban on explicit discounting would have the effect of either forcing companies to rely on implicit discounting or to rely on financial reinsurance which suffered from '*the disadvantage of expense and obscurity*'.

483 It appears that of the alternatives, discounting was considered to be the 'lesser evil'. The draft paper suggested that within prudent limits and with proper disclosure of the assumptions used, discounting was less risky, easier for the market and the regulator to understand and less expensive for the company. If financial reinsurance was to be used, there should be sufficient information in the company's accounts to enable the reader to reconstruct the financial position of the company before the reinsurance was taken into account. Otherwise there could be no guarantee that reinsurance was not being used to present an unduly favourable, or even misleading, picture.

484 The draft paper concluded with the view that:

> *When companies engage in complex, expensive and opaque transactions it is imperative that the regulator should understand why. If he finds it is to circumvent his own regulations he needs to be even more alert. It may be a sign of weakness or wickedness on the part of the company. Or it may be a sign that his own regulations are inconsistent with commercial reality. If it is the latter then extending the scope of the rules may simply result in even more ingenious, expensive and impenetrable devices to get around that too. Regulators must live in the real world too.*

The Third Life Directive 92/96/EEC

Introduction

485 The aims of the Third Life Directive of 10 November 1992 were to complete the internal market in life insurance both as regards freedom of establishment and freedom to provide services, to make it easier for assurance undertakings with head offices in the Community to cover commitments (including life assurance and annuities) situated anywhere in the Community and to provide consumers with the widest possible choice of life assurance products.

486 This Directive applied to all the insurance activities covered by the First Life Directive (and is also known as the 'Framework Directive'). It was repealed (with the successive amendments which had been made to it) by a further Life Directive 2002/83/EC[327].

[327] Of 5 November 2002.

487 The preamble to the Third Life Directive states in paragraphs 5 and 10 that:

> *... the approach adopted consists in bringing about such harmonisation as is essential, necessary and sufficient to achieve the mutual recognition of authorisations and prudential control systems, thereby making it possible to grant a single authorisation valid throughout the Community and apply the principle of supervision by the home Member State ...*
>
> *... the competent authorities of the Member States must have at their disposal such means of supervision as are necessary to ensure the orderly pursuit of business by assurance undertakings throughout the Community whether carried on under the right of establishment or the freedom to provide services ... , in particular, they must be able to introduce appropriate safeguards or impose sanctions aimed at preventing irregularities and infringements of the provisions on assurance supervision.*

The 'single passport'

488 The major change made by the Third Life Directive was to introduce a system of authorisation by the state in which the head office of the insurance company was based (the 'home Member State'), which was to apply throughout the Community[328], sometimes known as the 'single passport' for insurance companies.

489 Other member states were not to require a company which held such authorisation to be authorised by them in order to do business within their country, subject to a procedure under which the company was required to notify the authorities in its home state if it wished to establish a branch in another member state[329].

490 Financial supervision became (virtually) the sole responsibility[330] of the home member state, which was required to monitor the '*financial health of assurance undertakings, including their state of solvency, the establishment of adequate provisions and the covering of those provisions by matching assets*'[331].

491 The 'host state'[332] was required to notify the home state if it had reason to consider that the company's activities might affect its financial soundness[333]. Article 15 of the First Life Directive, as amended by the Third Life Directive, provided:

> 1. *The financial supervision of an assurance undertaking, including that of the business it carries on either through branches or under the freedom to provide services, shall be the sole responsibility of the home Member State. If the competent authorities of the Member State of the commitment have reason to consider that the activities of an assurance undertaking might affect its financial soundness, they shall inform the competent authorities of the undertaking's home Member State. The latter authorities shall determine whether the undertaking is complying with the prudential principles laid down in this Directive.*

328 Article 4, amending Article 7 of the First Life Directive.
329 Article 32, amending article 10 of the First Life Directive.
330 Article 8, amending article 15 of the First Life Directive, which stated that such supervision was to be the *'sole responsibility'* of the home member state.
331 Preamble, paragraph 7.
332 This expression is not used in the Directive.
333 Article 8, amending article 15 of the First Life Directive.

2. *That financial supervision shall include verification, with respect to the assurance undertaking's entire business, of its state of solvency, the establishment of technical provisions, including mathematical provisions, and of the assets covering them, in accordance with the rules laid down or practices followed in the home Member State pursuant to the provisions adopted at Community level.*

3. *The competent authorities of the home Member State shall require every assurance undertaking to have sound administrative and accounting procedures and adequate internal control mechanisms.*

492 The Third Life Directive extensively modified the regimes under the First and Second Directives. It abolished the 'own initiative' provisions by introducing the concept of 'home state' authorisation (subject to compliance with the notification provisions). It also greatly simplified the Second Life Directive's provisions concerning transfer of an insurance company's portfolio of contracts to another member state.

Domestic measures to safeguard the 'general good'

493 The Third Life Directive allowed host states to continue to implement certain of their domestic measures aimed at safeguarding the 'general good', specifically those prohibiting the sale of insurance contracts which conflicted with provisions of the domestic legislation protecting the general good[334] and those requiring companies to comply with the requirements of domestic legislation concerning the form and content of advertising adopted in the interests of the general good[335].

Authorisation, 'sound and prudent management' and 'qualifying holdings'

494 The conditions for authorisation in the First Life Directive were largely unchanged. However, there was an additional requirement for the company to be run by persons of good repute with appropriate professional qualifications or experience (which had formerly been an optional condition) and prior approval or 'systematic notification' of policy conditions, premium scales and technical bases for calculations, was no longer a permissible pre-condition of authorisation[336].

495 Authorisation was not to be issued by the home member state before it had been informed of the identities of any shareholders or members who held 'qualifying holdings' in an insurance company (broadly, holdings of 10% or more of the capital or voting rights or other holding providing a significant influence over the management of the business). Authorisation was to be refused if '*taking into account the need to ensure **sound and prudent management** of an assurance undertaking,* [the competent authorities] *are not satisfied as to the qualifications of the shareholders and members*'[337].

496 The home member state was to be notified of and to monitor the suitability of anyone wishing to acquire a 'qualifying holding' in an insurance company. The competent authorities of that state were given a maximum of three months from the date of such notification to oppose the proposal if, '*in view of the need to ensure sound and prudent management of the assurance undertaking*', they were not satisfied as to the qualifications of the person proposing to take that holding. Other member states could require the home state to

334 Article 28.
335 Article 41.
336 Article 8.3 of the First Life Directive as replaced by article 5 of the Third Life Directive.
337 Article 7 of the Third Life Directive; the implications of this requirement for the UK legislation are set out below.

take appropriate measures where the influence exercised by those with qualifying holdings operated to the detriment of the '*prudent and sound*' management of the company[338].

Restrictions on free disposal of assets

497 In relation to the restrictions on the free disposal of assets[339], an additional circumstance was prescribed in which this might be permitted. In exceptional circumstances, if the competent authority was concerned that the financial position of an insurance undertaking would further deteriorate, such a restriction might be imposed where the solvency margin had fallen below the minimum required by article 19 of the First Life Directive (in the UK legislation, the margin of solvency under section 32 of the ICA 1982), rather than only once the solvency margin had fallen below the lower level of the 'guarantee fund' under article 20 of the First Life Directive (in the UK legislation, the minimum margin under section 33)[340].

Harmonisation and protection of consumers

498 Many issues were harmonised in order to make supervision by the 'home authority' consistent and with the aim of providing the same level of protection for consumers in every member state. These harmonisation measures included changes to the assets which could be used to provide cover for technical provisions, a requirement of localisation of assets anywhere within the Community (rather than in particular member states) and changes to the rules on valuation of assets and determination of liabilities. Clear and accurate information had to be provided to policyholders on a range of matters specified in Annex II.

Assets to provide cover for margin of solvency – subordinated loans or 'hybrid capital'

499 Changes were introduced to the assets which could be used to provide cover for the margin of solvency[341]. In particular, the value of subordinated loan capital and cumulative preference share capital could be taken into account, but only up to 50% of the margin, with no more than 25% to consist of subordinated loans with a fixed maturity, or fixed term cumulative preference share capital and subject to a number of conditions regarding the terms of the instruments.

500 For example, under a subordinated loan agreement, the lender's claims on the insurance company were to rank entirely after all non-subordinated creditors and the agreement could not provide for early repayment, other than on the winding up of the insurance company.

501 The change under the Directive in relation to the use of such loans to provide cover for the margin of solvency did not result in any amendment to the legislation in the UK to permit this.

502 Instead, arrangements were put in place under which companies could apply to the Secretary of State for an order under section 68 of the ICA 1982 to permit the use of a subordinated loan to provide such cover in an individual case. These arrangements, including the intended effect of an order made under section 68 in these circumstances, were set out in a 'Prudential Note 1994/1 – Hybrid Capital: Admissibility for Solvency' issued by the DTI which is referred to in paragraphs 530 et seq.

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338 Article 14.4 of the Third Life Directive.
339 See paragraph 230 in relation to the First Life Directive.
340 Articles 12 and 27 of the Third Life Directive amending articles 24 and 21 of the First Life Directive.
341 Article 25, amending article 18 of the First Life Directive.

Technical provisions

503 The Directive provided for some harmonisation of the way in which technical provisions[342] were calculated by specifying the basis of the actuarial principles to be used, whilst continuing to allow member states to determine interest rates locally ('prudently' and in accordance with prescribed principles). Limitations were imposed on the nature of the assets (and the extent to which investments could be made in particular types of asset) which could provide cover for the technical provisions, in order to ensure diversification and reduce risks (articles 17-25). The host state was given power to require notification of the technical bases for calculating scales of premium and technical provisions in order to verify compliance with national provisions concerning actuarial principles, although not as a prior condition to the company carrying on its business[343].

504 There had been extensive negotiations between member states on harmonisation of the calculation of technical reserves[344] based on five actuarial principles proposed by *Le Groupe Consultatif des Associations d'Actuaires des Pays des Communautés Européennes*. In summary these proposals were that:

(a) technical provisions should be calculated on a suitable prudent basis, not on a 'best estimate' basis;

(b) the calculation of reserves should take into account all the benefits guaranteed to be available under the conditions of the policy and the detailed calculation should require the technical reserves to be at least as great as any surrender value guaranteed;

(c) the calculation of the technical reserves should take account of the reasonable expectations of policyholders in respect of future bonuses and terminal bonuses (although it should be clear that this did not mean that the company should be able to pay at its present scales indefinitely, but that the method of distribution of bonus would continue to take account of the 'surplus' or 'profit' on interest, mortality, expenses etc in the same sort of way as the present method, whatever that might be);

(d) there should be no discrimination between domestic and non-domestic policyholders; and

(e) the methods of calculating technical reserves for liabilities should be consistent with those for valuing the corresponding assets.

505 The provisions of article 18 of the Third Life Directive[345] regarding the obligation of the home member state to require insurance companies to establish technical provisions (including mathematical provisions) based on prescribed principles were the result of still further negotiation between member states on these proposals and various compromises. No reference is made in the Directive to the term PRE[346].

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342 Article 17 of the First Life Directive as substituted by article 18 of the Third Life Directive referred to obligations of insurance companies to establish sufficient 'technical *provisions*' including 'mathematical *provisions*', rather than 'technical reserves' and 'mathematical reserves' as in the original drafting of the First Life Directive.

343 Article 29 of the Third Life Directive.

344 As noted in the Penrose Report, Chapter 10, paragraphs 21 et seq.

345 Replacing article 17 of the First Life Directive.

346 Although it was later embodied in Regulation 64 of ICR 1994 on the determination of the amount of the long term liabilities, in relation to the actuarial principles to be used.

506 Put briefly, the principles for determining technical life assurance provisions set out in article 17 of the First Life Directive as replaced by article 18 of the Third Life Directive involved requirements for:

(a) the technical provisions to be calculated by a sufficiently prudent prospective actuarial valuation, taking account of all future liabilities as determined by the policy conditions, including specified matters such as guaranteed benefits, allotted bonuses, options available to the policyholder and expenses; the method used to be prudent in itself, but also to have regard to the method used to value assets; technical provisions to be calculated separately for each contract (but with approximations permissible if likely to produce approximately the same result) with additional provision for general risk; mathematical provisions at least as great as any surrender value guaranteed at the time; the use of a retrospective method of valuation was permissible if it did not result in lower technical provisions than a prudent prospective method (or if a prospective method was not appropriate for the particular contract);

(b) the use of a prudent rate of interest, with the maximum rate to be fixed by the home member state in accordance with specified rules;

(c) the statistical elements of the valuation and allowance for expenses used to be chosen prudently, having regard to the state in which the contract had been concluded, the type of policy and the administrative costs and commissions expected to be incurred;

(d) in the case of participating contracts[347] the method of calculation for technical provisions might take into account, either implicitly or explicitly, future bonuses of all kinds in a manner consistent with other assumptions on future experience and the current method of bonus distribution;

(e) allowance for future expenses permitted to be made implicitly e.g. the use of future premiums net of management charges, with a prudent estimate of future expenses; and

(f) the method of calculation was not to be subject to discontinuities from year to year arising from arbitrary changes to the method or bases of calculation and was to recognise distribution of profits in an appropriate way over the duration of the contract.

507 The Third Life Directive was implemented in the UK from 1 July 1994 by:

(a) the Insurance Companies (Third Insurance Directives) Regulations 1994[348] which amended the ICA 1982;

(b) the Insurance Companies Regulations 1994[349] which replaced ICR 1981; and

(c) the Insurance Companies (Accounts and Statements) (Amendment) Regulations 1994[350] which amended the ICAS Regulations 1983.

508 The Directive was amended by Directive 95/26/EC and was repealed by Directive 2002/83/EC when the various directives on life assurance were consolidated, simplified and clarified.

347 This term is not defined in the Directive, but appears to be used in the sense of 'with-profits' contracts.
348 SI 1994 No. 1696.
349 SI 1994 No. 1516.
350 SI 1994 No. 1515 (subsequently revoked by the Insurance (Accounts and Statements) Regulations 1996 SI No. 943).

Amendments to the ICA 1982 through subordinate legislation in 1991 and 1992

The Companies Act 1989 (Eligibility for Appointment as Company Auditor) (Consequential Amendments) Regulations 1991

509 In 1991, in the light of changes introduced by Part II of the Companies Act 1989 in relation to eligibility for appointment as a company auditor, a consequential amendment was made to section 21 of the ICA 1982 regarding the requirements for insurance companies to be audited in the prescribed manner by a person of the prescribed description.

510 The amendments made by the Companies Act 1989 (Eligibility for Appointment as Company Auditor) (Consequential Amendments) Regulations 1991[351] enabled regulations made under section 21 of the ICA 1982 to apply the updated provisions of Part II of the Companies Act 1989 relating to eligibility for appointment as a company auditor when specifying the requirements for the audit of accounts of insurance companies (using general Companies Acts provisions, subject to such adaptations or modifications as might appear necessary or expedient).

The Insurance Companies (Amendment) Regulations 1992

511 Amendments were made to the ICA 1982 and the FS Act 1986 in November 1992 by the Insurance Companies (Amendment) Regulations 1992[352] to implement various EEC Directives, primarily in relation to non-life business.

512 The amendments made to the ICA 1982 of more general application were those to section 5 (applications for authorisation) and section 61 (approval of proposed controllers) to enable the Secretary of State to act in certain ways in order to implement a direction of the Council or Commission of the European Communities and a new section 63A, which required any controller of an insurance company which had its head office in the UK to notify the Secretary of State if he or she increased their shareholding so as to become the parent undertaking of the company.

Guidance for Appointed Actuaries – 1992 revisions to GN1 and GN8, guidance from GAD ('Dear Appointed Actuary' letters) on resilience testing and survey on 'asset shares' and the assessment of terminal bonus

513 Revised versions of GN1 and GN8 were issued during 1992 following a review of the guidance by a working party of the F&IA. The amendments were described as being largely of a '*tidying-up nature*' as a precursor to the proposed introduction of practising certificates for appointed actuaries in 1992[353], but the revisions made to GN1 in 1992 go beyond that and seem to have been intended to extend the responsibilities of the appointed actuary (or at least to articulate them in greater detail). In addition, the number of references made in the guidance to PRE was increased significantly[354].

351 SI 1991 No. 1997.

352 SI 1992 No. 2890.

353 Notes of the Current Issues in Life Assurance seminar on 6 June 1991: JIA 118, III, 517-521 at page 519. It is understood that the practising certificate system was implemented by the F&IA at the end of 1992 and the requirement for appointed actuaries to possess such a certificate was first referred to in the version of GN1 issued in 1994 (v.4.0). The notes of the 1991 Seminar outline the general criteria proposed for practising certificates (see paragraph 704) and indicate that the timetable for their introduction had originally been January 1993, but it was planned to make this a year earlier, with the Continuing Professional Education requirements being added at a later date.

354 The second joint working party report on PRE of 26 October 1992 referred to below, indicates that the revisions to GN1 in respect of PRE were intended to increase the attention to be given to those expectations; however, it was noted that this created a potential problem for the profession '*in view of the vagueness of the definition of PRE and the limited debate within the profession as to the practical interpretation of PRE*'.

GN1

514 Additions and amendments to version 3.0 of GN1 (1 July 1992) included:

(a) an introductory comment requiring the appointed actuary to ensure, so far as it was within his or her authority, that the long term business of the company was operated on sound financial lines and with regard to its policyholders' reasonable expectations (paragraph 1.1). (It was suggested in the second F&IA working party report on PRE[355] that this requirement in the guidance signalled a material change in the emphasis placed on PRE);

(b) an expansion of the guidance which had appeared in earlier versions of GN1 on the potential for conflict between the appointed actuary's responsibilities to the company and to the DTI and the actuary's duty to advise the company of matters which created a material risk that the long term fund might be insufficient to cover the liabilities, or that the company might fail to meet its obligations under the ICA 1982 in relation to its long term business; and in the event that the company persisted in that course of action, or failed to remedy the position or report it to the DTI, the actuary was under a duty to advise the DTI, having so informed the company (paragraph 3.2);

(c) the appointed actuary was required to advise the company of '*his interpretation of its policyholders' reasonable expectations*'. In the event that a significant change was likely to take place, the actuary was required to take all reasonable steps to ensure that the company appreciated the implications for the reasonable expectations of its policyholders; the appointed actuary was also required to take all reasonable steps to ensure that the company's incoming policyholders should not be misled in their expectations (paragraph 3.3);

(d) the former obligation of the appointed actuary to ensure that he or she was '*at all times*' satisfied as to the sufficiency of the long term fund (and not simply at the time of the statutory investigation) was bolstered with a further obligation: to be satisfied at all times that the company would be able to satisfy '*any obligation to which it is subject by virtue of the* [ICA 1982]' (paragraph 4.1);

(e) the guidance on factors likely to affect the financial position of the company was expanded; the appointed actuary was required to have regard to all aspects likely to affect the company's financial position including the possible effect of contingent liabilities should they crystallise; items were added to the list of factors considered to be of particular importance to the appointed actuary's assessment of the financial position of the company, including options contained in contracts in force or being sold (paragraph 4.2);

(f) the need to provide for the solvency margin was added to the factors to be considered in relation to the setting of appropriate premium rates for new business (paragraph 5.4);

(g) in relation to actuarial investigations, paragraph 6.3 stated that '*when assessing the liabilities of the long-term business of the company he must also have regard to policyholders' reasonable expectations*'[356]; the actuary was required to satisfy him or herself as regards the resilience of the financial position of the

[355] See paragraphs 533 et seq.

[356] The second F&IA joint working party paper noted that this revised wording required the appointed actuary to take PRE into account in valuing long term business liabilities and made recommendations on how this should be dealt with in the actuary's report.

company in all reasonably foreseeable circumstances which might affect that position; the actuary was also required to ensure that appropriate valuation procedures had been correctly carried out and adequately documented (paragraphs 6.1 and 6.2); and

(h) references to the need for the actuary to have regard to the current and likely future taxation position of the company were inserted (paragraphs 4.2(i) and 6.6).

GN8

515 The version of GN8 issued in 1992 (version 3.0) contained few revisions, but included slightly more detailed guidance on Regulations 55 (nature and term of the assets representing the long term fund) and 59 (rates of interest used in valuations) of ICR 1981, although still in general terms. For example, paragraph 3.2.3 stated that the company's reserves, including any resilience reserves, '*should be sufficient to absorb the effect of immediate changes in interest rates and asset values, on a suitably prudent basis ...*', but did not specify any particular hypothetical changes which should be considered.

Guidance from GAD on resilience testing (DAA letters)

516 Following the issue of revised versions of GN1 and GN8 on 1 July 1992, a further DAA letter was sent by the Government Actuary to appointed actuaries of insurance companies (dated 31 July 1992, DAA4) on the topic of resilience testing.

517 The letter stated that GN8 incorporated '*the main content*' of Temporary Practice Note No. 2 (TPN2)[357] which, in turn, was said to endorse effectively the specific parameters for resilience testing which had been propounded by the Government Actuary in his letter to actuaries dated 13 November 1985 (DAA1, see paragraph 397).

518 DAA4 described the earlier recommendations as being, in normal economic circumstances, to test the resilience of the valuation basis against an immediate fall of 25% in the value of equities and properties and an immediate rise or fall in the yield on fixed interest securities of 3%. It was noted that GN8 did not specifically refer to these parameters, but instead required the appointed actuary to use professional judgment to determine an appropriate range of changes in the financial conditions over which to test the resilience of the valuation basis.

519 It was stated that great care had been taken in the wording of GN8, since the actuary was then soon to be required to certify compliance with that guidance in the statutory returns[358] and it was considered inappropriate to include a fixed set of parameters to cover all possible financial conditions.

520 The DAA4 letter stated that it remained the view of the DTI and GAD that, in most financial conditions, the parameters in TPN2 should continue to be the benchmark against which the actuary's valuation basis would be tested, although higher parameters might be appropriate in certain financial conditions.

521 DAA4 went on to express the view that in '*more extreme circumstances*' the parameters outlined in TPN2 might be '*unreasonably strong for offices to have to maintain*', given the reserving standards built into the determination of liabilities regulations.

[357] Which had been issued by the F&IA to actuaries in May 1986.
[358] From 1 January 1994, by virtue of SI 1993 No. 946 (see paragraph 685).

522 It was said that it would be reasonable for companies whose equity portfolios broadly corresponded to the Financial Times All-Share Index to review the resilience test when the dividend yield on that index exceeded 5.25% and a gradual tapering of the 25% parameter '*would be envisaged*'. Actuaries who were considering introducing such a taper of the 25% parameter or any weakening of the other parameters were advised that they should contact GAD straight away to discuss their proposed basis.

523 Actuaries were also advised that they should consider the possibility of more extreme financial conditions in the future and the extent to which the technical reserves, together with the margin of solvency, would be sufficient to satisfy liabilities in such circumstances. Full details of the assumptions which had been used were to be provided in Schedule 4 to the statutory returns[359]. Companies and appointed actuaries were invited to discuss and to clarify the contents of DAA4 with officials at the DTI and GAD.

524 On 30 September 1993 a further DAA letter (DAA6) was sent by the Government Actuary to appointed actuaries on the topic of resilience testing, stating that the investment outlook had changed considerably since DAA4 was written and notifying actuaries of new benchmarks which were considered to be appropriate by the DTI and GAD. For with-profit offices it was advised that three different scenarios for resilience testing should be applied:

(a) a reduction in fixed-interest yields by 20% combined with a fall in the value of equities of 10%;

(b) a reduction in fixed-interest yields by 10% combined with a fall in the value of equities of 25%; and

(c) a rise in fixed-interest yields of 3 percentage points combined with a fall in equity values of 25%.

525 In relation to interest rates, reference was made to the requirements of Regulation 59(6)(b) of ICR 1981 and it was said that the overriding limitation in that provision, that the yield assumed should not exceed the yield on British Government 2½ per cent Consolidated Stock on the valuation date (known as the 'Consols test'), did not apply to the hypothetical yields which arose on the resilience test. However, actuaries were to bear in mind the possible need to fund future reserve strengthening to enable the Consols test to be satisfied at the next valuation if the scenarios were to emerge in practice.

526 The earlier advice was repeated, requiring appointed actuaries to consider the possibility of more extreme financial conditions and the extent to which the solvency margin would be sufficient to meet liabilities in such circumstances and to specify the assumptions used as part of the statutory returns. It was indicated that in the longer term, it was being considered whether further refinement of resilience testing should be applied along the lines adopted in other countries.

527 DAA7 dated 31 March 1994 drew attention to the requirements of paragraph 3.2.3 of GN8 (version 3.0, July 1992) regarding the requirement for the company's reserves to be sufficient to absorb the effect of immediate changes in interest rates and asset values on a suitably prudent basis without prejudicing the company's ability to hold reserves

359 The abstract of the appointed actuary's valuation report.

which satisfied the regulations for valuing liabilities (other than Regulation 55). The requirements of Regulation 59(6)(b) regarding the overriding limitation in the Consols test were set out.

528 DAA7 referred back to the advice in DAA6 to disregard the Consols test when applying the three scenarios (explaining that the Consols test had been devised before the concept of resilience testing was established in 1985). DAA7 noted that the effect of not applying the limitation in the Consols test in the resilience scenarios was that the actuary would need to state that this had been done in the certificate of compliance[360] in respect of GN8, because that guidance required the Consols test to be applied. DAA7 proposed a form for the certificate which could be given by actuaries in relation to compliance with GN8 in these circumstances which would be acceptable to the DTI.

GAD survey on the use of 'asset shares' and the assessment of terminal bonus

529 Reference had been made to the use by life insurance companies of 'asset shares' as a means of assessing bonuses by the 1990s[361] and the suggested use of asset shares as a means of providing equity for policyholders and meeting PRE. However, it is apparent that 'asset share' had no precise meaning and there were no standard means by which assets shares were to be calculated.

530 On 9 July 1993 a letter was sent by a Directing Actuary at GAD to appointed actuaries of companies transacting with-profit business, enclosing a survey requesting information about:

(a) the contents of current literature on the allocation of surpluses to policyholders and the information on the principles for distribution of surpluses in the company's constitution; and

(b) the company's actual methodology in respect of the determination of appropriate levels of final or terminal bonus on with-profit policies.

531 The letter records a growing debate in the life insurance industry over the appropriate method for determining distribution of surpluses in long term funds and GAD's view that there was no clearly accepted definition of the technique known as 'asset shares'; that the '*art or science of asset shares is still not fully developed in actuarial literature*'.

532 In relation to item (b) above, the survey raised a number of questions about the actual practices of life companies with with-profit contracts in relation to the calculation of terminal bonuses and the actuarial techniques which were being used. For example, a brief explanation was requested of how appropriate scales of final or terminal bonus were assessed in various circumstances and whether bonus reserve valuations or other methods were used, how frequently scales of final or terminal bonus were reviewed, how asset shares were determined in relation to various specified factors, how expenses were attributed, what allowances were made in the assessment of final or terminal bonus scales for various specified factors such as any charges made for guarantees in respect of benefits payable on maturity and the material considerations which affected the 'smoothing policy' applied to final or terminal bonus.

360 As required from 1 January 1994, see paragraph 685.

361 In a paper presented in 1989, the appointed actuary of Equitable referred to the use of asset shares in the calculation of final or terminal bonus, referring to the rates needed to lift the guaranteed benefits and declared bonuses to the appropriate asset share as the starting point for the calculation of such bonus rates: 'With-Profits without Mystery', R.H. Ranson and C.P. Headdon, JIA 116 (1989) 301-345 at paragraph 3.2.15.

Second and third F&IA joint working party reports on PRE

Second report – 26 October 1992

533 The second F&IA joint working party report on PRE was dated 26 October 1992, a few months after a revised version of GN1 had been issued in which a considerably greater number of references to 'policyholders' reasonable expectations' had been included (version 3.0 of GN1 dated 1 July 1992, referred to in paragraph 514 above).

534 The second report acknowledged the potential difficulties this could cause for the profession in view of the vagueness of the term, but on balance favoured the strengthening of the guidance in this respect. In order to assist appointed actuaries, the report made a number of recommendations on how they should meet their obligations in relation to PRE.

535 It was suggested that uncertainty over the interpretation of PRE could be reduced by greater disclosure to current and future policyholders and their advisers regarding the company's bonus philosophy and approach to determining discretionary benefits and charges. The recommendations made in the second report included:

(a) **reporting to the board**: all appointed actuaries should report annually to the board of their company regarding their interpretation of PRE and the way this interpretation was being implemented and communicated by the company[362];

(b) **bonus levels**: all appointed actuaries should make available at least internally to the company an analysis of current levels of payouts under with-profits policies, analysed by the source of the profit and stating whether, in his or her opinion, that level would continue[363];

(c) **company literature**: the statements made in the company's with-profits guide should be submitted to the board for formal approval and the appointed actuary should endeavour to ensure that suitably abbreviated summaries were included in all literature for contracts offering with-profits options;

(d) **staff training**: the appointed actuary should provide input to the training given to the company's sales staff to ensure that they accurately represented the company's views on PRE[364];

(e) **discretionary charges and benefits**: appointed actuaries should use their best endeavours to ensure that companies adopted a clear and consistent approach towards discretionary charges and benefits and this should be described in plain English for policyholders;

(f) **assessment of liabilities with regard to PRE**: in reporting the results of the valuation[365] the appointed actuary should include statements on the extent to which the method used took

362 The Working Party had found that very few appointed actuaries reported formally to their boards on PRE.

363 The Working Party had noted that there were some well-known examples of with-profit policies for which payouts were very high in comparison to accumulated premiums at the typical rates of return it had been possible to achieve historically, and that confusion could be caused if the reasons for the high payouts and the likelihood that they would not be sustained indefinitely were not explained.

364 It was suggested that the influence of sales staff was likely to be greater than the company's literature in relation to PRE.

365 It was noted that special factors to be considered in determining the amount of long term liabilities included PRE of discretionary charges and benefits, PRE of terminal bonus and PRE of reversionary bonus rates (and if there was a risk that current bonus levels could not be maintained this should be communicated to policyholders so that their expectations would be modified).

account of PRE, with particular reference to discontinuance and expense assumptions, the relationship between reserves and asset shares and the maintainability of current reversionary bonus rates; and

(g) **written reports to the company board on PRE**: it was suggested that reporting might be undertaken in two stages: first, a document setting out the company's agreed approach to PRE and second, inclusion of appropriate references to PRE in the appointed actuary's report to the board regarding the allocation of profit or surplus. A recommended form for the first of these reports was provided and an outline of the information on PRE to be included in a report to the board on an allocation of surplus was set out in a separate recommendation[366].

Third report – June 1993

536 The third F&IA joint working party report, dated June 1993, provided feedback on the results of a questionnaire which had been sent to the appointed actuaries of the largest 25 with-profit companies, following the completion of a questionnaire at a 'face-to-face' interview with the appointed actuary concerned. The report was the result of a comparison of the responses provided.

537 General points made in the 'feedback exercise' included:

(a) the recommendations in the second report had been too prescriptive, that actuaries were better left to judge the situation in the particular circumstances of their own company;

(b) the structure and modus operandi of individual companies varied such that reliance on the existence of a 'board' (e.g. as the recipient of the appointed actuary's advice) was unsatisfactory, although this seemed to work reasonably well for most mutuals. It was suggested that it would be more helpful to define the 'seat of power';

(c) there was a fairly widespread (but not universal) view expressed by the actuaries interviewed that their company did not have any problem with PRE which, at the extreme, bordered on complacency. Notwithstanding the dominance given to asset shares in the context of PRE some companies did not calculate them in a very rigorous way and were reluctant to reveal them within the company, other than in general terms (see further footnote 298); and

(d) with reducing bonuses, PRE was becoming much more of an issue[367].

538 Responses to the Working Party's questions relating to the recommendations made in the second report and general follow-up questions revealed that:

(a) most companies were doing something about the recommendation that an annual report should be made to the board on the interpretation of PRE, the most common way being to include a section in the annual actuarial report;

366 Suggesting that the report should cover such matters as the company's 'smoothing policy', target ratio of asset shares to guaranteed benefits, the extent to which a proposed declaration departed from the general principles for distribution of surpluses, an analysis of proposed payouts on maturing policies and future trends in profits and smoothing adjustments, rates of investment return required to support current reversionary bonus rates, projected asset shares over a five-year period at alternative levels of future investment return and the implications of these matters for information to be provided to existing and prospective policyholders.

367 One respondent put it that whilst bonus rates were going up the marketing department was pleased to take the lead, but once they were declining it seemed that the actuaries were left to deal with the issue.

(b) by no means did all companies follow the recommendation that the actuary should provide, at least internally, an analysis of current levels of payouts for with-profit policies and the source of profit. Many actuaries did not disclose asset shares and there was seldom a reconciliation between asset shares and payouts; there was considerable variation in the detail in which asset shares were calculated and it was said to be difficult to explain asset shares to the company's board;

(c) very few companies sought formal approval of the board to the with-profits guide and there was a '*notable absence*' of formal processes for ensuring that an appropriate summary of the guide was included in company literature;

(d) the proposal that actuaries should be involved in staff training on PRE was considered to go too far[368], taking the appointed actuary into areas outside his or her responsibilities, although many actuaries did explain PRE '*in general terms*' to their sales and marketing staff;

(e) all actuaries agreed with the principle that they should use their best endeavours to ensure that the company adopted a clear and consistent approach towards discretionary charges and benefits (although opinions had differed about the extent to which discretionary charges could be increased). There were also differing opinions as to whether a plain English explanation for policyholders was possible;

(f) nearly all appointed actuaries were of the view that no explicit reference to PRE should be made in the statutory valuation report[369]; however, most actuaries reported internally along the lines of the Working Party's recommendation in this regard;

(g) the general view of actuaries was to oppose reporting to the board on the company's attitude to PRE in such detail as that suggested in the outline report provided, but nobody had seriously disagreed with the philosophy underlying the recommendation and various simpler approaches had been suggested;

(h) in relation to the proposed report to the board by the actuary on the allocation of surplus, all the respondents provided some of the information recommended by the Working Party; projected asset shares over a five-year period were rarely given in the annual actuarial report (but might be covered in connection with business plans); many actuaries considered that the implications of such a report for the information to be given to existing and prospective policyholders fell outside the terms of reference of an appointed actuary;

(i) fears about guarantees and 'quasi guarantees' caused by old policy literature, for example about with-profit bonds, were raised in response to a question regarding special features of significance; concerns were also expressed about cases where current premium rates were known to be inadequate, where an assumed rate of growth until maturity now

368 One actuary suggested that it would be pointless to explain PRE to the salesforce as some would not understand the issues and might misrepresent them to policyholders.

369 It was to become a statutory requirement, not only that due regard should be had to PRE in the determination of liabilities (under regulation 64 of ICR 1994, see paragraph 613) but eventually, that specific reference should be made to the method by which due regard had been given to PRE in the abstract of the actuary's report (under regulation 25 and paragraph 6(1)(b) of Schedule 4 to the Insurance Companies (Accounts and Statements) Regulations 1996 SI No. 943 (paragraph 788(b)).

appeared excessive or was reliant on bonus rates which were unlikely to be paid;

(j) adequate communication with policyholders was seen as the main way to deal with PRE. Expectations had been given at the point of sale and subsequent bonus announcements and advertisements extolled the bonus performance. When bonus rates were falling it was desirable that the actuary ensured that the company took the necessary action to circulate details of reduced rates to policyholders and, if appropriate, set out the need for further reductions. In this way, expectations could be modified by current conditions and remain realistic. The frequency of review of terminal bonus rates and market value adjustments affected PRE and the company practice in these areas should be clearly defined; and

(k) among the responses to a question concerning 'other comments' the point was made that the appointed actuary's role was advisory rather than executive but that he or she would be concerned to see an adequate system of actuarial protocols in place which would run through the company '*independent of line management*'. Professional guidance on PRE was not seen as desirable.

539 The third joint working party report recommended that no formal professional guidance be given on PRE at that time. However, appointed actuaries should test their own practice against the recommendations made in the second report and the general reactions to those recommendations summarised in the third report.

The Companies Act 1985 (Insurance Companies Accounts) Regulations 1993

540 The Companies Act 1985 (Insurance Companies Accounts) Regulations 1993[370] (the CAICA Regulations 1993) were made to amend sections 255 and 255A of the Companies Act 1985 and to substitute a new Schedule 9A to that Act in order to implement a European Directive on the annual accounts and consolidated accounts of insurance companies[371], in so far as that Directive applied to bodies corporate subject to Part VII of the Companies Act 1985[372].

541 The Directive had been made to co-ordinate the requirements for the annual accounts of insurance undertakings across member states in order to increase comparability and transparency for creditors, debtors, members, policyholders and their advisers.

542 The Directive stated that it was '*urgently required*'. It recorded the major differences between the practices of various member states regarding the form and contents of insurance undertakings' accounts and the disclosures made. It also acknowledged the fundamental importance of the values at which assets and liabilities were shown in the balance sheet and of the disclosures made in the accounts in obtaining a proper understanding of the financial situation of the undertaking and to enable comparability of figures[373].

370 SI 1993 No. 3246.
371 Council Directive 91/674/EEC of 31 December 1991 (which applied to all insurance companies other than small mutual associations with an annual contribution income of no more than 500,000 ECU for three consecutive years).
372 Separate provision was made for insurance companies which were not subject to those provisions of the Companies Act 1985 in the Insurance Accounts Directive (Miscellaneous Insurance Undertakings) Regulations 1993 SI No. 3245.
373 Preamble to the Directive.

543 The Directive prescribed a precise layout for the balance sheet and profit and loss account, the items to be included in each and made requirements for the contents of certain notes to the accounts (for example, in relation to the valuation methods which had been used).

544 Under the Directive, member states were permitted either to impose valuation rules or to leave it to the company to choose between alternative rules set out in the Directive. In calculating provisions for life assurance, use was to be made of actuarial methods '*customarily applied on the market or accepted by the insurance-monitoring authorities*', implemented by any actuary or expert in accordance with conditions laid down by national law '*and with due regard for the actuarial principles recognised in the framework of present and future coordination of the fundamental rules for the prudential and financial monitoring of direct life assurance business*'.

545 To meet the requirements of the Directive, the CAICA Regulations 1993 substituted a new Schedule 9A to the Companies Act 1985 which made new provision for the form and content of the accounts of insurance companies and groups of companies.

546 Part I of the Schedule set out the prescribed formats, the valuation rules to be applied, the rules for determining provisions and the disclosures to be made in the notes to the accounts. Part II of the Schedule adapted the rules in Part VII of the Companies Act 1985 in relation to consolidation of accounts to make them applicable to the special circumstances of insurance groups.

547 The accounts prepared for the purpose of Schedule 9A of the Companies Act 1985 were (and are) required to provide a 'true and fair' view of the company's affairs, in contrast to the annual returns which were prepared for the purposes of the ICA 1982, which were required to be prepared in accordance with the regulations made under that Act, in particular in relation to the valuation of assets and determination of the amount of the liabilities[374].

548 Schedule 9A requires that the company's balance sheet include in the technical provisions a 'long term business provision'. The notes[375] to that balance sheet item require that the item:

> *... shall comprise the actuarially estimated value of the company's liabilities (excluding technical provisions included in Liabilities in item D[376]), including bonuses already declared and after deducting the actuarial value of future premiums.*

The item was also to include unreported claims which had been incurred.

374 See Regulation 4 of the ICAS Regulations 1983 and Regulation 4 of the ICAS Regulations 1996. In relation to the general question of accounting standards for insurance companies, and how provisions should be calculated in order to present a 'true and fair view', the Penrose Report and other sources suggest that this was the subject of considerable debate within the actuarial and accounting professions. Chapter 10 of the Penrose Report (paragraph 37 et seq) describes the application of general company accounting requirements to insurance companies and the implications of the requirement that financial statements should present a 'true and fair view'. The Report notes that insurance companies had largely escaped accounting regulation and that no specific accounting standards had been devised for insurance companies in the United Kingdom (Chapter 10, paragraph 55). In response to the Penrose Report, the Accounting Standards Board issued a new financial reporting standard and the Treasury produced a report in June 2005 on financial reporting for life assurance, which identified the need for further work to be undertaken on various aspects of accounting requirements for life assurance.

375 Note (21) to Section B of Schedule 9A.

376 Technical provisions for linked liabilities, which were provided for separately in note (26).

549 The rules for determining provisions specified[377] that:

(1) *The long term business provision shall in principle be computed separately for each long term contract, save that statistical or mathematical methods may be used where they may be expected to give approximately the same results as individual calculations.*

(2) *A summary of the principal assumptions in making the provision under sub-paragraph (1) shall be given in the notes to the accounts.*

(3) *The computation shall be made annually by a Fellow of the Institute or Faculty of Actuaries on the basis of recognised actuarial methods, with due regard to the principles laid down in Council Directive 92/96/EEC[378].*

550 The guidance issued by the F&IA to the actuary undertaking the required calculations (described in that guidance as the 'reporting actuary') and on the wider implications of Schedule 9A is referred to below. It was permissible for the reporting actuary to be the same person as the appointed actuary, but there was no requirement to this effect[379].

551 The requirements of the CAICA Regulations 1993 applied to insurance companies' accounts for financial years commencing on or after 23 December 1994.

552 The Directive (91/674/EEC) remains in force, subject to amendments made by a further Directive in June 2003[380]. The CAICA Regulations 1993 also continue in force, subject to minor amendments made with effect from January 2005[381] consequent on the consolidation and repeal of the Life Directives[382].

553 In recent years, one of the aims of the FSA has been to try to align the approach in the regulatory returns with the approach in the Companies Act accounts so as to enable reconciliation between the two, thereby increasing the transparency of the figures presented[383].

377 Paragraph 46 of Schedule 9A.
378 i.e. the Third Life Directive (a reference to Directive 2002/83/EC was substituted by the Life Assurance Consolidation Directive (Consequential Amendments) Regulations 2004 SI No. 3379).
379 In the case of Equitable, the roles of chief executive and appointed actuary were combined for the period 1991-1997 (see footnote 94).
380 Council Directive 2003/51/EC.
381 By virtue of SI 2004 No. 3379, see footnote 378.
382 By Council Directive 2002/83/EC.
383 See the FSA Consultation Paper 202, September 2003, paragraph 4.11.

Phase 5: 1994 – 1999

Introduction to Phase 5 – the DTI's view of the concept of 'sound and prudent management' and 'freedom with disclosure'

1994 – a year of change

554 1994 saw considerable reform of the UK legislation relating to insurance, triggered by the need to give effect to the Third Non-Life Directive384 and the Third Life Directive[385] in domestic legislation.

555 This entailed significant amendments to the primary legislation (in particular, the ICA 1982), and the subordinate legislation (including that relating to the valuation of assets and determination of liabilities of long-term insurance businesses (through the replacement of ICR 1981) and in relation to accounting requirements and statutory returns (although the ICAS Regulations 1983 were not replaced until 1996)).

556 Implementation of the changes arising from the Directives provided the opportunity to consolidate amendments which had been made to the subordinate legislation over the years and to make other adjustments for domestic reasons.

557 A paper written by officials in the DTI for the Minister towards the end of 1994, after the changes to the UK legislation had been enacted, entitled 'Insurance Supervisory Powers and Practice', described the regime as it then stood.

The three main 'supervisory weapons'

558 The paper explained the DTI's regulatory objectives as being to supervise the insurance industry effectively so that policyholders were protected against the risks that companies would not meet liabilities or fulfil policyholders' reasonable expectations. The DTI's three 'main weapons' in achieving these objectives were described as being:

(a) **Authorisation:** controlling the entry of new companies into the market, ensuring so far as possible that they were adequately capitalised and had a sound business plan.

(b) **Financial supervision:** requiring insurance companies to submit detailed, comprehensive annual returns in addition to (and containing considerably more detail than) the shareholder accounts required under companies legislation. In particular, the solvency margin which insurance companies were required to maintain was intended to provide a safety margin so that they could suffer a degree of loss and still be able to meet their commitments in full. The asset valuation rules were designed to ensure that companies held a sensible spread of assets and valued them conservatively. Examination of the returns entailed consideration of such matters as assets, liabilities, reinsurance protection, profitability, quality of management and future trends, and was supplemented by visits to companies in order to ensure that '*supervision is forward rather than backward looking*'.

(c) **Sound and prudent management:** it was noted that the implementation of the Third Insurance Directives in the UK in July 1994 had supplemented the pre-existing powers of supervisors to take action in respect of unfit controllers, directors and managers, with the wider concept of 'sound and prudent management' which companies were required to maintain (see paragraphs 570 et seq). It was said that this new concept enabled the DTI to take a view as to whether the management of the company as a whole had the right balance of skills and experience (and not just to assess the fitness of the separately notified key individuals). It was said that this enabled the DTI to take action in a wider set of

384 92/49/EEC.
385 92/96/EEC.

circumstances where it believed that a company was not acting in a prudent way and enabled the DTI to use all its existing powers of intervention in the event of failure by a company to comply with specified criteria of sound and prudent management.

559 The addition of the concept of 'sound and prudent management' to the legislation was described as having considerably strengthened the supervisors' powers. The paper explained:

> '*we are now able to intervene more easily where we have concerns that a company is acting in an imprudent manner, ie it is failing to comply with the criteria of sound and prudent management. In the past, there have been occasions where supervisors have regarded intervention as desirable but have either had no specific power to do so, or considered that the power was not clearly enough defined to allow it to be used*[386]*. These augmented powers are not intended to increase the overall level of supervision of soundly run insurance companies. They are designed to enable us to intervene in cases where previous legislation proved to be inadequate. It remains the case that the main grounds for intervention are the protection of policyholders or breach of an obligation under the legislation.*'

560 The paper went on to describe a case in which the new powers had by then already been used in a 'robust' way. In the case described (which concerned non-life business), the 'sound and prudent management' ground of intervention had been used to withdraw the company's authorisation to write new business, notwithstanding that the company had shown a reasonable standard of solvency in its December 1993 return.

561 In view of considerable uncertainties about the adequacy of the company's reserves to meet a particular potential liability (which had been highlighted in a report from an independent actuary), the DTI considered that the uncertainties about the company's solvency were too great to permit it to continue to write business.

562 It was noted, in relation to the new 'sound and prudent management' ground that there were '*difficult judgements to be made as to when these powers should be invoked and to what extent*', but that in the majority of cases, the DTI was able to rely on its '*informal powers of persuasion*' to ensure that companies took appropriate action before serious problems arose, with the threat of formal sanctions in the background.

Freedom with publicity or freedom with disclosure

563 As regards the underlying philosophy of insurance regulation in the UK, the paper prepared for the Minister in late 1994 described the UK regulatory system as being founded on the principle of '*freedom with disclosure*', *in a freely competitive market place*'. Insurance companies were said to have '*considerable freedom to follow their commercial judgement within a broadly defined and non-intrusive regulatory framework*'.

564 However, insurance companies were required to place on the public record a considerable amount of detail about the business they had accepted and their solvency position. It was noted that not only policyholders, but competitors, brokers, market analysts and journalists had access to the information in statutory returns, resulting in a growth in comparative analyses of data and a market in insurance information '*producing a more informed market in insurance products and their financial security*'.

[386] Apparently an allusion to uncertainties over the ambit of the residual power to impose requirements to protect policyholders under section 45 of the ICA 1982.

565 It was considered that the commercial freedom enjoyed by insurance companies in the UK was one of the strengths of the domestic insurance industry which would help UK companies to compete in the European Single Market. It was stated that in a competitive market it was unrealistic to expect that all failures could be prevented, but that the risk of companies going out of business was '*an acceptable price for an innovative and price competitive market, operating in the interests of its customers*'. The aim of the regulator was to get as much early warning as possible about developing problems '*and take appropriately robust action to prevent or minimise damage to policyholders*'.

Amendments to the ICA 1982 – the Insurance Companies (Third Insurance Directives) Regulations 1994

Introduction and overview

566 The Insurance Companies (Third Insurance Directives) Regulations 1994[387] (the ICTID Regulations 1994) gave effect to the Third Life Directive in terms of revisions to the ICA 1982. They were made by the Secretary of State as designated minister under section 2(2) of the ECA 1972.

567 One of the principal effects of the ICTID Regulations 1994 was to introduce into the UK legislation the principle of home state control, or the 'single passport' for insurance undertakings across the European Community. The Regulations also included provisions reflecting the further harmonisation of the rules regarding authorisation and regulation of insurance undertakings.

568 The ICTID Regulations 1994 came into force on 1 July 1994 and extended to Northern Ireland.

569 Part II of the Regulations contained amendments to the ICA 1982 and comprised six chapters dealing with:

I Restrictions on carrying on insurance business (amending Part I of the ICA 1982);

II Regulation of insurance companies (amending Part II of the ICA 1982);

III Conduct of business regulation (amending Part III of the ICA 1982);

IV Recognition in accordance with insurance directives (replacing the whole of Part IIIA of the ICA 1982[388]);

V Special classes of insurers (amending Part IV of the ICA 1982);

VI Supplementary provisions (amending Schedule 3A to the ICA 1982[389]).

570 The major changes to Parts I and II of the ICA 1982 introduced by the ICTID Regulations 1994 included:

- revisions to the structure and substance of those Parts of the Act to take account of the concept of home state control of insurance companies and to make distinct provision for companies with head offices in various parts of the EC or outside the EC;

- the introduction of the concept of the need for insurance companies to have 'sound and prudent management' based on specified criteria (in a new Schedule 2A);

387 SI 1994 No. 1696.
388 Which had been inserted in the ICA 1982 by SI 1990 No. 1333 (see paragraph 416) implementing the Non-Life Directive 88/357/EEC and later amended by further statutory instruments.
389 Inserted in the ICA 1982 by SI 1990 No. 1333.

- revision to the incorporate the concept of 'sound and prudent management' in the specified grounds for refusal of authorisation, withdrawal of authorisation, or intervention by the Secretary of State and other changes to the provisions on authorisation and intervention arising from the Third Life Directive;

- a new power for the Secretary of State to suspend authorisation of an insurance company to carry out new business '*forthwith*' in cases of urgency (section 12A);

- new obligations for insurance companies to secure the adequacy of their assets in terms of their safety, yield and marketability and to ensure the adequacy of the premiums payable to meet commitments under long term • extending the circumstances in which the Secretary of State's powers might be used in such a way as to restrict the free disposal of assets by a company to include those where the company had failed to maintain the margin of solvency under section 32 or to secure the adequacy of its assets under the new section 35A (sections 37(3)(d) and 45(2)(d));

- new intervention powers for the Secretary of State:

  – to seek an injunction to restrain a company from disposing of or otherwise dealing with its assets (section 40A);

  – to appoint a competent person to conduct a general investigation into whether the specified criteria of sound and prudent management were being fulfilled by a company or would be fulfilled with an intended new controller of the company (section 43A);

  – to require the company to provide a report from an actuary, accountant or other professional person regarding specified matters (section 44(2B);

- revisions to the residual power of intervention under section 45 to give the Secretary of State the additional power to require a company to take action to ensure fulfilment of the new sound and prudent management criteria (where this objective could not be appropriately achieved through reliance on other specified powers) and to make changes in relation to restrictions on the free disposal of assets;

- recasting the provisions on transfers and winding up of insurance businesses to take account of the position of companies operating in other countries; and

- a new prohibition on a controller of a UK insurance company acquiring a 'qualifying holding' in that company or its parent unless written notice had been served on the Secretary of State and no objection had been raised.

Sound and prudent management ground to refuse authorisation and criteria

571 A new limitation was imposed on the power of the Secretary of State to issue authorisation to a company on grounds of failure to fulfil specified criteria of 'sound and prudent management'[390]. A new section 5(1A) was inserted in the ICA 1982 by Regulation 5 of the ICTID Regulations 1994:

> *The Secretary of State shall not issue authorisation under section 3 above to an applicant which is a UK or a non-EC company if it appears to him that the criteria of sound and prudent management are not or will not be fulfilled with respect to the applicant.*

390 In the light of article 7 of the Third Life Directive.

572 'UK company' and 'non-EC company' were defined in a new section 5(4) of the ICA 1982, inserted by Regulation 5(2), covering insurance companies issued with authorisation in the UK under the ICA 1982, other than those conducting only reinsurance or certain other limited forms of insurance business.

573 The term 'criteria of sound and prudent management' was also defined in the new section 5(4) to mean the criteria set out in the new Schedule 2A to the ICA 1982 which was inserted by Regulation 5(3).

574 The criteria specified in that schedule related to the integrity and skill of those directing, managing or controlling the company, their sufficiency in number and the manner in which business was to be conducted. The criteria included:

- that the business of the insurance company was carried on with integrity, due care and the professional skills appropriate to the nature of its activities;
- that each director, controller, manager or main agent of the company was a fit and proper person to hold that position;
- that the company was directed and managed by a sufficient number of persons who were fit and proper persons to hold their positions;
- that the company conducted its business in a sound and prudent manner; and
- that the company was not to be regarded as conducting its business in a sound and prudent manner:
  - – unless the company maintained adequate accounting and other records of its business and adequate systems of control of its business and records (which arrangements were not to be considered adequate unless they enabled the business of the company to be prudently managed; and in determining whether any systems of control were adequate, the Secretary of State was to have regard to the functions and responsibilities for those systems which were held by the directors, controllers, managers or main agents of the company);
  - – if the company failed to conduct its business with due regard to the interests of policyholders and potential policyholders;
  - – if the company failed to satisfy an obligation under the ICA 1982 or (in the case of a UK company) an obligation to which it was subject by virtue of the law of another EEA State[391] in which it conducted insurance business; or
  - – if the company failed to supervise the activities of a subsidiary undertaking with due care and diligence and without detriment to the company's business.

Additional grounds for withdrawal of authorisation in respect of new business and new power to suspend authorisation in urgent cases

575 Two new grounds for the withdrawal of authorisation in respect of new business were added to section 11(2) of the ICA 1982[392] by Regulation 10. The Secretary of State was empowered to withdraw authorisation in respect of new business if:

[391] A state which was a contracting party to the Agreement on the European Economic Area signed at Oporto on 2 May 1992 as adjusted by the Protocol signed at Brussels on 17 March 1993, with special provision for Liechtenstein (Regulations 5(2) and 50(1)(g) of the ICTID Regulations 1994).

[392] See paragraph 293 above.

(aa) the company was a UK company and it appeared to him that it had failed to satisfy an obligation to which it was subject by virtue of the law of another EEA State which gave effect to the insurance Directives or was otherwise applicable to insurance activities in that State;

(ab) the company was a UK company or a non-EC company and it appeared to him that any of the criteria of sound and prudent management was not or might not be fulfilled by the company (or had not or might not have been fulfilled in the past).

576 Further, Regulation 11 inserted a new section 12A into the ICA 1982, giving the Secretary of State power to direct that the authorisation of a UK company or non-EC company to carry out new business generally or of a specified description be suspended *'forthwith'* if it appeared to him that one of the grounds in section 11(2) (as extended) for the withdrawal of authorisation in respect of new business existed and that the authorisation should be suspended '*as a matter of urgency*'.

577 The company was entitled to make representations in writing to the Secretary of State within one month (and orally to an officer of the DTI if it so wished) which the Secretary of State was required to consider before deciding whether to confirm the direction. The direction would lapse two months after it was given unless it had been confirmed by the Secretary of State within that period.

New classes of insurance long term business, single authorisation by home state and amendment of rule on composite insurance businesses

578 Chapter I also added two new classes of long term business[393] to the list in Schedule 1 to the ICA 1982 (Regulation 3).

579 Regulation 4 inserted a new definition of an 'EC company' which was to be excluded from the authorisation requirements under section 2 of the ICA 1982 provided that conditions set out in a new Schedule 2F had been complied with[394], giving effect to the principle of a 'single passport'.

580 The limitation on the authorisation of a combination of long term and general business under section 6 of the ICA 1982 was slightly relaxed to permit authorisation of a combination of long term business and any class within the 'accident and health' group of general business (Regulation 6).

Part II of the ICA 1982 on regulation of insurance business – EC companies

581 Again to give effect to the principle of home state control, EC companies were removed from the ambit of most of the provisions of Part II of the ICA 1982 on regulation of insurance business (regulation 13)[395].

Adequacy of assets and premiums

582 New sections 35A and 35B were inserted in the ICA 1982 regarding the adequacy of assets and premiums (Regulations 17 and 18).

583 Under the new section 35A(1), a UK company was required to secure that its liabilities under contracts of insurance were '*covered by assets of appropriate safety, yield and marketability having regard to the classes of business carried on*' and without prejudice to the generality of this

393 Collective insurance and social insurance.
394 Relating to authorisation of the company by its home state and notification and certification of matters to the Secretary of State by the supervisory authority of the company's home state.
395 Exceptions to this exclusion (i.e. where provisions of Part II of the ICA 1982 continued to apply in some way to an EC company) related to the special requirements under Part I of Schedule 2F for EC companies carrying on business in the UK; restrictions on disclosure of information under sections 47A, 47B and Schedule 2B and the winding up provisions of sections 54-59.

requirement, to secure that '*its investments are appropriately diversified and adequately spread and that excessive reliance is not placed on investments of any particular category or description*'.

584 Separate obligations were imposed in relation to linked long term contracts, which included a requirement for the company to secure that liabilities in respect of linked benefits were covered by assets of a description prescribed by regulations made under section 78[396].

585 The new section 35B required an insurance company to satisfy itself, before entering into a long term insurance contract, that the aggregate premiums under the contract and the income to be derived from them and any other resources of the company available for the purpose (without jeopardising its solvency in the long term) would be '*sufficient, on reasonable actuarial assumptions, to meet all commitments arising under or in connection with the contract*'.

Revised and additional grounds for intervention under section 37 of the ICA 1982

586 Several substantive and consequential amendments were made to section 37 of the ICA 1982 regarding the grounds on which the powers of the Secretary of State to intervene under the subsequent provisions of Part II of the Act could be exercised (Regulation 19).

587 The grounds for intervention under section 37(2)[397] (which applied to the Secretary of State's intervention powers under section 38 and 41-45) were supplemented by a new ground in relation to 'sound and prudent management':

(aa) *that the company is a UK or non-EC company and it appears to [the Secretary of State] that any of the criteria of sound and prudent management is not or has not been or may not be or may not have been fulfilled with respect to the company.*

The 'criteria of sound and prudent management' were set out in Schedule 2A to the ICA 1982 and are summarised in paragraph 574 above.

588 As noted above, section 37(3) restricted the Secretary of State's powers to intervene by way of imposing requirements for the maintenance of assets in the UK and the custody of assets by a trustee under sections 39 and 40, other than on exceptional specified grounds (in order to give effect to the earlier limitations in the Directives on restrictions on the free disposal of assets by insurance companies[398]). Section 37(3) was amended by Regulation 19:

(a) to take into account a new intervention power which had the effect of restricting the free disposal of assets under section 40A (see paragraph 595);

(b) to include a new exceptional ground for intervention under section 37(3)(a) to encompass the Secretary of State's power to give a direction to suspend a company's authorisation in urgent cases under the new section 12A[399]

[396] Regulation 43 of and Schedule 10 to the Insurance Companies Regulations 1994 SI No. 1516 specified, by description, the property and stipulated the indices by reference to which linked benefits were to be determined.
[397] See paragraph 315 above. The seven original grounds for intervention under section 37(2) of the ICA 1982 had been supplemented by an eighth ground in relation to Swiss insurance companies in January 1994 by the Insurance Companies (Switzerland) Regulations 1993 SI No. 3127.
[398] Under the Directives, free disposal of assets by an insurance company could only be restricted in exceptional specified circumstances which were slightly extended by the Third Life Directive. See paragraphs 230 and 497 above.
[399] See paragraph 576 above.

(c) to include further exceptional grounds for intervention under a new section 37(3)(d), namely where it appeared to the Secretary of State that the company had failed to comply with the obligation to maintain the margin of solvency under section 32[400] or the obligation to secure the adequacy of the company's assets to cover its liabilities under the new section 35A[401].

589 A new section 37(4A) was inserted which specified that the Secretary of State's powers to intervene under the new section 43A (on general investigations by competent persons)[402] or under section 44 (to obtain information or production of documents) were exercisable to obtain information to enable him to perform his functions under the ICA 1982 (apparently to make it clear that these sections could be relied on even where none of the more general grounds for intervention under section 37(2) existed).

590 Consequential amendments were made to section 37(5) in relation to the more extensive powers of the Secretary of State to intervene under specified sections of Part II of the ICA 1982 in respect of companies which had been authorised or had been subject to a change of control within the preceding five years.

591 The provisions were extended to apply in cases where the Secretary of State had been notified of a person's intention to acquire a 'notifiable holding' (under the new requirements of section 61A, referred to below) within the preceding five years.

592 Section 37(6), which restricted the Secretary of State's powers to intervene under the residual power of section 45 in relation to PRE to circumstances where the objectives could not be appropriately achieved by reliance on other invention powers, was not affected by any of the above changes.

Maintenance of assets of a specified value in a specified location

593 The provisions of section 39 of the ICA 1982 empowering the Secretary of State to impose a requirement for the maintenance of assets in the UK were replaced to take account of the effects of the Third Life Directive. UK companies could be required to maintain assets of a value equal to the whole or a specified proportion of the amount of their EC liabilities in the European Community (rather than an amount related to their domestic liabilities being maintained in the UK) (Regulation 21).

Prohibition on disposal of assets

594 The Secretary of State was given powers under a new section 40A to apply to the court to obtain, on specified grounds, an injunction to prohibit a UK company from disposing of, or otherwise dealing with, its assets to the value of the liabilities of its business in the EC (Regulation 22).

595 The specified grounds on which the court might grant an injunction were those in section 37(3) (namely, the exceptional circumstances in which the Secretary of State could intervene to restrict the free disposal of assets by a company under sections 39, 40 or 40A such as withdrawal or urgent suspension of authorisation, failure to satisfy the obligations in respect of the minimum margin or to maintain the margin of solvency, or calculation of liabilities in the company's accounts otherwise than in accordance with the valuation regulations).

400 Formerly, the particular powers of intervention which were subject to section 37(3) could not be relied on unless the company's solvency margin had fallen below the amount of the minimum margin (or 'guarantee fund') under section 33. See paragraph 497 regarding the change in the Directives.
401 See paragraph 583.
402 Referred to in paragraph 597.

596 If an order was made, the court was empowered to make subsequent orders to provide for incidental, consequential and supplementary matters as necessary to enable the Secretary of State to perform his functions under the ICA 1982.

General investigation by a competent person or persons

597 Regulation 23 inserted a new section 43A in the ICA 1982 empowering the Secretary of State to appoint one or more competent persons to make an investigation into, and to report to him on whether, the criteria of sound and prudent management[403] were being fulfilled by a UK (or non-EC) company, or whether they would be fulfilled if a person who had notified the Secretary of State of his or her intention to do so, became a controller of such a company.

598 Obligations were imposed on directors, managers, controllers, agents, actuaries, auditors and solicitors of a company under investigation to produce documents, attend before and otherwise assist the person conducting the investigation. The person conducting the investigation was given power to enter premises occupied by the company provided prior written notice was given (unless he or she had reason to believe that documents would be removed, tampered with or destroyed if such notice was given).

Powers to obtain information and reports by an actuary, accountant or other professional

599 The powers of the Secretary of State under section 44 of the ICA 1982 to require the provision of information and production of documents by a company were extended by Regulation 24.

600 A new section 44(2B) empowered the Secretary of State to require a UK (or non-EC) company to furnish him, at a specified time, with a report by a specified person, being an actuary or an accountant or other person with relevant professional skills, on any matter about which the Secretary of State had required or could require the company to provide information under section 44(1).

601 A power of entry to premises occupied by a UK or non-EC insurance company was also given to any person authorised by the Secretary of State for the purpose of obtaining information or documents (new section 44(4A)).

Residual power to impose requirements for the protection of policyholders

602 The residual power under section 45(1)[404] was recast by Regulation 25(1) to enable the Secretary of State to intervene not only to protect policyholders or potential policyholders against the risk that the company might be unable to meet its liabilities or to fulfil their reasonable expectations, but also:

> *... in the case of a UK or non-EC company, for the purpose of ensuring that the criteria of sound and prudent management are fulfilled with respect to the company.*

603 Amendments were also made to section 45(2) in relation to the exceptional circumstances in which the power under section 45(1) might be used in such a way as to restrict a company's freedom to dispose of it assets, equivalent to those which had been made to section 37(3).

604 The new exceptional grounds were those where a direction had been given under the new power to suspend authorisation in cases of urgency under section 12A; those where the company had failed

403 Summarised in paragraph 574 above.
404 Which continued to be subject to the limitation in section 37(6) that it was only available where the purposes of section 45 could not appropriately be achieved by exercise of powers under sections 38 to 44 or by exercise of those powers alone.

to satisfy the margin of solvency requirement under section 32; or where it had failed to secure the adequacy of assets to cover its liabilities under section 35A (Regulation 25(2)).

Restrictions on disclosure and privilege from disclosure

605 Section 47A[405] of the ICA 1982 was replaced and a new Schedule 2B to the Act was inserted, imposing restrictions on disclosure of information relating to the business affairs of any person which had been obtained by the Secretary of State for the purpose of the discharge of his functions under the 1982 Act without the consent of the person from whom the information was obtained, and if different, from the person to whom the information related (Regulation 26).

606 Exceptions applied if the information had been made available to the public from other sources, or if the information was in summary form or was so framed that information relating to any particular person could not be ascertained. Further exemptions related to disclosures made to enable or assist the Secretary of State to discharge his functions under the 1982 Act or rules or regulations made under it and disclosures made to certain other government departments, bodies or officials in connection with specified statutory functions. Criminal sanctions were imposed for disclosures made in contravention of these requirements.

607 Section 47B, under which a document was exempt from disclosure to the Secretary of State under section 44(2)-(4) of the ICA 1982 in cases where production of the document by the person concerned could be refused in High Court proceedings on grounds of legal professional privilege, was extended to apply where the document was sought under the new section 43A (general investigation by a competent person) (Regulation 27).

Transfers of insurance business

608 In relation to an application to the court made on or after 1 July 1994 to sanction the transfer of an insurance business, sections 49 to 52 of the ICA 1982 were replaced with a new section 49 and Schedule 2C to the ICA 1982 (Regulation 28). Part I of the new schedule provided for transfers of long term business (and Part II dealt with transfers of general business).

609 The provisions of Schedule 2C were more elaborate than those they replaced and provided for the possibility that the transferor or the transferee company might be an undertaking with a head office outside the UK and that the transferor might have concluded contracts of insurance in other countries.

610 Section 52A of the ICA 1982 as originally introduced into the ICA 1982[406] concerned cases where general business was proposed to be transferred to a UK insurance company from a company established in another member state, empowering the Secretary of State to certify, if he was satisfied that it was the case, that the UK insurance company possessed the necessary margin of solvency after taking the proposed transfer into account.

611 Regulation 29 substituted a new section 52A which related to both general and long term business and empowered the Secretary of State to issue such a certificate when a transfer to a UK company or to a non-EC company supervised by the Secretary of State was contemplated. The court was prohibited from sanctioning a transfer unless the Secretary of State (or the supervisory authority of the state in which the transferee was situated) had certified that the transferee company possessed the necessary margin of solvency after taking account of the proposed transfer (paragraph 3(1)(b) of Schedule 2C).

[405] Which, together with section 47B, had been inserted in the ICA 1982 by section 25 of the Companies Consolidation (Consequential Provisions) Act 1985.

[406] By Regulation 9 of SI 1990 No. 1333, (see paragraph 416).

Winding up

612 The grounds on which the Secretary of State could petition the court to wind up an insurance company were slightly revised by Regulation 31. In 1990 section 54 of the ICA 1982 had been amended to include an additional ground for winding up in relation to companies conducting general business[407] in circumstances where the company had failed to comply with an obligation to which it was subject by virtue of the law of another member state giving effect to the general insurance Directives. These provisions were extended to make them applicable to non-compliance with the law of another EEA State[408] which gave effect to general or long term insurance Directives or which was otherwise applicable to the insurance activities of the company in that State.

Changes of director, controller or manager

613 Sections 60 to 64 of the ICA 1982 made provision for the Secretary of State to object to the appointment by an insurance company of a managing director or chief executive, or to a person becoming a controller of a company[409] and contained requirements for the Secretary of State to be notified by the company of changes in the directors, controllers, managers and main agents and of such other matters as might be prescribed. (Notice of prescribed matters was also required to be given to the insurance company by controllers, shareholder controllers, directors and managers.)

614 Those provisions were revised by Regulations 32-35 of the ICTID Regulations 1994 and a new Schedule 2D was inserted in the 1982 Act which made further provision for the situation where a new managing director, chief executive or controller of an insurance company was proposed, or where a controller proposed to acquire a 'notifiable holding'.

615 Section 60(3) was amended by regulation 32 so as to include an additional ground on which the Secretary of State might serve notice of objection to a person whom the company proposed to appoint as managing director or chief executive:

> *... where the insurance company is a UK or non-EC company, that it appears to him that, if that person were appointed, the criteria of sound and prudent management would not or might not continue to be fulfilled in respect of the company.*

The layout of section 60(3) was revised (by the creation of new subsection (3A)), but the substance of the remaining provisions of section 60 was preserved.

616 Equivalent revisions were made to section 61 regarding objection by the Secretary of State to a person proposing to become a controller (otherwise than by appointment as a managing director or chief executive), enabling the Secretary of State to serve notice of objection on 'sound and prudent management' grounds (Regulation 33).

617 Regulation 34 created a new section 61A which enabled the Secretary of State to serve notice of objection if a controller of a company intended to acquire a 'notifiable holding' in the company. A notifiable holding was defined[410] as being voting rights or shares which, if acquired by the person, would result in that person becoming a 10 per

407 New sections 54(1)(bb) and 54(2)(bb) had been inserted by Regulation 8 of SI 1990 No. 1333.
408 See footnote 391.
409 The effect of such an objection being to debar the company from making the appointment or the proposed controller from taking control.
410 In section 96(1) together with the new section 96C, inserted in the ICA 1982 by the ICTID Regulations 1994.

cent shareholder controller, a 20 per cent shareholder controller, a 33 per cent shareholder controller, a 50 per cent shareholder controller or a majority shareholder controller[411].

618 The controller was prohibited from acquiring the holding if the Secretary of State notified his objection within three months. Such an objection could be raised on the grounds that it appeared that the controller was not a 'fit and proper person' or it appeared that the criteria of 'sound and prudent management' might not be fulfilled. The provisions of section 61(2)-(4) applied, requiring preliminary notice to be given by the Secretary of State that he was considering giving notice of objection and inviting the person concerned to make written and oral representations.

619 Section 62(1) was replaced with a new section which required those who became or ceased to be 10, 20, 33 or 50 per cent shareholder controllers or majority shareholder controllers[412] to give notice to the company within seven days of having done so (in addition to such notice being required of those who became or ceased to be controllers[413] as under the original provisions) (Regulation 36). The obligation of the company to notify the Secretary of State within 14 days of such changes coming to the company's knowledge (and of other matters of which notice was required to be given to it) was preserved.

Offences under Part II

620 Consequential amendments were made to section 71 of the ICA 1982 on offences under Part II to take account of the new requirements.

Other changes made by the ICTID Regulations 1994

621 Chapter III of Part II of the ICTID Regulations 1994 made changes to Part III of the ICA 1982 on conduct of business regulation, including changes in respect of information and statutory notices to be provided to policyholders and potential policyholders (inserting or amending sections 72A, 72B, 74 and 75).

622 Chapter IV of Part II replaced the whole of Part IIIA of the ICA 1982[414] and inserted two new Schedules (2F and 2G) concerning recognition in the UK of insurance companies which had their head office in one of the other states of the European Economic Area and the recognition of UK companies in those states.

623 Changes were also made to the provisions on special classes of insurers in Part IV of the ICA 1982 and to Schedule 3A[415] regarding the law applicable to insurance contracts concluded in various states.

411 A 'shareholder controller' was defined as a person who was a 'controller' by virtue of section 96C(2) (being one of five categories of 'controller' as defined in section 96C(1)), namely a person who alone or with associates held 10% or more of the shares in the company or its parent, or was entitled to exercise, or control the exercise of, 10% or more of the voting rights at a general meeting of the company or of its parent, or was able to exert significant influence over the management of the company or of its parent by virtue of a holding in shares or entitlement to exercise or to control the exercise of voting power at a general meeting of the company or the parent. A '10 per cent shareholder controller', '20 per cent shareholder' and the related expressions were defined in section 96C(3) to mean a shareholder controller in whose case the percentage referred to in section 96C(2) was 10 or more but less than 20; 20 or more but less than 33; etc.

412 See previous footnote.

413 Defined in the new section 96C as the managing director or chief executive of the company or its parent; a person in accordance with whose directions or instructions the directors of the company or its parent were accustomed to act; a person who satisfied the 'shareholder controller' requirements of section 96C(2) referred to in footnote 411; or in the case of a non-UK company, a person who alone or with any associates was entitled to exercise, or controlled the exercise, of 15% or more of the voting power at a general meeting of the company or its parent.

414 Which had been inserted in the Act by SI 1990 No. 1333 (see paragraph 416).

415 Inserted in the Act by SI 1990 No. 1333.

624 Part III of the ICTID Regulations 1994 made amendments to the FS Act 1986, for example in relation to the application of the rules for self-regulating organisations as they applied to EC companies, to provide powers of intervention in respect of such companies and to extend the powers of the SIB to obtain information from 'authorised persons' and certain specified 'recognised bodies' under that Act.

Further amendments in 1994 and eventual repeal of the ICTID Regulations 1994

625 Further amendments were made to the ICA 1982 and to the ICTID Regulations 1994 by the Insurance Companies (Amendment) Regulations 1994[416] which came into force on 30 December 1994. The further revisions were mainly minor or technical and are not of relevance here.

626 The ICA 1982 was amended in 1995 by the Insurance Companies (Reserves) Act 1995, which inserted a new section 34A. This section required insurance companies which carried on general business of prescribed descriptions to maintain an 'equalisation reserve' in relation to that business. Tax relief was provided in relation to the reserve, under section 166 of the Finance Act 1996.

627 The ICTID Regulations 1994 were repealed along with the ICA 1982 with effect from 1 December 2001 by the Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001[417].

The Insurance Companies Regulations 1994

628 The Insurance Companies Regulations 1994[418] (ICR 1994) came into force on 1 July 1994 at the same time as the ICTID Regulations 1994. ICR 1994 was made under the ECA 1972 and various provisions of the ICA 1982. They consolidated ICR 1981 with the amendments which had been made to it over the years[419] and parts of other subordinate legislation[420] and included amendments to implement the Third Life Directive.

629 As originally enacted ICR 1994 consisted of twelve parts[421] and seventeen Schedules. Those of most relevance to the prudential regulation[422] of life insurance business were:

Part I:	commencement and definitions;
Part II:	authorisation, with the information to be submitted in connection with authorisation of long term business set out in Schedule 1;
Part IV:	margins of solvency, with the minimum guarantee fund set out in Schedule 5;
Part V:	currency matching and localisation;
Part VI:	change of control, with Schedule 6 specifying the particulars to be given

416 SI 1994 No. 3132.
417 SI 2001 No. 3649.
418 SI 1994 No. 1516.
419 Certain of the amendments made to ICR 1981 up to 1990 are referred to in paragraphs 412 et seq. Further minor amendments were made by the Insurance Companies (Amendment) Regulations 1992 SI No. 445 and by the Insurance Companies (Cancellation No. 2) Regulations 1993 SI No. 1092, including amendments to the form of the statutory notice to be sent to long-term policyholders in relation to cancellation under section 75 of the ICA 1982.
420 Part of the Insurance Companies (Credit Insurance) Regulations 1990 SI No. 1181 and Regulation 13 of SI 1992 No. 2890, (referred to in paragraph 511).
421 Part X which dealt with credit insurance business was revoked by the Insurance Companies (Reserves) Regulations 1996 SI No. 946 which introduced equalisation reserves for general insurance companies.
422 ICR 1994 also dealt with matters relevant to conduct of business regulation such as the contents of advertisements.

by an insurance company in relation to proposed managing directors, chief executives and other 'controllers' when giving notice under section 60(1) or 61(1) of the ICA 1982;

Part VII conduct of business, including not only matters relating to insurance advertisements and information given by intermediaries, but also provisions concerning the prescribed assets and indices to which benefits under linked long term contracts could be linked, with the list of permitted links set out in Schedule 10;

Part VIII: valuation of assets, with the value of the assets of 'dependants' (subsidiary undertakings of an insurance company) set out in Schedule 11 and assets which could be taken into account only to a specified extent set out in Schedule 12; and

Part IX: determination of liabilities.

630 The substantive changes introduced by ICR 1994 were comparatively minimal, since many of the basic requirements of the earlier EEC Directives on such matters as the margin of solvency and the guarantee fund had been embodied in ICR 1981, and a number of the harmonisation measures in the Third Life Directive were already broadly reflected in some form in the UK provisions.

631 However, changes were made to Regulation 64[423] on the determination of liabilities, including an express requirement that the actuarial principles used in valuing long term liabilities should have due regard to PRE.

632 The following outlines the provisions of ICR 1994 which concerned the margin of solvency and guarantee fund, matching and localisation, valuation of assets and determination of liabilities for UK life companies (other than pure reinsurers).

Margin of solvency and guarantee fund – Part IV and Schedule 5

633 Part IV largely reproduced Part II of ICR 1981, with some additions. In simplified terms, the margin of solvency for non-linked life assurance and annuities (classes I, II and IX) under Regulation 18 was the sum of:

(a) 4% of the mathematical reserves reduced by not more than 15% for liabilities which were reinsured; and

(b) 0.3%[424] of the capital at risk reduced by not more than 50% for reinsured liabilities.

634 For linked long term assurance, permanent health insurance, capital redemption, managed funds and collective insurance (classes III, IV, VI, VII and VIII), the calculation was as in (a) in the preceding paragraph, but the required percentage was reduced to 1% for contracts in classes III, VII and VIII if the company bore no investment risk.

635 For companies in those three classes the required margin of solvency was zero if the company bore no investment risk and the term of the contract (expired and unexpired) was no more than five years, or if management expenses were not subject to a fixed upper limit for a period of more than five years (Regulations 19 and 20).

423 The equivalent provision to Regulation 54 of ICR 1981.
424 This percentage was reduced in the case of short-term contracts (of no more than five years) which provided only for benefits payable on death within a specified period.

636 Where a company carried on more than one class of long-term business such that more than one margin of solvency calculation applied, those margins were to be aggregated in order to arrive at the company's required margin of solvency (Regulation 17(4)).

637 In general, the 'guarantee fund' (or minimum margin for the purpose of section 33 of the ICA 1982), was one third of the margin of solvency, subject to a minimum (in the case of a mutual) of 600,000 ECU (the 'minimum guarantee fund') (Regulation 22 and Schedule 5).

638 In the case of long term business, the minimum guarantee fund or at least half of the guarantee fund (whichever was larger) was required to be covered by explicit items[425] such as share capital and reserves that were not attributed to any general business and the excess of the assets representing the fund over the liabilities (in so far as this excess did not form part of the mathematical reserves[426] assessed in relation to assets at market value).

639 Regulation 23 made specific provision for determining the extent to which the value of a company's assets exceeded its liabilities in connection with the required calculations of the margin of solvency, the guarantee fund and the minimum guarantee fund, in addition to all other applicable regulations[427].

640 The extent to which implicit items could be taken into consideration in the margin of solvency calculations continued to be dependent upon an order being made by the Secretary of State under section 68 of the ICA 1982 (Regulation 23(5)). Implicit items consisted of:

(a) an allowance for future profits of up to 50% of the product of the estimated annual profit and a factor representing the average outstanding term of the policies subject to a maximum of ten years (Regulation 24);

(b) an allowance, where zillmerising was appropriate but had not been used or had been used only partially, of not more than 3.5% of the relevant capital at risk or at a rate equal to the loading for acquisition costs included in the premium, subject to a reduction for any Zillmer adjustment which had already be made in the valuation (Regulation 25);

(c) hidden reserves[428] resulting from an underestimation of assets and overestimation of liabilities (other than the mathematical reserves) which were not of an exceptional nature (Regulation 26).

Matching and localisation – Part V

641 The currency matching and localisation rules in Part V required that where an insurance company's liabilities in a particular currency exceeded 5% of its total liabilities, at least 80% of those liabilities were to be covered in the same currency. If the liabilities were in sterling, the assets could be held in any member state; if they were to cover liabilities in any other currency, the assets were to

425 Regulation 22(3) referred to '*items that are not implicit items*' rather than to 'explicit items' (and defined 'implicit items' in Regulation 23(5) as being the future profits, Zillmer adjustment and hidden reserves valued in accordance with Regulations 24-26).

426 'Mathematical reserves' were defined in Regulation 2(1) as in ICR 1981 (see paragraph 265), save for a new exclusion in relation to 'deposit back arrangements': '*the provision made by an insurer to cover liabilities (excluding liabilities which have fallen due and liabilities arising from deposit back arrangements) arising under or in connection with contracts for long term business*'.

427 Regulation 23(1).

428 In a paper entitled 'Statutory Regulation of Long Term Insurance Business' prepared for the F&IA by William M. Abbott and revised by Nick C. Dexter in 2000 it was said that 'hidden reserves' were most relevant to non-UK companies as they adopted a different approach to the valuation of assets and liabilities, but in principle the concept might be used to disapply the admissibility limits relating to particular assets.

be held in the EC or in the country of the currency concerned (Regulations 27 and 31).

642 Index linked liabilities, business conducted by a UK company outside the EC and pure reinsurance business were excluded from the matching and localisation provisions (Regulations 28 and 32(1)(b) and (c)).

Valuation of assets – Part VIII and Schedules 11 and 12

643 Part VIII of ICR 1994 was made under the power of the Secretary of State to make valuation regulations under section 90 of the ICA 1982 and consolidated the law previously in force in relation to assets under Part V of ICR 1981[429] with amendments. Regulations on the valuation of assets had first been made in 1974[430] and had become progressively more complex over the years.

644 The interpretation regulation in Part VIII included a number of new or revised definitions[431] and ran to some eight pages; however, the general approach of the regulations remained as being to specify the manner in which assets were to be valued and to impose limitations on the extent to which certain assets could be taken into consideration when determining the solvency of a company. The basic aims remained as being to ensure that there was no undue concentration of risk in particular kinds of asset or overvaluation of assets which could endanger solvency.

645 Part VIII applied to the valuation of assets for the purposes of the following provisions of the ICA 1982: sections 29(7) (declaration of dividends), 31 (restrictions on transactions with connected persons), 32 (margin of solvency), 34 (companies supervised in other member states), 35 (form and situation of assets), 38 (requirements about investments), 39 (maintenance of assets in the UK) and 45 (residual powers to impose requirements to protect policyholders) and in relation to investigations under sections 18 and 42 of the 1982 Act.

646 Part VIII did not apply to the determination of the value of linked assets in relation to contracts providing for the payment of property linked benefits to the extent that the assets were held to comply with the requirements of section 35A of the ICA 1982 (regarding the adequacy of assets), to match liabilities in respect of such benefits[432].

647 Part VIII applied to both long term business and general business. In broad terms, the approach to valuation of assets (set out in Regulations 46-56) was to require that assets be valued as at a prescribed amount (for example, at their market value) or as not being greater than a specified amount, in the latter case, subject to an overriding requirement that this should be no more than the amount which, in all the circumstances of the case, was likely to be

429 See paragraph 194. Guidance in implicit items under the former provisions of regulations 10-13 of ICR 1981 in a Prudential Guidance Note for appointed actuaries, issued on 5 October 1984, explained that under-estimation of the value of an asset might occur because of an express requirement of ICR 1981 which had the effect of excluding or limiting the value of certain assets which could be counted towards the margin of solvency. Paragraph 32 of that guidance stated that allowing items which were explicitly excluded under the Regulations to be counted towards the margin of solvency would be '*tantamount to nullifying the effect of those regulations*'. Consequently, it was envisaged that concessions to allow inadmissible assets would '*rarely if ever be given*'.

430 In SI 1974 No. 2203, see footnote 56 and paragraph 167.

431 To allow for the valuation of assets in respect of such items as derivative contracts and stock lending transactions, to make provision for assets relating to regulated financial institutions and with revised definitions for secured debts and dependants (subsidiary companies).

432 Section 35A(2) and (3) made special provision for assets to match liabilities under linked long term contracts, requiring the assets to be of descriptions prescribed in regulations made under section 78 (Regulation 43 and Schedule 10 to ICR 1994 on permitted links were made for the purpose of section 78).

realisable (Regulation 45(4), which was extended in the following year, see paragraph 684)[433].

648 Regulation 48 on the valuation of debts and other rights was substantially revised from its predecessor provision[434]. Debts in respect of premiums which were due but had been outstanding for more than three months were to be disregarded[435]. The value attributed to land was to be no greater than the open market sale value assessed within the preceding three years by a qualified valuer (Regulation 49). The value of computer equipment was to be written off over four years and of other office machinery over two years (Regulation 50). Regulation 55 made provision for the valuation of rights under derivative contracts (for which no specific provision had been made in ICR 1981)[436].

649 The rules on the extent to which assets could be taken into account (known as the 'admissibility rules'[437]) were substantially revised (Regulation 57 and Schedule 12). The admissibility rules limited the extent to which most assets could be taken into account, based on the company's *'aggregate exposure to such assets'*. If the aggregate exposure exceeded the *'maximum admissible value'* for assets of the particular description, the excess value was to be left out of account.

650 The 'maximum admissible value' of various assets for a company carrying on long term business was included in Part I of Schedule 12. The limits were assessed by reference to the 'long term business amount' (initially defined as being, broadly, the sum of the company's long term liabilities and one sixth of its margin of solvency (or 800,000 ECU if greater), less specified deductions for such items as liabilities in respect of property linked benefits). Part I of Schedule 12 prescribed percentages of the long term business amount in relation to various descriptions of assets; assets of a value which exceed this percentage were to be disregarded in assessing the value of the company's assets for solvency purposes. For example, unsecured debts due from any one unincorporated body of a value greater than 1% of the long term business amount were to be left out of account.

651 The aim of the admissibility rules was to reduce the amount which could be taken into account for solvency purposes where there was considered to be too great a concentration of holding of a particular type of asset or holding with a particular party.

652 The admissibility rules were most strict in relation to assets considered to present the greatest risks. Certain assets were excluded from the admissibility rules, such as approved securities, debts due under reinsurance contracts and debts in respect of premiums.

653 As noted in paragraph 684, Regulation 57 of and Schedule 12 to ICR 1994 were replaced in 1995 and a revised definition of the 'long term business amount' was included in the new Schedule 12 (which was then re-amended in 1996). Under the amended definition, the long term business amount was defined as being the amount of the company's long term insurance liabilities (net of reinsurance ceded and excluding property-linked

433 In regulations 46 and 47 and Schedule 11.
434 Regulation 41 of ICR 1981.
435 Implementing article 21.1(vii) of the Third Life Directive.
436 'Derivative contracts' were defined in Regulation 44(1) as '*a contract for differences, a futures contract or an option*'. Article 21.1(iv) of the Third Life Directive referred to '*derivative instruments such as options, futures and swaps*' and required that they be valued on a prudent basis.
437 Reflecting articles 20-22 of the Third Life Directive, which required prudence and diversity in the investments and other assets used as cover for technical provisions, and imposed limits on the kinds of asset and degree of investment in specified kinds of investment.

liabilities), together with the (entire) amount of the margin of solvency (less any implicit items) and the amount of any deposit-back in connection with reinsurance in respect of long term business.

654 In the main, separate provision was made in relation to assets which supported linked long term business. As noted, assets required to match liabilities in respect of property linked benefits were excluded from Part VIII of ICR 1994. The benefits under such contracts entered into on or after 1 July 1994 were to be determined wholly by reference to the value, or fluctuations in the value, of the property listed in Part I of Schedule 10 (Regulation 43(1)).

655 Although assets held to cover index linked benefits were subject to the asset valuation rules in Part VIII, most descriptions of assets used to cover the liabilities under such contracts were initially excluded from the admissibility rules under Regulation 57 (by Regulation 57(14)). Regulation 57 was then substituted in 1995 and the assets used to cover the liabilities under contracts providing for index-linked benefits were made subject to the counterparty exposure limits under the asset admissibility rules. Index linked benefits were to be determined by reference to fluctuations in an index which met the description in Part II of Schedule 10 (Regulation 43(2)).

Determination of liabilities regulations – Part IX

656 In common with Part VIII, Part IX was made under the Secretary of State's power to make valuation regulations under section 90 of the ICA 1982. It re-enacted, with amendments, the provisions of Part VI of ICR 1981 which had first introduced regulations in relation to the determination of liabilities[438].

657 Part IX applied in respect of the determination of liabilities for the purposes of the same provisions of the ICA 1982 as those for which Part VIII on valuation of assets applied (see paragraph 645), and for the purpose of section 37(3) (exceptional grounds for intervention in relation to sections 39, 40 and 40A, which included the submission by the company to the Secretary of State of an account or statement which specified an amount of any liabilities which appeared to the Secretary of State to have been determined otherwise than in accordance with valuation regulations).

658 Part IX applied to the determination of property-linked liabilities (unlike Part VIII, from which valuation of assets held to match such liabilities was excluded (see paragraph 646)).

659 It has been noted that, although the effect of the liability regulations was to restrict the actuary's freedom to choose a valuation basis, the actuary still retained a very considerable degree of flexibility of choice in comparison to that available to actuaries in many other countries of the European Union[439].

660 Regulation 60 re-enacted the basic requirements in relation to the determination of liabilities for long term and general insurance business previously contained in Regulation 52 of ICR 1981, with a new exception in relation to cumulative preference shares (which were dealt with in Regulation 23(3) of the 1994 Regulations).

661 Although, as noted in paragraph 195 there were no financial reporting standards specifically for insurance business, Regulation 60 stated that:

(1) *Subject to this Part of these Regulations, the amount of liabilities of an insurance company in respect of its long term and general business shall be determined in accordance with generally accepted accounting concepts, bases*

[438] See paragraphs 261 et seq.
[439] The paper entitled 'Statutory Regulation of Long Term Insurance Business' referred to in footnote 428.

and policies or other generally accepted methods appropriate for insurance companies.

(2) *In determining under paragraph (1) above the amount of the liabilities of an insurance company, all contingent and prospective liabilities shall be taken into account but save as provided in regulation 23(3) of these Regulations not liabilities in respect of share capital.*

662 'Long term liabilities' were defined as under regulation 50 of ICR 1981 to mean '*liabilities of an insurance company arising under or in connection with contracts for long term business*', but with the addition of a reference to the expression including liabilities arising from 'deposit back arrangements'[440] (Regulation 58).

663 A new requirement was imposed on companies under regulation 61 in relation to liabilities under derivative contracts (and contracts with equivalent effect), to make sufficient provision on prudent assumptions for the effect of possible adverse changes in the value of the assets to which the contract related[441].

664 As noted above, Regulation 64 (derived from regulation 54 of ICR 1981), which contained general requirements for the determination of the amount of the long term liabilities, included for the first time a reference to the 'reasonable expectations of policyholders' in relation to the actuarial principles to be used.

665 Regulation 64 was intended to impose overriding obligations in relation to the determination of the amount of a company's liabilities. It required, without prejudice to its generality, compliance with the more detailed provisions of Regulations 65 to 75 in determining the amount of the long term liabilities. Regulation 64 provided:

(1) *The determination of the amount of long term liabilities (other than liabilities which have fallen due for payment before the valuation date) shall be made* ***on actuarial principles which have due regard to the reasonable expectations of policy holders*** *and shall make proper provision for all liabilities on prudent assumptions and shall include appropriate margins for adverse deviation of the relevant factors.* (Emphasis added.)

(2) *The determination shall take account of all prospective liabilities as determined by the policy conditions for each existing contract, taking credit for premiums payable after the valuation date.*

(3) *Without prejudice to the generality of paragraph (1) above, the amount of the long term liabilities shall be determined in compliance with each of regulations 65 to 75 below and shall take into account, inter alia, the following factors:*

   (a) *all guaranteed benefits, including guaranteed surrender values;*

   (b) *vested, declared or allotted bonuses to which policy holders are already either collectively or individually entitled;*

   (c) *all options available to the policy holder under the terms of the contract;*

   (d) *expenses, including commissions.*

440 Defined in regulation 2(1) as meaning, in relation to a contract for reinsurance, an arrangement whereby an amount is deposited by the reinsurer with the cedant (i.e. the insurance company which has arranged reinsurance).

441 Article 21.1(iv) of the Third Life Directive specified that such instruments could be used as cover for technical provisions '*in so far as they contribute to a reduction of investment risk or facilitate efficient portfolio management*'.

666 It is to be noted that paragraph (1) of Regulation 64 required provisions to include appropriate margins for adverse deviation of relevant factors[442]. Paragraphs (2) and (3) were also new and mirrored the provisions of the first principle for the determination of technical provisions under the Life Directives[443], which required a prudent prospective actuarial valuation which included the specified items listed in paragraph (3) of Regulation 64.

667 Regulation 54 of ICR 1981 (from which Regulation 64 of ICR 1994 was derived) had specified that the amount of the long term liabilities should *'in the aggregate not in any case be less than the amount calculated in accordance with regulations 55 to 64 below'* (see paragraph 266). The reference to '*in the aggregate*' in respect of the determination of the amount of the long term liabilities was not replicated in Regulation 64 of ICR 1994, which did not, in general, envisage the use of alternative valuation methods to those prescribed in the Regulations[444].

668 However, Regulation 67 of ICR 1994, which made specific provision for the valuation of future premiums, provided that if any alternative valuation method to those described in Regulation 67 had been used to value future premiums, it should be demonstrated that the alternative method resulted in reserves which were no less, in aggregate, than those which would result from the application of the methods specified in Regulation 67 (see paragraph 679 regarding Regulation 67(4)).

669 It is difficult to assess the practical impact of the inclusion of a reference to '*the reasonable expectations of policyholders*'[445] in the regulation which set out the fundamental requirements for the determination of long term liabilities. Its predecessor provision (Regulation 54 of ICR 1981) which had not included this term had been considered to provide a means of strengthening reserves where necessary in relation to the interests of with-profits policyholders if the net premium valuation basis did not result in sufficient provision for future bonuses[446].

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442 Implementing item A.(iii) of article 17.1 of the First Life Directive as replaced by article 18 of the Third Life Directive which specified that a prudent valuation was not a 'best estimate' valuation and should include appropriate margins for adverse deviations of relevant factors.

443 Item A.(i) of article 17.1 of the First Life Directive as replaced by article 18 of the Third Life Directive.

444 Regulation 54 of ICR 1981 had referred to the amount of the liabilities being '*in the aggregate not... less than the amount calculated in accordance with regulations 55 to 64 below*'. Thus if any valuation methods other than those prescribed in regulations 55 to 64 had been used for the 'main valuation' a second valuation, compliant with those regulations, would be needed in order to demonstrate compliance with regulation 54. In effect, regulations 55 to 64 provided a minimum 'benchmark figure' against which the aggregate figure for the liabilities produced by the main valuation was to be tested. In calculating the 'benchmark figure' in accordance with regulations 55 to 64 offsetting of provisions or margins required by those individual regulations was not permitted. The guidance in early versions of GN8 concerning regulation 54 of ICR 1981 (e.g. in paragraph 3.1.1 of version 1.0) advised that the actuary should interpret the tests in regulations 55-64 in a prudent way, satisfy him or herself that, within the aggregate liability produced by his or her valuation, the various provisions and margins required by those regulations could be provided for in full, whether explicitly or implicity, and that, if he or she considered that one provision or margin required by the regulations for one category of contract was excessive, it was not permissible to offset part of it against another provision or margin required by those regulations for that or another category of contract, except in one specified circumstance. Under regulation 64 of ICR 1994 only one valuation was envisaged (subject to regulation 67(4) in respect of future premiums, see paragraph 679) and that valuation was required to be conducted taking account of specified factors and in accordance with the detailed regulations (65 -75), without offsetting of any margins required by those regulations. The updated guidance to appointed actuaries in GN8 version 4 issued at the end of 1994 in relation to regulation 64 of ICR 1994 advised (in paragraph 3.1.1) that offsetting a perceived excess in one provision or margin required by regulations 65- 75 for '*any element of the basis*' against another provision or margin required by the regulations was not permissible, save in one specified exceptional circumstance.

445 It is to be noted that no reference was made in Regulation 64 to 'potential policyholders', suggesting that the expectations of prospective policyholders' were not considered to be relevant in this context.

446 See the comments of the GAD actuary quoted at paragraph 279.

670 The professional guidance issued to appointed actuaries by the F&IA had made reference to the need for actuaries to consider policyholders' reasonable expectations in some way from the time GN1 was first issued in 1975 and by 1992, that guidance referred to the need for the actuary to have regard to policyholders' reasonable expectations when assessing long term liabilities[447].

671 The inclusion of the expression in the legislation in 1994 appears to have been intended to give the concept greater significance. Although doubts continued to be expressed about the ambit of the phrase, it appears to have been accepted that it was intended to encompass something more than contractual liabilities, and was of particular significance for policyholders' expectations in relation to discretionary items, such as reversionary and terminal bonus.

672 A note of a meeting between DTI and GAD officials regarding the drafting of ICR 1994 in or around April 1994[448] indicates that it had been proposed that the words '*which have due regard to the reasonable expectations of policyholders* ***and to the value placed on assets***' should be included to amplify the reference to 'actuarial principles', in order to make it clear that proper allowance should be made in the valuation for future bonuses.

673 The final words of this proposed additional drafting (quoted in bold text) did not appear in ICR 1994, as it had been considered that those words would '*steer the actuary towards requiring a reserve for terminal bonus*'[449]. It was considered that the remaining requirement (to have regard to the reasonable expectations of policyholders in the actuarial principles used) would be '*sufficient to supervise this area adequately, and it will allow the use of the investment reserve for accrued terminal bonus*'.

674 The Penrose Report[450] indicates that even ICR 1994 did not require *recognition* of liabilities by reference to policyholders' reasonable expectations, but simply that liabilities which were recognised should be quantified for the purpose of the statutory returns taking into account, inter alia, policyholders' reasonable expectations (noting that Skerman's[451] original approach to policyholders' reasonable expectations was to cater for them through the use of a net premium basis for valuation and not by treating them as liabilities).

675 Whether or not policyholders' reasonable expectations were to be treated as 'liabilities' under ICR 1994, if the additional reference to them was to serve any function, it is to be assumed that it was intended that policyholders' reasonable expectations should be a factor which could affect the amount or composition of the technical provisions which a company was required to make.

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447 See paragraph 514(g) (and paragraph 352 regarding the requirement introduced in 1983 for actuaries '*to pay due regard to the future interests of with-profit policyholders*' in their valuations under paragraph 2.1.3 of GN8).

448 The note appears to have been prepared by another GAD actuary. It refers to the deletion of a paragraph proposed to be numbered (7) in the draft regulation concerning the method of calculation (Regulation 65 in the enacted version of ICR 1994) because of a '*genuine concern that the regulation as drafted required companies to reserve for final bonuses, even though we have made it clear that this was not the intention. (We want UK companies to be able to continue their present practices with regard to the cover for the solvency margin, which will thus enable them to use the investment reserve for this purpose.)*'. The note goes on to state that in order to ensure that the reasonable expectations of policyholders would be covered and proper allowance was made in the valuation for future bonuses, it had been decided to include the additional phrase quoted in the paragraph above, to amplify the meaning of 'actuarial principles'.

449 The note indicates that this was the view of the three actuaries representing the actuarial profession on the implications of the originally proposed additional drafting, although each of them had interpreted it in a different way.

450 Chapter 10, paragraph 19. This view is based in part on the definition of 'long term liabilities' in Regulation 58 as being those arising '*under or in connection with contracts*'.

451 In his 1966 paper on 'A Solvency Standard for Life Assurance Business': JIA 92 (1966) 57-84.

676 Describing the changes then shortly to be introduced by ICR 1994 at a meeting of the Institute of Actuaries in April 1994, a GAD actuary explained that there would no longer be any reference to specific reserves for future bonuses; instead the actuary would have to have regard to PRE. '*There was, however, no intention of requiring a general strengthening of reserves in this area.*'[452]

677. Regulation 65 on methods of calculation of long term liabilities was entirely new and was made to implement obligations under the Third Life Directive. It required the amount of the long term liabilities to be determined separately for each contract by a prospective calculation, permitting a retrospective calculation only if a prospective calculation could not be applied to the particular type of contract or benefit or where a retrospective calculation would produce an amount at least as great as a prudent prospective calculation[453].

678 That Regulation also required that the method of calculation of the amount of the liabilities and the assumptions used should not be subject to discontinuities from year to year arising from the arbitrary changes. It required that liabilities for with-profits contracts should have regard to the level of premiums under the contracts, to the assets held in respect of those liabilities, and to the custom and practice of the company in the manner and timing of the distribution of profits or the granting of discretionary additions.

679 Regulation 67 dealt with the valuation of future premiums. The first three paragraphs of the regulation repeated the provisions of Regulation 57 of ICR 1981[454] which entailed a net premium method of calculation in most cases. A new paragraph (4) was added which provided:

> *An alternative valuation method to that described in paragraphs (1)-(3) above may be used where it can be demonstrated that the alternative method results in reserves no less, in aggregate, than would result from the use of the method described in those paragraphs.*

680 Regulation 69 which dealt with the rates of interest to be used in calculating the present value of future payments by or to an insurance company was revised from its predecessor provision (Regulation 59 of ICR 1981), in light of the provisions of the Third Life Directive which set out limits and requirements for the rules to be made by member states in relation to the prudent choice of an interest rate[455] in determining the amount of the technical provisions.

681 Regulation 72 regarding options replaced Regulation 62 of ICR 1981[456]. The wording of paragraph (1) was revised to require that provision should be made '*on prudent assumptions*' to cover any increase in the liabilities caused by policyholders exercising options under their contracts[457]. Paragraph (2), regarding the calculation of the required provision for options under which the policyholder could secure a guaranteed cash payment within twelve months after the valuation date, re-enacted the provisions of Regulation 62(2) of ICR 1981 without amendment.

452 JIA 121, III, 597-601 at page 597.
453 Implementing items A.(i) and (ii) of article 17.1 of the First Life Directive as replaced by article 18 of the Third Life Directive.
454 See paragraph 269.
455 Item B. of article 17.1 of the First Life Directive as replaced by article 18 of the Third Life Directive.
456 See paragraph 272.
457 The Report of the FSA on the Review of the Regulation of Equitable from 1 January 1999 to 8 December 2000 submitted as evidence to the inquiry conducted by Lord Penrose (16 October 2001) (the Baird Report), at paragraph 3.22.5 describes the interpretation of Regulation 72 as being at the heart of the debate on reserving between Equitable and the Treasury (and later, the FSA). See paragraph 978 regarding the amendments made to Regulation 72 in May 2000 by the Insurance Companies (Amendment) Regulations 2000 SI No. 1231.

682 Regulation 75 which replaced Regulation 55 of ICR 1981[458] regarding the impact on the determination of liabilities of the nature and term of the assets representing the long term fund, contained revised and expanded provisions. The changes were intended to clarify the need to ensure the adequacy of the assets to meet obligations under long term contracts as they arose and the liabilities as determined in accordance with regulations 65-74.

Amendments to ICR 1994

683 ICR 1994 was amended later in 1994[459] and in 1995[460]. Revisions made in 1995 included a substituted Regulation 45(4) (which extended to all valuations under Part VIII the overriding rule that assets should not be valued at an amount greater than that at which they were expected to be realised), a new regulation 47A (relating to certain sale and repurchase transactions), the replacement of certain of the asset valuation regulations (Regulations 51-53 and 55-57), the replacement of Schedule 12 (which was substantially amended and contained a revised definition of the 'long term business amount', which was re-amended in the following year), and minor revisions to the determination of liability regulations (Regulations 58, 60, 61, 62, 64 and 69).

684 ICR 1994 was amended by six other statutory instruments[461] before they were revoked with effect from 1 December 2001 by article 460 of the Financial Services and Markets Act 2000 (Consequential Amendment and Repeals) Order 2001[462]. The amendments made in 2000 by the Insurance Companies (Amendment) Regulations 2000[463] are referred to below (paragraphs 969 et seq).

The Insurance Companies (Accounts and Statements) (Amendment) Regulations 1993 and 1994

1993 amendment regulations to the ICAS Regulations 1983 (appointed actuary certificate of compliance with professional guidance)

685 The Insurance Companies (Accounts and Statements) (Amendment) Regulations 1993[464] revised the certificate which the appointed actuary was required to give under Schedule 6 to the ICAS Regulations 1983 in connection with the statutory returns, as had been proposed in the consultation paper issued by the DTI in 1990 regarding the need to strengthen the role of the appointed actuary system[465].

686 With effect from 1 January 1994, the actuary's certificate was required to include a statement (provided it was the case) that the two guidance notes issued by the F&IA: GN1 and GN8 dated July 1992, had been complied with. Thus, the professional guidance to actuaries was given some acknowledgment within the statutory regime (but without making it a statutory requirement to comply with it).

458 Which had led to the practice of 'resilience testing'.
459 By the Insurance Companies (Amendment No.2) Regulations 1994 SI No. 3133, which came into force on 31 December 1994, to make consequential amendments to ICR 1994 in the light of amendments made on 30 December 1994 to the ICA 1982 by SI 1994 No. 3132 (referred to at paragraph 625), implementing aspects of the Agreement on the European Economic Area.
460 By the Insurance Companies (Amendment) Regulations 1995 SI No. 3248 which came into force on 31 December 1995.
461 The Insurance Companies (Amendment) Regulations 1996 SI No. 942; the Insurance Companies (Amendment No. 2) Regulations 1996 SI No. 944; the Insurance Companies (Amendment) Regulations 1998 SI No. 2996; SI 2000 No. 1231 (see footnote 457) and the Banking Consolidation Directive (Consequential Amendments) Regulations 2000 SI No. 2952.
462 SI 2001 No. 3649.
463 SI 2000 No. 1231.
464 SI 1993 No. 946.
465 See paragraphs 401 et seq.

1994 amendment regulations to the ICAS Regulations 1983

687 The third main set of regulations enacted to give effect to the Third Life Directive (and the Third Non-Life Directive) in the UK was the Insurance Companies (Accounts and Statements) (Amendment) Regulations 1994[466] (the ICASA Regulations 1994). Their primary purpose was to implement the Directives to the extent that they affected the form and content of the annual returns required to be submitted by insurance companies under the ICA 1982 as prescribed in the 1983 Regulations. They also contained amendments consequent upon the consolidation of ICR 1981 by ICR 1994.

688 The ICASA Regulations 1994 were made by the Secretary of State as designated Minister under section 2(2) of the ECA 1972 and under various provisions of the ICA 1982. They came into force on 1 July 1994, the same date as the other two main sets of regulations made in 1994.

689 Changes were made by the ICASA Regulations 1994 to a number of provisions of the ICAS Regulations 1983, including the prescribed forms, to take account of the European Economic Area Act 1993[467] and to exclude 'EC companies'[468] from the obligation to submit annual returns to the Secretary of State, save in exceptional circumstances (regulation 2).

690 The ICASA Regulations 1994 required that additional information be given in the returns in relation to derivative contracts, subordinated loan capital[469] and cumulative preference shares, with a new prescribed form to provide an analysis of derivative contracts, a new statement of additional information on such contracts and amendments to other prescribed forms (Regulations 9 and 15 inserting a new Regulation 22B and Form 13A in the ICAS Regulations 1983).

691 Regulation 17 of the ICASA Regulations 1994 imposed a new requirement for the abstract of the valuation report prepared by the appointed actuary (under Schedule 4 to the ICAS Regulations 1983) to describe the investment guidelines of the long term fund, including the use of derivative contracts and the method by which allowance had been made for derivative contracts in determining the long term liabilities.

692 Additional information was required to be provided in relation to 'shareholder controllers'[470]. The company was required to provide, in respect of each person who was a shareholder controller at the end of the financial year, a statement of the percentage of shares that person held and the percentage of the voting power that he or she was entitled to exercise (under a new Regulation 22C inserted in the ICAS Regulations 1983 by Regulation 10 of the ICASA Regulations 1994).

466 SI 1994 No. 1515.

467 Which made provision for the general implementation in the UK of the Oporto Agreement relating to the establishment of the European Economic Area (dated 2 May 1992, as adjusted by the Brussels Protocol of 17 March 1993) and specified that UK legislation which was limited by reference to the European Communities should, in general, have effect with the substitution of a corresponding limitation relating to the European Economic Area.

468 i.e. companies with their head office situated in and authorised by a member state other than the UK.

469 See paragraphs 499 and 715 et seq regarding the changes introduced by the Third Life Directive in relation to the value of subordinated loans and cumulative preference share capital being treated as an asset which could (within specified limits) count towards the required margin of solvency and the arrangements in the UK for a company to rely on a subordinated loan for this purpose if a successful application had been made by the company to the Secretary of State for an order under section 68 of the ICA 1982. The change to the ICASA Regulations 1994 referred to above simply required that additional information be provided about such loans (it did not permit their use for margin of solvency purposes).

470 As defined in section 96C of the ICA 1982, see footnote 410.

693 Regulation 18 of the ICASA Regulations 1994 required an additional statement to be included in the certificate to be given by the directors of the company under Schedule 6 to the ICAS Regulations 1983, in the form of a list of any published guidance[471] with which the company's internal systems of control complied or in accordance with which the return had been prepared (new paragraph 6A of Schedule 6 to the 1983 Regulations).

694 The requirements for the certificate to be given by the appointed actuary were also revised to require an additional statement (if it was the case) of his or her opinion that the premiums for contracts entered into during the financial year were sufficient to enable the company to meet its commitments in respect of those contracts and, in particular, to establish adequate mathematical reserves (new paragraph 9(a)(v) of Schedule 6 to the 1983 Regulations).

695 The requirements for qualifications of auditors under Regulation 30 of the ICAS Regulations 1983 were amended to specify that the auditor of an insurance company's accounts for the purpose of section 21 of the ICA 1982[472] should be a person eligible for appointment as the company's auditor under section 25 of the Companies Act 1989, other than a person to whom section 34(1) of the Act applied[473] (Regulation 14). The requirements relating to qualifications of appointed actuaries in Regulation 28 of the ICAS Regulations 1983 were not amended.

696 The ICAS Regulations 1983 were revoked together with the ICASA Regulations 1994 and other amending regulations in respect of any financial year ending on or after 23 December 1996 by the Insurance Companies (Accounts and Statements) Regulations 1996[474] referred to below.

The Auditors (Insurance Companies Act 1982) Regulations 1994

697 Section 21A of the ICA 1982 (inserted in that Act by the FS Act 1986[475]) was designed to enable auditors of insurance companies to communicate to the Secretary of State any matters which came to their attention which were relevant to the Secretary of State's functions under the 1982 Act.

698 Section 21A(2) and (3) empowered the Secretary of State to make regulations to specify circumstances in which an auditor would be under a *duty* to communicate a matter to the Secretary of State, if it appeared to him that any auditor or class of auditor was not subject to satisfactory rules made or guidance issued by a professional body in this respect. The matters to be communicated could include matters relating to persons other than the insurance company.

699 The Auditors (Insurance Companies Act 1982) Regulations 1994[476] were made for the purpose of section 21A(2) and (3), to specify the circumstances in which an auditor of an insurance company was under an obligation to communicate a matter to the Secretary of State.

[471] The Prudential Guidance Notes (or 'PGNs') issued by the DTI to insurance companies referred to in paragraphs 715 et seq below were considered to be 'published guidance' with which directors of insurance companies were required to certify compliance.
[472] See paragraph 509 regarding the amendment of section 21 in 1991 by SI 1991 No. 1997.
[473] Namely, a person whose only appropriate qualification was authorisation granted by the BT under section 13(1) of the Companies Act 1967.
[474] SI No. 1996 No. 943.
[475] See paragraph 383.
[476] SI 1994 No. 449.

700 In effect, such an obligation arose where the auditor became aware of matters which gave him or her reasonable cause to believe that they were or might be of material significance for determining whether any of the Secretary of State's powers of intervention under sections 38 to 45 of the ICA 1982 should be exercised.

701 With effect from 16 July 1996, the Auditors (Insurance Companies Act 1982) Regulations 1994 were amended[477], inter alia, to place the auditor under obligations to communicate information to the Secretary of State in additional circumstances. These additional circumstances were those in which the auditor had reasonable cause to believe that:

(a) the authorisation of the company concerned[478] could be withdrawn under section 11 of the ICA 1982, other than on grounds of sound and prudent management under section 11(2)(ab);

(b) there had been, or might be or might have been, a failure to fulfil any of the criteria of sound and prudent management and that the failure was likely to be of material significance[479];

(c) there had been, or might be or might have been, a contravention of any provision of the ICA 1982 and that contravention was likely to be of material significance; or

(d) the company's continuous functioning might be affected;

or where the circumstances were such as to preclude the auditor from stating in his or her report that the company's annual accounts had been properly prepared in accordance with the Companies Act 1985 or section 17 of that Act.

Guidance for Appointed Actuaries - 1994 revisions to GN1 and GN8

702 As noted above[480], from 1 January 1994 the certificate to be given by the actuary as part of the statutory returns was required to include a statement of compliance with the guidance notes GN1 and GN8, giving the professional guidance a degree of statutory recognition.

GN1

703 A revised version of GN1 (version 4.0) was issued in December 1994, following the various changes to the ICA 1982 and the subordinate legislation which had been introduced in July of that year. On this occasion PRE did not feature in the revisions, which related to such matters as:

(a) the new requirement for an actuary to possess a practising certificate[481] in order to act as an appointed actuary (paragraph 2.1);

(b) a requirement for the appointed actuary to certify, inter alia, that GN1 and GN8 had been complied with (and stating the effective dates of the Guidance Notes); if sufficient information on issues relating to the financial position of the company had not been made available to ensure compliance with GN1 and GN8 the actuary was required to qualify the certificate (paragraphs 4.1 and 4.3);

477 By paragraph 5(4) of Schedule 4 to the Financial Institutions (Prudential Supervision) Regulations 1996 SI No. 1669 which inserted an additional paragraph (1A) in Regulation 3.

478 The 'company concerned' included a company which was closely linked by control to the company subject to audit by the auditor.

479 'Of material significance' was defined to mean of material significance for the purpose of determining whether any of the powers conferred on the Secretary of State by sections 38 to 45 of the ICA 1982 should be exercised.

480 See paragraph 685 regarding SI 1993 No. 946.

481 See paragraph 704 regarding the proposed criteria for the issue of practising certificates.

(c) to advise that any appointed actuary who became doubtful as to the proper course to adopt in relation to a potentially significant problem should seek help and advice through the Professional Guidance Committee[482] (replacing the previous reference to the Honorary Secretaries of the Institutes) (paragraph 1.2);

(d) the new requirement for the certificate to be given by the appointed actuary to include a statement of the adequacy of the premium rate *'on reasonable actuarial assumptions, to meet all commitments under or in connection with the contract'* as required by section 35B of the ICA 1982[483], noting that the certificate was retrospective (relating to contracts written during the financial year) and that reserves would have been set up to allow for any anticipated losses such that this requirement should not in itself make any demands on the actuary (paragraph 5.2);

(e) to specify a basis for assessing the minimum provision to be made for future expenses of continuing the existing business (paragraph 6.4);

(f) requirements for the appointed actuary to be aware of the possible effects of derivative instruments used by the company when choosing the valuation basis (paragraph 6.6) and to advise the company that appropriate guidelines should be given to investment managers regarding the use of derivative contracts (paragraph 6.11);

(g) a requirement that the appointed actuary should be satisfied that the margins in any published valuation of the liabilities, including those required by statute, were adequate having regard to the actuary's own assessment of the risks inherent in the conduct of the company's business (paragraph 6.13); and

(h) in respect of the actuary's written report to the DTI, the appointed actuary was required to use best endeavours to ensure that the financial results were presented in a way which demonstrated the true underlying position of the company and that the results were not distorted by any undisclosed valuation methods or assumptions (paragraph 8.1).

704 The F&IA began to issue practising certificates at the end of 1992. The criteria for the issue of practising certificates were intended to address both the experience and knowledge and the 'good character' of the actuary, and incorporated the statutory criteria[484]. According to the proposals outlined before their introduction[485] the criteria for issue of practising certificates were to require an appointed actuary:

(a) to be a fellow of the Faculty or the Institute of Actuaries;

(b) to be at least thirty years of age;

(c) to have undertaken appropriate Continuing Professional Education (CPE);

482 A committee of the F&IA. Its current terms of reference are: '*to assist the Professional Affairs Board (PAB) by guiding members of the profession in all professional matters, particularly those relating to interpretation of and compliance with professional guidance...*'.

483 Section 35B was inserted in the ICA 1982 by the ICTID Regulations 1994. Under paragraph 9 of Schedule 6 to the ICAS Regulations 1983 (regarding the certificate given by the actuary to be annexed to the returns) as amended by Regulation 18(5) of the ICASA Regulations 1994 the actuary was required to state (if it was the case) '*that, in his opinion, premiums for contracts entered into during the financial year and the income earned thereon are sufficient, on reasonable actuarial assumptions, and taking into account the other financial resources of the company that are available for the purpose, to enable the company to meet its commitments in respect of those contracts and, in particular, to establish adequate mathematical reserves*'.

484 In regulation 28 of the ICAS Regulations 1983.

485 JIA 118, III, 517-521 at page 519.

(d) to have appropriate practical experience;

(e) to have undertaken a professionalism course if recently qualified;

(f) to have had no adverse tribunal[486] finding; and

(g) to be 'Form B satisfactory'[487], i.e. 'fit and proper' (later described as an 'appropriate person', similar to the 'fit and proper' requirement for insurance company directors).

It was intended that appointed actuaries would receive a certificate automatically on application, which was to include an undertaking by the actuary to notify relevant changes in circumstances, for example if the person's CPE record was not up to date or if there had been changes affecting their 'fit and proper' status.

705 The DTI commented informally on the proposals for the practising certificate system established by the F&IA[488].

706 By 1994, GN1 had become a significantly longer document than when first introduced in 1975 and imposed even greater obligations on the appointed actuary in relation to the regulation of the company's business. Nonetheless it continued to contain substantial elements of the original guidance, drafted in broad and general terms. It also continued to envisage that the appointed actuary might hold more than one role within a company, such as that of a director.

GN8

707 The version of GN8 issued in 1994 (version 4.0) was considerably updated and expanded in the light of ICR 1994.

708 The advice on Regulation 64 of ICR 1994 (corresponding to that on Regulation 54 of ICR 1981) was extended in view of the new drafting in Regulation 64 which specified that the actuarial principles used to determine the amount of the long-term liabilities must have due regard to policyholders' reasonable expectations and include appropriate margins for adverse deviation of the relevant factors.

709 Actuaries were advised that it was permissible to group categories of contract (e.g. those with similar kinds of benefit, including options and guarantees which were considered to be sufficiently homogeneous) in deriving a valuation basis (paragraph 2.1); two separate paragraphs then dealt with policyholders' reasonable expectations and resilience testing.

710 In relation to policyholders' reasonable expectations, paragraph 2.3 stated:

> *When carrying out the valuation in compliance with Regulations 65 to 75[489], this should be interpreted as requiring the valuation basis to be sufficiently strong to enable an appropriate level of reversionary bonus to emerge (and similar bonuses which are added periodically over the term of the contract)* ***but not as requiring implicit or explicit provision for any element of terminal bonus or any final payment of additional bonus****. The actuary*

486 Apparently a reference to the disciplinary tribunal of the F&IA.
487 Apparently a reference to the Form B which had appeared in Schedule 6 to ICR 1981, requiring particulars to be given of a proposed controller or newly appointed director or manager.
488 According to a letter from an actuary who been involved in developing the system of practising certificates for the F&IA to the DTI, dated 21 November 1991.
489 Which contained details of the minimum criteria for the determination of liabilities.

would, however, be expected to make other investigations in order to be satisfied that the life fund is able to support a proper level of future terminal bonus having regard to the bonus smoothing policy followed by the company. (Emphasis added.)

711 In relation to the need to provide appropriate margins for adverse deviations of the relevant factors under Regulation 64, paragraph 2.4 of version 4.0 of GN8 repeated earlier guidance on Regulation 54 of ICR 1981, that the appointed actuary should consider the resilience of the valuation to changes in circumstances with special reference to more extreme changes to which the office might be vulnerable – but did not give specific examples of changes to be considered.

712 The requirement under Regulation 64(1) to '*include appropriate margins for adverse deviation of the relevant factors*' gave effect to part of the provisions of article 18 of the Third Life Directive (amending article 17 of the First Life Directive) and applied to all the assumptions used in the valuation. Regulation 64(1) created an additional requirement to that under Regulation 75 of ICR 1994 (to take account of possible future changes in the value of assets) which gave rise to resilience testing and resilience reserves and which had been a UK requirement which had been part of the original UK determination of liabilities regulations (Regulation 55 of ICR 1981).

713 Much of the guidance on individual regulations was expanded or revised. In relation to Regulation 75[490], paragraph 3.6.3 stated that the company's reserves (including any additional reserves required under Regulation 75) should be sufficient to absorb the effect of changes in interest rates and asset values on a suitably prudent basis without prejudicing the company's ability to hold reserves which satisfied Regulations 64-74 in the changed conditions.

714 When assessing any additional reserves required by Regulation 75, any derivative contracts were to be revalued taking those changes into account. In relation to with-profits business, paragraph 3.6.4 specified that actuaries were to ensure that '*the liability in the changed investment conditions adequately covers policyholders' (revised) reasonable expectations and (more generally) that the valuation basis satisfies regulation 64 (excluding the reference to regulation 75)*'.

Prudential Guidance Notes and 'Dear Director' letters from the DTI

Prudential Note 1994/1 – Hybrid Capital: Admissibility for Solvency

715 From 1994 onwards the DTI began to issue a series of guidance notes to insurance companies on topics of interest or concern, described as 'Prudential Notes' or 'Prudential Guidance Notes' (PGNs). The first, numbered 1994/1, dealt with 'hybrid capital', the subordinated loans which had been the subject of changes introduced by article 25 of the Third Life Directive, allowing the value of such loans to count towards the cover for the margin of solvency, subject to certain limits[491].

716 In the UK, no 'blanket' permission was included in the legislation to allow companies to use subordinated loans for these purposes. Instead, a company had to make an application to the Secretary of State for an order under section

490 Which required the nature and term of the assets representing the liabilities to be taken into account when determining the amount of the long term liabilities, including prudent provision against the effects of possible changes in the value of the assets on the ability of the company to meet its obligations under long term contracts as they arose and the adequacy of the assets to meet the liabilities determined in accordance with Regulations 65-74.

491 See paragraphs 499 to 502.

68 of the ICA 1982 to permit this on a case by case basis.

717 Prudential Note 1994/1 explained the meaning of 'hybrid capital' as being essentially loan capital, but with a number of conditions which removed some of the lender's usual rights, allowing the loan to be treated like the proceeds of a share issue for regulatory purposes. The note stated that the Department's main concern was to ensure that companies had sufficient risk capital to meet unexpected pressures on business and that it would view applications to count loan capital as part of the solvency margin in that light.

718 Prudential Note 1994/1 described four categories of capital which would satisfy the requirements of the First Life Directive: three specified types of subordinated loan capital and in the case of a mutual, a 'subordinated members' account'[492].

719 The note explained the detailed requirements for hybrid capital, including the required limitations on the usual lender's rights and the extent of the subordination and imposed additional requirements to those in the Directive. In order to protect the interests of with-profit policyholders in the long term fund, the loan was not to constitute a liability attributable to that fund.

720 Furthermore, the lender's rights were to be subordinated to all other creditors in the event of winding up. The note repeated the limits on the use of subordinated loans in meeting the solvency margin as set out in the Third Life Directive (up to 50% of the required margin of solvency with no more than 25% in aggregate being covered by fixed term instruments).

721 Prudential Note 1994/1 explained that under insurance companies legislation, the value of hybrid capital instruments could not count for the purpose of providing the required margin of solvency because the instruments gave rise to liabilities which would offset the value of the funds raised. However, section 68 of the ICA 1982 gave the Secretary of State[493] discretion to modify or disapply specified provisions of the Act and regulations made under it.

722 It was envisaged that a section 68 order made in those circumstances would vary the terms of Regulations 23 and 60(2) of ICR 1994, so that the liability to repay the loan would be excluded from the margin of solvency calculations (up to the appropriate proportion of the margin of solvency).

723 Insurers *'wishing to take advantage of the opportunity offered'* were invited to apply to the DTI for a section 68 order[494]. The procedure and timescale for such applications were explained in the note.

'Dear Director' letters

724 From 1 December 1994, the DTI began to issue a series of letters to the chief executives of insurance companies known as 'Dear Director' or 'DD' letters. The first, referenced DD1994/1, drew the company's attention to two new series of PGNs on 'Systems of Control' (in relation to the new 'sound and prudent management' obligations under the ICA 1982 as amended) and 'Preparation of Returns'.

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492 Which, under the Third Life Directive, could also count as cover for the solvency margin and, unlike subordinated loans, could count against the entire margin. The Prudential Note described the members' account as being a loan made by a member of the company (subject to a number of significant specified conditions), intended to be part of the core capital of the company, to be available to meet losses.

493 Prudential Note 1994/1 referred to the discretion being that of the DTI.

494 Equitable considered the possibility of taking out a subordinated loan in 1993 but did not proceed at that time. The company eventually obtained an order under section 68 of the ICA 1982 in respect of a subordinated loan of £346 million on 19 August 1997.

725 These two series of guidance notes were intended to be treated as 'published guidance' for the purpose of the requirement that the directors should include in their certificates as part of the statutory returns, a list of, inter alia, the published guidance with which the company's systems of control complied or in accordance with which the return had been prepared[495].

726 Companies were advised that it was not compulsory to comply with the guidance, but that it was compulsory to have adequate systems of control in place (and to comply with, for example, the valuation regulations). Appendices to the letter described the background to the two types of guidance and listed guidance on those and other topics which the DTI had issued or intended to issue.

727 The first DD letter enclosed a copy of PGN 1994/6 on systems of control over investments, counterparty exposure and the use of derivatives and asked companies to provide a 'state of play' report summarising the extent to which the company's systems already complied with PGN 1994/6 and any remedial action being undertaken if they did not.

728 The next such letter, DD1994/2 (16 December 1994), circulated PGN 1994/7 on asset valuation. Subsequent DD letters dealt with such matters as guidance on valuation of reinsurance recoveries (DD1994/3), clarification of the accounting treatment which should apply to financial reinsurance arrangements in preparing the statutory returns to the DTI (DD1995/1) and the contents of directors' certificates in relation to years starting on or after 1 January 1995 (DD1995/2), which annexed an updated list of the published guidance considered to be relevant for this purpose.

729 The last of those letters explained that what the DTI was looking for from the directors' certificates in so far as they applied to the 'preparation of returns guidance' was an assurance that a responsible individual or team had read the guidance and had understood its implications and that the company had a reasonable system for valuing assets and assessing derivatives which was consistent with the guidance.

Departmental consideration of PRE and Ministerial statement in 1995

730 From around 1989 onwards a number of individual cases came to the attention of the DTI and GAD in which the meaning of PRE was considered to be of particular importance. Seven such cases had been outlined in the first F&IA joint working party report of April 1990 and individual cases of concern continued to emerge, commonly relating to the balance between the interests of policyholders and those of shareholders in relation to the division of profits.

731 Counsel's opinion had been obtained by the DTI (and by the insurance companies concerned) on a number of occasions[496]. A draft DTI document dated 11 April 1995 summarised the main principles to emerge from the advice the DTI had obtained from counsel. This included advice to the effect that:

(a) policyholders may have a 'reasonable expectation' for the purposes of the ICA 1982 notwithstanding that it went beyond enforceable legal rights;

(b) the subjective expectations of a particular policyholder or even the generality of

[495] Paragraph 6A of Schedule 6 to the ICAS Regulations 1983 inserted by the ICASA Regulations 1994 (see paragraph 693).
[496] References to or copies of opinions and notes of advice indicate that advice from counsel had been provided in 1987, 1989 and 1993.

policyholders were not relevant (and the 'expectations' in question included those of potential policyholders, who by definition could have no state of mind about the affairs of the company); the word 'reasonable' imported an objective test relating to a hypothetical reasonable policyholder;

(c) the hypothetical policyholder could have an expectation of the manner in which the business of the company would be conducted notwithstanding that the generality of policyholders were wholly ignorant of the relevant facts. If this were not so, the Secretary of State would be unable to exercise his intervention powers if the information which led him to act was not available to the generality of policyholders and a company would be less amenable to regulation the more secretively it behaved. The Secretary of State's powers to intervene depended upon the information which was available to him at the time and not necessarily that which was available to policyholders;

(d) action by a company would certainly be contrary to the reasonable expectations of policyholders if their policies had been marketed to them on a basis which was inconsistent with that action;

(e) PRE related to more than the amount of any declared bonuses; a hypothetical policyholder could reasonably expect that the balance between policyholders and shareholders or between different classes of policyholders would not be, in any substantial respect, altered in a manner adverse to them (or to any class of them). 'Adverse' referred to the balance between groups and not to the anticipated return before and after the relevant action by the company. Policyholders might therefore be adversely affected even if they would be better off after the relevant action, if the facts showed that they would have been better off by a larger margin had the balance of competing interests been left undisturbed; and

(f) factors relevant to the determination of PRE in any particular case depended upon:

(i) past practice of the company;

(ii) written or oral statements made by the company at the point of sale, in marketing literature, policy documentation, with-profit guides etc; and

(iii) industry practice as understood through media commentary.

(Advice had also been given on 'orphan estates'[497] suggesting a division between policyholders and shareholders in a 90:10 proportion as a starting point based on industry practice.)

732 In view of the increasing number of cases in which PRE was emerging as an issue, from at least 1994 onwards, correspondence took place within the DTI and between the DTI and GAD about the need to establish some principles relating to PRE against which to judge the different cases. The possibility of a public statement or even further legislation was suggested.

[497] Loosely meaning assets held in excess of those to meet liabilities (and meeting PRE, including terminal bonus); often used in a context of most relevance to proprietary offices rather than to mutuals (but Equitable's policy was to pay out any such surplus in any event). Sometimes referred to as a company's 'free estate' or simply its 'estate'.

733 Eventually a public statement on PRE was made, in the form of an answer to a Parliamentary Question given by the then Minister for Consumer Affairs on 24 February 1995[498], following the announcement by a major insurance company of its proposal to restructure its long-term funds in a manner which was considered to be consistent with the response given by the Minister.

734 The statement was directed at the position of with-profit proprietary offices which had accumulated a surplus in their long term funds and the issue of the division of that surplus between policyholders and shareholders, advocating division in the proportion 90:10, unless there was clear evidence to support a different allocation. The principles were outlined in very general terms:

> *The Department considers that policyholders' reasonable expectations in respect of attribution of surplus are influenced by a range of factors, notably:*
>
> *(a) the fair treatment of policyholders vis-á-vis shareholders;*
>
> *(b) any statements of the company as to its bonus philosophy and the entitlement of policyholders to share in profits, for example, in its articles of association or in company literature;*
>
> *(c) the history and past practice of the company;*
>
> *(d) general practice within the life insurance industry.*

It was said that the Department would assess any similar proposals from other life offices having regard to the facts and the principles set out in the statement.

735 It appears that little or no detailed guidance was issued at this time in relation to the question of the interpretation of PRE for policies containing guarantees or options, although there had been statutory requirements under the Regulations to make proper provision for them for many years. Nor was there any published guidance from the DTI, GAD or the profession on how reserves should be made for them[499].

736 The working party set up by the Life Board of the F&IA in 1997 to consider reserving for annuity guarantees, the letter sent to managing directors of insurance companies by the Treasury in December 1998[500] in relation to PRE and guaranteed annuity option costs, the DAA letters sent to actuaries by GAD on reserving for guarantees and the position statement on annuity guarantees issued by the Life Board in March 1999 are all referred to in paragraphs 854 et seq.

Internal audit of insurance supervision and IT strategy in 1994

737 During 1994 the Internal Audit Directorate of the DTI undertook an audit of insurance supervision and IT strategy. An 'end of audit meeting' was held on 14 June 1994 (prior to the preparation of the audit report) and was attended by audit staff and senior officials in the DTI.

498 Hansard Debates, House of Commons, 24 February 1995, columns 390-391.
499 For most years from 1993 onwards, the guaranteed annuity rates contained in certain policies issued by Equitable between 1956 and 1988 exceeded the then current annuity rates, but no reserve was being made for them until the time of the 1998 returns (which would have been submitted after the advice in DAA11 had been promulgated, see paragraphs 882 et seq.). As at 1998, some 100,000 Equitable policies containing GARs remained in existence (according to a joint counsel's opinion obtained by the company at that time).
500 Withdrawn following the decision of the House of Lords in *Equitable Life Assurance Society v Hyman* [2002] 1 AC 408.

738 The report of that meeting is prefaced with the comment that although it concentrated on weaknesses, the internal auditors had identified several areas of strength, including management of change (for example in relation to the Third Life Directive), the programme of visits to companies[501], the professional expertise provided by GAD and the system for the initial analysis of returns. Those strengths were also to be referred to in the audit report.

739 The report of the June 1994 meeting shows that audit findings[502] had been made in respect of such areas as:

(a) increasing the degree of specialist expertise at Higher Executive Officer (HEO) level in the DTI's Insurance Division;

(b) ensuring that information obtained from and about companies was readily available, possibly using the computer system Insurance Division Information System (IDIS) to store key items of data;

(c) updating lists of advisers and completing the Policy Guidance Notes[503] manual;

(d) various improvements to the systems for dealing with annual returns and setting deadlines for companies to respond to queries regarding their returns;

(e) in cases where companies were failing to notify changes or were late in doing so or in submitting their returns[504], standard letters should be issued to companies warning that formal action would be taken;

(f) using formal action against companies rather than informal action in some instances;

(g) in relation to the supervision of long term business, although the responsibility rested with the DTI, in practice any required action arising from annual and quarterly returns was determined by GAD; the DTI agreement[505] should be reviewed regularly (possibly annually) to ensure that the DTI was receiving the right information and advice from GAD at the right time, with a view to ensuring that the DTI was discharging its responsibilities in relation to the supervision of companies conducting long-term business in an effective manner; it was suggested that there might be a case for GAD actuaries concerned with this work to be 'housed' within the DTI or employing external actuaries if GAD was unable to provide a service of *'acceptable timeliness'*[506];

(h) there appeared to be a lack of active monitoring by the DTI of the agreement between the DTI and GAD[507];

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501 See paragraphs 404 et seq.

502 Audit recommendations were not made in respect of all the findings noted in the report of the June 1994 meeting and it appears that some of the initial findings and proposed recommendations may have been revised following further discussions with officials in the DTI.

503 See paragraphs 450 et seq.

504 The DTI management response to this item noted that most companies had the same year end and there were only a limited number of experienced auditors, making it difficult for all companies' returns to be submitted on time.

505 Apparently a reference to the 1984 service level agreement referred to at paragraphs 355 et seq.

506 The DTI's Insurance Division's management response to this finding indicated that the situation was under review. It stated that there were '*difficulties in relying on GAD*' and that it was '[i]*mportant for supervisors to realise that they are responsible for supervision and not just* [a] *post box*'. It was also noted that DTI would have liked to have had GAD 'in house' (and that this had been suggested six or seven years earlier but had been rejected by GAD as it was concerned that its expertise would be dissipated). It was noted that employing external actuaries would be expensive.

507 See paragraphs 355 et seq regarding the 1984 agreement. The management response to this item stated that it was agreed that '*clarification of the informal arrangements is necessary*'.

(i) responsibilities between the DTI and GAD relating to the supervision of long-term business did not appear to be as clear-cut as they should be; this appeared to be because the agreement between the DTI and GAD was not being enforced;

(j) there was some evidence that the responses GAD received to queries raised with companies on their annual returns were not copied to the DTI[508];

(k) the system for quarterly returns for long-term business was almost wholly reliant on examination by GAD, but there was no system for regular reports by GAD on the progress of the examinations[509];

(l) a qualitative and not just a quantitative analysis of the visits programme to companies was needed; and

(m) in relation to the IDIS system, a large part of the supervision process seemed to fall outside the scope of IDIS; the system faced obsolescence (as neither the hardware nor the software were likely to be supported in the future); the system lacked a 'plain English' description of its capabilities; the data quality was poor and in some cases the output was not directly relevant; and performance monitoring, testing and training were needed or required improvement.

740 The findings of the internal audit and the proposed recommendations were discussed with officials in the DTI over the following months.

741 A memorandum from the Director of the Insurance Division to DTI Internal Audit of 30 September 1994 indicates that the DTI's Insurance Division was '*content to accept most of the recommendations and the underlying analysis*', although there were a few areas in which changes to the recommendations were suggested by the Insurance Division. The final internal audit report was issued in November 1994.

742 In response to the audit report the DTI prepared an 'action document'[510] showing how each of the recommendations which had been accepted was being implemented or had been implemented. It appears from that document that the final recommendations included points concerning:

(a) he need for renegotiation of the agreement between the DTI and GAD (see the following section regarding the 1995 service level agreement which addressed a number points raised during the internal audit);

(b) regular (at least annual) review of the agreement with GAD should be undertaken;

(c) the allocation of priority ratings for companies should be reviewed to ensure the most effective use of supervisory resources;

(d) the implementation of a 'bring forward' system for letters to companies which required a reply; the DTI was also to operate such a system for major requests for information from companies made by GAD and the DTI was to remind GAD if further details were not supplied within a reasonable time;

508 The DTI's Insurance Division's management response noted that there was a '*a desire in GAD for more independence*' and a debate as to whether GAD should copy all correspondence to the DTI or just the outcome (with a potential for embarrassment to the DTI if it was not aware of what GAD was doing).

509 The DTI's Insurance Division's management response suggested that a 'bring forward' system was needed rather than monthly reports.

510 A copy of the action document was attached to a memorandum from the Head of DTI Internal Audit to the Director of Insurance Division, dated 11 May 1995.

(e) initial assessment of annual returns for companies conducting long-term business should be completed within six weeks;

(f) targets should be set for the annual review of the DTI training strategy;

(g) a qualitative review of the programme of visits to companies should be undertaken and the frequency of visits to companies should be varied to reflect their anticipated value to the supervisory process; and

(h) improvements should be made in relation to management information, sources of advice and information, record keeping and in relation to the IDIS system.

743 An DTI memorandum of 22 May 1995 indicates that by the time it was written, all the recommendations in the final audit report had been implemented.

1995 Service Level Agreement between the DTI and GAD

744 As noted above, the service level agreement (SLA) entered into between the DTI and GAD in 1984 indicated that the agreement was to be reviewed in 1986, but it does not appear that any further agreement was concluded at that time.

745 A new agreement, on broadly similar lines to the 1984 SLA, was entered into between the DTI and GAD in March 1995. The 1995 SLA related to the supervision of insurance companies conducting long term business and the supervision of the long term business of composite companies.

746 The language used in the 1995 SLA was more 'colloquial' than that in the earlier agreement and in general, less concise. Four references to 'policyholders' reasonable expectations' were made in the 1995 agreement.

747 As before, the focus was on scrutiny of the statutory returns and the need for the DTI to form a view on insurance companies' present and future solvency. The main outcome of the process continued to be the provision of scrutiny reports on individual companies by GAD to the DTI, to enable the DTI to form a view on the company's solvency, compliance with the statutory requirements and, on this occasion, to identify any failure by a company to meet PRE. However, the need for advice and services from GAD in relation to wider aspects of the prudential regime, particularly in relation to issues of solvency, was also provided for.

Main principles

748 The respective roles of the parties were recorded with some care. The section of the agreement on 'Main Principles' stated that the primary role of the DTI as set out in its 'mission statement' was to:

> *... regulate the insurance industry effectively (within its duties and powers set out in the Act) so that policyholders can have confidence in the ability of the UK insurers to meet their liabilities and fulfil policyholders' reasonable expectations.*

749 One of GAD's primary functions was to advise the DTI on the fulfilment of those aims. As in the first SLA, it was made clear that the DTI retained sole responsibility for all executive decisions. The distinction in the parties' roles was given emphasis by a statement that GAD recognised that its function was advisory and that it had no responsibility for the exercise of the Secretary of State's powers under the Act.

750 The SLA recorded the importance of a close working relationship between the DTI and GAD in which '*both sides*' would keep each other fully informed, with the DTI copying all relevant correspondence[511] with companies to GAD. GAD was to be notified of all changes of control of companies and changes of appointed actuaries.

751 GAD was to accompany the DTI on all visits to companies and was to attend all meetings between the DTI and companies unless 'special circumstances' arose. GAD was allowed to hold meetings with companies on actuarial issues at GAD, but was to notify the DTI of the meetings and offer the Division the opportunity to attend.

Detailed activities

752 The detailed activities required of GAD under the 1995 SLA were set out in three separate sections. Section A of the 1995 SLA concerned the examination or scrutiny of annual returns (described with slightly less precision than in the earlier agreement). Section B dealt with authorisation of new companies and section C with 'other supervisory matters'.

753 The description of the detailed activities was prefaced with a statement that it did not provide an exhaustive description of the services to be provided by GAD to the DTI (in this context reference was made to the DTI rather than to its Insurance Division): '*In particular, as section B and C[512] make clear, GAD will stand ready to comment and advise where appropriate on all issues when asked to do so by the DTI[513].*'

Section A – examination or scrutiny of annual returns

754 Section A refers to five levels of priority to be used in the scrutiny process (as opposed to the four levels described in the 1984 SLA), but the meaning of each priority level was not explained within the document. In practice, GAD supplemented the SLA by issuing internal criteria for setting the priority ratings as part of their internal guidance. This is dealt with in more detail in chapter 5 of Part 1 of the report.

755 The document proceeded on the basis that most company year ends were on 31 December, but if the year end of a company differed, *'the same principles'* were to apply. A general timetable of events was then set out.

Scrutiny programme

756 By September of each year the parties were to agree a programme for the order in which returns were to be examined by GAD. If it was known that a visit to the company was to take place during the year, GAD was to make every effort to carry out the scrutiny and report to the DTI before the visit. The parties were to agree any topical issues affecting the life assurance industry in the forthcoming year which needed to be addressed in the scrutiny.

Initial action (prior to September)

757 The DTI was to be responsible for ensuring that GAD received copies of the statutory returns and the shareholders' accounts and for chasing late returns (which were normally due to be deposited within six months of the close of the period to which they related – it was aimed to provide GAD with appropriate copies within four working days of receipt). The DTI was to inform GAD of the visits to be carried out in the next year and of any extensions of time given to companies for the submission of their returns.

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511 Letters of complaint from policyholders would not be copied to GAD (unless there were actuarial issues involved) and it appears that notification of management changes were not to be copied to GAD.

512 See paragraphs 766 et seq.

513 Section C of the SLA indicates that all documents received by DTI from life offices were to be copied to GAD and GAD was to be '*always free to comment on any document*' (see paragraph 769).

758 The role of GAD during the initial process was to deal with the following matters and provide the DTI with a '*clear overview of the scrutiny programme*' by mid September:

(a) report to the DTI[514] immediately if the initial scrutiny of a company raised any serious concern, of which the following 'main examples' were given:

- (i) a company had failed to meet its solvency margin or was in financial difficulties;
- (ii) the company had failed to provide the necessary directors', actuary's and auditor's certificates or any of the certificates had been significantly qualified;
- (iii) significant data errors or omissions existed;
- (iv) section 30 of the ICA 1982 (allocation of surplus to with-profit policyholders) appeared to have been breached;
- (v) it appeared that a company was not complying with its 'Notice of Requirements'[515] or an undertaking it had given to the DTI; and
- (vi) there appeared to be any other clear breaches of the Act or Regulations.

(b) send a report to the DTI by the end of August covering all initial scrutinies, consisting of:

- (i) a priority rating for each company based on GAD's view of its financial strength;
- (ii) an indication of the solvency cover for the company; and
- (iii) a target date for full scrutiny of the company's return.

759 The DTI and GAD were to use their best endeavours to agree, by mid September, the scrutiny programme including both timetabling and allocation of priority ratings. GAD was not required to wait for the scrutiny programme to be agreed before starting detailed scrutiny of what it perceived to be the most urgent cases (which would generally be 'priority 1' cases).

The detailed scrutiny process

760 The required outcome of the detailed scrutiny process was to provide the DTI with a means, in the form of a report, of identifying companies which:

- (a) were not complying with statutory requirements;
- (b) were failing to meet the statutory requirements, or were in danger of doing so in the near future; and
- (c) appeared '*not to be meeting policyholders' reasonable expectations*'.

761 The scrutiny report was required to contain a basis for action in relation to individual companies where any of the fundamental requirements listed above were not being met, or if trends in the returns pointed to problems arising in the near future. It was also to contain a basis for '*informed longer term discussion*' with individual companies on problems which might arise in the future if '*current trends in key performance indicators continue*[d]'.

514 Again, at this point the SLA referred to the DTI rather than specifically to its Insurance Division.
515 'Notices of Requirements' were served on companies by the Secretary of State in relation to authorisation, change of control and the exercise of intervention powers under sections 38-45 of the ICA 1982 to require a company to take, or refrain from, certain action (see paragraph 455 regarding the internal DTI guidance).

These key performance indicators were said to include:

(a) cover for the solvency margin and trends in free asset ratios[516];

(b) actuarial issues, for example a change in the strength of the valuation basis or issues about matching;

(c) the volume and mix of new business being written;

(d) trends in expense ratios;

(e) trends in lapse rates;

(f) assets: *'worrying exposures'*, investment strategy and impact on bonus strategy; and

(g) significant developments during the year.

762 The scrutiny report was to follow a prescribed format, referred to as being set out in an annex to the SLA (unless a different format had been agreed between GAD and DTI in an individual case).

763 The broad aim was to provide detailed reports for all companies:

(a) with **priority ratings 1 to 3**: by the end of March of the following year, with priority 1 and 2 cases being given priority within that period;

(b) with **priority 4** rating: by the end of May[517]; and

(c) with **priority 5** rating: the cases would not be given full scrutiny in the year in question, but were to receive a fuller initial scrutiny.

764 It was envisaged that this programme, including the ratings and timetable, might need to be amended to allow *'some fine tuning'* for example, due to the level of the stock market at the balance sheet date. The DTI and GAD were to agree revised target dates where it was necessary to make amendments to the programme.

Action arising from detailed scrutiny and monitoring of progress

765 GAD was required:

(a) (normally) to be responsible for taking up points arising from the detailed scrutiny of the returns with the company or its actuary; however, GAD was always to consider whether it was more appropriate for the DTI to do so and to recommend accordingly;

(b) to chase for responses from companies within six weeks and to respond to points arising from replies from companies within two weeks;

(c) to make appropriate recommendations to the DTI if GAD considered that the Secretary of State might need to exercise his powers; it was stressed that GAD was not to initiate any such action or commit the DTI to any particular decision or course of action; and

(d) to circulate a report to the DTI at the end of each month on the progress of the scrutiny programme.

Sections B and C – other areas in which services from GAD were required

766 Sections B and C of the 1995 SLA outlined additional areas in which GAD's assistance or advice was or might be required.

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516 In simple terms a 'free asset ratio' is the amount by which a company's free assets exceed its required minimum margin, expressed as a percentage of its total assets as determined for the purpose of its regulatory returns.

517 Apparently, May of the following year.

767 Section B dealt with services and advice to be provided by GAD in relation to the authorisation of new life offices, explaining that the purpose of the authorisation procedure was to form a view on whether the company would remain solvent until its fourth year of operation and that it would be managed and controlled by fit and proper persons.

768 GAD's main role was to evaluate the financial projections and to provide its opinion to the DTI as to whether the solvency requirements would be met. GAD's services were to include commenting on successive drafts of the applications and attending meetings with the companies which intended to make, or had made, an application for authorisation.

769 Section C dealt with 'other supervisory matters', covering the need for advice on all areas with an impact on the solvency of a life office aside from the scrutiny of returns and the authorisation process, noting that it was '*not possible in a document of this nature to anticipate all of the instances in* [the] *future where GAD's advice will be sought*'. All documents received from the life office were to be copied to GAD[518]. The SLA stated that the DTI:

> *... will request advice from the GAD when there are issues which might affect, for example, the financial security of a life office, policyholders' reasonable expectations, or where the issues raised are actuarial or professional. However, GAD are always free to comment on any document if it believes that there are issues that should be brought to I Division's attention. These other areas of responsibility include: ...*

770 The document went on to identify six particular areas and referred to required response times and similar 'level of service' requirements in relation to each. These specific areas included transfers of portfolios; requests by companies for concessions under section 68 of the ICA 1982[519]; quarterly returns; company visits; and miscellaneous correspondence including requests for interpretation of legislation.

771 GAD was to provide such other services as might be agreed from time to time including '*input to policy development as appropriate*' and representation at meetings, for example, of the F&IA or in relation to the EU.

Fees

772 The level of fees to be paid by the DTI to GAD was to be the subject of a separate agreement to be negotiated annually.

773 The 1995 SLA was superseded by the agreement between the Treasury and GAD in 1998 referred to below (paragraphs 909 et seq).

The Insurance Companies (Accounts and Statements) Regulations 1996 (and the Deregulation (Insurance Companies Act 1982) Order 1996)

Introduction

774 In December 1996[520], the Insurance Companies (Accounts and Statements) Regulations 1996[521] (the ICAS Regulations 1996) revoked and replaced the ICAS Regulations 1983 and the various regulations

518 It is not clear whether this was intended to refer only to a situation in which advice from GAD was being sought by the DTI, or that all such documents would be copied to GAD routinely. The reference to GAD being *'free to comment on any document'* in the quoted section suggests the latter.

519 Which might arise, for example, where a company wished to rely on implicit items or hybrid loan capital in its margin of solvency calculations: see paragraphs 337 and 715 et seq.

520 Most of the provisions of the ICAS Regulations 1996 came into force on 23 December 1996, other than Regulation 34 which came into force on 30 April 1996 and substituted various provisions of the ICAS Regulations 1983 until they were revoked (the substitute provisions related to the meaning of *'receivable'* in Regulation 3, the value of assets and liabilities in Regulation 4 and the required additional information on derivative contracts in Regulation 22B).

521 SI 1996 No. 943.

which had amended them. They were made by the Secretary of State in the exercise of various powers conferred on him by the ICA 1982.

775 Notwithstanding the emphasis placed on PRE in various parts of the legislation and in the guidance issued to appointed actuaries by the F&IA, up until 1996 there was no requirement for insurance companies to provide any specific information in their statutory returns about the manner in which the company had taken PRE into account.

776 Such a requirement was included in the changes introduced by the ICAS Regulations. Those changes also included a requirement for the abstract of the appointed actuary's valuation report to include a new statement in a prescribed form (Form 57) described as a 'matching rectangle'[522], as further described in paragraphs 797 et seq.

777 This form was to be provided in relation to each fund or group of funds, showing how assets had been notionally allocated to corresponding long term liabilities (subject to specified exceptions), dealing with with-profit and non-profit policies separately and with separate forms prepared for each interest rate used in the valuation.

778 General changes from the ICAS Regulations 1983 made by the ICAS Regulations 1996 included the following:

(a) reorganisation and updating of the prescribed forms for the statutory returns to take account of then current commercial practice;

(b) transfer of several of the long term business forms which had appeared in Schedule 3 to the ICAS Regulations 1983 to Schedule 4 to the ICAS Regulations 1996, making those forms the responsibility of the appointed actuary and no longer subject to audit;

(c) a reduction of reporting in certain areas through the introduction of increased de minimis thresholds; and

(d) the omission of a prescribed form for a quinquennial statement of long term business as required by section 18(3) of the ICA 1982 in anticipation of an order being made under the Deregulation and Contracting Out Act 1994 (the DCOA 1994), abolishing the requirement for such a statement.

The Deregulation (Insurance Companies Act 1982) Order 1996

779 Under section 1 of the DCOA 1994, Ministers of the Crown were given power to remove or reduce burdens on businesses and individuals (but without removing any necessary protection), by amending or repealing an enactment contained in an Act passed before or in the same session as the 1994 Act.

780 The Deregulation (Insurance Companies Act 1982) Order 1996[523] was made by the Secretary of State under those powers, following consultation with representative organisations and others as required by section 3 of the DCOA 1994. The Order came into force concurrently with the ICAS Regulations 1996 on 23 December 1996 and provided for:

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522 In terms of the statutory regime, matching rectangles provided the regulator with a means of establishing or checking the interest rates used in the valuation. They were described in general terms in a paper presented to the Institute of Actuaries in 1989 as '*a powerful tool for understanding the interactions within a life and pensions company. They also provide an excellent control on the interface between the work of accountants – which largely relates to assets – and to the valuation work of actuaries – which largely relates to liabilities*.' They consisted of a balance sheet which was not presented simply as two columns, but was broken down more fully into a two dimensional table in which the row and column totals corresponded to the liability and asset entries in a traditional balance sheet. The matching rectangle showed the collection of assets used to match each classification of liability (C.M. Johnson: JIA 116 (1989) 673-690 at pages 684-685). Form 57 was in such a format. Appendix D contains copies of the prescribed form as it appeared in the ICAS Regulations 1996 and as it appeared in the amendment regulations of the following year (see paragraph 800).

523 SI 1996 No. 2102.

(a) the repeal of section 18(3) of the ICA 1982 (which required companies to which Part II of that Act applied which carried on long term business to prepare a statement of that business every five years);

(b) the repeal of section 42(1)(c) of the ICA 1982 (which empowered the Secretary of State to require a company to prepare a statement of its long term business);

(c) the repeal of section 22(2) of the ICA 1982 (which required insurance companies to deposit with the Secretary of State details of persons who had acted as intermediaries (under section 74) and who were connected with the company); and

(d) the amendment of sections 22(1), 42 and 82 of the ICA 1982 so that the insurance company could choose whether to deposit five printed copies of every account, balance sheet, abstract, statement and other document which comprised the annual returns and the abstract of any special actuarial investigation report (as originally required) or only one printed copy of each of the required documents, together with a copy of each document in a form approved by the Secretary of State.

Requirements for annual returns of long term insurance companies under the ICAS Regulations 1996

781 The general objectives of the ICAS Regulations 1996 were later described[524] as being:

(a) to demonstrate that the solvency margin requirements had been met and that the directors, appointed actuary and auditor had certified compliance with various requirements;

(b) to provide the regulator with backing data with which to form its own assessment of the value given to the company's assets and liabilities and the potential for fluctuations;

(c) to standardise the treatment of reporting certain information to facilitate interpretation of the situation of individual companies and to enable comparisons to be made between companies;

(d) to establish a body of data which could provide 'screening tests' or an early warning system for problem areas or problems within particular companies; and

(e) to satisfy the concept of '*freedom with publicity*'.

782 The annual returns required under the ICAS Regulations 1996 were in six parts corresponding to the Schedules in the Regulations (two of which related to general business). Those relevant to long term business comprised:

Schedule 1: Balance sheet and profit and loss account (Forms 9 to 17);

Schedule 3: Long term business: revenue account and additional information (Forms 40 to 45);

Schedule 4: Abstract of the valuation report prepared by the appointed actuary (Forms 46 to 61);

Schedule 6: Certificates by the directors and appointed actuary and report of the auditors.

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524 In a paper entitled 'Statutory Regulation of Long Term Insurance Business' prepared for the F&IA by William M. Abbott and revised by Nick C. Dexter in 2000.

Basis of values and amounts stated

783 The value or amount given for any asset or liability shown in the documents required to be prepared under the ICAS Regulations 1996 was to be that determined in accordance with Parts VIII and IX of ICR 1994[525] unless otherwise provided (Regulation 4). Every account, balance sheet, note, statement, report and certificate that a company was required to prepare under section 17(1)-(3) of the IC Act 1982 (annual accounts and balance sheets) was to be prepared in the manner prescribed in the ICAS Regulations 1996 and to '*fairly state the information provided on the basis required in these Regulations*' (Regulation 5 of the ICAS Regulations 1996).

Balance sheet, profit and loss account and revenue account

784 Regulations 6 and 7 required that the balance sheet and profit and loss account should comply with the requirements of Schedule 1 and identified the required prescribed forms for the various classes of business. The revenue account of a company carrying on long term business was required to be in Form 40 in Schedule 3, with additional information provided in Forms 41 to 45 in that Schedule (Regulations 8 and 17).

Abstract of actuary's valuation report (including PRE information and matching rectangles)

785 The abstract of the actuary's report of the annual actuarial investigation under section 18 of the ICA 1982 was to comply with the requirements of Schedule 4 and contain the information specified in that Schedule, together with such of Forms 46 to 49 and 51 to 58 as might be appropriate (Regulation 25). Schedule 4 and the forms prescribed in that Schedule required that extensive information be provided about an insurance company's long term business.

786 Schedule 4 required that information be given on issues set out in 23 numbered paragraphs of the Schedule, with the answers numbered accordingly in the abstract.

787 In relation to each category of contract which comprised accumulating with-profits contracts, paragraph 4(1)(a) required that the abstract contain a full description of the benefits, including various specified factors, such as the circumstances in which, and the method by which, any charge might be deducted from the benefits on payment of a claim and a full description of any 'material options'. Paragraphs 4(1)(b) and (c) required that details be provided of material options contained in other kinds of non-linked contracts.

788 Paragraph 6 related to the general principles and method adopted in the valuation, and required specific reference to matters which included:

(a) the method by which account had been taken of derivative contracts in the determination of the long term liabilities;

(b) **the method by which due regard had been given to the reasonable expectations of policyholders** as required by Regulation 64 of ICR 1994 and by which account had been taken in the custom and practice of the company in the manner and timing of the distribution of profits or the grant of discretionary additions over the duration of each policy, as required by Regulation 65(6) of ICR 1994;

(c) where the net premium method had been used[526], whether and to what extent it had been modified, the purposes for which any such modification had been made and whether any modifications on account of zillmerising conformed to Regulation 68 of ICR 1994;

[525] See paragraphs 643 et seq.

(d) whether any negative reserves had arisen and the steps taken to ensure that no contract of insurance was treated as an asset as required by Regulation 73 of ICR 1994;

(e) whether any specific reserve had been made for future bonuses and if so at what rate or rates; and

(f) **the basis of the reserve made for any guarantees and options.**

789 Paragraph 7 of Schedule 4 required information to be given on the rates of interest and tables of mortality and morbidity which had been assumed in the valuation for each category of contract. Subparagraph 7(6) required that a description be provided of the scenarios of future changes in the value of assets which had been tested in order to take account of the nature and terms of the assets held in determining the amount of the long term liabilities in accordance with Regulation 75 of ICR 1994.

790 Subparagraph 7(7) required information to be given on any reserves which had been made pursuant to Regulations 75(a) (ability of the company to meet its obligations under long term contracts as they arose) and 75(b) (adequacy of the assets to meet the liabilities determined in accordance with Regulations 65-74 of ICR 1994). Subparagraph 7(8) required further information to be given in relation to the test for the purpose of 75(b) which produced the most onerous requirement (whether or not a reserve was required).

791 Paragraph 10 required information on the assumed levels of inflation of expenses and the bases used in the valuation to allow for such future inflation.

792 Where any rights of policyholders to participate in profits related to particular parts of the long term business fund, a revenue account in the format of Form 40 was required for each such part and information was to be given on the methods applied in apportioning the investment income, increase or decrease in the value of assets brought into account and expenses and taxation (unless the information was provided elsewhere).

793 Paragraph 14(1) required information to be provided about the principles on which the distribution of profits among policyholders and shareholders was based (as described in the constitution of the company, board resolutions, issued policies, advertisements, documents required to be issued by a regulatory body authorised under the FS Act 1986 and other relevant documents).

794 Paragraph 14(2) required a broad statement of the company's aims in relation to the distribution of profits among policyholders, including the company's aims in relation to:

(a) policies which matured or were surrendered and claims arising on death;

(b) the appropriate and equitable treatment of groups of participating policyholders;

(c) smoothing[527];

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526 Paragraph (1) of Regulation 67 of ICR 1994 required a net premium method to be used for most contracts unless paragraph (3) of that regulation applied or, under paragraph (4), an alternative method could be shown to produce equally strong reserves (see paragraph 269 regarding the provisions from which paragraphs (1)-(3) of regulation 67 were derived and paragraph 679 regarding paragraph (4)). See further below regarding the amendment of regulation 67 by SI 2000 No. 1231 to permit the use of a gross premium method where the policyholder was not entitled to participate in profits (paragraph 975).

527 This expression does not appear to be defined in the ICAS Regulations 1996.

and the methods used to ensure that those aims were achieved. (Where different principles or bonus policies applied to different categories of with-profit policies issued by the company, the required information was to be given in respect of each category.)

795 Paragraphs 15 and 16 required information to be provided in respect of bonuses allocated to each category of contract and the practice of the company in relation to any bonus payments to be made in the period up to the next actuarial investigation, including the basis of calculation and the form in which the bonus was payable.

796 Paragraphs 17-20 dealt with Forms 46 and 46A (summary of changes in long-term and industrial business); Forms 47 and 47A (analysis of business in force); Forms 48 and 49 (separate statements of assets covering long term liabilities (other than linked liabilities) in respect of each fund or group of funds for which separate assets were appropriated); and Forms 51-54 (which required separate valuation summaries to be completed in respect of each fund (and category of contract) for which a surplus was to be determined, analysed in various ways).

797 Paragraph 21 required statements in the form set out in Form 57 (the 'matching rectangle') for each fund or group of funds for which separate assets were appropriated in respect of long term liabilities, except unit liabilities in respect of property linked benefits, investment liabilities in respect of index linked benefits and any reserve in respect of tax on unrealised capital gains. Form 57 was included in Schedule 4 with instructions for its completion.

798 The matching rectangle in Form 57 was required to show a notional allocation of assets to corresponding liabilities, with separate forms to be complete for with-profit and non-profit contracts in each of the categories; (i) life assurance and annuity business; (ii) pension business; (iii) permanent health business and (iv) other business.

799 The matching rectangles were intended to enable the DTI to check the interest rates which were being used in the valuation and a separate form was to be used for each rate of interest used. The forms were to cover 90% of the remaining liabilities after excluding the specified items concerning linked policies and any tax reserve. In its originally prescribed format, the final line of the matching rectangle was required to show the values attributed to the assets in the 'worst case' resilience test referred to in paragraph 7(8) of Schedule 4 (see paragraph 808 regarding the changes made in 1997).

800 The prescribed format for the matching rectangle in Form 57 (and the instructions for its completion) were replaced for financial years ending on or after 31 December 1997 by the Insurance Companies (Accounts and Statements) (Amendment) Regulations 1997[528] which made other amendments as noted in paragraphs 807 et seq. Appendix C contains copies of Form 57 as originally prescribed and as substituted in 1997.

801 Form 57 (both the 1996 and 1997 versions) was intended to demonstrate that:

(a) the valuation rates of interest were supported by the investment returns earned on the assets notionally allocated to each group of contracts (on the basis that the value of such assets equalled the mathematical reserves, including any resilience reserve, for that group of contracts) and thus satisfied Regulation 69 of ICR 1994; and

[528] SI 1997 No. 2911.

(b) in the most extreme resilience test scenario, the changed value of the notionally allocated assets (but possibly reallocated among different groups of contract) still covered the changed mathematical reserves (excluding any resilience reserves) calculated using valuation rates of interest that were supportable in that scenario and which complied with the relevant regulations.

Information on derivative contracts

802 Regulation 23 required additional information to be provided on derivative contracts in the form of a statement annexed to the balance sheet, profit and loss account and revenue account.

Signing of documents

803 All the documents relating to the business of the company were to be signed by at least two directors and by the chief executive[529]. The abstract of the appointed actuary's report under section 18 of the ICA 1982 was to be signed, additionally, by the appointed actuary who had made the investigation on which the abstract was based (Regulation 27). It is understood that, in practice, these provisions have generally been interpreted as requiring that only the appointed actuary should sign the actuary's report.

Certificates of directors and actuary and opinion of company auditor

804 As under the ICAS Regulations 1983, all insurance companies were required to annex to their accounts a certificate from the directors and an opinion of the company auditor; in the case of companies carrying on long term business, they were also to annex a certificate from the appointed actuary (Regulations 28 and 29). These documents were required to contain statements prescribed in Schedule 6 to the ICAS Regulations 1996.

805 Part I of Schedule 6 dealt with the directors' certificate which was to be signed by the same directors as those who had signed the account documents[530] and include statements about specified matters[531]. If any of the required statements could not truthfully be made by the directors they were to be omitted. Part II of the Schedule dealt with the certificate to be given by the appointed actuary[532], to which the actuary was to add any qualification, amplification or explanation as he or she considered necessary. Part III dealt with the auditors' report, which was to state his or her opinion on specified matters[533] (which did not include the prescribed forms which comprised the abstract of the actuary's valuation report under Schedule 4) and which was to be qualified, amplified or explained if the information

529 Or the secretary if any, if the company had no chief executive.
530 Regulation 28(a).
531 These included statements to the effect that the return had been prepared in accordance with the Regulations; that proper accounting records had been maintained; that an adequate system of control had been established over the company's transactions and records; and that a margin of solvency had been maintained throughout the financial year in question and a statement in the form of a list of published guidance with which the systems of control complied and in accordance with which the return had been prepared.
532 Covering such matters as the actuary's opinion as to whether proper records had been kept by the company; that the mathematical reserves (plus any additional surplus shown in Form 14 and specified in the certificate) constituted proper provision at the year end for the long term liabilities; that the liabilities had been assessed in accordance with Part IX of ICR 1994; the actuary's opinion on the sufficiency of the premiums for contracts entered into during the financial year to meet commitments under those contracts; and, by way of a list, that the professional guidance notes which had been complied with (in place of the earlier requirement which had referred only to compliance with GN1 and GN8).
533 Such as whether the balance sheet, profit and loss account and revenue account had been prepared in accordance with the ICAS Regulations 1996; whether or not it was reasonable for the directors to make the statements given in their certificates; the extent to which, in giving the opinion, the auditor had relied on the certificate of the actuary with respect to the mathematical reserves and the required minimum margin and the identity and value of any implicit items (for which authorisation had been given by an order made by the Secretary of State under section 68 of the ICA 1982).

or explanations the auditor had received did not allow the auditor to express one of the required opinions. If the auditor referred in the report to any uncertainty, he or she was to state whether that uncertainty was material to determining whether the company had available assets in excess of the required minimum margin.

Qualifications of appointed actuary and company auditor

806 The requirements concerning the qualifications of the appointed actuary, the information to be supplied about the appointed actuary and the qualifications of the auditor were substantively unchanged from those in the ICAS Regulations 1983 as amended (Regulations 30, 31 and 32).

Amendment and lapse of the ICAS Regulations 1996

807 The ICAS Regulations 1996 were amended by the Insurance Companies (Accounts and Statements) (Amendment) Regulations 1997[534], which applied to documents submitted to the Secretary of State in respect of any financial year ending on or after 31 December 1997.

808 The 1997 Regulations made a number of detailed amendments which affected the disclosure requirements for both the accounts documents and the abstract of the actuary's valuation report and slightly reduced the scope of the audit report. New prescribed forms were introduced and a number were replaced including Form 57, the 'matching rectangle', notionally attributing assets to liabilities, as it was widely felt that the originally prescribed form had proved unsatisfactory.

809 For financial years ending on or after 31 December 1997 the layout of Form 57 was revised, although similar information was required to be shown. In the revised form, the last four columns were intended to demonstrate, under the 'worst case' scenario, how asset values changed and were reallocated between groups of contract and how the associated supportable valuation rates of interest altered.

810 The last line of the form disclosed the mathematical reserves for the contracts before and after the scenario change, with the difference being the release of the resilience reserve and the effect of changing the valuation rate of interest used in the resilience scenario[535].

811 Separate forms continued to be required for each rate of interest used in the valuation (and as before, one form could include all contracts valued at the same rate provided they came within specified categories, such as the 'sterling liabilities of life assurance and annuity business').

812 The ICAS Regulations 1996 were further amended by the Insurance Companies (Amendment) Regulations 2000[536] as referred to below. They lapsed on 1 December 2001 with the repeal of the ICA 1982 by the Financial Services and Markets Act 2000 (Consequential Amendments and Repeals) Order 2001[537].

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534 SI 1997 No. 2911.
535 Appendix D includes a copy of Form 57 as substituted in 1997.
536 SI 2000 No. 1231 (referred to in paragraph 683).
537 SI 2001 No. 3649 (referred to in paragraph 683).

Guidance for Appointed Actuaries: GN1, GN2 (dynamic solvency testing) and GN8 in 1996 and GN7 (the reporting actuary) in 1997

GN1

813 An updated version of GN1 was issued in September 1996 (5.0)[538]. The main changes related to the three areas of guidance outlined in the following paragraphs (which entailed still further references to PRE).

814 **The extent of the appointed actuary's responsibility** (section 3 of GN1): earlier versions of the guidance had stated that the two aspects of an appointed actuary's appointment, namely his or her appointment and remuneration by the company and his or her duties to the DTI, would '*seldom ... conflict in a material way*'. Version 5.0 acknowledged that '[these] *responsibilities may be in conflict from time to time but it would be seldom that any such conflict could not be resolved by discussions internal to the company*'.

815 Paragraph 3.2 of GN1 was expanded and slightly revised. This paragraph dealt with the actuary's responsibilities in circumstances where there was a material risk that the long term fund would be insufficient to cover the company's liabilities or that the company would fail to meet obligations under the ICA 1982 in relation to long-term business.

816 According to the covering letter issued with the revised guidance, the aim of the amendments was to clarify the circumstances and sequence of events to be followed before the appointed actuary informed the DTI. The revised paragraph set out three possible reasons for such a risk arising:

(a) because of a particular course of action being, or proposed to be, followed by the company;

(b) because of a failure by the company to take appropriate action in response to a change in circumstances; or

(c) because a particular situation had arisen, perhaps outside the control of the company.

Earlier guidance was then repeated, that in such circumstances the appointed actuary should inform the company accordingly; if the company failed to take action to remedy the position and did not advise the DTI of the situation, then the appointed actuary was under a duty to do so after so informing the company (notwithstanding the contents of the F&IA's Memorandum on Professional Conduct)[539].

817 A new paragraph 3.4 was added in relation to the statutory requirements for insurance companies to fulfil the criteria of sound and prudent management[540]. It was stated that these criteria included the need for insurance business to be conducted with due regard to the interests of policyholders and potential policyholders and that in formulating his or her advice to the company, the appointed actuary was required to take account of those interests.

538 This guidance was reissued in a slightly corrected form in February 1997 (with the same version number), in which the layout of one paragraph (5.8) was revised, apparently, to make the intended meaning clearer.

539 In 1994, the Government Actuary (then president of the Institute of Actuaries) expressed the view that '*the whistle-blowing role of the appointed actuary is significant, but most effective if it does not ever have to be used. The appointed actuary acts not so much as an arm of the supervisor, but instead of a supervisor, by providing the management of the company with an internal control mechanism which obviates the need for heavy regulatory intervention .... Clearly the relationship* [with the senior management of the company] *is not a simple one, but the role is of as much to the benefit of the company as the supervisor. There should rarely be a true conflict of interest*'. (This extract of the address was circulated within the DTI on 18 July 1994).

540 See paragraph 574 regarding the criteria set out in Schedule 2A to the ICA 1982.

818 **Premium rates and conditions** (section 5): two new paragraphs were added. The first (paragraph 5.7) related to contracts which specified that particular terms were to be determined by the appointed actuary or by the company on the advice of the appointed actuary. In determining such terms or when advising the company, the appointed actuary was required to have regard to policyholders' reasonable expectations and to '*existing legislation*' including, where relevant, that covering unfair contract terms.

819 The second addition to section 5 was a new paragraph concerning unit linked business (paragraph 5.8), which noted that unit pricing, fund charges and deductions in respect of taxation were all key elements of policyholders' reasonable expectations; all discretionary elements affecting these matters should be applied consistently with policyholders' reasonable expectations and equitably to any policyholders who were directly or indirectly affected.

820 **Internal matters** (section 9): paragraph 9.3 of the guidance was expanded. This paragraph concerned the relationship between a director who was an actuary (which I refer to as a 'director-actuary') and the company's appointed actuary.

821 The additional guidance made clear that the presence of a director-actuary on the board of the company did not lessen the responsibilities of the appointed actuary in any way or make it any less necessary for the appointed actuary to have direct access to the board.

822 The guidance envisaged that director-actuaries might give actuarial advice to the board formally or informally. However, if a director-actuary did so in a way which could encroach on the role of the appointed actuary, the director-actuary was required to ensure that the appointed actuary was informed of that advice and given the opportunity to present properly reasoned comments to the board.

823 A further version of GN1 was issued on 1 December 1998 (version 5.1). A few minor deletions were made, the most significant of which was the deletion of the advice to appointed actuaries to seek help and advice through the Secretary of the Professional Affairs Board if doubtful about the proper course to follow when facing a potentially significant problem. References to the DTI and to the Secretary of State were replaced with references to the 'Supervisory Authority'.

824 GN1 now stated that policyholders' reasonable expectations were 'clearly influenced by policy literature and other publicly available information such as own charge illustrations'. Version 5.1 of GN1 was replaced by version 6.0 on 1 December 2001.

GN2 – Dynamic Solvency Testing and Financial Condition Reports

825 In March 1996 a new series of Guidance Notes for appointed actuaries was issued, 'GN2: Financial Condition Reports', the first version of which came into effect on 25 March 1996.

826 The status of this guidance was 'recommended' rather than mandatory[541]. The aim of GN2 was to suggest a possible format for a Financial Condition Report and to outline how 'Dynamic Solvency Testing' (DST) would *'normally be used'* to derive the background information underlying such a report.

827 DST was described in GN2 as the '*principal technique*' which enabled appointed actuaries to assess the ability of an office to withstand changes in the external economic environment and in the particular experience of the office.

[541] See paragraph 178.

828 DST involves projecting the company's revenue account and balance sheet forward and then changing each of the important assumptions in turn, to establish the company's sensitivity to changes in a particular assumption or in a combination of assumptions in the future, having allowed for plausible action by management[542]. DST is intended to provide a means by which the management of an insurance company can plan for various scenarios which might emerge in the future.

829 The production of GN2 followed on from the work of a further joint actuarial working party of the F&IA on DST which had reported in November 1993 at the Blackpool Life Insurance Convention[543]. The work undertaken by the Working Party was discussed at a Current Issues in Life Assurance seminar in April 1994[544], at which there appears to have been debate about whether the production of a financial condition report should be mandatory and whether the report should automatically be made available to the supervisory authorities (and, if so, whether it would be possible to maintain its confidentiality). Nonetheless, some of those present saw DST as 'fundamental to the role of the life office actuary'. There was discussion about whether deterministic[545] or stochastic modelling[546] should be used and a request was made for detailed guidance on the form that a financial condition report should take[547].

830 Correspondence between the DTI and GAD in June and July 1994[548] in relation to the findings of the Working Party on DST suggests that there was considerable interest in DST. GAD suggested that information of the kind contained in a financial condition report would be of *'enormous value to the regulator'*.

831 However, it was considered that the value of such a report would be diminished if it were to become a statutory requirement to deposit the report with the regulator, as companies would be concerned that the regulator might react prematurely to the information contained in it and would therefore produce a 'sanitised version' of what was originally intended to be a 'management tool'. GAD noted that:

> *DST is essentially a management tool rather than a method of assessing liabilities and therefore seems to have little direct relevance to the solvency margin review. ... DST is more useful as part of a package of requirements for judging the adequacy of a company's capital and reserves to meet its solvency requirements in the future over different scenarios i.e. a form of medium-term resilience test.*

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542 In contrast, resilience testing considers the impact of various changes in conditions instantaneously at the date of the valuation.

543 In the extract of the presidential address given in 1994 mentioned in footnote 539, the Government Actuary had also stressed the benefits of DST. The extract referred to the position in Canada, where there was said to be a strong emphasis on the role of the appointed actuary in reporting to the board of the company on the future financial condition of the company. The Government Actuary expressed the view that DST was an *'invaluable tool in exposing the weakness in the company's financial condition and in focusing management attention on strategies to reduce risk and increase resilience. It also provides the appointed actuary with a basis for discussing strategy with the Board and senior management in a way which is dynamic and relevant to the business decision-making process, rather than being defensive or regulatory in its emphasis.'*

544 JIA 121 III, 597-601.

545 Mathematical models involving specific selected assumptions which of themselves have no element of randomness.

546 Mathematical models in which, for each run of the model, the values for key assumptions (e.g. interest, inflation, mortality, and lapse rates) are selected randomly from statistical distributions. These runs are repeated many times so that the likelihood of a variety of outcomes can be investigated.

547 The speaker had noted that, based on his experience, it could be difficult to reduce the amount of information in the report to an intelligible level.

548 Memoranda from the Director of the DTI's Insurance Division dated 20 June 1994 (which was copied to GAD) and from GAD to the Director of the Insurance Division dated 6 July 1994.

832 GN2 recommended that the financial condition report should be addressed to the board of the company or the appropriate group with responsibility for policy formation for the company concerned (paragraph 1.3). It was stressed that the report should be '*expressed in a form which is accessible to its readers*' and that important information should not be concealed inadvertently, for example through undue length or complexity (paragraph 1.4).

833 GN2 recommended that the appointed actuary should address the actions open to the company to deal with particular circumstances and make recommendations where appropriate. GN2 envisaged the use of both deterministic and stochastic techniques to appraise the various risks or whatever techniques the actuary considered appropriate to the company's business (paragraph 1.7).

834 Section 2 of the guidance provided an outline of the main points which were normally to be addressed in a Financial Condition Report, among which were the methods and assumptions which had been used and any changes in those methods and assumptions since the last similar report.

835 Section 3 provided guidance on DST and included examples of the areas in which testing of variations in assumptions should be undertaken, noting that there '*would need to be specific reasons for not testing variations in the* [...] *assumptions*' about future investment conditions, levels of new business, expenses and persistency (paragraph 3.4.1).

836 Among the list of assumptions suggested as being of '*considerable importance in some companies but not in others*' was the assumption about the exercise of options by policyholders (paragraph 3.4.2). A further list of factors (in paragraph 3.4.3) which the appointed actuary needed to be alert to as potentially affecting the company included such matters as:

(v) impending major claims or litigation that might affect the company;

(vii) unusual contracts or relationships which may have financial implications;

(viii) risks created by deficient product literature or policy documentation; and

(x) the effect in different scenarios of options and guarantees in the insurance liabilities.

For each scenario tested, provision was to be made for all elements of the statutory liability including an appropriate level of resilience reserve (paragraph 3.4.4).

837 The conclusion of GN2 stated that:

> *The very least that it is reasonable for a Board to expect of the advice from the Appointed Actuary is that the company does not unknowingly run foreseeable risks which could jeopardise its financial well-being.*

838 The first version of GN2 on Financial Condition Reports remained in effect up to 30 December 2002 when it was replaced with version 1.1.

839 A paper produced for the F&IA in 2000[549] suggested that GN2 had become best practice, with most appointed actuaries by then producing a report on the impact of different '*likely potential scenarios*' on the financial condition of the company.

[549] 'Statutory Regulation of Long Term Insurance Business' prepared for the F&IA by William M. Abbott and revised by Nick C. Dexter in 2000.

840 One of the recommendations made in the Corley Report[550] was that the provision of an annual Financial Condition Report should be made mandatory through GN1, although GN2 should remain as recommended practice[551].

GN8

841 GN8 was updated in September 1996 (version 5.0). Additional guidance was given on Regulation 70 of ICR 1994, which required the use of prudent rates of mortality and disability when determining the amount of the company's long term liabilities.

842 The additional guidance referred to the need to take account of future improvements in mortality[552] where this would increase the required reserve. For assurance and sickness business, allowance was to be made for the incidence of mortality and morbidity arising from known diseases where the impact might not have been reflected fully in the mortality or morbidity experience current at that time (paragraph 3.4).

843 The guidance on Regulation 71 of ICR 1994, concerning the need to make prudent assumptions for expenses when calculating liabilities, was also expanded following discussions between the F&IA and the DTI and GAD. The additional subparagraphs (3.5.4.1 and 3.5.4.2) explained the circumstances in which explicit provision would and would not be necessary in relation to the costs of new business and how the additional provision should be calculated where it was required.

844 Revised and additional guidance was given on Regulation 75 of ICR 1994, which required the actuary to take into account the nature and term of the assets in determining the amount of the long term liabilities.

845 The new guidance explained that Regulation 75(a) required the appointed actuary to consider mismatching provisions from the point of view of cash flows, whilst Regulation 75(b) required a test of the resilience of the overall reserves to satisfy Regulations 65 to 74 in changed investment conditions. The overall provision to be established was to be equal to the greater of these two amounts. Additional guidance was then given on how the two calculations, under paragraphs (a) and (b) of Regulation 75, were to be undertaken (paragraphs 3.6.1, 3.6.3 and 3.6.4).

846 Version 5.0 of GN8 was superseded in March 2001 by version 6.0 which is mentioned below.

Guidance in GN7 and the reporting actuary

847 The F&IA issued guidance concerning the Companies Act accounts of insurance companies and the role of actuaries and their relationship with auditors in Guidance Note 7 (GN7). The version of that guidance issued in 1997 (version 3.0) took account of the new Schedule 9A inserted in the Companies Act 1985 by the CAICA Regulations 1993[553]. The classification of the guidance in GN7 was 'recommended practice' rather than 'mandatory', or a 'practice standard', as in the case of GN1 and GN8.

848 The guidance noted that the technical provisions for long term insurance under Schedule 9A came within the scope of audit, unlike those in the regulatory returns where the auditor, in giving his or her opinion, was permitted to rely on the

550 Paragraph 35 and paragraph B of Appendix 8.

551 Version 6.0 of GN1 which was issued on 1 December 2001 required the appointed actuary to prepare and submit to the board either a financial condition report in accordance with GN2 or a report *'in whatever format he or she considers necessary to ensure that the board is sufficiently well informed of the foreseeable risks which could jeopardise the insurer's financial position'* (paragraph 6.1).

552 The Penrose Report (paragraphs 85 and 86 of Chapter 6) suggests that many life offices, including Equitable, were slow to take account of improvements in life expectancy which had been taking place up to that time.

553 See paragraphs 540 et seq.

certificate issued by the appointed actuary[554].

849 The stated aim of GN7 was to explain the professional duties of the various parties in relation to the financial statements under Schedule 9A. GN7 also referred to the relationship between the appointed actuary and the company's auditors in respect of the preparation of the statutory returns under the ICA 1982.

850 GN7 referred to the actuary who made the computation of the long term business provision[555] for the purpose of the Companies Act accounts as the 'reporting actuary'.

851 The guidance included the following points in relation to the role of the reporting actuary (and the auditor):

(a) the directors of an insurance company remained legally responsible for all statements made in the financial statements required under the Companies Act, although they were entitled to rely on the professional expertise of the reporting actuary to calculate the amounts which were required to be calculated by an actuary under Schedule 9A;

(b) the making of computations under Schedule 9A required the exercise of professional judgment by the reporting actuary;

(c) it was perfectly proper for the directors to give instructions to the reporting actuary regarding the broad approach to the calculation of the long term business provision, but the reporting actuary should be aware that readers of the financial statements would be placing reliance on the figure shown (and the actuary was reminded of his or her professional duties to third parties);

(d) '*in many instances*', the reporting actuary and the appointed actuary would be the same person (but this need not be the case);

(e) the reporting actuary would need to be familiar with accounting principles and current audit practice since the computations were made under the framework of the Companies Act where a different methodology to that appropriate for the solvency test might be applicable;

(f) the reporting actuary should ensure that the auditor was aware of the approach he or she proposed to adopt to the accounting principles in SSAP 2[556] as there was particular uncertainty as to their application;

(g) the reporting actuary could choose to base the calculation of the long term business provision on the equivalent mathematical reserves calculation made by the appointed actuary (but the reporting actuary would retain full responsibility for the calculation). Reference was then made to the need to modify[557] the amounts calculated by the appointed actuary to comply with the Modified Statutory Guidance Note[558];

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554 It was said that the accountancy bodies recognised that the valuation and certification of the long term liabilities under the ICA 1982 were the sole professional responsibility of the appointed actuary; hence the actuary's certificate and Schedule 4 of the statutory returns (abstract of the valuation report) were not subject to audit.

555 See paragraphs 549 and 550

556 Statement of Standard Accounting Practice 2: Disclosure of accounting policies, issued by the Accounting Standards Committee in 1971; since superseded by Financial Reporting Standard (FRS) 18 – Accounting Policies issued by the Accounting Standards Board.

557 The statutory basis for calculation of the long term liabilities under the ICA 1982 was modified for the purposes of the Companies Act accounts, particularly as regards the treatment of reserves. This was known as the 'modified statutory basis'.

558 Association of British Insurers (ABI) Guidance Note – Accounting for Insurance Business (Excluding Accounting for Investments) 1995.

(h) the reporting actuary might reach different professional judgments to those of the appointed actuary, but should defer to the appointed actuary on matters regarding PRE;

(i) where the reporting actuary relied on *'other areas within the company'* to produce information on which to base his or her calculations, although that information would be subject to audit, it would be inappropriate for the reporting actuary to place too much reliance on the auditor for its accuracy and completeness as the auditor may have carried out work at a *'different level of materiality'* to that required by the reporting actuary; (further, the auditor might well consider it inappropriate to extend the scope of the audit work to give comfort to the actuary, since the auditor might be required to express an independent view on the work of the reporting actuary);

(j) although the statutory role of the reporting actuary was limited to the long term business provision, actuarial advice might be needed to calculate other elements of the balance sheet and profit and loss account;

(k) an important part of the reporting actuary's work was the preparation of a report to the directors on the approach to the computation of the long term business amount and the material assumptions used; the actuary's report should not only address the amounts computed, but it should also make recommendations about disclosures;

(l) actuaries involved in the preparation of published financial statements should be familiar with Audit Guideline 311[559];

(m) in order to form an opinion as required by the legislation, the auditor must assess, understand and where appropriate challenge the assumptions underlying the work of the reporting actuary; an actuary advising an auditor in supporting a reasonable challenge to the work of the reporting actuary would not be in breach of the Memorandum on Professional Conduct[560].

852 In relation to the role of the appointed actuary (and the auditor) the guidance:

(a) required the appointed actuary to be prepared to advise the directors on the evidence of compliance (or lack of compliance) with the Prudential Guidance Notes[561];

(b) noted that there were certain areas in which the work of the appointed actuary and that of the auditor overlapped, most particularly in checking the accuracy of policy data and the valuation of assets; the guidance advised that it was inappropriate for the appointed actuary to place too much reliance on the work of the auditor unless the work had been undertaken in accordance with 'a *specifically scoped assignment*' outlined in a formal letter of engagement;

(c) advised that the auditor might wish to discuss with the appointed actuary any financial condition report which the appointed actuary had prepared, in order to understand the appointed actuary's view of the future development of the company's finances and the risks to which the long term fund was exposed, but this did not imply that the financial condition report was subject to audit.

559 Issued by the Audit Practice Committee (later the Audit Practice Board).
560 The current Professional Conduct Standards of the F&IA require that members of either Institute avoid any action which would unfairly injure the professional reputation of any other member.
561 See paragraphs 693 and 724 regarding the requirements for directors' certificates to list certain Prudential Guidance Notes issued by the DTI if they had been complied with.

853 The version of GN7 referred to above was not revised until December 2004.

Working party on annuity guarantees and guidance on annuity guarantees, reserves and terminal bonus calculations 1997-1999

854 With falling rates of interest during the early part of the 1990s, the advantage to policyholders of taking benefits in guaranteed annuity form as opposed at the current annuity rate was apparent[562].

855 However, it was not until the late 1990s that there were public signs that consideration was being given to the impact of annuity guarantees and the reserves which companies made for them, although GAR options had commonly been available in some form in connection with with-profit policies since at least the 1950s.

856 The following outlines some of the events and key correspondence regarding the issues surrounding GARs, the reserves made for them and the issue of differential bonus calculations.

The Annuity Guarantees Working Party report

857 In January 1997, the Life Board of the F&IA set up a working party to consider the issues surrounding GARs. The terms of reference of the Annuity Guarantees Working Party (AGWP) stated that:

> *Currently there is no accepted practice for reserving for these guarantees and there is no published research to guide Appointed Actuaries in setting reserves. The DTI have not published any guidance or regulations specific to annuity guarantees.*

858 The AGWP was to:

(a) determine the different kinds of GAR which had been issued and obtain an indication of the volume of business;

(b) determine the current practice regarding reserving for guarantees;

(c) research the cost of such guarantees under different scenarios of investment return and mortality;

(d) consider PRE issues;

(e) consider and recommend appropriate reserving bases for annuity guarantees, taking account of DTI general guidance and regulations; and

(f) prepare a report summarising its conclusions.

859 The AGWP completed its report in November 1997. The introduction to the report noted that, collectively, insurance companies had over ú35 billion of liabilities to which GARs applied. It stated that, with relatively low interest rates and improving mortality, the guarantees were potentially very valuable, yet there had not been 'any attempt to consider appropriate reserving standards in the light of the Insurance Company Regulations'.

860 The AGWP:

(a) conducted a survey of life companies carrying on pensions business in order to ascertain the extent of the guarantees currently in force and the practices of companies in reserving for them;

562 In the case of Equitable, the guaranteed annuity rate exceeded the current rate from October 1993 until May 1994 and from May 1995 onwards. The interest rate offered on GARs in policies issued by Equitable between 1975 and 1988 (when the company ceased to offer them on new policies) was 7%. As at December 1998, Equitable had some 100,000 GAR policies still in existence (according to a joint opinion of counsel dated 18 December 1998 obtained by the company).

(b) analysed the implications of the guarantees in terms of the statutory requirements for reserving; and

(c) considered two alternative approaches to measuring the value of the guarantees, using stochastic investment models or a market based approach using financial instruments to 'hedge' the guarantees.

861 Questionnaires had been issued to 85 insurance companies. Of the 66 companies which had responded, 41 had issued GARs. It was estimated that the 66 respondents represented at least 90% of the total market liabilities. Key findings from the survey included the following:

(a) almost all the companies had ceased offering GARs on new policies, but in the majority of cases the guarantee continued to apply to the premiums being paid on existing policies which contained GARs;

(b) 51% of the companies held no reserves for guarantees[563], the remainder calculated the liability on the basis of the greater of the value of the cash option and the value of the guaranteed annuity on the valuation basis;

(c) few companies made explicit allowance for the effect of future premiums to which the GAR applied;

(d) a number of companies said that no allowance for the effect of GARs was made in the resilience test for the resilience reserve;

(e) the majority of companies took no account of GARs in setting investment guidelines; and

(f) the majority of companies made no allowance for GARs when establishing maturity values; a small number had made adjustments to asset shares or had made specific adjustments to terminal bonus rates[564].

862 The AGWP report noted in passing that the whole question of reserving for with-profits business (leaving aside the effect of GARs) was not a precise science and that alternatives to the net premium valuation method had been considered by other working parties, which raised issues which went '*far beyond*' the scope of the AGWP paper[565].

863 In relation to the action which should be taken in respect of reserving for GARs under with-profits contracts, the AGWP made no recommendations, but offered three '*possible approaches for consideration*', none of which it considered to be entirely satisfactory. These comprised:

(a) allowing for guarantees in the same way as unit-linked business, by setting aside additional reserves related to prudent estimates of the cost over and above existing, unadjusted, with-profit reserves;

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563 The joint counsel's opinion obtained by Equitable in December 1998 records that the company had notified the DTI in its annual returns from 1993 to 1997 that it made no explicit provision for GARs. The advice expressed the view that whether ICR 1994 required any reserve at all was a matter for *'actuarial judgment on which we are not qualified to comment'*, although the parameters within which that judgment was to be made were a matter of law. The view expressed in that advice was firmly rejected by the prudential regulator and GAD.

564 Starting with the 1994 bonus declaration, Equitable had declared different final bonuses for GAR policyholders based on whether or not they elected to take benefits in guaranteed annuity form. The Society's intention was to ensure that policyholders received the same level of benefits, whether they took those benefits in guaranteed annuity form or at the current rate.

565 A separate F&IA working party, which reported early in 1998 on the net premium method of valuation, recommended the retention of this approach as a minimum standard for with-profits business, but a gross premium method for non-profit business, leading to the amendments to ICR 1994 made by SI 2000 No. 1231 referred to in paragraph 975.

(b) recognising the cost of GARs as effectively increasing the guaranteed sum assured on some prudent basis and then recalculating the net premium reserves on this basis; or

(c) the third option was: *'reviewing whether and to what extent the guarantee will be covered by terminal bonus adjustments. Providing that terminal bonus adjustments will be used and are sufficient to cover guarantees in all circumstances, there is an argument for not reserving for such guarantees – no explicit provision is made for terminal bonuses and hence the provision for guarantees is simply part of this implicit provision subject to the existence of appropriate terminal bonus margins.'*

864 The AGWP considered that the first option was the most prudent, recognising however that the adverse impact on published survey ratios for an office adopting this approach in isolation[566] might make it unattractive.

865 The second approach was said to be somewhat arbitrary in its effect on the overall strength of the valuation basis, whilst the third approach could be viewed as unsound as it made no explicit provision for an explicit guarantee[567].

866 The AGWP survey had requested comments on PRE issues, but relatively few had been made. The AGWP noted that if maturity payments were in some way linked to asset shares (as appeared to be almost universal practice), an office's approach to spreading the costs across generations of policyholders and across policy types was likely to be of most significance. (The survey had revealed that most offices had made no allowance for the cost of guarantees either through adjusting asset shares or terminal bonuses.) Some respondents had made the point that allowing for the cost of guarantees in 'payouts', particularly through adjustments to terminal bonus only as and when guarantees bite, would be contrary to the spirit of the guarantees and hence contrary to PRE.

867 The report noted that other offices practised or intended to consider exactly such an approach: appendix 2 to the AGWP report indicated that four of the 29 companies that responded said that they would consider adjusting terminal bonus rates to compensate for a guarantee which was biting.

868 The report recommended that life offices needed to consider some (apparently fundamental) issues in relation to GARs such as their likely cost and sensitivity to changes in future conditions and how the costs of meeting them should be provided for, whether by adjustments to asset shares, adjustments to terminal bonus or implicitly against the company's estate[568].

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566 Suggesting, perhaps, that if such an approach were to be a universal requirement, it might be less unattractive (but this was not explored).

567 Equitable had adopted this third approach, in terms of making adjustments to terminal bonus payments and not making any specific provision for guarantees. The Society's justification for not reserving for GARs had been that reserving could reflect actual and expected experience as to whether policyholders elected to take benefits in guaranteed annuity form. According to the Society, up to and including the end of 1997 the number of policyholders so electing was virtually nil. Equitable made the point that it had notified the DTI (and later the Treasury) of the absence of any specific provision for GARs, by means of a note in the annual returns which appeared from the time of the 1993 returns.

568 See footnote 497.

869 The report of the AGWP discussed the use of stochastic methods to assess the costs of guarantees, using variable interest rates. As an alternative, it was suggested that financial instruments such as 'options to swap', or 'swaptions', might be used to protect the fund against the impact of guarantees, by eliminating or setting an upper limit on the interest rate risk.

870 It was suggested that a '*promising approach*' might be to purchase an option to swap floating rate interest payments for a fixed rate payment at a specified date for a specified period. It was said that there was a very large liquid market for trading such swaptions, particularly at the shorter dates, and illustrative prices were given.

871 The conclusions of the report stated that there was '*limited evidence*' that insurance companies had started to address issues such as the opportunity to take account of guarantees in setting bonus rates and the impact this might have on PRE.

872 It was noted that many companies had not worked out their approach to reserving for guarantees and with low interest rates and improving mortality, they would need to do so in the near future. The AGWP had felt unable to recommend an approach to reserving as 'the variation between products and the approaches of different companies to managing guarantees [were] so great'.

GAD questionnaire on annuity guarantees – June 1998

873 The AGWP report is dated November 1997. On 20 June 1998, GAD wrote to appointed actuaries with its own questionnaire, having expressed the view to the Treasury (to which prudential regulation functions had by then been transferred[569]) that the regulatory returns did not provide sufficient information about companies' exposure to GARs.

Treasury letter on guaranteed annuity option costs and PRE (and terminal bonus) – 18 December 1998

874 Following on from the survey conducted by GAD, on 18 December 1998[570] the Insurance Directorate at the Treasury wrote to all managing directors of insurance companies authorised to carry on long term business, noting that the results of that survey had indicated that exposure to guaranteed annuity options (GAOs) was relatively widespread in the industry and had the potential to have a significant financial impact on a number of companies.

875 The stated purpose of the letter was to give some guidance to companies on the Treasury's interpretation of PRE in the context of GAOs[571]. The letter was said to contain the Treasury's considered view, but to be '*without prejudice to any decision of the courts which might affect it*'.

876 According to the letter, as a starting point, the Treasury took the view that:

> *'policyholders entitled to some form of annuity guarantee or option on guaranteed annuity terms could reasonably be expected to pay some premium, or charge, towards their option or guarantee.'*

877 Having made clear the Treasury's view that in relation to linked contracts any costs of meeting a guarantee which could not be covered by accumulated charges made to the policyholder would fall to be met by the insurer, the letter went on to suggest that in the case of participating[572] policies:

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569 See paragraph 908.
570 DD1998/5.
571 Whilst noting that the nature of the guarantees offered by companies varied widely.
572 With-profits.

... any charge could be deemed to be met out of each premium received (or the investment return to be credited by way of bonus), and hence would impact on the assessment of bonuses, including in particular any terminal bonus that would normally be payable to the policyholders. Generally we consider that it would be appropriate for the level of the charge deemed to be payable by participating policyholders for their guarantee (or annuity option) to reflect the perceived value of that guarantee (or option) over the duration of the contract. This could be achieved in some cases through some reduction in the terminal bonus that would be payable if there were no such guarantee (or option) attached to the policy. However the selected treatment by each office would need to depend on the wording of the contract involved and how it had been presented to policyholders.

Under the majority of participating policies which have been written it appears that any guarantee or annuity option is applicable to at least the guaranteed initial benefit under the policy and any attaching declared bonuses. As a consequence of this, we would expect that for most companies the present guaranteed cash benefits (including declared bonuses) would be converted, as a contractual minimum, to the annuity on the guaranteed terms. However as indicated above, it would appear possible, depending on the particular circumstances relating to the contract, that any terminal bonus added at maturity may be somewhat lower than for contracts without such options or guarantees, and that this terminal bonus could in some cases be applied at current annuity rates.

878 The letter went on to deal with the apportionment of any 'residual cost' which fell to be met by the insurer in respect of GAOs (for both participating and non-participating contracts), specifying that they should be met from the long term fund and any shareholder funds.

879 Where the long term fund was to be used, in the first instance the cost would be met out of any estate; thereafter the insurer might wish to consider adjusting future bonus allocations for some or all participating policyholders (or making a transfer to the long term fund from any shareholders' fund).

880 The letter then highlighted that the appropriateness of any such adjustments to bonus allocations for participating policyholders would need to be assessed by each office in the context of the reasonable expectations of all[573] their policyholders, and that this assessment would be influenced by such matters as policy documents and representations made through marketing literature, bonus statements or elsewhere.

881 The letter appeared to suggest that ex post facto charges might be made to GAR policyholders who exercised their options[574]. The guidance in the letter was suspended by the FSA[575] on 27 July 2000, seven days after judgment was given by the House of *Lords in Equitable Life Assurance Society v Hyman*[576].

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573 The inclusion of '*all*' appears to suggest a need for companies to be aware of the potentially competing interests of different classes of policyholders when deciding on their approach.

574 Subject to the caveats mentioned above regarding the appropriateness of any such adjustments in the context of PRE (paragraph 880) and any decision of the courts (paragraph 874). Those involved at the time have told me that the letter was interpreted by Equitable as providing support for its approach of making adjustments to terminal bonuses.

575 To which the Treasury had, by then, delegated its prudential regulation functions in relation to insurance (with effect from 1 January 1999).

576 [2002] 1 AC 408.

Dear Appointed Actuary letter from the Government Actuary: DAA11, January 1999

882 On 11 January 1999[577], the Government Actuary wrote to appointed actuaries, following up on the letter from the Treasury to managing directors of 18 December 1998, on the specific issue of reserving for GAOs (DAA11).

883 The letter stated that the Government Actuary considered that Regulation 64 of ICR 1994 required life offices to calculate their liabilities, and hence to reserve, on the basis of all the benefits offered under the contract and that long term liabilities should be determined on '*actuarial principles*' and '*make proper provision for all liabilities on prudent assumptions*'. In addition to reserving for all guaranteed annuity benefits companies should, in his view, have been reserving fully in respect of any facility for policyholders to select an alternative form of benefits:

> *In general it would not in my view be prudent to assume that policyholders will choose a benefit form that is of significantly lower nominal value to them...*

He then went on to suggest that some limited allowance '*of a few percentage points of the reserve*' could be made in some cases for the possibility that some policyholders might prefer to take their benefit in some other form. This statement was clarified in a subsequent DAA letter of 22 December 1999 (DAA13, mentioned below). This clarification explained that the Government Actuary had been referring to a few percentage points of the reserve for the contract and not to a reserve for the guaranteed annuity rate.

884 Paragraph 7 of the Government Actuary's letter stated:

> *Where the levels of terminal bonus are to be adjusted with the aim of bringing the value of the guaranteed annuity option closer to the value of the alternative benefits, there might at first sight appear to be some room for argument that it was not necessary to reserve on the assumption that almost all policyholders will take the guaranteed annuity benefit. However, it needs to be remembered that, although the benefits formally 'guaranteed' under the alternative form of benefit may be lower than those under the guaranteed annuity option, the company's discretion in setting the value of the terminal bonus applied to the alternative form is limited as a result of the guaranteed annuity. It is likely that close to 100% of policyholders will exercise the annuity guarantee unless the company maintains terminal bonus at a level which ensures that the value to the policyholder of the alternative benefit is at least equal to the value of the guaranteed annuity. Accordingly, this constraint will need to be reflected in the valuation assumptions made about either the proportion of policyholders opting for the alternative benefit or the value of that alternative benefit. Consequently any reduction in the reserves held by the insurer by more than a few percentage points below the full value of the guaranteed annuity for this reason would require very careful justification by the actuary.*

885 The paragraph quoted above appears to envisage that it might be permissible to make some form of adjustment to ensure parity been the two alternatives, consistent with the Treasury's letter dated 18 December 1998 (see paragraphs 874 et seq), albeit that the subject of the Government Actuary's advice was the valuation assumptions that should be adopted.

[577] Several later references to this letter (including those in DAA13) refer to it being dated 13 January 1999; however, they appear to relate to the same letter.

886 The letter went on to record that the Government Actuary did not consider it prudent to use past experience alone, of a 25% take up of benefits in the form of a tax free cash lump sum, as a basis for reducing the percentage of benefits assumed to be taken in guaranteed annuity form. It was likely that policyholders and their advisers would see the annuity guarantees as valuable and something to be used in full.

887 The Government Actuary went on to advise that companies should assess the extent to which a resilience reserve was required to cover their annuity guarantees. The need to hold substantial mathematical reserves to cover guaranteed annuity options was not a sound argument for reducing the stringency of the resilience test applied.

888 The Government Actuary drew attention to the requirements of paragraphs 4(1) and 5(1) of Schedule 4 to the ICAS Regulations 1996 which required that the abstract of the actuary's valuation report include a description[578] of the benefits under the contracts, including any 'material options' and indicated that he would expect such a description to provide an indication of the form of any annuity guarantee offered. In addition, he advised that actuaries should provide a description of the way in which reserves for any annuity guarantees and options had been determined (including an indication of the interest rate and mortality assumptions used), in order to comply with paragraph 6(1)(h) of Schedule 4.

889 The Government Actuary made clear that annual returns should include sufficient information to enable the FSA and GAD to make an assessment of the extent of the guarantees offered, the reserving basis adopted by the company and hence the scope for the annuity guarantees to have an impact on the financial position of the company.

890 The Government Actuary concluded the letter with a statement (as contained in the letter from the Treasury of 18 December 1998) that it contained his considered view and was '*without prejudice to any decision of the courts which may affect it*'.

F&IA position statement on annuity guarantees

891 In March 1999, in the light of considerable press comment about annuity guarantees, the F&IA issued a 'position statement' for use within the F&IA, to enable its Officers, Council members and senior members of staff to answer questions from members of the actuarial profession, members of the public and the press. The document stated that it did not contain formal guidance and nor should it be taken as a full expression of the profession's views on the subject.

892 The statement expressed the '*full support*' of the profession for the position set out in the letter from the Treasury of 18 December 1998 and the clarification and guidance given by the Government Actuary in his letter of 13 January 1999 (see footnote 577).

893 The statement noted that it had been suggested in the press that insurance companies had not reserved fully for annuity guarantees, and that the profession was '*unaware of any specific examples of this*' but would be concerned to ensure that any such cases were as a result of reasonable professional differences of opinion. If not, they would be subject to the profession's disciplinary procedures.

894 In relation to the question of whether companies had reserved adequately for the guarantees, it was stated that the appointed actuary of each insurer had a duty to ensure that sufficient reserves were held to meet that insurer's obligations under its

[578] In the case of accumulating with-profits contracts under paragraph 4(1)(a) of the Schedule a '***full** description of the benefits, including ... any guaranteed investment returns ... and; any material options*' was required.

own approach; in doing so, the appointed actuary should have regard to the Government Actuary's letter of January 1999, as well as the requirements of the Regulations and the profession's guidance in GN1 and GN8.

895 The position statement offered alternative ways of dealing with GAOs. For an insurer with no constraints caused by policy conditions, marketing literature or other representations, the first alternative was to:

> *… ensure that the value of the cash benefits and the value of the pension benefits remain the same, by working out the amount of the guaranteed annuity but then re-expressing the cash option on the basis of the current annuity rates.*

This was identified as producing no cost to the office unless terminal bonus rates fell to zero.

896 The next alternative was to allow the value of the guaranteed annuity and the cash option to move apart, leading to a significant cost to the office. The third option was an intermediate position between the two extremes, for example, by applying the guaranteed annuity rate to only a part of the benefits.

897 The paper urged insurers to explain their position so that each policyholder, particularly those close to retirement, would have a clear idea of how the guarantees might affect them.

Dear Appointed Actuary letter from the Government Actuary: DAA13, 22 December 1999

898 Having reviewed, initially, the returns submitted by insurance companies following his letter of 13 January 1999 (DAA11), the Government Actuary wrote again to appointed actuaries to provide further '*clarification*' of the reserving standards which would normally be expected to be seen in future returns to the regulator, having noted that some aspects of his earlier advice had been interpreted in a variety of ways in the recent returns.

899 In a letter of 22 December 1999 (DAA13), the Government Actuary reiterated his earlier advice about the assumptions which could prudently be made about the take up rate of guaranteed annuity options, bearing in mind that the alternative offered a significantly lower nominal value to policyholders. He clarified his earlier reference to an allowance of '*a few percentage points*' being made to reduce the liability for guaranteed annuities in respect of policyholders who chose to take alternative benefits.

900 In his view, an allowance in excess of 5% would not be considered to represent '*a few percentage points*'. Whilst there might be a stronger case for making an allowance for policyholders choosing to take a proportion of their benefits in the form of a tax free cash lump sum, in his view it would not be prudent to assume that more than 20% would take the maximum cash lump sum permitted.

901 The Government Actuary also indicated that he was reviewing the level of disclosure made by each company in their 1998 returns, regarding the assumptions made to determine the level of reserve for contracts containing a guaranteed annuity, saying: '*For the avoidance of any doubt, we would expect to see full disclosure of the proportions of policyholders assumed to take any available guaranteed annuity, along with the underlying mortality and interest rate assumptions*', adding that GAD would expect to see prudent assumptions for future mortality improvements.

Proposals to reform prudential regulation and transfer of functions in relation to insurance to the Treasury

902 In a statement to the House of Commons on 20 May 1997, the then Chancellor of the Exchequer announced in broad terms the government's proposals to reform the regulation of the financial services industry, to create a single statutory regulator with a single set of statutory powers.

903 The Chancellor noted that the distinctions between different types of financial institution: banks, securities firms and insurance companies, were becoming increasingly blurred and that many of them were regulated by a plethora of different supervisors. The supervision of banking and financial services was to be merged under an enhanced SIB, underpinned by statute. On 28 October 1997, the SIB changed its name to the Financial Services Authority.

904 These proposals eventually led to the enactment of the Bank of England Act 1998 and the FSMA 2000. The background to the latter is described in Phase 6.

905 As a preparatory step towards the implementation of the government's proposals to create a single financial regulator, with effect from 5 January 1998 the functions of the Secretary of State in relation to various aspects of insurance regulation which had been administered by the DTI were transferred to the Treasury. This was achieved through the Transfer of Functions (Insurance) Order 1997[579], an Order in Council made under the Ministers of the Crown Act 1975.

906 The functions transferred to the Treasury included those under the ICA 1982 and the PPA 1975, although certain functions under the 1982 Act were to be exercisable concurrently by the Secretary of State and the Treasury[580]. Functions under the FS Act 1986 which had been retained by the Secretary of State, or which were exercisable by the Secretary of State and the Treasury jointly as a result of changes made in 1992[581], were also transferred to the Treasury.

907 The transfer of functions order made consequential modifications to a number of enactments, including the ICA 1982, to replace references to the Secretary of State with references to the Treasury.

908 The Treasury assumed responsibility for the prudential regulation of insurance companies on 5 January 1998, pending the enactment and coming into force of the FSMA 2000. Staff in the Insurance Division of the DTI were seconded to the Treasury, Insurance Directorate until certain functions relating to prudential regulation were contracted out by the Treasury to the FSA with effect from 1 January 1999.

1998 Service Level Agreement between the Treasury and GAD

909 A service level agreement (SLA) was entered into between the Treasury and GAD, signed by the parties on 29 October and 6 November 1998.

910 Most of the terms of the new SLA replicated those of the agreement between the DTI and GAD signed in March 1995[582], with the references to the DTI and

579 SI 1997 No. 2781.
580 Examples of such concurrently held functions were the powers to require the production of documents under section 44 of the ICA 1982 and to petition the court for the winding up of an insurance company under section 54.
581 By SI 1992 No. 1315, see footnote 257.
582 See paragraphs 744 et seq.

to its Insurance Division substituted with references to the Treasury and its Insurance Directorate respectively.

911 Section 22(1) of the ICA 1982 continued to require that company returns be deposited with the Treasury within six months after the close of the period to which they related – meaning, for the majority of companies with a financial year end in December, that they were to be submitted by the end of June in the following year.

912 However some changes were made in the new SLA. These included:

(a) a new Annex A, which provided a description of the five priority ratings, indicators and target periods for scrutiny (a transcription of which appears in Appendix D to this document);

(b) the timescales for production of detailed scrutiny reports for all companies with priority ratings 1 to 3 were reduced by three months; they were to be received by the Treasury (from GAD) by the end of December in the year in which the returns had been received by the Treasury, with priority 1 and 2 being given greatest priority within that period and completed by the end of October (for companies with December year ends);

(c) the timescale for completion of detailed scrutiny reports for priority 4 cases was reduced by two months: they were to be received by the Treasury by the end of March of the following year;

(d) GAD was to endeavour to complete '*a scrutiny*' of the remaining priority 5 cases by the end of May (replacing a statement in the 1995 SLA that such cases would not receive a full scrutiny in the year in question, but would receive a fuller initial scrutiny);

(e) the position regarding companies with year ends other than December was clarified. Detailed reports were to be provided within a comparable timescale according to the priority awarded to them (as indicated in Annex A);

(f) in relation to action arising from the detailed scrutiny, a requirement was added for GAD actuaries to be available on request to discuss with supervisors any issues concerning individual companies arising out of their detailed scrutiny;

(g) in section C, which dealt with 'Other supervisory matters', having repeated the requirement that GAD should be notified of changes of appointed actuaries, it was specified that GAD would liaise with the Treasury over any action that was needed where there was any concern about the reasons for the change in the appointed actuary. All new appointed actuaries, who had not previously held such a position, were to be interviewed by the Government Actuary and a note of the meeting was to be forwarded to the Treasury; and

(h) a new item was added to the list of 'other areas of responsibility'. GAD was to provide appropriate training for insurance supervisors on request.

913 It appears that the 1998 SLA between the Treasury and GAD continued to be relied on in relation to services provided by GAD to the FSA following the contracting out of functions referred to in the next two sections[583].

[583] The Baird Report refers to the '*GAD SLA*' as being '*the service level agreement between GAD and the DTI (originally, then the Treasury and now the FSA as the prudential regulators) dated 6 November 1998*'.

The Contracting Out (Functions in Relation to Insurance) Order 1998

914 From 1 January 1999, the FSA was to assume day-to-day responsibility for most aspects of prudential regulation of insurance companies, prior to relevant functions being formally vested in it under the FSMA 2000 with effect from 1 December 2001. The means by which this was achieved was through the contracting out order referred to in this section, an authorisation issued by the Treasury to the FSA for the purpose of that order, and the SLA between the Treasury and the FSA outlined in the next section, which set out the terms and conditions upon which the functions were to be exercised by the FSA and the service standards to be achieved.

915 In November 1998 the Contracting Out (Functions in Relation to Insurance) Order 1998[584] (the Contracting Out Order) was made by the Treasury under sections 69 and 77(2) of the DCOA 1994 to permit the statutory functions specified in that Order to be exercised by or on behalf of such person, or the employees of such person, as might be authorised by the Treasury.

916 The Contracting Out Order came into force on 18 November 1998. In effect, it enabled the Treasury to 'contract out' most of the functions which had been transferred to the Treasury by the Transfer of Functions (Insurance) Order 1997[585]. This included specified functions under the ICA 1982, the PPA 1975, the FS Act 1986, the Policyholders' Protection Act 1997, ICR 1994 and other legislation.

917 Certain of the Treasury's functions under the ICA 1982 were not included in the Contracting Out Order[586], in particular the powers to make regulations and the power under section 68 to disapply or modify specified sections of Part II of the ICA 1982 and related subordinate legislation (which was of relevance to applications by companies for concessions in respect of implicit items and subordinated loans to provide cover for the margin of solvency).

918 The Contracting Out Order was enacted as a further interim step pending the enactment and coming into force of the FSMA 2000, a draft Bill for which had been published for consultation in July 1998.

December 1998 Service Level Agreement between the Treasury and the FSA

919 Before 18 December 1998, when the SLA between the Treasury and the FSA (the FSA SLA) was entered into, the FSA was discharging certain functions under the FS Act 1986 and the Banking Act 1987[587], whilst the Treasury was responsible for the discharge of functions under the ICA 1982 and other legislation relating to insurance business.

920 The purpose of the FSA SLA was to set the terms and conditions on which the FSA and its employees were to exercise functions under, inter alia, the ICA 1982 following authorisation being granted to the FSA by the Treasury in pursuance of the Contracting Out Order. It set the standards to be met by the FSA in exercising those functions and provided for monthly service charges to be paid by the Treasury to the FSA. The FSA SLA came into effect on 1 January 1999.

584 SI 1998 No. 2842.
585 SI 1997 No. 2781, see paragraphs 905 et seq.
586 Which the Treasury was not, therefore, empowered to contract out.
587 From 1 June 1998, in consequence of amendments made to that Act by the Bank of England Act 1998 (a date referred to as 'N1').

Functions contracted out to the FSA by the Treasury

921 The functions the FSA was to be authorised to exercise were listed in the schedule to the authorisation[588] which the Treasury issued to the FSA pursuant to the Contracting Out Order (a draft of which was stated to be annexed to the FSA SLA). The functions which were contracted out to the FSA under the authorisation included those of the Treasury under the ICA 1982:

(a) to grant authorisation to carry on insurance business and to suspend or withdraw authorisation (section 3);

(b) to receive the regulatory returns of insurance companies (section 22);

(c) to require a company in breach of its margin of solvency to submit a plan for the restoration of a sound financial position (section 32(4));

(d) to require a company which failed to maintain its minimum margin of solvency (as defined in the legislation) to submit a short term financial scheme (section 33(1) and (2));

(e) to impose requirements about investments (section 38);

(f) require the maintenance of assets in the UK (section 39);

(g) to impose requirements with respect to the custody and disposal of assets (section 40);

(h) to limit the premium income (section 41);

(i) to require a company to make an actuarial investigation into its financial condition (section 42);

(j) to require a company to submit its annual returns early (section 43);

(k) to obtain information and require the production of documents (under certain of the provisions of section 44); and

(l) the residual power to impose requirements for the protection of PRE (section 45).

922 The authorisation was for a period of two years and was subject to the provisions of sections 69(5)(b) and (c) of the DCOA 1994 (which specify that such an authorisation may be revoked at any time by the Minister or office-holder[589] by whom it was given and shall not prevent the Minister, the office-holder or any other person from exercising the function to which it relates). The FSA SLA stipulated that it was to be terminated with immediate effect if the authorisation was revoked (clause 6.2).

The Service Standard Specification – Schedule 1 to the FSA SLA

923 Schedule 1 to the FSA SLA contained a 'Service Standard Specification'. This set out the aims and objectives which the FSA was to adopt in respect of services it was authorised to exercise on behalf of the Treasury and defined standards and performance measures which the FSA was to use its best endeavours to achieve.

924 The aims and objectives of the service standards reflected the proposals for the role of the FSA as a single financial services regulatory body contained in the draft Financial Services and Markets Bill published in July 1998. Those proposals included such matters as:

[588] The authorisation containing the schedule of functions was signed on behalf of the Treasury on 18 December 1998, the day on which the FSA SLA was entered into.

[589] Defined by section 79(1) of the DCOA 1994 to include the holder of an office created or continued in existence by a public general Act or whose remuneration is paid out of money provided by Parliament.

(a) maintaining confidence in the UK financial system;

(b) promoting public understanding of the financial system, including an awareness of the risks associated with various kinds of investment; and

(c) securing an appropriate degree of protection for consumers, having regard to such matters as differing degrees of risk involved in different kinds of investments or other transactions, differing degrees of consumer experience and expertise and the general principle that 'consumers should take responsibility for their own decisions'.

It was noted that these objectives might be amended during the passage of the legislation but they '*serve*[d] *to inform the general approach the FSA proposes to take during the period prior to the new legislation coming into force*[590]'. This was to include the FSA's approach to carrying out the functions which it was to exercise on behalf of the Treasury for insurance supervision.

925 In relation to insurance, the FSA's aim was required to be:

> ... *effectively to regulate the insurance industry so that policyholders*[591] *can have confidence in the ability of UK insurers to meet their liabilities and fulfil policyholders' reasonable expectations ...*

The FSA was also to play a part in maintaining and improving international co-operation within the EC and more widely in relation to insurance regulation.

926 The FSA's '*key supporting objectives*' were to include:

(a) to ensure that persons or companies who were not fit and proper or appropriately resourced or otherwise not able to satisfy the criteria for authorisation did not carry on business in the UK;

(b) to carry out the regulation of insurance companies efficiently and effectively;

(c) to meet the industry's reasonable requests for prompt and clear responses to requests for information and advice;

(d) to keep the cost and inconvenience of regulation for insurers as low as was commensurate with effective protection of the customer;

(e) to co-operate with the Treasury in seeking to deliver efficient operation of the single market, including assistance in EU negotiations in relation to EC law.

927 A section of the FSA SLA headed 'Insurance Supervision Work Programme' identified key areas of work on which resources were to be deployed during 1999, covering three broad areas:

(a) the conduct of ongoing regulatory and related work to specified standards;

(b) initiatives to support the development of more effective and efficient regulatory procedures; and

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590 The date on which the new legislation was to come into force giving the FSA direct statutory responsibility for both prudential and conduct of business regulation of insurance companies was referred to as 'N2' (this date was 1 December 2001, pursuant to the FSMA 2000).

591 Defined in clause 1 of the FSA SLA to include potential policyholders where appropriate.

(c) preparations for the coming into force of the new regulatory regime.

928 The requirements for each of these three areas were then described in greater detail in relation to various sub-categories of work, with performance measures outlined for many of them. In respect of the first of the broad areas of work, the sub-categories comprised:

- 'Authorisation, fit and proper checking, perimeter';
- 'Supervision';
- 'International'; and
- 'Policy issues and case work'.

929 In respect of 'Supervision', the FSA's general responsibilities were to include the prudential supervision of some 350 non-life companies, 200 life companies and 40 composite insurance groups and:

> *Protecting policyholders against the risk of company failure and, more specifically, to protect them against the risk that UK authorised insurers might be unable to pay valid claims. In the case of life insurance companies this includes the risk that they will be unable to meet policyholders' reasonable expectations. The Treasury and FSA agree that it is neither realistic nor necessarily desirable in a climate which seeks to encourage competition, innovation and consumer choice, to seek to achieve 100% success in avoiding company failure. The FSA will therefore pursue its supervisory objectives by aiming to minimise, but not eliminate, the risk of company failure by identifying early signs of trouble, and taking preventative action.*

930 Key tasks for the '*supervisory resource*' included monitoring the financial soundness of insurers to see that they were run in a sound and prudent manner by fit and proper people, based mainly on scrutiny of financial returns and other information (with the assistance of GAD, particularly in the case of life insurance companies) and site visits.

931 In relation to performance measures it was stated that the supervisory process was in an '*ongoing state of development*'. Changes had been made to the examination procedure in the preceding six months and further changes were to be expected in the context of the development of more effective and efficient regulatory procedures (described in a later section on policy issues).

932 In respect of the way in which the supervisory process was expected to be conducted for the 1998/99 supervisory year, performance measures were set out in Annex A of Schedule 1 to the FSA SLA. Those measures were to be kept under review and amended from time to time as agreed between the Treasury and the FSA. Annex A set out target timescales for various activities such as receipt and processing of returns, with five priority ratings (which do not appear to be defined) and shorter timescales for higher priority cases.

933 In respect of 75% of the cases, the annual examination process was to be completed within nine months of receipt, with 100% to be completed within 12 months. In respect of life companies, in 90% of the cases any necessary follow-up action was to be taken within two weeks of completion and review of the GAD scrutiny (with the remaining 10% to be dealt with within six weeks). '*Timely and satisfactory outcomes*' to ongoing and future proposals for '*life industry restructuring and inherited estates*' were to be secured in 100% of cases.

934 In respect of 'General policy issues', the FSA was to provide the Treasury (on request or on its own initiative) with timely advice on such matters as the development of government policy initiatives with a bearing on the insurance industry; the proposed content of draft speeches or statements prepared for the Treasury, other ministers or senior officials; Parliamentary business; matters relating to the implementation of the Policyholders Protection Act 1997; matters relating to insurance law; specified tasks of investigation and enforcement and '*other relevant subjects, raised either by the Treasury or the FSA*'.

935 It was recorded that whilst the FSA was to have day-to-day responsibility for supervising insurance companies, certain of the powers required to carry out this function were to remain with the Treasury until the coming into force of the '*proposed relevant provisions of the Financial Services and Markets Bill'*.

936 As noted above, one of the provisions of the ICA 1982 which had been excluded from the Contracting Out Order and which the Treasury was therefore unable to authorise the FSA to exercise was section 68, the power to disapply or modify specified sections of Part II of the ICA 1982 and related subordinate legislation.

937 A section[592] of the Service Standard Specification dealt with the services the FSA was to provide in connection with section 68 orders. Those services included providing the Treasury Financial Services team and the Treasury Solicitor's Department with:

(a) a draft order;

(b) advice giving background, recommendation and timing for the Order; and

(c) a draft letter for the Treasury to send to the insurer to accompany the Order (containing specified information).

938 The Treasury was then to consider 'the Order', clarify any points with the FSA and/or the Treasury Solicitor's Department and if satisfied, make the Order and dispatch it. The Treasury was to maintain a separate record of Orders and letters issued and advise the FSA at the end of each month of the correspondence which had taken place.

939 It was noted that there were other '*supervisory Orders*' with a bearing on specific companies which would come within the responsibility of the FSA after the proposed new legislation was in force, but which until then could not be made by the FSA and would be '*taken forward by the Treasury using the same principles of co-operation, consultation, and good administration which are to apply to s68 Orders.*'

940 A section of the FSA SLA concerning 'Proposed secondary legislation on insurance matters' required the FSA to advise the Treasury on how legislation might keep pace with market developments, while remaining effective and without imposing an undue burden on the insurance industry.

941 The FSA was to provide the Treasury with statements of the policy to be achieved where subordinate legislation was required and was to support the preparation of new legislation needed to implement European Directives through secondary legislation.

942 As part of the initiatives to support the development of more effective and efficient regulatory procedures, during 1999 the FSA was to:

592 Paragraphs 16-18 of Schedule 1 to the FSA SLA.

(a) review and where necessary undertake an interim update of non-life and life insurance supervisory procedures and internal guidance to ensure a consistent and properly documented approach;

(b) prepare sectoral and market analyses to improve understanding of the context in which insurance companies operated;

(c) undertake specific projects in response to market developments;

(d) pursue the enhancement of a risk-based approach to insurance supervision against the FSA's '*broader canvas of financial regulation*' with a view to aligning the methodology and categorisation with other sectors of the financial industry (to the extent possible); a particular focus of this work was to be on the development of a risk rating system which could be implemented within two years of the proposed legislation coming into force; and

(e) the implementation of a comprehensive training and development programme to develop the skills and competencies of insurance and friendly society supervisors and specialists.

Responsibility within the FSA for the provision of services in relation to the prudential regulation of insurance companies pursuant to the FSA SLA

943 Responsibility for the functions which the FSA had been authorised by the Treasury to exercise was delegated by the FSA to its Insurance Supervisory Committee[593].

944 That Committee was responsible for considering the exercise of any power or discretion under the ICA 1982 which the FSA had been authorised to exercise in relation to any insurer, and for making recommendations to the Treasury to exercise supervisory powers which the FSA had not been authorised to exercise, in particular those under section 68 of the ICA 1982. GAD attended meetings of the Committee for papers on which it had a particular contribution to make.

945 The staff who had been seconded from the DTI to the Treasury in January 1998 moved to the FSA and combined with the supervisory staff of the Friendly Societies Commission to form the Insurance and Friendly Societies Division of the FSA. The IFSD had day-to-day responsibility for the supervision of insurance companies and continued to obtain actuarial advice from GAD.

Further guidance from GAD on resilience testing in 1998 and 1999

946 On 24 November 1998 the Government Actuary wrote to all appointed actuaries regarding the resilience test for life insurers (DAA10), to update the three scenarios for testing which had been set out in his letter of 30 September 1993[594]. He noted that increased volatility in equity markets had produced extreme daily fluctuations in the Financial Times Stock Exchange (FTSE) 100 Share Index and the FTSE All Share Index, such that the resilience tests which had been used since 1993 could produce '*unreasonable results*'.

947 This volatility was combined with a significant fall in the yields on gilts. The Government Actuary noted that a working party of the F&IA was considering possible revisions to the resilience test for the future, but their proposals were unlikely to come forward for several months. He therefore outlined a temporary amendment to the second of

593 The Baird Report, Chapter 2 section 2.6.
594 DAA6, see paragraph 524.

the September 1993 tests[595], substituting it with a more complex test in the event that the FTSE 100 Index fell below 4,500. (The first and third tests set out in the September 1993 DAA letter were not amended.)

948 On 30 September 1999, the Government Actuary again wrote to appointed actuaries regarding the resilience tests (DAA12) to set out a further revision to test (2). In place of the formula described in the November 1998 letter, test (2) was to comprise a combination of:

(a) a 10% fall in fixed interest yields; and

(b) a fall in the value of equities of the greater of:

  (i) 25%, subject to the fall being restricted to such as would not produce a price/earnings ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long term gilt yield before the assumed fall in paragraph (a); and

  (ii) 10%.

949 Shortly before the Insurance Companies (Amendment) Regulations 2000 came into force in May 2000, the Government Actuary wrote yet again to appointed actuaries to revise the resilience tests, in anticipation of changes to be made to ICR 1994 by the 2000 Regulations in relation to the assumed rate of interest on future investments, as noted below.

F&IA joint working parties on an alternative to the net premium valuation method of statutory reporting

1996 statutory valuation working party report

950 One of four joint working parties set up in 1993 by the F&IA through the operation of the JAWP to report on various aspects of statutory valuation considered the question of possible alternatives to the net premium method of valuation for reporting for regulatory purposes (the NPWP).

951 The NPWP consisted of members of the F&IA and GAD, with observers from the DTI. It was asked to look at alternative valuation methods used for supervisory purposes in other countries, make recommendations as to whether there should be a move to another method for supervisory purposes in the UK and if so, to recommend a method to be used and to consider the effects for reserves such as the resilience reserve.

952 The NPWP presented its report to the Faculty of Actuaries in January 1996 and to the Institute of Actuaries in February 1996[596]. In summary, it recommended that the net premium method of valuing liabilities should be replaced by a comprehensive gross premium system for all types of policies.

953 Perceived disadvantages of the net premium method were said to include:

(a) that it was not appropriate for many modern types of business, e.g. single premium with-profits business and flexible annuities;

(b) that the method was artificial, it made no explicit allowance for renewal expenses or future bonuses, in particular for terminal

595 Which required resilience to be tested against assumptions of a reduction in fixed-interest yields of 10%, combined with a fall in equity values of 25%.
596 British Actuarial Journal (BAJ) 2, III, 527-621 (1996).

bonus, which represented a significant part of PRE;

(c) the substantial use of equity-type investments did not sit easily with the net premium method;

(d) the value of liabilities did not always act consistently with changes in investment conditions which presented a difficulty with then current resilience reserve calculations;

(e) the method did not deal well with alterations to policies; and

(f) it was sometimes necessary to use a gross premium or cash flow method to take account of particular circumstances (and mixing the use of the net premium method with those other methods was unsatisfactory).

954 In relation to PRE, the NPWP noted:

> *It may also be argued that the regulations do not deal sufficiently rigorously with PRE and, in particular, future bonuses. The new regulations do specify that due regard has to be paid to PRE, a requirement that has been in actuarial Guidance Note GN1 for some time. It is not expected that the inclusion of PRE in the regulations will change companies' approach to the valuation of with-profits policies. Under conventional with-profits policies, the use of the net premium method makes an implicit reserve for reversionary bonuses by using a suitably low rate of interest. However, it is not clear how this implicit approach relates to the actual level of reversionary bonuses declared, nor does the method make any direct provision for terminal bonuses, which currently make up a large part of the proceeds of claims under with-profits policies.*

955 The replacement method proposed in the 1996 report involved the calculation of a 'statutory solvency reserve', based on the requirements of the Third Life Directive, with an appropriate allowance for tax, and a 'realistic policy liability', which would be a realistic gross premium valuation liability incorporating some prudent margins.

956 As regards the proposed statutory solvency reserve, the NPWP considered that no specific provision for terminal bonus need be made. Under the realistic policy valuation, the valuation was to reflect PRE and:

> *... in particular, make adequate provision for the level of bonuses, including terminal bonuses that the office would expect to pay, following its current practices, consistent with the assumptions used in the valuation.*

957 It was recommended that the realistic policy liability should be published, as a realistic valuation of the benefits which policyholders could reasonably expect in the future, calculated using realistic assumptions of future experience. It was proposed that reserves for both the statutory solvency reserve and the realistic policy liability should be published in the returns to the DTI and made available to the general public.

1998 statutory valuation working party report

958 A further working party was established (the SVWP) to build on the work of the NPWP and, in particular, to determine whether the idea for a statutory solvency reserve put forward in the 1996 report could be developed into a system of solvency valuation superior to the approach set out in the then current valuation of liability regulations.

959 The report of the SVWP presented to the F&IA in 1998[597] indicated that the reaction of members of the F&IA to the proposals in the NPWP's 1996 report to publish a realistic policy liability in the annual supervisory returns had been generally unfavourable, although the prospect of overhaul of the net premium method had received greater (but not universal) support.

960 The SVWP considered the approach to valuation which should be adopted in respect of various classes of business and made separate recommendations in relation to each. It noted that the overall strength of the reserves would be affected, to a very considerable extent, by the form and parameters for the resilience test (which, at the time of the report, were being considered by a separate working party).

961 For non-linked, non-profit business, it was recommended that the net premium standard should be replaced by a gross premium or cash flow approach. In the case of '*conventional with-profits business*', the SVWP recommended that the net premium standard for valuation should remain, however a requirement for a PRE surrender value should be made explicit (and regulations governing the treatment of altered policies should be liberalised).

962 For accumulating with-profits business the SVWP took the view (believed to be shared by the supervisory authority and GAD), that the variety of reserving bases for accumulating with-profit business then being used was unsatisfactory and could not be allowed to continue. The SVWP recommended that changes to ICR 1994 and/or GN8 were '*certainly needed, and should be introduced at the earliest practicable opportunity*'.

963 The report included, as Appendices E and F, possible changes to individual determination of liability regulations of ICR 1994 and to the guidance in GN8 which would accommodate the SVWP's recommendations.

964 The changes suggested by the SVWP to Regulations 64, 67 and 72 of ICR 1994 in Appendix E were largely[598] adopted and put into effect by the Insurance Companies (Amendment) Regulations 2000 referred to below and are not repeated here.

965 A separate recommendation made by the SVWP that the reinvestment rate of 6% in regulation 69(9)(a) should be reviewed in the light of economic trends was adopted when ICR 1994 was revised in 2000. Proposed changes to the ICAS Regulations 1996 to accommodate the results of gross premium valuations in the prescribed forms were also adopted and put into effect by the Insurance Companies (Amendment) Regulations 2000.

966 Similarly, the changes to GN8 suggested in Appendix F to the SVWP's report were substantially embodied in the revised version of GN8 (6.0) which was issued in March 2001 and is mentioned below.

967 The 1998 SVWP report stated that in recent years there had been a growing recognition within the profession of the need to '*interpret and safeguard*' PRE. It was said to be a common theme of various sections of the report that the mathematical reserves might not have kept pace with the development of the concept of PRE.

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597 Presented in March 1998 to the Faculty of Actuaries and April 1998 to the Institute of Actuaries: BAJ 4, IV, 803-864 (1998).
598 Although not entirely (and the proposed drafting was revised).

968 It was said to be in consequence of the considerable emphasis that the SVWP had given to PRE in its deliberations that it had recommended that the major part of the practical implementation of its proposals should be through amendments to GN8, rather than through amendments to ICR 1994. The SVWP considered such an approach to be advantageous, given the relative ease of amending GN8, as opposed to amending the Regulations.

Phase 6: 2000 – 2001

The Insurance Companies (Amendment) Regulations 2000

969 ICR 1994 was amended on a number of occasions[599] before they were revoked on 1 December 2001[600]. Of the changes made in the intervening years, those under the Insurance Companies (Amendment) Regulations 2000[601] (the ICA Regulations 2000) were of particular significance. The ICA Regulations 2000 came into force on 29 May 2000.

970 The ICA Regulations 2000 amended various regulations relating to the determination of liabilities under Part IX of ICR 1994:

- Regulation 64 regarding the general basis for determination of long term liabilities;
- Regulation 67 regarding valuation of future premiums;
- Regulation 69 regarding rates of interest; and
- Regulation 72 regarding options.

971 In addition, the ICA Regulations 2000 made a consequential amendment to Schedule 4 of the ICAS Regulations 1996 in relation to the required contents of the abstract of the appointed actuary's valuation report.

972 As noted above, these revisions largely flowed from the recommendations of the SVWP which had undertaken a review of statutory valuation of long-term business and reported in 1998.

Amendment to Regulation 64 of ICR 1994 – determination of long term liabilities

973 A new item was added to the list of matters under Regulation 64(3)[602] which, without prejudice to the general requirements of Regulation 64(1)[603], the appointed actuary was required to take into account in determining the amount of the long term liabilities.

974 The additional item was discretionary charges and deductions, in so far as they did not exceed the '*reasonable expectations of policyholders*' (Regulation 2(a) of the ICA Regulations 2000). This was described as a '*clarificatory amendment*' in the explanatory notes to the 2000 Regulations.

Amendments to Regulation 67 of ICR 1994 – valuation of future premiums

975 Regulation 67 of ICR 1994, which described the methods by which future premiums were to be valued (and required, in general, that a net premium valuation method should be used[604]), was amended so as to limit its application to contracts under which the policyholder was entitled to participate in any surplus.

599 See paragraph 683 and the footnotes thereto.
600 By SI 2001 No. 3649 (referred to in paragraph 683).
601 SI 2000 No. 1231, see paragraph 613.
602 See paragraph 644 in which paragraph (3) of regulation 64 as originally enacted is quoted.
603 Namely, that the amount of the long term liabilities should be determined on actuarial principles which had due regard to PRE and made proper provision for all liabilities on prudent assumptions that included appropriate margins for adverse deviation of relevant factors.
604 Regulation 67(1) required that a net premium valuation method should be used where further premiums were payable under the contract and benefits were determined at the outset in relation to the total premiums payable. For contracts under which each premium increased the benefits or those where the amount of premium payable in the future could not be determined until it was paid (such as certain of the contracts entered into by Equitable), Regulation 67(3) permitted future premiums and the corresponding liability to be left out of account so long as adequate provision was made against any risk that the increase in liabilities resulting from the payment of future premiums might exceed the amount of those premiums. Paragraph (4) of Regulation 67 allowed an alternative method of valuation to be used to that described in paragraphs (1)-(3) of that regulation provided that it could be demonstrated that the alternative method would result in reserves no less, in aggregate, than those which would result from the use of the methods described in paragraphs (1)-(3).

976 The aim of this amendment was to allow a gross premium method to be used for non-profit contracts[605]. Amendments were also made to paragraph (2) of Regulation 67 to provide alternative methods of valuation where the terms of an insurance contract were changed (regulation 2(b) of the ICA Regulations 2000).

Amendment to Regulation 69 of ICR 1994 – rates of interest

977 Paragraph (9)(a) of Regulation 69 of ICR 1994, which set upper limits on the assumptions made about yields on investments to be made more than three years after the valuation date, was revised to take account of changes to the indices referred to in that paragraph, following a fall in interest rates (Regulation 2(c) of the ICA Regulations 2000).

Amendments to Regulation 72 of ICR 1994 – options

978 Paragraph (1) of Regulation 72 of ICR 1994 (and its predecessor provision, Regulation 62(1) of ICR 1981) imposed a general requirement that provision should be made to cover any increase in liabilities caused by policyholders exercising options under their contracts.

979 From 1994, the Regulation had stated that such provision was to be made on '*prudent assumptions*'. Paragraph (2) of Regulation 72 made more detailed provision regarding the calculation of the amount of the required provision for certain kinds of options, namely those where the policyholder had an option to secure a guaranteed cash payment within twelve months of the valuation date. However, as originally drafted, Regulation 72 did not provide any detail of how the calculation was to be undertaken in other cases (beyond the stipulation, from 1994 onwards, that it should be made '*on prudent assumptions*').

980 Regulation 2(d) of the ICA Regulations 2000 added new paragraphs (3)-(5) to Regulation 72 to make detailed provision regarding the calculation of provisions for other kinds of option, which were not catered for by paragraph (2). The new paragraphs (3) and (4) of Regulation 72 provided:

(3) Where a contract includes an option whereby the policy holder could secure a cash payment, but paragraph (2) above does not apply, the provision for that option shall at all times be such as to ensure that, if the assumptions adopted for the valuation of the contract are fulfilled in practice –

(a) the resulting value (and therefore the provision) is not less than the amount required to provide for the payment which would have to be made if the option were exercised; and

(b) the payment when it falls due is covered from resources arising solely from the contract and from the assets covering the amount of the liability determined at the current valuation.

(4) For the purposes of paragraph (3) above, the amount of a cash payment secured by the exercise of an option shall be assumed to be –

(a) in the case of an accumulating with-profits policy[606], the lower of –

605 According to the explanatory notes to the ICA Regulations 2000.

606 The definitions in the new paragraph (5) of regulation 72 provided that an 'accumulating with-profits policy' meant *'a with-profits policy which has a readily identifiable current benefit, whether or not this benefit is currently realisable, which is adjusted by an amount explicitly related to the amount of any premium payment and to which additional benefits are added in respect of participation in profits by additions directly related to the current benefit, or a policy which has similar characteristics'*. A 'with-profits policy' was given the same meaning as in the ICAS Regulations 1996, namely a contract falling within a class of long term business as specified in Schedule 1 to the Act which was eligible to participate in any part of any established surplus.

(i) *the amount which would reasonably be expected to be paid if the option were exercised, having regard to the representations of the company; and*

(ii) *that amount, disregarding all discretionary adjustments; and*

(b) *in the case of any other policy to which this regulation applies, the amount which would reasonably be expected to be paid if the option were exercised, having regard to the representations of the company, without taking into account any expectations regarding future distributions of profits or the granting of discretionary additions in respect of an established surplus*[607] *or in anticipation thereof*.

981 Whilst this amendment specified, for the first time, particular ways in which the provision for certain contracts containing options was to be made, it did not alter the basic requirement (which had existed since 1981) that provision should be made for '*any increase in liabilities*' caused by policyholders exercising options under their contracts.

Amendments to Schedule 4 of the ICAS Regulations 1996 – revised instructions for prescribed forms where the net premium method was not used

982 Consequential amendments were made to Schedule 4 of the ICAS Regulations 1996 (regarding the abstract of the valuation report prepared by the appointed actuary) to revise the instructions for the completion of Forms 51-54[608] to allow for cases in which the net premium method of valuation had not been used.

Further guidance for appointed actuaries on resilience testing from GAD (and the FSA) in 2000 and 2001 and the Resilience Reserves Working Party report

DAA14

983 On 15 May 2000, shortly before the ICA Regulations 2000 came into force, the Government Actuary wrote to appointed actuaries again on the topic of resilience testing (DAA14). The letter noted that the revisions to ICR 1994 were to include a revised formula for determining the yield on investments which were to be made more than three years in the future, with consequent effects on shorter term assumptions.

984 The letter went on to state that the effect of two of the scenarios promulgated in the Government Actuary's letter of 30 September 1993[609] as amended by his letter of 30 September 1999[610] appeared to be unnecessarily severe, given that ICR 1994 as amended allowed for the effect of a sustained reduction in interest rates.

985 DAA14 stated that from the date of the ICA Regulations 2000 coming into force (29 May 2000), for with-profit offices, the second of the three scenarios to be used as a benchmark by GAD would comprise a combination of:

(a) a fall in the value of equities of the greater of:

(i) 25%, subject to the fall being restricted to such as would not produce a price/earnings ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long

[607] Paragraph (5) provided that 'established surplus' had the same meaning as in section 30(4) of the ICA 1982, namely *'an excess of assets representing the whole or a particular part of the fund or funds maintained by the company in respect of its long term business over the liabilities, or a particular part of the liabilities, of the company attributable to that business as shown by an investigation to which section 18 above applies or which is made in pursuance of a requirement imposed under section 42 below'*.

[608] Forms 51-54 were the prescribed forms for the valuation summaries of non-linked contracts (other than accumulating with-profit policies), accumulating with-profit policies, property linked contracts and index linked contracts.

[609] DAA6, see paragraph 524.

[610] DAA12, see paragraph 706.

term gilt yield (as defined in regulation 69(9)) before the assumed fall in paragraph (b), and

(ii) 10%;

(b) for fixed interest securities:

(i) a fall in the yields on risk-free securities of less than five years outstanding term to redemption and on short-term deposits to the level which is calculated under Regulation 69(9) for future investments (or remain constant if already at or below this level),

(ii) the yields on risk-free securities of at least fifteen years' duration remaining constant, and

(iii) a fall in the yields on risk-free securities of more than five but less than fifteen years' outstanding term to redemption to levels obtained by interpolating between the figures given by (i) above and the 15 year gilt index yield (or remain constant if already at or below this level);

(c) a fall in property values of 20%; and

(d) a rise in the real yields on indexed gilts of 10% (e.g. from 2% to 2.2%).

986 DAA14 noted that in arriving at these benchmarks, GAD had been mindful of the existence of the professional working party[611] and had endeavoured not to anticipate its recommendations; for this reason, core features of the previous tests had been retained.

987 The Baird Report (paragraph 3.24.10) noted that where assets and liabilities were well matched, then the changes in investment conditions described in the above resilience tests might require little reserves. However, if assets and liabilities were not well matched or the liabilities included onerous options or guarantees, the tests could require significant reserves[612].

DAA15, DAA15A and the FSA letter of 4 December 2001

988 The guidance from the Government Actuary on resilience testing was replaced on a temporary basis (intended to be until 31 May 2002) by a further DAA letter issued on 10 September 2001 by the Head of Actuarial Department of the FSA[613] (DAA15).

989 The contents of DAA15 were said to constitute guidance for the purpose of section 157 of the FSMA 2000, which had come into force on 18 June 2001, empowering the FSA to give guidance consisting of such information and advice as it considered appropriate with respect to such matters as the operation of rules made under the Act.

990 DAA15 stated that the FSA had decided that the guidance on resilience testing should be modified and simplified. In place of the set of scenarios previously recommended by the Government Actuary as revised over the years, the letter advised that the actuary should, as a minimum, consider the scenario of a fall in the value of equities of the greater of:

611 Apparently a reference to the Resilience Reserves Working Party mentioned below.

612 Paragraph 3.24.11 of the Baird Report notes that in the case of Equitable, the tests described in DAA14 had a significant effect on the reserves required to be made. On 11 August 2000, the company's appointed actuary estimated the effect would be to reduce net explicit assets by some £600 million.

613 To which the GAD staff involved in prudential regulation of insurance companies had transferred (on 26 April 2001), in order to provide the FSA with 'in house' actuarial advice (paragraph 2.8.9 of the Baird Report).

(a) 25%, subject to the fall being restricted to such as would not produce a price/earnings ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long term gilt yield (as defined in Regulation 69 of ICR 1994 and rule 5.11 of the Interim Prudential Sourcebook for Insurers), and

(b) 10%.

At the same time, the actuary was to make the 'prudent assumption' that company earnings might fall by 10% (shortly after the above fall in equity values), but that dividends would remain unaltered when assessing the corresponding rate of interest at which the liabilities should be valued.

991 A further letter was issued by the Head of Actuarial Department of the FSA to appointed actuaries on 24 September 2001 (DAA15A), indicating that the suggested minimum figure of 10% in subparagraph (b) of the 10 September 2001 letter should not be regarded as an absolute figure which was to be applied in all circumstances.

992 Instead, appointed actuaries were to apply their professional judgment which could well lead, in some circumstances, to a lower figure being assumed.

993 DAA15A was described in a further letter from the FSA to appointed actuaries of 4 December 2001 as '*emergency guidance*', issued against a background of unusual market conditions of extreme volatility following the attack on the World Trade Centre on 11 September 2001, aimed at avoiding the risk that insurance companies might sell equities for short term technical reasons in a way which could be damaging to the interests of policyholders.

994 The FSA letter of 4 December 2001 restored the guidance as set out in the letter of 10 September 2001 on a temporary basis until 31 May 2002.

The Resilience Reserves Working Party report

995 A further working party established by the F&IA, the Resilience Reserves Working Party (RRWP), examined resilience reserve requirements under the UK regulatory framework. The RRWP produced an interim report in May 1998 and presented its final report at the Life Convention in November 2000.

996 The RRWP's report noted that the requirement to make an allowance for the resilience of an office to changes in financial circumstances had been implicit for many years[614], and that an approach outlined in 1985[615] had formed the cornerstone of what had been required by the regulators since then, albeit amended to remove the effects of particular unintentional features.

997 The aim of the RRWP was to use actuarial techniques which had become commonplace since 1985 to find a more robust framework for identifying what needed to be tested and to try to make recommendations regarding a way forward. Its terms of reference were '[t]*o consider whether the Government Actuary should be asked to revise the standard of the resilience test as set out in his letter to Appointed Actuaries dated 30 September 1993 and amplified in his letter to Appointed Actuaries dated 29 October 1996, and if so for what reasons*'. The Government Actuary's letters of 24 November 1998, 30 September 1999 and 15 May 2000 were also taken into account.

614 An express requirement for insurance companies to make *'appropriate provision against the effects of possible future changes in the value of the assets on their adequacy to meet the liabilities'* had existed since the coming into force of Regulation 55 of ICR 1981 in October 1982, see paragraphs 267 and 268.

615 Apparently a reference to the 'working rule' first outlined by the Government Actuary in DAA1 (referred to in paragraph 397).

998 One of the issues considered by the RRWP was the purpose of the resilience test. The view was expressed that this was an issue over which the profession might not display a 'common understanding'.

999 As a 'working hypothesis' it was assumed that the purpose of resilience testing was to provide comfort to regulators that no life assurance company meeting the test scenarios was likely to require statutory intervention within the period from the date on which the returns were calculated until the date on which the next returns were due.

1000 The RRWP decided to look at the probability of events occurring within 12 months of the valuation date, and described the test as effectively '*a short term stress test of solvency*'.

1001 The RRWP noted that '*as currently constructed the impact of a resilience test is merely to make the statutory test* [of solvency] *more harsh. It does not provide an advance warning of statutory insolvency'* (although it was noted that it was unlikely that a company would fail the statutory insolvency test without first having failed the statutory solvency test with the resilience test applied).

1002 The RRWP also noted that most of the 'numerous' working parties which had looked at the fundamental valuation regime had found that their results were, in practice, heavily dependent upon the nature of the resilience regime which was applied to them.

1003 Much of the RRWP report was concerned with methodology for resilience testing and an examination of the efficacy of alternative models for solvency investigations. Ultimately the RRWP selected an approach which looked only at short term investment fluctuations and identified four specific risks which it considered to be worthy of investigation:

(a) a fall in equity values, accompanied by a fall in fixed interest yields for terms of less than 15 years;

(b) a fall in gilt yields;

(c) a fall in equity values and a rise in gilt yields; and

(d) a rise in equity values coupled with a fall in gilt yields.

Illustrations were given of the application of the proposed tests and proposals were made for the treatment of other investments such as property.

1004 The RRWP concluded that the tests it had proposed, although complex, were '*somewhat simpler to use than to write down*'. It was acknowledged that the tests would not eliminate the need for the actuary to apply professional judgment if '*post balance sheet events were to expose imprudence in any assumption*'.

1005 However, the RRWP was of the view that the tests it proposed would meet the needs of the profession, the regulators and the industry. It was recommended that the outcome of all the tests should be reported in the briefest summary form '*in Schedule 4*' (i.e. in the abstract of the actuary's valuation report forming part of the statutory returns under the ICAS Regulations 1996). No change was recommended to the then existing requirement that only the most onerous resilience test should be the subject of '*the full rigours of Form 57*' (i.e. the matching rectangle[616]).

616 See paragraphs 797 et seq and Appendix C.

Revisions to GN8 in 2001

1006 A revised version of GN8 (6.0) came into effect on 12 March 2001. The covering letter from the F&IA[617] described the revised guidance as being required to take account of changes introduced by the ICA Regulations 2000 and of other issues '*arising from the conclusions of the statutory valuation working party* ... [including] ... *new requirements for provisions for surrender values or other options available to policyholders, as well as a number of other technical amendments*'. The changes made to GN8 largely followed the proposals outlined in Appendix F to the 1998 SVWP report referred to above[618].

1007 The covering letter suggested that version 6.0 of GN8 incorporated, among other changes, amendments regarding the valuation of with-profit business which was not subject to a net premium method of valuation. However, such guidance as appeared on that topic was brief.

1008 The amendments made in version 6.0 included guidance on certain of the determination of liability regulations of Part IX of ICR 1994 which had not been addressed in the earlier versions of GN8, such as Regulation 66 (avoidance of future valuation strain); Regulation 67 (valuation of future premiums, as revised by the ICA Regulations 2000) and Regulation 72 (on options, which had also been revised by the 2000 Regulations).

Additional guidance on Regulation 65

1009 Additional guidance was given on Regulation 65 of ICR 1994 (which, in general, required a prospective calculation of long term liabilities). Paragraph 3.2.2 of GN8 version 6.0 provided specific guidance in respect of with-profit business not subject to a net premium valuation.

1010 That paragraph repeated general requirements for with-profits policies (that the appointed actuary should ensure that the reserve was sufficient to provide for future reversionary bonus, including the cost of any shareholders' share of the surplus associated with the declaration of such a bonus (including tax where appropriate)), and, in addition, required that the rates for future bonus to be assumed for this purpose were to be selected '*having regard to current rates of bonus and to changes in the rates of future bonus which would be consistent with the reasonable expectations of policyholders in the event that experience were to follow the valuation basis*'.

1011 This appears to be the extent of the specific advice on 'with-profits business not subject to a net premium valuation' (but see paragraphs 1017 to 1020 regarding the guidance on Regulations 72 and 75, which were of particular relevance to such business).

1012 The guidance does not specify the circumstances in which a net premium method would *not* be used for with-profits business, as to which see the comments on Regulation 67 in paragraph 975 and footnote 604[619].

1013 Additional guidance was also given in connection with Regulation 65 on assessing the adequacy of the reserve in relation to permanent health insurance business, generally requiring the use of a method which made specific allowance for claim inception rates and the duration of sickness.

[617] Dated February 2001.
[618] Paragraph 963.
[619] The amendments to GN8 proposed in Appendix F to the 1998 report of the SVWP indicated that the additional guidance on Regulation 65 was intended to apply to business which was subject to Regulation 67(3) which allowed for the use of a specified alternative method for certain contracts under which each premium increased the benefits or where the amount of the premium payable in the future could not be ascertained in advance, provided certain conditions were met.

Guidance on Regulation 66

1014 For the first time, GN8 included guidance on Regulation 66 of ICR 1994 regarding avoidance of future valuation strain, which was said to be of particular importance in the assessment of the non-unit reserves for linked contracts.

Guidance on Regulation 67

1015 Reference was also made to Regulation 67, but without any detailed commentary. The guidance simply stated that:

> *Regulation 67(1) requires the use of a net premium method for certain categories of with-profits business. It does not apply to non-profit business, which may be valued on a gross premium or a net premium method.*

1016 The second sentence reflected the amendment which had been made to Regulation 67 by the ICA Regulations 2000 (see paragraph 975).

Guidance on Regulation 72

1017 The guidance noted that Regulation 64(3)(c) required that all options available to the policyholder be taken into account in determining the amount of the long term liabilities and that Regulation 72(1) required that provision should be made on prudent assumptions to cover any increase in liabilities caused by policyholders exercising options under their contracts. The guidance went on to state (in paragraph 3.8.2):

> *Where an optional benefit is of greater value than the basic benefit under the valuation assumptions then a prudent allowance should be made in the valuation for the proportion of policyholders likely to exercise the option. Where the optional benefit is likely to be the most attractive alternative to the policyholder and the most costly option to the company, then it will normally be appropriate to assume that all policyholders exercise the option. However, where there are advantages to policyholders in not exercising the option, for example tax treatment, or a preference for a cash sum alternative to an annuity, then it may be appropriate to make allowance for a proportion failing to exercise the option. In making such an allowance past experience may only be taken into account to the extent that it is deemed likely to remain relevant under the other valuation assumptions. In addition, any such allowance must be sufficiently prudent to allow for possible future changes in circumstances.*

1018 The guidance went on to state (in paragraphs 3.8.5 and 3.8.6):

> *Regulation 72(4) refers to an amount which would reasonably be expected to be paid if the option were exercised, having regard to the representations of the company. This may be interpreted as referring to the level of that amount in the event of a significant level of policy discontinuances. Regulation 72(4)(a)(ii) refers to an amount obtained by disregarding all discretionary adjustments. This means disregarding all such adjustments, both positive (such as terminal bonus) and negative (such as market value adjustment factors), but does not mean that it is necessary to disregard automatic adjustments (such as surrender penalties) that are applied to discontinuance values in any financial conditions.*
>
> *When considering reasonable expectations with regard to discontinuance values, the Appointed Actuary must take account of representations made by the company to policyholders, including those in marketing literature and the company's With-Profits Guide, and also the practice of the company*

in determining discontinuance values, with particular regard to:

(a) the relationship between the discontinuance values and the value of the underlying assets, and

(b) any circumstances of which the policyholder can reasonably be expected to be aware in which discontinuance values might be reduced due to losses not directly related to the investment return earned by the company on those assets.

Additional guidance on Regulation 75

1019 Additional guidance was given on Regulation 75, which required that the nature and term of the assets representing the long term liabilities be taken into account when determining the amount of the long term liabilities and that prudent provision be made for possible future changes in the value of those assets.

1020 A new paragraph 3.9.6 of GN8 stated that the appointed actuary should ensure that the '*liability*'[620] in the changed investment conditions would adequately cover '*policyholders' (revised) reasonable expectations ...*'.

1021 Version 6.0 of GN8 was replaced by version 6.1 with effect from 1 December 2001.

Background to the introduction of the Financial Services and Markets Act 2000

General background

1022 As noted above[621], the proposals which eventually led to the enactment of the FSMA 2000 were outlined in broad terms by the then Chancellor of the Exchequer in a statement made to the House of Commons on 20 May 1997 in relation to the Bank of England, in which he announced the government's wider intentions to reorganise the financial sector and establish a single financial regulator for a considerable part of the UK financial services sector.

1023 The Chancellor stated that '[the] *financial services industry needs a regulator which can deliver the most effective supervision in the world*', and that '[o]*ne cannot ensure the success of British financial services in the 21st century without modernising arrangements for the protection of investors*'.

1024 The Chancellor noted that the distinction between different types of financial institution, '*banks, security firms and insurance companies – are becoming increasingly blurred*', and that many were regulated by a plethora of different supervisors, increasing the costs and reducing the effectiveness of supervision[622]. He considered that regulators needed to look at the businesses of financial institutions in a consistent way, to bring the regulatory structure more closely into line with '*today's increasingly integrated financial markets*'.

1025 The Chancellor proposed that the SIB (which changed its name to the FSA five months later) should become the single financial regulator underpinned by statute, with the then current regime of self-regulation being replaced by a new and fully statutory system '*which will put the public first, and increase public confidence in the system*'. He requested that the SIB 'project manage' the process of implementation of the proposals, working with the SROs and the financial industry.

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620 See paragraphs 674 to 676 regarding the question of whether the cost of meeting PRE was to be treated as a liability of an insurance company for the purpose of ICR 1994.
621 At paragraph 902 and 903.
622 Hansard Debates, House of Commons, 20 May 1997, column 510.

1026 In July 1998, the Treasury published 'Financial Services and Markets Bill: A Consultation Document' which included an incomplete draft of the Bill, a document containing an overview of the proposed regulatory reform and draft Explanatory Notes.

1027 The consultation exercise was reported to have attracted responses from over 220 firms and bodies with an interest in the regulation of financial services. A number of further consultation documents and drafts of proposed subordinate legislation were published by the Treasury in relation to particular aspects of the proposals.

1028 The draft Bill was subject to 'pre-legislative scrutiny'. In February 1999 the Treasury Select Committee of the House of Commons published a report on the draft Bill[623]. Aspects of the Bill were considered by a Joint Committee of both Houses of Parliament before being introduced into the House of Commons on 17 June 1999. Following a fairly difficult passage through Parliament, the Bill received Royal Assent on 14 June 2000.

1029 The main cause of contention over the Bill does not appear to have been the basic principle of the establishment of a single regulator, but rather the proposed extent of the FSA's powers and the need for controls over those powers to ensure fairness and public accountability. These issues were the subject of considerable debate and resulted in extensive amendments to the Bill[624].

1030 The Act gave power to the FSA to undertake authorisation and regulation of those engaged in investment business, including stocks and shares, unit trusts, life assurance and personal pensions.

1031 The FSA assumed responsibility for the work of nine separate regulatory bodies[625] and the SROs were dissolved. The categories of business subject to regulation was not greatly varied. Despite the shift towards regulation through detailed rules made mainly by the FSA, rather than by primary or secondary legislation, the FSMA 2000 is underpinned by an extensive network of secondary legislation which contains much of the detailed provision[626].

1032 Only five provisions of the Act came into force on the date of Royal Assent, the remainder were brought into force on various dates appointed by the Treasury[627]. As outlined above, implementation of the regime under the FSMA 2000 was undertaken in stages, with the main implementation date of 1 December 2001.

1033 Neither the FSA, nor the new bodies created under the FSMA 2000 (some of which are mentioned below), are subject to my powers of investigation under the 1967 Act[628].

Regulatory objectives and functions of the FSA

1034 Under section 2(2) of the FSMA 2000, the FSA is given four regulatory objectives:

623 Financial Services Regulation, Third Report from the Treasury Committee, Session 1998-99, HC 73.
624 It has been reported that the Bill was subject to some 2,500 amendments prior to enactment.
625 In addition to the former functions of the SIB, the FSA assumed responsibility for work formerly undertaken by the Supervision and Surveillance Division of the Bank of England; the Treasury; the Building Societies Commission; the Friendly Societies Commission; the Registry of Friendly Societies; and the three SROs: the Securities and Futures Authority, the PIA and IMRO. Lloyd's of London is also subject to external supervision by the FSA. More recently, the FSA has assumed responsibility for regulation of mortgage lending and for general insurance regulation (formerly the responsibility of the General Insurance Council). The FSA has been described as a 'super-regulator'.
626 More than 80 statutory instruments were identified as being required even before the main implementation date on 1 December 2001 and some 136 statutory instruments have been made under the FSMA 2000 to date.
627 Section 431 of the FSMA 2000.

(a) market confidence;

(b) public awareness;

(c) the protection of consumers; and

(d) the reduction of financial crime.

In discharging its general functions under the FSMA 2000, the FSA is required to act in a way which, so far as is reasonably possible, is compatible with its regulatory objectives and which it considers most appropriate for the purpose of meeting those objectives.

1035 Under section 2(4) of the FSMA 2000, the general functions of the FSA are:

(a) the making of rules under the Act;

(b) preparing and issuing codes under the Act;

(c) the giving of general guidance; and

(d) determining the general policy and principles by reference to which it performs particular functions.

1036 Under section 2(3) of the FSMA 2000, in discharging its general functions the FSA is required to have regard to:

(a) the need to use its resources in the most efficient and economic way;

(b) the responsibilities of those who manage the affairs of authorised persons;

(c) the principle that the burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;

(d) the desirability of facilitating innovation in connection with regulated activities;

(e) the international character of financial services and markets and the desirability of maintaining the competitive position of the UK;

(f) the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions; and

(g) the desirability of facilitating competition between those who are subject to any form of regulation by the FSA.

1037 In addition to its functions under the FSMA 2000, the FSA was given regulatory powers under other legislation including enactments relating to building societies, friendly societies and industrial and provident societies, the Enterprise Act 2002, the Unfair Terms in Consumer Contracts Regulations 1999[629] and the Financial Services (Distance Marketing) Regulations 2004[630].

[628] As noted at the outset of this Part of the report, the actions of the FSA in respect of the prudential regulation of insurance companies are relevant to this investigation only in so far as they relate to functions 'contracted out' to the FSA by the Treasury during the period from 1 January 1999 until immediately before the FSMA 2000 came into force on 1 December 2001.
[629] SI No. 2083 as amended by the Unfair Terms in Consumer Contracts (Amendment) Regulations 2001 SI No.1186.
[630] SI 2004 No. 2095.

The role of the Treasury

1038 The FSMA 2000 confers a number of functions on the Treasury, including powers to make orders and regulations and to arrange independent inquiries. The Treasury's order-making powers include powers to specify the activities which are to be subject to regulation under the Act and those to exempt persons from the general prohibition on carrying on a regulated activity without being authorised under the Act[631].

1039 The FSA is required to report annually to the Treasury on the discharge of its functions and regarding its opinion on the extent to which its regulatory objectives have been met. That report must be laid before Parliament (and the FSA must hold an annual public meeting to enable the report to be considered)[632]. The Chairman and other members of the governing body of the FSA are appointed and liable to removal from office by the Treasury (paragraph 2(3) of Schedule 1 to the FSMA 2000).

1040 The FSA describes its relationship with the Treasury as being one under which it is accountable to Treasury Ministers and through them, to Parliament, but that it is '*operationally independent of the Treasury*'. The relationship between the Treasury and the FSA was set out in a published exchange of letters between the Chancellor of the Exchequer and the Chairman of the FSA dated 13 December 2001.

1041 In his letter, the Chancellor described his proposals for the use of his powers, '*without in any way compromising the FSA's statutory independence*', as covering such matters as:

- directing the FSA to cover particular issues in its public annual report, including how the FSA had dealt with major regulatory cases or issues which had arisen during the year (subject to statutory restrictions on disclosure and any market sensitivities);

- establishing whether the FSA was providing value for money, through periodic independent review under section 12 of the FSMA 2000 as necessary;

- periodically reviewing the *'panoply of statutory instruments which sit under the* [FSMA 2000]'; and

- the power to launch a statutory inquiry into possible serious regulatory failure (but emphasising that the failures of individual firms were not, in themselves, evidence of regulatory failure by the FSA[633]).

The Financial Services and Markets Tribunal, the Ombudsman Scheme and the compensation scheme

1042 Part IX of the FSMA 2000 (and Schedule 13 to the Act) established an independent tribunal, known as the Financial Services and Markets Tribunal, to determine issues referred to it by an aggrieved party under various provisions of the FSMA 2000 in respect of decisions of, or action taken by, the FSA, including decision notices and supervisory notices and in relation to applications for permissions to undertake regulated activities under Part IV.

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631 Sections 22 and 38 of the FSMA 2000.

632 Paragraphs 10 and 11 of Schedule 1 to the FSMA 2000.

633 The Chancellor added that '[the] *Government believes that it is right for the FSA to set the maintenance of confidence in the financial system as a target, rather than the avoidance of failure of firms per se'.*

1043 Appeals on a point of law arising from a decision of the Tribunal may be made, with the permission of the Tribunal, to the Court of Appeal (or to the Court of Session in Scotland). The Lord Chancellor is responsible for appointing a panel of people to act as chairmen of the Tribunal (paragraph 3(1) of Schedule 13 to the FSMA).

1044 Part XVI of the FSMA 2000 established a single Ombudsman Scheme, bringing together at least five former dispute resolution schemes. The Scheme is administered by a body corporate (the Financial Ombudsman Service Limited) and deals with complaints made against authorised persons (or against those who had been authorised persons at the time of the act or omission to which the complaint relates) in relation to activities regulated by the FSMA 2000.

1045 The stated aim of the Scheme is to provide a means by which certain disputes can be resolved '*quickly and with minimum formality by an independent person*'. The Chairman and other members of the Board of the Ombudsman Scheme are appointed and liable to removal by the FSA acting, in the case of the Chairman, with the approval of the Treasury (paragraph 3(2) of Schedule 17 to the FSMA 2000).

1046 Part XV of the FSMA 2000 created a single compensation scheme to replace the Investor's Compensation Scheme, the Policyholders Protection Board Scheme and three other compensation schemes.

1047 The compensation scheme is administered by a body corporate (the Financial Service Compensation Scheme Limited – the 'scheme manager' for the purpose of section 212 of the Act) and financed by a levy on authorised persons.

1048 The FSA is responsible for the appointment and removal of the Chairman and other members of the board of the compensation scheme management company acting, in the case of the Chairman, with the approval of the Treasury (section 212(4) of the FSMA 2000).

Some implications of the FSMA 2000 for prudential regulation of long term insurance business

1049 Effecting and carrying out contracts of insurance is an activity of a 'specified kind' which is a 'regulated activity' for the purpose of the FSMA 2000[634].

1050 The effects of the FSMA 2000 for the prudential regulation of long term insurance include:

- the repeal of the ICA 1982, the FS Act 1986, the PPA 1975, the Policyholders Protection Act 1997, the Insurance Companies (Reserves) Act 1995 and related subordinate legislation, mainly with effect from 1 December 2001[635];

- the vesting of responsibility for prudential regulation and conduct of business regulation in a single regulator and the gradual harmonisation of rules for regulation of insurance business with those applied to other parts of the financial sector;

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634 Contracts of insurance are described in general terms in Schedule 2 to the FSMA 2000 as being within the scope of regulated activities for the purpose of the Act. Effecting a contract of insurance as a principal and carrying out a contract of insurance as a principal are 'specified kinds of activity' which are 'regulated activities' for the purpose of the FSMA 2000 by virtue of article 10 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 SI No. 544 (made by the Treasury in exercise of powers under, inter alia, section 22 of the FSMA 2000).

635 By SI 2001 No. 3649 (referred to in paragraph 683).

- (for most purposes) the replacement of the relevant legislation with rules made by the FSA[636] set out as 'rule making instruments'[637], consolidated in the FSA Handbook, a lengthy (and constantly evolving) document which contains 'business standards' for, inter alia, insurance business in 'prudential sourcebooks' (initially in 'interim prudential sourcebooks' specific to individual financial sectors, but now being combined into an 'integrated prudential sourcebook' of general application);

- the designation of the Institute of Actuaries (but not the Faculty of Actuaries) as a 'designated professional body' for the purpose of section 326 of the FSMA 2000[638] (actuaries supervised by the Institute are thereby entitled to undertake certain regulated activities without breaching the general prohibition on carrying on a regulated activity unless authorised or exempt under the Act); and

- specific provision in the legislation:

  – to the effect that an actuary (or auditor) appointed for the purpose of rules made under the FSMA 2000 does not contravene any duty merely through providing the FSA with information or his or her opinion on any matter, provided that the actuary (or auditor) acts in good faith and reasonably believes that the information or opinion is relevant to the functions of the FSA[639]; and

  – to impose a duty on the actuary who is acting or has acted for an authorised person to communicate information or his or her opinion to the FSA in specified circumstances[640].

1051 Guidance for appointed actuaries such as that in GN1, GN2, GN7 and GN8 continues to be issued by the F&IA. In versions of the guidance issued at the end of December 2004, references to legislation have largely been replaced by references to the FSA Handbook and Interim Prudential Sourcebook for Insurers.

1052 Since the issue of that guidance, the Integrated Prudential Sourcebook for Insurers has been produced.

636 Generally, made by the FSA under section 138 of the FSMA 2000.
637 Under section 153 of the FSMA 2000, any power of the FSA to make rules is to be exercisable in writing and must specify the provision under which the rule is made. The instrument by which rules are made by the FSA is described as 'a rule-making instrument'. The Treasury has limited power to make supplementary rules in relation to insurance business for the purpose of preventing certain persons who are not authorised under the Act from doing anything which would lessen the effectiveness of certain 'asset identification rules' (section 142).
638 By virtue of the Financial Services and Markets Act 2000 (Designated Professional Bodies) Order 2001 SI No. 1226.
639 Section 342(3) of the FSMA 2000 (see paragraph 383 regarding the former provisions in relation to auditors under section 21A of the ICA 1982).
640 By virtue of the Financial Services and Markets Act 2000 (Communications by Actuaries) Regulations 2003 SI No. 1294. Comparable provision was made in relation to communication of information by auditors to the FSA, by the Financial Services and Markets Act 2000 (Communications by Auditors) Regulations 2001 SI No. 2587, to replace the provisions of SI 1994 No. 449 (referred to in paragraphs 697 et seq) which was revoked when the relevant provisions of the FSMA 2000 came into force.

Appendix A

Insurance Companies Act 1982 Parts i, ii & v – main derivations

Sections in: ICA 1982	ICA 1981	ICA 1974	ICAA 1973	CA 1967	ICA 1958	Other
Part I Restriction on Carrying on Insurance Business						
Preliminary						
1. Classification	1	1			{59}[641]	
2. Restriction on carrying on insurance business	2	2			{60}	
Authorised insurance companies						
3. Authorisation by Secretary of State	3	3			{61}	
4. Existing insurance companies	4	3				
5. Submission of proposals etc	5					
6. Combination of long term and general business	6					SI 1994/1696, reg 6
7. United Kingdom applicants	7					
8. Applicants from other member States	8					
9. Applicants from outside the Community	9					
10. General representatives	10					
Withdrawal of authorisation						
11. Withdrawal of authorisation in respect of new business	11	{9}		{69}		
12. Notices of withdrawal under section 11	12					
12A Suspension of authorisation in urgent cases						SI 1994/1696, reg 11
13. Final withdrawal of authorisation	13					
Offences						
14. Offences under Part 1	14	11	{52}	{85}	{26}	
Part II Regulation of Insurance Companies						
Preliminary						
15. Insurance companies to which Part II applies	16	12		{70}	{1}	
16. Restriction of business to insurance	15					
Accounts and statements						
17. Annual accounts and balance sheets		13		71	4	
18. Periodic actuarial investigation of company with long term business	17	14	3	{78}	{5}	
19. Appointment of actuary by company with long term business		15	3			
20. Annual statements by company with prescribed class of insurance business		16		74	{7}	

[641] { } indicates broadly equivalent or relevant provisions of earlier legislation.

Sections in: ICA 1982		ICA 1981	ICA 1974	ICAA 1973	CA 1967	ICA 1958	Other
21.	Audit of accounts		17		72	9	Companies Act 1981, Sched 3
21A.	Communication by auditor with Secretary of State						Financial Services Act 1986, s135
22.	Deposit of accounts etc with Treasury	18	18	4	{71}	8	
23.	Right of shareholders and policy holders to receive copies of deposited documents		19	4	{76}	8	
24.	Deposit of accounts etc by registered society		20		77		
25.	Periodic statements by company with prescribed class of business		21	5			
26.	Statements of transactions of prescribed class or description		22	6			
27.	Companies from outside the Community	18	22A				
Assets and liabilities attributable to long term business							
28.	Separation of assets and liabilities attributable to long term business		23	7		{3}	
29.	Application of assets of company with long term business	19	24	8			
30.	Allocations to policyholders	20	25	9			
31.	Restriction on transactions with connected persons		26	10			
31A.	Arrangements to avoid unfairness between separate insurance funds etc						FS Act 1986, s136
32.	Margins of solvency	21	26A				
33.	Failure to maintain minimum margin	21	26B				
34.	Companies supervised in other Member States	21	26C				
34A.	General business: equalisation reserve						IC (Reserves) Act 1995, s1
35.	Form and situation of assets	21	26D				
35A.	Adequacy of assets						SI 1994/1696, reg 17
35B.	Adequacy of premiums: long term business						SI 1994/1696, reg 18
Liabilities of unlimited amount							
36.	Avoidance of contracts for unlimited amounts		27	11			
Powers of intervention							
37.	Grounds on which powers are exercisable	22	28	12			
38.	Requirements about investments	23	30	14			
39.	Maintenance of assets in the United Kingdom	23	31	15			

Sections in: ICA 1982	ICA 1981	ICA 1974	ICAA 1973	CA 1967	ICA 1958	Other
40. Custody of assets		32	16			
40A. Prohibition on disposal of assets						SI 1994/1696, reg 22
41. Limitation of premium income		33	17			
42. Actuarial investigations		34	18			
43. Acceleration of information required by accounting provisions		35	19			
43A. General investigations						SI 1994/1696, reg 23
44. Power to obtain information and require production of documents		36	20	{109}		
44A. Entry and search of premises						Companies Act 1989, s77
45. Residual power to impose requirements for protection of policy holders	23	37	21			
46. Notice of proposed exercise of powers on ground of unfitness of certain persons		39	23			
47. Rescission, variation and publication of requirements		40	24			
47A. Restriction on disclosure of information						Companies Consolidation (Consequential Provisions) Act 1985, s25 SI 1994/1696, reg 26
47B. Privilege from disclosure						Companies Consolidation (Consequential Provisions) Act 1985, s25
48. Power of Secretary of State to bring civil proceedings on behalf of insurance company		41	25	{37}		
Transfers of long term business						
49. Transfers of long term and general business	27	42	26			SI 1994/1696, reg 28[642] Substituted ss 49, 49A, 49B, 50,51 and 52 with new s49.
49A. Transfer of long term business to friendly society						Friendly Societies Act 1992, s120 and see fn 2
49B. Modifications of section 49 in certain cases						SI 1993/174, reg 3 and see fn 2
50. Provisions supplementary to section 49		43	27			See fn 2
Transfer of general business						
51. Approval of transfers of general business	25					See fn 2
52. Effect of approval under section 51	26					See fn 2

642 Substituted ss 49, 49A, 49B, 50, 51 and 52 with new s 49.

Sections in: ICA 1982	ICA 1981	ICA 1974	ICAA 1973	CA 1967	ICA 1958	Other
52A. Issue of certificates by Secretary of State						SI 1990/1333, reg 9
52B. Effect of transfers authorised in other EEA States						SI 1994/1696, reg 30
Winding up						
53. Winding up of insurance companies under Companies Acts		45	29		15	
54. Winding up on petition of Secretary of State		46	29	81	15	Companies Act 1976, Sched 2
55. Winding up of insurance companies with long term business		47	30			
56. Continuation of long term business of insurance companies in liquidation		48	31			
57. Subsidiary companies		49			16	
58. Reduction of contracts as alternative to winding up		50			18	
59. Winding up rules		51	29 + 30	17		
Changes of director, controller or manager etc						
60. Approval of proposed managing director or chief executive of insurance company		52	33			
61. Approval of person proposing to become controller of insurance company where section 60 does not apply		53	34			
61A. Approval of acquisition of notifiable holding in UK company						SI 1994/1696, reg 34
61B. Further provisions with respect to controllers of UK companies						SI 1994/1696, reg 35
62. Duty to notify change of director, controller or manager		54	35	82/83		
63. Change of manager etc of company from outside United Kingdom	28					
64. Duty to notify change of main agent	29	54A				
Miscellaneous						
65. Documents deposited with Secretary of State		55	36		{30}	
66. Documents deposited in Northern Ireland		55A				
67. Power to treat certain business as or as not being ordinary long-term insurance business		56	37			Policyholders Protection Act 1975, s22

Sections in: ICA 1982	ICA 1981	ICA 1974	ICAA 1973	CA 1967	ICA 1958	Other
68. Power to modify Part II in relation to particular companies		57	38	{92}		
69. Power to alter insurance company's financial year		59		73		
70. Service of notices		60			29	
71. Offences under Part II	61	52	84	26		
Part V Supplementary Provisions						
Valuation regulations						
90. Powers to make valuation regulations	33	78	32			
Criminal proceedings						
91. Criminal liability of directors		79	52	89		
92. Criminal proceedings against unincorporated bodies		80	52	88		
93. Restriction on institution of prosecutions		81	52	91		
94. Summary proceedings		82	52	90		
94A. Fees						Insurance (Fees) Act 1985, s1
94B. Law applicable to certain contracts of insurance						SI 1990/1333, reg 6
Interpretation						
95. Insurance business	34					
96. General interpretation	35	85	55	102	33	
96A. Interpretation of expressions derived from insurance Directives						SI 1990/1333, reg 2
96B. Meaning of 'large risks'						SI 1990/1333, reg 4
96C. Meaning of 'controller' etc						SI 1994/1696, reg 52
96D. Meanings of 'manager' and 'chief executive'						SI 1994/1696, reg 53
96E. Meaning of 'main agent'						SI 1994/1696, reg 54
Supplementary						
97. Regulations and orders	33	86	53		34	

Appendix B

Frequency of exercise of powers of intervention under the Insurance Companies Act 1982

Reproduced from the Minutes of Evidence Submitted to the House of Commons Select Committee on the Treasury

Ninth Report 1997-98 – Pension Mis-selling

Annex A to Appendix 4 Supplementary Memorandum from HM Treasury as ordered to be printed on 12 November 1998

Section of the Act conferring power and description of power	**Number of times power exercised in each given year**												
	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Section 38—Requirements about Investments													
—on or within 5 years of authorisation under S37(5)(a)	17	12	21	10	11	27	16	18	21	18	11	14	16
—on or within 5 years of change of control under S37(5)(b)	3	6	12	7	7	9	5	2	4	5	9	18	7
—in other cases under S37(2),(3),(4),(4A) or (6)	1	0	2	4	2	9	7	8	26	12	7	0	7
Section 39 Maintenance of assets in EEA													
—on or within 5 years of authorisation under S37(5)(a)	0	0	0	0	0	0	0	0	0	0	0	0	0
—on or within 5 years of change of control under S37(5)(b)	0	0	0	0	0	0	0	0	0	0	0	0	0
—in other cases under S37(2),(3),(4),(4A) or (6)	2	0	3	1	0	3	1	0	0	0	0	0	0
Section 40 Custody of assets													
—on or within 5 years of authorisation under S37(5)(a)	0	0	0	0	0	0	0	0	0	0	0	0	0
—on or within 5 years of change of control under S37(5)(b)	0	0	0	0	0	0	0	0	0	0	0	0	0
—in other cases under S37(2),(3),(4),(4A) or (6)	2	0	3	0	0	3	0	0	0	0	0	0	0
Section 40A Freezing of Assets													
—on or within 5 years of authorisation under S37(5)(a)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0	0	0	0
—on or within 5 years of change of control under S37(5)(b)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0	0	0	0
—in other cases under S37(2),(3),(4),(4A) or (6)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0	0	0	0
Section 41 Premium Income limit													
—on or within 5 years of authorisation under S37(5)(a)	18	15	16	4	10	26	16	18	22	17	14	18	15
—on or within 5 years of change of control under S37(5)(b)	2	7	12	7	6	9	6	8	7	4	8	17	4
—in other cases under S37(2),(3),(4),(4A) or (6)	1	2	1	4	2	9	1	9	15	8	11	1	2
Section 42 Actuarial Investigations													
—on or within 5 years of authorisation under S37(5)(a)	3	3	3	1	2	7	3	0	1	0	0	0	0
—on or within 5 years of change of control under S37(5)(b)	3	1	3	0	1	3	0	2	0	0	0	0	0
—in other cases under S37(2),(3),(4),(4A) or (6)	0	0	0	0	0	2	0	0	0	0	0	0	0

Section of the Act conferring power and description of power	Number of times power exercised in each given year												
	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
Section 43 Accelerated accounting information													
—on or within 5 years of authorisation under S37(5)(a)	0	0	0	0	0	0	0	0	0	0	0	0	0
—on or within 5 years of change of control under S37(5)(b)	0	0	0	0	1	0	0	0	0	0	0	0	0
—in other cases under S37(2),(3),(4), (4A) or (6)	0	0	1	0	0	2	8	9	2	1	0	0	4
Section 43(A) General Investigations													
—on or within 5 years of authorisation under S37(5)(a)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0	0	0	0
—on or within 5 years of change of control under S37(5)(b)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0	0	0	0
—in other cases under S37(2),(3),(4),(4A) or (6)	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	0	0	0	1
Section 44(1) Obtaining Information													
—on or within 5 years of authorisation under S37(5)(a)	19	12	21	12	11	29	16	18	22	18	15	24	21
—on or within 5 years of change of control under S37(5)(b)	3	8	12	7	7	9	5	5	3	5	9	29	8
—in other cases under S37(2),(3),(4),(4A) or (6)	3	1	3	2	12	19	11	14	27	12	16	5	9
Section 44(2) Obtaining Information by production of specific books and papers													
—on or within 5 years of authorisation under S37(5)(a)	0	0	0	0	0	0	0	0	2	0	0	0	0
—on or within 5 years of change of control under S37(5)(b)	0	0	0	0	0	0	0	0	0	0	1	0	0
—in other cases under S37(2),(3),(4),(4A) or (6)	0	0	3	3	1	2	0	2	0	1	2	11	11
Section 45 Residual power to impose requirements for protection of policyholders													
—on or within 5 years of authorisation under S37(5)(a)	18	12	21	12	11	28	16	18	22	18	14	24	20
—on or within 5 years of change of control under S37(5)(b)	3	5	3	7	8	9	5	5	3	4	9	33	7
—in other cases under S37(2),(3),(4),(4A) or (6)	1	0	3	2	4	10	11	19	32	12	8	4	9

Appendix C

Matching rectangle Form 57 and instructions for completion

Two Versions:

The Insurance Companies (Accounts and Statements) Regulations 1996 SI No. 943 and The Insurance Companies (Accounts and Statements)(Amendment) Regulations 1997 SI No. 2911

SI 1996 No. 943: FORM 57

Returns under Insurance Companies Legislation

Form 57

Long term business : Matching rectangle

Name of company

Global business/UK branch business/EEA branch business

Financial year ended

Sterling/Non sterling liabilities

Rate of interest

Type of business

With profits/Non profit

Category of assets

140

	Company registration number	GL/UK/CM	Period ended day	month	year	Units	Stg/Nonstg	Rate of interest	LBGA/Pens/PHI/Other	WP/NP	Category of assets
R17						£000					

Type of asset notionally allocated			Value of asset notionally allocated 1	Risk adjusted yield % 2	Gross valuation interest rate % 3	Net valuation interest rate % (where appropriate) 4	Mathematical reserve or other liability, net of reinsurance 5
Land and buildings		11					
Fixed interest securities	Approved securities	12					
	Other	13					
Variable yield securities (excluding items shown at line 16)	Approved securities	14					
	Other	15					
Equity shares and holdings in collective investment schemes		16					
Loans secured by mortgages		17					
All other assets	Producing income	18					
	Not producing income	19					
Total		29					
Total under resilience scenario		39					

Transcript of instructions for completion of form 57 in Schedule 4 to SI 1996 No. 943

Instructions for completion of Form 57

1. The word 'Total' or the name of the fund shall be shown against the heading 'Category of assets'. The corresponding code box shall contain '10' for the total assets and, in the case of separate funds, code numbers corresponding to those allocated on completion of Form 13.
2. Separate forms shall be prepared for sterling and non-sterling liabilities. The box marked 'Stg/NonStg' shall be completed by the insertion of 'Stg' for sterling liabilities and 'NonStg' for non-sterling liabilities.
3. Separate forms are required for with profit and non-profit contracts within the following types of business
   (i) life assurance and annuity businesses
   (ii) pension business
   (iii) permanent health business
   (iv) other business

   The box marked 'L&GA/Pens/PHI/Other' shall be completed by the insertion of 'L&GA', 'Pens', 'PHI' or 'Other' respectively for each of the types (i), (ii), (iii) and (iv) specified above. The box marked 'WP/NP' shall be completed by the insertion of 'WP' for with profits policies or 'NP' for non-profit policies both as defined in Regulation 3.
4. Separate forms shall be prepared for each rate of interest used in the valuation and may include all contracts valued at the same rate. The rate of interest shall be shown against the heading 'Rate of Interest' and in the corresponding code box.
5. The forms specified above shall exclude the liabilities described in paragraph 21(1)(a) to (c) of schedule 4, and must cover at least 90% of the remaining long term liabilities.

   The balance of the remaining long term liabilities shall be shown in a separate form in which columns 3 and 4 may be left blank, and details of the contracts covered by the form shall be given in a note. The word 'Balance' shall be shown against the heading 'Rate of Interest' and the corresponding code box shall contain '98'.
6. A summary of all the separate forms shall be produced as a separate form in which columns 2, 3 and 4 may be left blank. The word 'Total' shall be shown against the heading 'Rate of Interest' and the corresponding code box shall contain '99'.
7. The risk adjusted yield in column 2 for each asset shall be calculated as in Regulations 69(3) to (6) of the Insurance Companies Regulations 1994, taking account of any adjustment considered necessary because of Regulation 69(7). Where a number of assets with different risk adjusted yields are held, the weighted average risk adjusted yield shall be calculated using as weights the value of the asset applicable for entry into column 1.
8. The value of each asset shown in column 1 shall be the value attributed to it in Form 13 and the assets will be grouped according to instruction 1 to Form 48 including adjustments in respect of accrued interest as required by that instruction.
9. Where the valuation has been carried out at a net rate of interest the figure in column 3 shall be the next rate grossed up at the corresponding effective rate of tax.

10. The mathematical reserve in column 5 will include any increase in reserve resulting from the bonus declaration for the year and shall be net of reassurance ceded.

11. The entries shown at line 39 shall be those applicable to the scenario described in the answer to paragraph 7(8) of Schedule 4, and details of any material changes to the notional allocation of assets made in investigating that position shall be given in a supplementary note.

SI 1997 No 2911: FORM 57

Returns under Insurance Companies Legislation

Form 57

Long term business : Matching rectangle

Name of company

Global business/UK branch business/EEA branch business

Financial year ended

Sterling/Non sterling liabilities

Valuation rate(s) of interest

Type of business

With profits/Non profit

Category of assets

	Company registration number	GL/UK/CM	Period ended day	Period ended month	Period ended year	Units	Stg/ NonStg	Valuation rate of interest	L&GA/Pens/ PHI/Other	WP/NP	Category of assets
R57						£000					

Type of asset notionally allocated			The valuation		The resilience scenario			
			Value of asset notionally allocated 1	Risk adjusted yield % 2	Value of assets notionally allocated: On original allocation 3	Increase or decrease 4	Total under resilience scenario 5	Risk adjusted yield % 6
Land and buildings		11						
Fixed interest securities	Approved securities	12						
	Other	13						
Variable interest and variable yield securities (excluding items shown at line 16)	Approved securities	14						
	Other	15						
Equity shares and holdings in collective investment schemes		16						
Loans secured by mortgages		17						
All other assets	Producing income	18						
	Not producing income	19						
Total (11 to 19)		29						
Gross valuation interest rate %		31						
Net valuation interest rate % (where appropriate)		32						
Mathematical reserve or other liability, net of reinsurance		33						

Instructions for completion of Form 57

1. The word "Total" or the name of the fund shall be shown against the heading "Category of assets". The corresponding code box shall contain "10" for the total assets and, in the case of separate funds, code numbers corresponding to those allocated on completion of Form 13.
2. Separate forms shall be prepared for sterling and non-sterling liabilities. The box marked "Stg/NonStg" shall be completed by the insertion of "Stg" for Sterling liabilities and "NonStg" for non-sterling liabilities.
3. Separate forms are required for with profit and non-profit contracts within the following types of business

    (i) life assurance and annuity businesses

    (ii) pension business

    (iii) permanent health business

    (iv) other business
4. The box marked "L&GA/Pens/PHI/Other" shall be completed by the insertion of "L&GA", "Pens", "PHI" or "Other" respectively for each of the types (i), (ii), (iii) and (iv) specified above. The box marked "WP/NP" shall be completed by the insertion of "WP" for with profits policies or "NP" for non-profit policies both as defined in Regulation 3.
5. Separate forms shall be prepared for each rate of interest used in the valuation in pursuance of regulation 69(12) of the Insurance Companies Regulations and may include all contracts valued at the same rate, subject to instructions 2 and 3 to this Form. Contracts valued at a lower rate of interest but subject to the same apportionment of assets may also be included provided that the rationale for such inclusion is given in a supplementary note. Each of the valuation rates of interest used shall be itemised against the heading "Valuation rate(s) of interest". The highest valuation rate of interest used shall be shown in line 31 or 32 as appropriate and in the code box headed "Valuation rate of interest".
6. The forms specified above shall exclude the liabilities described in paragraph 21(1) (a) to (d) of Schedule 4, and must cover at least 90% of the remaining long term liabilities.

    The balance of the remaining long term liabilities shall be shown in a separate form in which lines 31 and 32 shall be left blank, and details of the contracts covered by the form shall be given in a supplementary note. The word "Balance" shall be shown against the heading "Valuation rate(s) of interest" and the corresponding code box shall contain "98".
7. A summary of all the separate forms shall be produced as a separate form in which lines 31 and 32 shall be left blank. The word "Total" shall be shown against the heading "Valuation rate(s) of interest" and the corresponding code box shall contain "99".
8. The risk adjusted yield in columns 2 and 6 for each asset included in column 1 and 5 respectively shall be that calculated as in Regulations 69(3) to (6) of the Insurance Companies Regulations 1994, taking account of any adjustment considered necessary because of Regulation 69(7). Where a number of assets with different risk adjusted yields are held, the weighted average risk adjusted yield shall be calculated using as weights the value of the asset applicable for entry into columns 2 and 6.

9. The value of each asset included in column 1 shall be the value attributed to it in Form 13 and the assets will be grouped according to instruction 1 to Form 48 including adjustments in respect of accrued interest as required by that instruction.

10. Where the valuation has been carried out at a net rate or rates of interest the figure in line 31 shall be the net rate grossed up at the corresponding effective rate of tax in respect of the highest valuation rate of interest used in the Form.

11. The mathematical reserve in line 33 will include any increase in reserve resulting from the bonus declaration for the year and shall be net of reassurance ceded.

12. The entries shown in columns 3, 4, 5 and 6 shall be those applicable to the scenario described in the answer to paragraph 7(8) of Schedule 4. The entries in column 3 shall be the value of the assets shown in column 1 according to the changed assumptions of that scenario. The entries in column 4 shall be the value of assets on the changed assumptions for each type of asset notionally re-allocated to cover the mathematical reserve or other liability, net of reinsurance, in the resilience scenario. The entries in column 5 shall equal the sum of the entries in columns 3 and 4.

13. The entries in line 29, column 1 shall equal the entries in line 33, column 1. The entries in line 29, column 5 shall not be less than the entries in line 33, column 5.

Appendix D

Service Level Agreement 1998 between the Treasury and GAD

Annex A – Allocation of Priority for Detailed Scrutiny of Life Insurers

Priority	Description	Other indicators (note: these indicators are subordinate to the description, and are merely to give some broad assistance. They are no substitute for judgement, both where a higher or lower priority may be justified)	Target
1	As at present, the allocation of priority 1 will denote a company which either is not demonstrating that it holds the required minimum margin or else where there are significant problems which lead GAD to believe that it does not meet the requirements under proper bases.		Within two weeks
2	This priority denotes those companies that there are significant and substantial concerns.	1 The cover for the RMM is less than 1.25x 2 There is evidence of material non-compliance with the valuation regulations	Within four months
3	This priority denotes companies where there are sufficient concerns to warrant early attention, or there are other reasons to require scrutiny early in the cycle.	1 The cover for the RMM is less than 1.5x 2 There is evidence of a non-trivial, but not material non-compliance with the valuation regulations 3 The company was in priority 1 or 2 for the previous year 4 A company visit is scheduled for September to January (or equivalent for non-December companies) 5 The company had commenced trading, but was authorised for less than eighteen months at the valuation date.	Within six months
4	Companies which warrant a full scrutiny for any reason, but would otherwise not fall within a category to ensure this.	1 The cover for the RMM is less than 2 x 2 The company was in priority 3 in the previous year 3 There is evidence of non-compliance with less important regulations 4 The company did not receive a full scrutiny in either of the previous two years 5 A company visit is scheduled for February to August (or equivalent for non-December companies).	Within nine months
5	Companies which do not qualify for priority 4 or higher after the initial scrutiny	Cover for the RMM is more than 2 x, and scrutiny within the last two years	Within eleven months

Appendix E

The Government paper on 'the regulatory regime pursuant to which Equitable Life was regulated during the period 1973 to 2001'.

This appendix contains the paper submitted by the bodies under investigation describing the relevant regulatory regime. It is reproduced here in its original form, with the exception that some minor linguistic editing has been necessary.

Introduction

1 Until 1 December 2001, when the Financial Services and Markets Act 2000 ('the FSMA') came into force, life insurance companies such as Equitable Life were subject to two regulatory regimes: prudential regulation and conduct of business regulation.

2 Prudential regulation is concerned essentially with the solvency of insurance companies, and the soundness and prudence of their management. Conduct of business regulation relates primarily to the marketing and sale of a company's products and the provision of related advice to current and potential policyholders.

3 Conduct of business regulation does not fall within the Parliamentary Ombudsman's remit and the conduct of business regulation of Equitable Life is accordingly not within the scope of the present investigation.

4 This paper describes the regime for the prudential regulation of life insurance companies pursuant to which Equitable Life was regulated during the period under investigation. Part I describes the background to the regulation of life insurance business in the UK prior to the introduction of the Insurance Companies (Amendment) Act 1973 ('the 1973 Act'). Part II describes the regulatory regime that was introduced under the 1973 Act, and subsequent events leading up to the Insurance Companies Act 1982 ('the 1982 Act'). Part III describes the regulatory regime that was put in place pursuant to the 1982 Act. That regulatory regime then remained in place (subject to some changes which are considered in Part IV) until the FSMA came into force on 1 December 2001. Part V deals with the changing identity of the relevant prudential regulator, and its relationship with the Government Actuary's Department ('GAD').

5 The philosophy which has guided the prudential regulation of life insurance companies in the UK from its inception is the doctrine of 'freedom with publicity'. In summary:

(1) From as early as the nineteenth century, it was recognised that, whilst it was desirable for there to be some prudential regulation of life insurance business to safeguard policyholders' interests, it was also desirable not to restrict commercial freedom. It was also recognised that excessive prudential regulation could have an inhibiting effect on the development of an innovative and competitive life insurance market in the UK.

(2) The doctrine of 'freedom with publicity' was developed, whereby life insurance companies would make their affairs public through financial information being placed in the public domain. This approach was perceived as providing an appropriate balance between commercial freedom and innovation on the one hand and policyholder protection on the other.

(3) Over the course of the twentieth century, the extent of the financial information required to be disclosed by life insurance companies, and the regularity with which that information had

to be disclosed, was gradually increased. At the same time, sophisticated actuarial professional practices were developed to try to safeguard policyholders' interests.

(4) The doctrine of 'freedom with publicity' was subject to policy consideration prior to the passing of the Insurance Companies (Amendment) Act 1973, and the view taken was that the policy should continue.[643] Indeed when contrasted with the prescriptive approach to prudential regulation adopted by some EEC countries at that time (in areas such as premium rates, policy conditions and choice of investments) the view was that this had led to higher charges and poorer service in those countries, whereas the UK's more liberal approach had *'paid off handsomely in terms of an enterprising innovating industry with substantial overseas earnings'*.[644].

(5) Under the 1973 Act, the regulatory regime placed an increasing amount of reliance on the insurance companies' actuaries through the introduction of the Appointed Actuary system. In addition, a greater role was given to the prudential regulator in scrutinising the financial returns submitted by insurance companies, and, from 1981, in ensuring that appropriate margins of solvency were maintained. But at its heart, the regulatory regime remained one based on insurance companies' freedom of action rather than on prescriptive rules covering, for example, product design or premium rates.

(6) It was not seen as necessary to change the basic policy approach at the time of the passing of the Insurance Companies Act 1982,[645] nor when the insurance regulations were reviewed in 1994/95[646].

(7) Not only was this approach favoured in the UK, but it came to be substantially accepted by the European Community as striking the right balance between competing policy objectives. Thus the doctrine of 'freedom with publicity' also lay behind some of the provisions of the First to Third Life Insurance Directives.[647]

(8) Throughout the period under review, the doctrine of 'freedom with publicity' accordingly remained a fundamental principle of prudential insurance regulation of insurance companies in the UK.

6 Judged on its own terms, it is fair to say that the policy of 'freedom with publicity' was generally successful. It contributed to the development of a highly innovative and competitive life insurance market in the UK. At the same time, during the last quarter of the twentieth century, the UK insurance industry enjoyed a high degree of stability under the policy with few corporate failures.

7 The regulatory approach built on the principle of 'freedom with publicity' (and augmented with requirements for limited disclosures to the prudential regulator and professional duties for the Appointed Actuary) was longstanding, endorsed by

643 As is evident in communications among officials and with departmental lawyers at the time and in statements to Parliament at the time that the Bill was being debated.
644 Minute dated 27 February 1973 to Minister.
645 As is clear from statements made to Parliament at the time that legislation was passed and contemporaneous briefs on the Insurance Companies Bill.
646 Representations were in fact taken from industry on the general policy approach during a consultation in 1994. The conclusion was that there were 'no compelling reasons for a change' and that there were *'many advantages of* [the] *traditional approach'*, conclusions with which '[a] *very large majority'* of those who responded to the consultation agreed.
647 For example, those limiting the circumstances in which regulators could prohibit life insurance companies from disposing of their assets, and provisions which forbade prescriptive rules as to premium rates, policy conditions and choice of investments.

the domestic and European legislatures and perfectly legitimate for the government to adopt. Moreover, it was a policy decision that had important ramifications for (i) the amount of financial information to which the prudential regulator was to have regard; (ii) the extent of the prudential regulator's interference in the affairs of the companies it regulated; and (iii) the level of resources that were made available to the prudential regulator.

8 Thus, the amount of financial information to which the prudential regulator was expected to have regard was always carefully circumscribed. Whilst various statutory instruments gradually increased the amount of financial information that life insurance companies were required to disclose to the prudential regulator, at the same time it was perceived that a balance had to be struck, so as to ensure that the regulatory burden imposed on life insurance companies was not so great as to stifle innovation and competition. For example, during the 1990s the DTI's Insurance Division had an objective: *'To keep the cost and inconvenience of regulation for insurers as low as is commensurate with effective protection of the consumer'*.[648]

9 Likewise, when the concept of 'policyholders' reasonable expectations' ('PRE') was first introduced into legislation in 1973, the Government of the day pointed out that the new legislation was not to be operated so as to curtail market competition and innovation.[649] Subsequent statutes made clear that intervention by the prudential regulator on the grounds of PRE was a 'residual' power, or 'long-stop' measure that was only to be used if the regulator's purpose could not be achieved by any of the other powers of intervention;[650] and one that should be used sparingly by the regulator, and not in such a way so as to restrict a life insurance company's freedom to dispose of its assets (save in very limited circumstances).[651]

10 The doctrine of 'freedom with publicity' also had implications for the resources and skills that were made available to the prudential regulator. Given the importance attached by the statutory regime to the role of the Appointed Actuary, it made sense for the prudential regulator to work closely alongside the UK actuarial profession, including outsourcing a scrutiny and advisory role to GAD (from 1984 onwards by way of a series of Service Level Agreements). It also meant that prudential regulation of the UK insurance industry could be resourced on a more streamlined basis.

Part 1 – the background to prudential regulation of life insurance business in the UK prior to 1973

The start of prudential insurance regulation in the UK

11 Substantive legislation to control the prudential regulation of life insurance companies was first introduced in the nineteenth century, following a large number of business failures and mergers that took place in the first half of that century.

12 The 1853 Select Committee on Assurance Associations, chaired by the Rt Hon James Wilson MP, took evidence from a number of leading actuaries and insurance men of the day. John Finlaison, the Actuary and Principal Accountant of the Check Department of the National Debt Office (the nearest there was at that time to a

648 MINIS 94, Objective 10.
649 See paragraph 37.
650 See section 37(6), and the heading to section 45 of the 1982 Act.
651 See section 45(2) of the 1982 Act. This was required to give effect to EEC law, and in particular Article 21 of the First Life Directive, described in Part III.

Government Actuary), was an advocate of a free market. As the first President also of the Institute of Actuaries (from 1848 to 1860), Finlaison argued that the right approach was to rely on the professional expertise of actuaries and to protect the public by giving official recognition to the Institute of Actuaries and controlling entry to the profession by examination. As a result no substantive legislation was introduced.

13 However, the collapse of both the Albert Life Assurance Company and the European Assurance Society in 1869 prompted renewed political concern over the lack of any prudential regulation of the activity of life insurance companies. Legislation was introduced into the House by Mr Stephen Cave, as Vice-President of the Board of Trade, and this became the Life Assurance Companies Act 1870 ('the 1870 Act'). In introducing the Bill, Stephen Cave observed that 285 pure life insurance companies had been formed up to that point, of which only 111 had survived.

14 The 1870 Act required that a separate account should be kept of all receipts in respect of life assurance and annuity contracts of an insurance company and that this fund should be regarded as the absolute security for the life insurance policies. This approach gave particular safeguards in the case of composite insurance companies, which were also carrying on general insurance business, but also entailed, in the case of pure life insurance companies, separation of the life and annuity business transactions from any shareholders' funds. This was the origin of the long-term business fund, which continues to form part of the legislative structure to the present day.

15 The 1870 Act also required regular investigations to be carried out by an actuary into the financial condition of a life insurance company. Existing companies had to be looked at every 10 years and new companies every 5 years, unless more frequent reviews were required under the company's constitution. A key feature of prudential regulation, which has remained in its essential form up to the present day, was that the annual accounts of the company, together with the abstract of the actuarial valuation when carried out, had to be deposited with the Board of Trade, which then made these available to the public through the Registry of Joint Stock Companies.

16 In 1870 few countries had any statutory regulation of life insurance companies. Sprague (1872) compared the new UK legislation with that recently introduced in Massachusetts and New York, which had the expressed objective of securing the solvency of all life insurance companies. Sprague believed that this could never be absolutely secured; nor was it a desirable objective. In his view it was best to allow insurance companies a good deal of freedom, but require them to make their affairs public by way of regular financial returns.

The early 20th century

17 The 1870 Act concerned only life insurance business, and it was not until 1907 that prudential regulation was extended to any general insurance business with the passage of the Employers' Liability Insurance Companies Act 1907. Two years later, in 1909, the then President of the Board of Trade, Winston Churchill, introduced a Bill to replace the Life Assurance Companies Acts 1870 to 1872 and to extend the regulatory regime to cover also fire, accident and employers' liability insurance and bond investment business.

18 The principles set out in the resulting Assurance Companies Act 1909 were essentially the same as in the 1870 Act. Separate funds were to be maintained for each class of general insurance business, although separation of assets was not necessarily implied. A new certificate was introduced in which the company had to state that, where there was more than one fund, no part of any such fund had been applied directly or indirectly for any purpose other than the class of business to which it related.

19 The actuary's valuation statement, which now appeared in the Fourth Schedule to the Act, was only slightly modified from the format in which this had previously appeared in the 1870 Act, although separate statements were now required for ordinary branch business, industrial life assurance and sinking fund business. The same split was applied to the tabulation of business in force required under the Fifth Schedule to the Act.

20 The legislation continued to rely on 'freedom with publicity' and the Board of Trade was inclined towards non-interventionism. For much of the time this was a successful policy but there were a number of problem companies and a small number of life insurance company insolvencies. The first important failure to occur since the passing of the 1870 Act was the National Standard Life Assurance Company Limited, which was forced to wind up in 1916.

The post-war period and the early influence of Europe

21 The process of developing a single insurance market in Europe started within the Organization for European Economic Co-operation (OEEC), the predecessor of the OECD, in the mid 1950s. At this time an Insurance Sub-committee was established to explore ways in which the European insurance market might be opened up and international trade in insurance encouraged.

22 Reports were commissioned by the Sub-committee from Professor Campagne, which were produced in 1957 and 1961. These reports advocated the adoption of minimum standards for solvency of insurance companies, with Professor Campagne advocating minimum margins of solvency based on 25% of annual premium income for general insurance business and 4% of mathematical reserves[652] for life insurance business.

23 Following the establishment of the European Economic Community by the Treaty of Rome in 1957, the Conference of EEC Insurance Supervisory Authorities began to address the same problems as those already under consideration by the OEEC. The objective was to move as quickly as possible towards the ideal of a free market in insurance within the EEC. The first stage was to establish the credentials which insurance companies must demonstrate before being allowed to establish branch operations in other EEC countries and write business there.

[652] Mathematical reserves are based on a mathematical calculation of the basic reserves required to meet all prospective guaranteed liabilities, including additional measures of prudence.
[653] France, Germany, Italy, Belgium, Netherlands and Luxembourg.

24 The UK was closely involved in the OEEC/OECD developments, but not in the early EC discussions, which at that time concerned only the original 6 members.[653] In the course of the 1960s, UK representatives attended three active OECD Committees on insurance matters.[654]

Market turmoil in the 1960s

25 The 1960s saw some significant developments in the insurance market in the UK. On the life insurance side there were some noteworthy new products, in particular the beginnings of unit-linked business and various types of guaranteed income bonds. Pension business was also beginning to grow strongly, subject to a variety of constraints imposed by the Inland Revenue. A number of new insurance companies began to spring up to exploit these opportunities.

26 In general insurance there was an intensification of competition, with a number of new motor insurance companies trying to enter the market. The fraudulent activities associated with the demise of Fire, Auto and Marine raised concerns within Government circles; as did the collapse of Vehicle & General in the late 1960s, which led to a substantial inquiry conducted by the Board of Trade.

27 During the mid to late 1960s the Board of Trade had sought advice from ASTIN, the general insurance section of the International Actuarial Association, and from a leading UK general insurance actuary (Bobby Beard), on how to make material improvements to the information available to the prudential regulator concerning general insurance companies. This led to the general insurance sections of the Insurance Companies (Accounts and Forms) Regulations 1968 and, in particular, to the requirement for general insurance companies to supply information, by each year of origin, relating to the year by year settlement of claims and the amounts estimated to be outstanding.

Part II – the introduction of the 1973 Act

28 At the beginning of the 1970s, the prudential regulation of life insurance business still relied fundamentally, as it had done for 100 years, on the company actuary, whose responsibility it was to value the liabilities and to ensure the adequacy of the assets constituting the long-term business fund to cover the liabilities and to give a good return to the with-profit policyholders. However, under regulations which had been introduced in 1958 and remained in force into the 1970s, a full actuarial valuation was only required every 3 years, with a simple certificate from the actuary in the intervening years to confirm the adequacy of the long-term business fund.

The Appointed Actuary

29 The Insurance Companies (Amendment) Act 1973 introduced for the first time the concept of the 'Appointed Actuary'. The idea was to upgrade the statutory requirement for an actuary to carry out a valuation of the assets and liabilities every 3 years, and an approximate valuation each year, into a requirement to designate a specific professional person within the company (the Appointed Actuary) who could be relied on by the prudential regulator to monitor the financial position of the company on a continuous basis.

30 The provisions in the 1973 Act, which were consolidated into the Insurance Companies Act

[654] The Buol Committee on life insurance technical reserves; the Homewood Committee on general insurance technical reserves; and the de Florinier Committee on solvency margins. The latter made little progress, since it awaited the outcome of the other two committees; Buol reported in 1972.

1974, did not specify in any detail the role which the Appointed Actuary was intended to fulfil. However, discussions took place with the UK actuarial profession, which agreed to issue guidance to its members on how to fulfil the responsibilities of the Appointed Actuary to a life insurance company. A Joint Committee (of the Institute of Actuaries and the Faculty of Actuaries) on Financial Standards drew up the first draft of the guidance (entitled *'Actuaries and Long-Term Business'*), which was issued in May 1975. This later came to be known as GN1 (Guidance Note 1), being the first of what was to become an extensive series of guidance notes for actuaries involved in different areas of professional activity. Compliance with GN1 was mandatory.

31 When the Appointed Actuary system was introduced, there was no requirement for a life insurance company to hold an explicit solvency margin. It was, however, regarded as the professional responsibility of the Appointed Actuary to monitor the overall financial position of the company and to ensure that the size of the long-term business fund, and the way in which it was invested, were such as to ensure that the future liabilities of the company towards policyholders, including meeting their reasonable expectations (as to which see below), could be met with a high degree of probability. The 1973 Act required the Appointed Actuary to carry out a formal investigation into the financial condition of the company once a year. In addition, the profession made it the Appointed Actuary's duty to monitor the financial position on a continuous basis. Thus, GN1 stated that the Appointed Actuary was to take all reasonable steps to ensure that he was, at all times, satisfied that if he were to carry out an investigation the position would be satisfactory.

32 A cornerstone of prudential regulation thus became reliance on the Appointed Actuary, who was close to the company and had a professional responsibility to monitor its financial position on a day-to-day basis and to establish prudent mathematical (or technical) reserves. There was no regulation of policy conditions or premium rates, since this was seen to be properly the responsibility of the company, acting on the advice of its Appointed Actuary, and it was considered that regulatory intervention would inhibit competition. Having the Appointed Actuary at the heart of the company (with full right of access to the Board, which was a requirement of GN1) was intended to provide protection for policyholder interests, as well as a strong internal system of financial control and risk management. This structure was reflected both in the legislation and associated regulations and in the extensive mandatory professional guidance to which Appointed Actuaries were subject.

33 Each new Appointed Actuary was invited, following the notification to the prudential regulator of their appointment, to come for a meeting with the Government Actuary. Such meetings were informal in nature, being an opportunity to establish personal contact and to discuss the nature of the Appointed Actuary's relationship with the Board and other senior executives of the company. The agenda ranged over each of the areas covered by GN1, such as product design, premium setting, investment policy, valuation and data systems, and sought to explore what influence the Appointed Actuary expected to be able to bring to bear in each area and what arrangements had been put in place to ensure that the Appointed Actuary was able to comply with GN1.

34 It is worth noting that this system of regulation has been widely recognised as successful, and many other countries around the world have introduced variants of the Appointed Actuary system. This includes a number of European countries (e.g. the *verantwortlicher Aktuar* in Germany and Switzerland, and the Appointed Actuary in Belgium, Denmark, Italy and the Republic of Ireland).

Introduction of PRE

35 Another new feature of the 1973 Act was the first mention in statute of the term *'policyholders' reasonable expectations'* ('PRE'), although the term was not specifically defined. The origins of this term, in its application to life insurance regulation, are thought to lie in a paper which Ronald Skerman, then Chief Actuary of Prudential, prepared for discussions in Europe and which was then tabled at a discussion at the Institute of Actuaries in the mid 1960s. His purpose was to articulate the criteria for a solvency test of a life insurance company. He argued that provision should be made within the determination of the company's liabilities for ensuring that the *'reasonable expectations of policyholders'* were met.

36 The 1973 Act gave the prudential regulator the power to intervene in the affairs of a company if there were grounds to believe that PRE were not being met. One of the Government's main policy concerns when considering the 1973 legislation was that the Boards of proprietary life insurance companies might favour the interests of shareholders over and above the interests of policyholders by 'milking' the surplus accruing in the long-term business fund for the shareholders' benefit. The concept of PRE was therefore introduced, at least in part, to enable the interests of policyholders to be protected beyond their strict contractual entitlements.[655] A further purpose was to support a regulatory requirement for the use of a *net premium valuation*, which had the effect of preventing a life insurance company from treating the bonus loadings in the premiums as an immediate contribution to surplus and supporting the gradual declaration of reversionary bonuses in an appropriate way over the duration of each policy. Thus PRE, in its original intention, was not concerned with the expectations of different cohorts of policyholder interests within a mutual life insurance company.

37 The notes on clauses presented to Parliament when the Bill was introduced show the intentions of Ministers in this regard. These notes explained that the new power of intervention on grounds of PRE would only be exercised *'where it was obvious that PRE were not going to be fulfilled'*, and that this would *'stop well short of seeking to ensure that with-profit policyholders received value for money under their contracts or a particular level of bonus... regardless of the amount of surplus revealed by the periodic actuarial valuation'*[656]. This is consistent with statements made by a senior DTI official at the time that Ministers had accepted that *'no system we could contemplate would eliminate the occasional failure or give absolute protection'* and that the aim should be to give policyholders *'a reasonable measure of protection'*, his view being that which prevailed when the matter was passed to the Parliamentary Under Secretary of State. These sentiments strongly echoed those of Sprague, advocated 100 years earlier.

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655 DTI minute dated 3 November 1971; instructions dated 29 September 1972 to departmental lawyer; and paragraphs 18 and 19 of instructions to Parliamentary Counsel.

656 See the notes on clauses to the Bill.

38 Consistent with this, Ministers took the decision when the 1973 Act was being drafted that regulation of life insurance companies by the prudential regulator would be based principally on an analysis of companies' annual regulatory returns, in the case of life insurance companies to be in large part carried out by GAD as actuarial adviser to the prudential regulator, and that any regulatory action taken on PRE grounds would be reactive to what was found in the regulatory returns. In substance, the responsibility for proper treatment of PRE devolved on the Appointed Actuary, This responsibility was reflected in a number of specific provisions relating to PRE being included in GN1.

39 A further indication of what was intended by Ministers in relation to PRE is provided by a speech made by the Minister of State to the Faculty of Actuaries on 16 February 1976, when he said:[657]

> *What expectations might be reasonable, in any particular case, will have to be determined in the light of the circumstances, but it is certainly our expectation that companies which charge large premiums, with a loading for bonuses, will, in fact, make profits to be shared with their policyholders, and will not take credit for the value of future bonus loadings so that they can hold smaller reserves than would a non-profit company. On the other hand, we do not envisage any general intervention in the determination of the amount of surplus to be disclosed by companies, or the manner in which it is distributed between policyholders of different generations or different classes. We would hope that this could continue to be left to the directors, acting on the advice of their Actuaries, particularly in view of the strengthening of the Actuary's role in the legislation and of the description of that role in the joint guide, which is the main subject of this evening's discussion.*

40 Pursuant to the 1973 Act, statutory regulations were passed, identifying the content of the regulatory returns, and also the basis upon which assets were to be valued. There were initially no substantive rules regarding the valuation of liabilities, but such rules were introduced in 1981.

41 Whilst the 1973 Act marked a significant increase in the extent of prudential regulation, the fact that the regulatory regime did not guarantee zero failure was underlined by the collapse of Nation Life in 1974, and by a clutch of other small life insurance companies getting into difficulty in 1974: Lifeguard, Capital Annuities and London Indemnity & General. These events had their origin before the introduction of the 1973 Act, however, and they were in fact a significant factor leading to the development of the Act. They also gave added impetus to the development of professional guidance to Appointed Actuaries on how to fulfil their responsibilities after the Act had been put in place.

Part III – the introduction of the 1982 Act and the regulatory regime imposed

The First Life Directive

42 The Insurance Companies Act 1981 and the subsequent Insurance Companies Regulations 198[658] ('ICR81') were designed to implement the First Life Directive,[659] which had been adopted by the EC in 1979. The Insurance Companies Act 1981 was then consolidated into the Insurance

[657] 17 Hymans J C S and Donald D W A (1976) Actuaries and long-term insurance business. Transactions of the Faculty of Actuaries, 34, 113-136.
[658] SI 1981 No 1654.
[659] Council Directive 79/267/EEC.

Companies Act 1982, along with the pre-existing regulatory regime introduced under the 1973 Act. To understand the regulatory framework that was put in place by the 1982 Act, it is therefore important to understand the reasons for and the scope of the First Life Directive.

43 As the first recital of that Directive made clear, its aims were to open up the life insurance market to the extent of allowing companies from one EC member state to establish a branch in another member state: 'freedom of establishment'. Consistent with this, the Directive sought to eliminate certain divergences that existed in national legislation concerning the prudential regulation of life insurance companies, and to coordinate the financial obligations required of life insurance companies. It specified the classes of business for which companies must obtain authorisation and also set out some minimum conditions for the granting (and withdrawal) of authorisation.[660]

44 The Directive required the establishment of technical reserves in respect of the liabilities arising from the whole of a company's in force business, and for these to be covered by equivalent and matching assets localised in the country where the business was written.[661] The calculation of the technical reserves, and the valuation of assets, including restrictions on the extent to which different assets could be used to match the technical reserves, were to be carried out in accordance with rules laid down in national regulatory legislation. A formal valuation was required to be carried out, and the results of this to be submitted to the prudential regulator, on an annual basis.[662]

45 The Directive also introduced a requirement for companies to maintain an explicit margin of assets over liabilities, referred to as the solvency margin, to reduce the risk of insolvency and to provide a cushion against adverse business fluctuations.[663] The required solvency margin was calculated on a prescribed basis[664] that was intended, in a very broad-brush way, to reflect the risks to which a company's capital was exposed; and was subject to an overall minimum called the minimum guarantee fund.[665]

46 The required solvency margin could be represented by explicit items and (to a limited extent and subject to the consent of the prudential regulator) by implicit items. Explicit items included capital, free reserves and surplus in the company's balance sheet. Implicit items included hidden reserves such as undisclosed undervaluation of assets[666], items relating to zillmerising[667]; and, in the case of life insurance companies, the present value of future profits[668]. The mechanism used in the UK to grant consent for, and give effect to, an implicit item in a particular case was the issuance by the prudential regulator of an order under section 57 of the 1974 Act (and subsequently section 68 of the 1982 Act)[669].

660 Articles 1 and 6. In particular, the submission of a 'scheme of operations' as set out in Article 8.2.
661 Article 17.
662 Article 23.
663 Article 18.
664 Set out in Article 19. The 4% of mathematical reserves recommended by Professor Campagne was adopted by the Directive, along with 0.3% of capital at risk.
665 See Article 20.
666 See Article 18(3)(c).
667 See Article 18(3)(b).
668 See Article 18(3)(a).
669 Regulation 10(4) of ICR81.

47. The Directive provided prudential regulators with limited powers of intervention in certain circumstances. In particular, prudential regulators were authorised: (i) if a company was unable to establish sufficient localised technical reserves, to prevent the free disposal of assets within a Member State;[670] (ii) if a company was unable to cover its required solvency margin, to require the submission of a plan for the restoration of a sound financial position;[671] and (iii) if a company's solvency margin fell below the guarantee fund[672], to require the submission of a short-term finance scheme and prevent the free disposal of assets.[673] The Directive also provided that, in the first and third cases, the prudential regulator might take all measures necessary to safeguard the policyholders' interests.

48 Furthermore, the Directive allowed prudential regulators to withdraw authorisation (thus requiring a company to close to new business) if: (i) the conditions for admission were no longer fulfilled;[674] (ii) the company had been unable to take the measures in any restoration plan or finance scheme that it had submitted to the prudential regulator;[675] or (iii) the company failed seriously in its obligations under the national regulations[676]. Any decision to withdraw authorisation or suspend business had to be supported by precise reasons from the prudential regulator; and provision had to be made to allow the life insurance company to apply to the court to challenge any such decision.[677] Furthermore, pursuant to Article 21 of the Directive, the prudential regulator was prohibited from preventing the disposal of assets, save in certain exceptional circumstances (such as where regulatory solvency had been breached; or the company was to be closed to new business).

49 From this it can be seen that one of the consequences of the First Life Directive was the introduction of a prudential regulatory regime across Europe that adopted a similar approach to regulation as had previously existed in the UK: with powers of intervention that were narrowly circumscribed, in order to avoid excessive regulatory requirements impeding the development of a single market in insurance within Europe. As set out further below, this approach was subsequently strengthened, at a European level, by the introduction of the Third Life Directive (under which, amongst other things, requirements for prior approval by the prudential regulator of products and premium rates were prohibited).

The Insurance Companies Act 1982

50 The provisions of the First Life Directive were incorporated into UK legislation by the Insurance Companies Act 1981, which was subsequently consolidated into the Insurance Companies Act 1982.

Continuation of the Appointed Actuary scheme

51 As under the previous legislation, the 1982 Act (by section 19) required each life insurance company to appoint an actuary, known as the Appointed Actuary. The appointment of an Appointed Actuary had to be notified to the prudential regulator within 14 days of its having been made. Regulatory approval was not required for the

[670] See Article 24(1).
[671] See Article 24(2).
[672] Defined in Article 20 as one-third of the required solvency margin, subject to a minimum of the minimum guarantee fund.
[673] See Article 24(3).
[674] See Article 26(1)(a).
[675] See Article 26(1)(b).
[676] See Article 26(1)(c).
[677] See Article 26(3).

actuary's appointment; nor did the prudential regulator have power to oppose the appointment of a particular individual or to seek an actuary's removal;[678] nor was there any statutory prohibition on the Appointed Actuary holding any other office within the company.[679] However, section 96(1) of the 1982 Act made it clear that an Appointed Actuary had to hold 'prescribed qualifications', which included a requirement that the actuary must have attained the age of 30 and be a Fellow of the Institute of Actuaries or the Faculty of Actuaries; subsequently it became a requirement of the UK actuarial profession that an Appointed Actuary must hold a 'practising certificate' from the Faculty and Institute of Actuaries. It also remained established practice for the appointee to be interviewed by the Government Actuary on first appointment.

52 Section 18 of the 1982 Act required the Appointed Actuary to make an annual investigation of the company's financial condition. The report, which would normally be presented to the Board, had also to be included in abstract in the company's regulatory returns.[680] The investigation was to include a valuation of liabilities of the company attributable to its life assurance business; and a determination of any excess over those liabilities of the assets representing the fund or funds maintained by the company in respect of that business.[681]

53 Provision was made in the 1982 Act for the basis of valuation of liabilities and assets and the form of the abstract of the Appointed Actuary's valuation report to be set out in delegated legislation. This was subsequently done in ICR81 and the Insurance Companies (Accounts & Statements) Regulations 1983[682] ('ICASR83'). The latter were a modified version of the earlier reporting requirements and included Schedules carried over from the former primary legislation. The abstract of the Appointed Actuary's valuation report, for example, now appeared in Schedule 4 to these regulations.

54 The determination of liabilities regulations in ICR81 were developed by means of a joint consultative process between DTI, GAD and the UK actuarial profession. As noted above, these were new, no valuation of liabilities regulations having previously been promulgated under the 1973 Act. The Joint Actuarial Working Party (JAWP) was established, with members from GAD and from the profession, chaired by the Government Actuary. DTI had the status of observer, so as to retain its independence of action in drafting the regulations and avoid being irrevocably committed to the recommendations coming from JAWP. The discussions in JAWP made it possible for the leadership of the profession better to understand DTI and GAD's concerns. They also allowed DTI and GAD to obtain feedback on the potential effect of the regulations, and a degree of 'buy-in' from the profession to what was being proposed.

55 Section 22 of the 1982 Act required each life insurance company to submit the abstract of the Appointed Actuary's valuation report to the prudential regulator each year (the regulatory returns), along with the annual report and accounts required under the Companies Acts (the Companies Act accounts). As noted above, the

678 Contrast the position in relation to the managing director or chief executive where, pursuant to section 60(3) of the 1982 Act, the prudential regulator could object to the appointment of either officer on 'fit and proper' grounds, subject to certain procedural requirements.
679 Contrast the position of general representatives for foreign applicants, who were expressly prohibited from holding the office of auditor to the proposed life insurance company pursuant to section 10(4) of the 1982 Act.
680 Section 18(1)(b).
681 Section 18(2).
682 SI 1983 No 1811.

content of the regulatory returns was prescribed by delegated legislation, and these tended to be considerably longer and more detailed than the Companies Act accounts (during the latter half of the 1990s those for Equitable Life ran to some 400 pages for each year).

56 The regulatory returns were the main source of information from which the prudential regulator, acting on advice from GAD, formed a view as to a life insurance company's current and future regulatory solvency.

Principal regulatory actuarial and accounting provisions

57 Section 32 of the 1982 Act required life insurance companies to hold assets which exceeded their liabilities by at least the margin prescribed by ICR81. That was known as the required margin of solvency and had in principle to be maintained throughout the year, not just at year-end, although it was normally only required to be demonstrated at the year-end. Ensuring continuous solvency was a responsibility of the Appointed Actuary. In accordance with the First Life Directive, in the event that a life insurance company failed to meet the required solvency margin: (i) the prudential regulator could require the company to submit a plan for the restoration of a sound financial position; (ii) the prudential regulator could require the company to modify any such plan; and (iii) the company then had to give effect to that plan.[683]

58 Pursuant to ICR81 the technical reserves were to be calculated in accordance with generally accepted actuarial methods and assumptions, as prescribed by the regulations, and the required solvency margin, the guarantee fund and minimum guarantee fund were to be calculated on the basis laid down in the First Life Directive.[684] Regulation 54 of ICR81 provided that the determination of life insurance business liabilities should be made on prudent actuarial principles, and should make proper provision for all liabilities on prudent assumptions with regard to the relevant factors. Initially there was no explicit statutory requirement that such liabilities be assessed having regard to PRE. However, the *net premium valuation* method was prescribed in regulation 57, using cautious assumptions, and under regulation 59(6) it was not permitted to take into account expected future returns on equities in excess of the current dividend or rental yield. These requirements, taken together with the applicable valuation of assets regulations, meant that implicit provision was appropriately made for future bonuses including future terminal bonuses. More explicit reference to PRE was made in amendments to the determination of liabilities regulations introduced in 1994. Zillmerisation[685] of the reserves was permitted (but not required) under regulation 58. The ICR81 requirements as to the valuation of life insurance business were amplified after their introduction by another mandatory professional guidance note, GN8 (entitled 'Additional Guidance for Appointed Actuaries on Valuation of Long-term Business').

Prudential regulator's powers of intervention

59 Under section 11 of the 1982 Act, the prudential regulator had the power, either at the request of the company or on any of certain specified grounds, to issue a direction withdrawing a company's authorisation to conduct new business. The specified grounds were: (i) that it appeared to the prudential regulator that the company had failed to

683 See Section 32(3).
684 See Regulations 5 and 9 of ICR81.
685 Zillmerisation was a technique that could be used for regular premium policies to spread the initial costs incurred in writing the policy over the duration of the contract in proportion to the premiums due. It operated by means of an increase (subject to specified limits) in the future regular premiums for which credit was taken in the net premium valuation.

satisfy an obligation to which it was subject by virtue of the Act (for example, failure to maintain the required margin of solvency pursuant to section 32);[686] (ii) that there were grounds on which the prudential regulator would have been prohibited from issuing authorisation to the company (for example, if share capital was not fully paid up; or the directors, controllers, managers or main agents of the company were not 'fit and proper' persons);[687] or (iii) that the company had ceased to be authorised to effect contracts of insurance in the country where its head office was situated.[688]

60 In accordance with the First Life Directive, before giving a direction to the company under section 11 of the 1982 Act, the prudential regulator had to serve on the company a written notice stating that it was considering giving a direction and the grounds on which this was being considered.[689] The company could, within one month of that notice being served, make written (or, if the company requested, oral) representations to the prudential regulator. The prudential regulator was then required to take those representations into account before giving a direction.[690]

61 In addition to the power under section 11 of the 1982 Act to withdraw authorisation from a life insurance company, section 37 provided that the prudential regulator could intervene (using a range of powers set out in sections 38 to 45 of the Act) in a limited number of circumstances. In particular, those circumstances included:

(1) If the company had failed to satisfy an obligation to which it was subject by virtue of the 1982 Act (for example the failure to maintain the required solvency margin in accordance with section 32);[691]

(2) If the company had furnished misleading or inaccurate information to the prudential regulator;[692]

(3) If no adequate arrangements were in force or would be made for the reinsurance of insured risks (where the prudential regulator considered that such a class of risks should be reinsured);[693]

(4) If there were grounds on which the prudential regulator would have been prohibited from issuing authorisation to the company: for example if share capital was not fully paid up; or the directors, controllers, managers or main agents of the company were not 'fit and proper' persons. (However, before exercising any powers on the grounds of unfitness or impropriety of certain persons, the prudential regulator had to give notice to that person and allow them to make representations which then had to be taken into account);[694]

(5) If the company had substantially departed from any business proposal submitted at the time it sought authorisation;[695] and

686 Section 11(2)(a).
687 Section 11(2)(b) and section 7.
688 Section 11(2)(c).
689 Section 12(1) and (2).
690 Section 12(6).
691 Section 37(2)(b).
692 Section 37(2)(c).
693 Section 37(2)(d).
694 Section 37(2)(e) and section 48.
695 Section 37(2)(f).

(6) If the company had ceased to be authorised to effect contracts of insurance in the country where its head office was situated.[696]

62 In addition to these closely circumscribed grounds of intervention, there was a further general ground of intervention pursuant to section 37(2)(a): to protect policyholders or potential policyholders against a risk that a life insurance company might be unable to meet its liabilities, or to fulfil the reasonable expectations of policyholders or potential policyholders.

63 As with the 1973 Act, there was therefore an explicit statutory reference to the concept of PRE, although there was no statutory definition of this concept. The concept of PRE was subsequently the subject of a Faculty and Institute of Actuaries Working Party report, and guidance was provided by the DTI in a Ministerial statement in February 1995 (as to which see further below).

64 The powers of intervention given to the prudential regulator pursuant to sections 38 to 45 of the 1982 Act were also, for the most part, closely circumscribed. They included:

(1) a power, under section 38, to require a life insurance company not to make, or to realise, certain investments;

(2) a power, under section 41, to limit the aggregate premium income of the company;

(3) a power, under section 42, to require the Appointed Actuary to investigate all or a specified part of the company's business, and to publish an abstract of that investigation;

(4) powers, under sections 43 and 44, to accelerate deposit with the prudential regulator of the regulatory returns; and to obtain information or require the production of documents.

65 There was also a power, expressly described in the heading of the section as a 'residual power', contained in section 45 of the 1982 Act, which enabled the prudential regulator to take such action as appeared to be appropriate for the purpose of protecting policyholders or potential policyholders of a life insurance company against the risk that the company might be unable to meet its liabilities, or to fulfil the reasonable expectations of policyholders or potential policyholders.

66 Express limits were imposed on that residual power in order to comply with the First Life Directive.[697] Thus, section 45(2) of the 1982 Act provided that the power could not be exercised by the prudential regulator in such a way as to restrict a company's freedom to dispose of its assets (e.g. by preventing a distribution of assets to policyholders), except where: (i) the prudential regulator had exercised powers under section 11 to withdraw authorisation and close the company to new business; or (ii) the prudential regulator believed that the company had failed to maintain the required solvency margin; or (iii) where the company had submitted accounts which had not been prepared in accordance with valuation regulations or generally accepted accounting practices.

67 Other express limits were also imposed on the section 45 power of intervention by the 1982 Act. Thus section 37(6) made it clear that this power should only be used in the event that policyholder protection could not be appropriately achieved by

[696] Section 37(2)(g).
[697] In particular, Article 21(2).

the exercise of the prudential regulator's more specific powers as set out above. There was also an implied constraint on the use of this power, as recognised by the Parliamentary Ombudsman in her first report on the 'Prudential Regulation of Equitable Life', in that the exercise of intervention powers might bring about consequences which the prudential regulator would otherwise want to avoid, including the possibility of adverse consequences for policyholders.[698]

68 Finally, pursuant to section 54 of the 1982 Act, the prudential regulator could apply to wind up a company if (i) the company was unable to pay its debts as and when they fell due; (ii) the company had failed to satisfy an obligation to which it was subject by virtue of the 1982 Act (e.g. the obligation to maintain the required solvency margin in accordance with section 32); or (iii) the company had failed to keep proper accounts in accordance with its obligations under the Companies Acts. Further rules dealt with the continuation of life insurance business of insurance companies in liquidation, and made provision for the reduction of contracts as an alternative to winding up.[699]

Part IV – subsequent developments in the regulation of life insurance companies under the 1982 Act

The introduction of resilience testing

69 In 1985, the Government Actuary issued guidance to Appointed Actuaries on the interpretation of the requirement under regulation 55 of ICR81 to establish *'appropriate provision against the effects of possible future changes in the value of the assets on their adequacy to meet the liabilities'.* This required life insurance companies to be able to demonstrate that their reserves were sufficient to continue to comply with all the other determination of liabilities regulations after one of a series of shock scenarios affecting the value of the assets. The process of establishing the sufficiency of the reserves in such scenarios came to be known as 'resilience testing'. The hypothetical scenarios included an immediate fall of 25% in the value of equity investments (and a comparable fall in the value of property) and significant movements in fixed interest yields, either up and down. Monies set aside to ensure the company could cope with the adverse investment scenarios were known as the 'resilience reserve', albeit that part of the margins used to satisfy resilience tests could be met by crediting 'excess' margins held elsewhere within the overall valuation basis used to calculate the basic policy reserves.

70 The requirement for Appointed Actuaries to conduct such a resilience test was subsequently incorporated into GN8 but without specifying the scenarios to be considered. At the same time, GAD developed and kept under review guidelines as to the changes in equity prices and fixed interest yields that it might be prudent to take into account. The guidelines were published as letters (known as *'Dear Appointed Actuary'* or 'DAA' letters) sent to all Appointed Actuaries, the first such letter relating specifically to the resilience test being issued in July 1992.

71 While not mandatory, such guidance provided the de facto standard for prudent resilience testing. GAD would question Appointed Actuaries on whether the aggregate reserves they had established met this standard. DAA10 from the Government Actuary, issued on 24 November 1998, amended the benchmark scenarios for resilience test 2. It said that, while the revised test was

698 See *'Prudential Regulation of Equitable Life'*, Part II, paragraph 34.
699 See sections 56 and 58 of the 1982 Act.

necessarily more complex, it was intended to avoid the unreasonable stringency which might apply if equity markets fell below their current levels.

The introduction of the Second Life Directive, and further consideration of PRE

72 In 1990 the Second Life Directive[700] was adopted by the EC, and was implemented in the UK in 1993. This extended the freedom of establishment provided by the First Life Directive to 'freedom of services', whereby an insurance company established in one EC member state could sell its products on a cross border basis in other member states. However, such cross-border business remained subject to authorisation by the prudential regulators in those other member states if they so wished.

73 In 1990 DTI issued a consultation document which proposed ways in which the Appointed Actuary system could be strengthened and JAWP was reconvened at this time to review the effectiveness of the existing system and generally to take this process forward. This led in due course to the introduction of the practising certificate regime by the UK actuarial profession and the setting up of various research initiatives within the profession. These included the establishment of professional working parties, on which GAD was represented, 1) to consider the meaning of PRE, 2) to investigate alternatives to the net premium method of valuing liabilities as the statutory minimum valuation basis and 3) to review the impact of guarantees within annuity contracts. The first working party reported in 1993 and the latter two towards the end of the 1990s; all three are mentioned further below.

74 It will be recalled that the concept of PRE had been first introduced in the 1973 Act, and re-enacted in the 1982 Act; and although there had been some Ministerial statements about the content of PRE when the 1973 Act was introduced, no statutory definition of what constituted PRE had been given.

75 It was generally accepted within the UK actuarial profession and the life insurance industry that PRE extended beyond the expectation simply that contractual liabilities or other legal rights would be met. Most with-profits policies contain some element of discretionary annual reversionary bonuses and also terminal bonuses, and it was seen as reasonable that holders of such policies should expect companies to behave fairly and responsibly in exercising their discretion to distribute such discretionary bonuses in a reasonably consistent way. For with-profits business, the profession developed the concept that policyholders were entitled to expect that benefits would, at least broadly, reflect their 'asset share' (effectively the proportion of the fund attributed to each policyholder[701]).

76 Over time asset share (subject to a smoothing process, that is averaging out the peaks and troughs of stock market movements) came to be regarded by the life insurance industry as providing the starting point for determining what the total benefit payable at maturity should be. If policyholders received something like their asset share, then PRE could generally be said to have been fulfilled. DTI did not fully accept this argument, mainly because it was usually a precursor to life insurance companies arguing that, once PRE according to this definition had been delivered to policyholders, the rest of the surplus could be

700 Council Directive 90/619/EEC.

701 More precisely, 'asset share' represents the actuarially adjusted accumulated value of premiums paid, less deductions for expenses, tax and other charges, plus allocations of business profits or losses, accumulated at the actual rate of investment return achieved.

allocated to shareholders. It was also the case that the policy wording of many with-profits contracts went much wider than this in promising bonuses not only in respect of the surplus emerging on the with-profits business but also a share in the profits emerging from the non-profit business.

77 Under pressure to give more guidance to the life insurance industry on how PRE should be interpreted, the prudential regulator always took the line that this was a matter for the Courts to decide. However, there were no test cases. Following on from discussions on PRE in JAWP, the UK actuarial profession set up a PRE working party. This sat between 1990 and 1993 and reported in that year. It carried out a series of interviews with Appointed Actuaries and attempted to distil principles.

78 Consistent with the prudential regulator's view that the interpretation of PRE was a matter for the courts to decide, no formal guidance was issued following the working party's recommendations. However, some of the principles identified still served to inform Appointed Actuaries as they prepared reports for their Boards. The working party's report indicated that, for with-profits business, policyholders were entitled to expect that the total benefits paid under the contract would reflect the accumulated value of premiums paid less expenses and the cost of risk benefits in accordance with the actual experience of the company. Thus, asset share would provide the starting point for determining maturity benefits. The degree to which returns were smoothed over time, and the extent to which part of the asset share was retained to finance future expansion, would vary considerably between companies. It was reasonable to expect that a company would change its policy in these areas only gradually; a sudden move from a passive to an active terminal bonus policy could be considered unreasonable.

79 Some case history began to be built up subsequently from agreements that life insurance companies reached with DTI to restructure their long-term business fund, merge ordinary business and industrial business or demutualise. One early case of a company trying to extract shareholder value by attributing a significant part of the 'inherited estate' to shareholders (the *United Friendly* case) involved detailed discussions between DTI and that company as to how section 30[702] of the 1982 Act should apply to it, and led to DTI obtaining legal advice from counsel regarding the balance of interest of shareholders and policyholders in that company's inherited estate. The prudential regulator's view of PRE was further developed subsequently from numerous demutualisations which took place during the 1990s, and from other life fund restructurings (for example, the relatively recent *Axa* case in 2000; and the earlier *London Life* case, in respect of which a court judgment was given which considered the competing interests affecting policyholders in a transfer of business).

80 Following on from the *United Friendly* case, a Ministerial statement on the subject of PRE was made by Jonathan Evans, the Consumer Affairs Minister, on 27 February 1995. This set out the view of DTI of the factors which influenced PRE in respect of the attribution of surpluses in with-profits funds (albeit in the specific context of an inherited estate and with regard to shareholders' expectations in a proprietary company, rather than PRE between policyholders in mutual companies). These factors were: the fair treatment of policyholders vis-a-vis shareholders; any statements made by the company as to its bonus

702 Section 30 imposed restrictions on the amount by which the proportion of the total distributed surplus allocated to policyholders could be reduced between successive valuations.

philosophy and the entitlement of policyholders to a share in profit (for example, in its Articles of Association or in company literature); the history and past practice of the company; and general practice within the life insurance industry.

81 GN1 contained a number of specific provisions relating to PRE. It made it clear that an important aspect of the Appointed Actuary's role was the duty to advise the Board on the interpretation of PRE. In general terms, it required such advice to have regard to the broad nature of the company and its approach to the treatment of policyholders both individually and (where appropriate) as a group vis-a-vis shareholders. When a significant change of approach was likely to take place, the Appointed Actuary was required take all reasonable steps to ensure that the company appreciated the implications for PRE. It was also incumbent on the Appointed Actuary to take all reasonable steps to ensure that the company's incoming policyholders should not be misled as to their expectations.

82 With regard to bonus declarations, the Appointed Actuary had to justify any recommendations regarding the allocation of profits and its consequences (if any) for the conduct of the company's business, by reference, as appropriate, to the Appointed Actuary's interpretation of the reasonable expectations of the company's policyholders, having regard to: (a) his appraisal of the relevant experience; (b) his understanding of the company's financial and business objectives; and (c) his assessment of the company's continuing ability to meet its statutory solvency requirements. Such expectations were influenced by policy literature and other publicly available information, such as own expense charge illustrations.

83 The Appointed Actuary was to assume, among the conditions for the fulfilment of these expectations: (i) that, in the recognition and allocation of profits in accordance with the company's terms of participation and its policy in respect of the nature and timing of allocations of profits, groups of with-profits policies were appropriately and equitably distinguished having regard, inter alia, to the terms of the policies, their duration and their relevant pooled experience; and (ii) that the company conducted its affairs, including its new business and investment strategies, with due regard to its financial resources.

84 The Appointed Actuary also had specific responsibilities under GN1 with respect to terminal bonus. In particular, the Appointed Actuary was required to include in his report to the Board on the statutory valuation comments on bonus prospects, with particular reference to the projected development of outgo on, and asset cover for, unreserved terminal bonus in different investment scenarios.

85 It was a statutory requirement for the Appointed Actuary to list in the regulatory returns the professional guidance notes that had been complied with. Compliance with GN1 was a mandatory professional requirement.

86 Equitable Life had a particular approach to asset shares and equity between policyholders, which was the subject of a paper presented to the Institute of Actuaries for discussion at a sessional meeting in March 1989.[703] This extended the concept of asset shares to say that, as a mutual company, Equitable Life could only achieve full equity between policyholders by allocating bonus in such a way as to give each cohort of members their 'effective asset share'.

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703 Ranson R H and Headdon C P (1989) With profits without mystery. *Journal of the Institute of Actuaries*, 116, 301-345.

The introduction of the Third Life Directive

87 In 1992 the Third Life Directive[704] was adopted by the EC, and was implemented in the UK in 1994.

88 The Third Life Directive further harmonised national legislation in order to provide for the mutual recognition of authorisation and prudential control systems for life insurance companies.[705] This made it possible to grant a single authorisation valid throughout the EC and apply the principle of prudential regulation by the home member state. The prudential regulator in a member state in which a company authorised in another member state operated was no longer permitted to exercise control over the company's operations in its state. The Directive thus completed the process of securing full freedom of services, which was the ultimate objective of the single insurance market.

89 The Directive required the calculation of the technical reserves of a life insurance company to be based on actuarial principles, common to all member states, and as recommended by the *Groupe Consultatif des Associations d'Actuaires dans les Pays des Communautés Européennes*. These principles included limiting the rates of interest that could be used in the valuation, but did not prescribe the valuation method to be used, the choice of which was left open to member states to decide.[706] The Directive introduced a requirement for 'admissibility limits' in relation to assets but prevented member states from requiring companies to invest in particular assets. It amended the asset matching and localisation rules introduced by the First Life Directive so that these applied across all member states.[707] It also permitted the required solvency margin to be covered (within limits and subject to specified conditions) by subordinated loan capital (and cumulative preference share capital) for the first time[708]. This was not subject to the consent of the prudential regulator under the Directive but such consent was nonetheless made a requirement in the UK, again implemented by means of the issuance by the prudential regulator of an order under section 68 of the 1982 Act.

90 The Directive prohibited the prior approval by the prudential regulator of products or premium rates,[709] instead relying on the required solvency margin, the rules concerning the technical reserves and the valuation of assets, and other prudential provisions, to afford adequate protection to policyholders. It established minimum requirements for information provided to potential policyholders at the point of sale,[710] and introduced various provisions intended to protect the 'general good' of policyholders. Whilst the Third Life Directive permitted member states to impose explicit reserving requirements for terminal bonus, it did not require this[711], and it remained the norm throughout the EC instead to adopt the UK approach of using a net premium valuation and prudent interest rate assumptions for valuing the liabilities, which, taken together with appropriate valuation of assets regulations, made implicit provision for future terminal bonuses (to the extent that these existed in other member states)[712].

704 Council Directive 92/96/EEC.
705 See in particular Recital 5 of the Third Life Directive.
706 See Article 18, amended Article 17(1)B.
707 See Article 18, amended Article 17(3) and Annex 1.
708 See Article 25(1).
709 See Articles 29 and 39.
710 See Annex 2.
711 See Article 18, Amended Article 17(1)D.
712 See paragraph 58.

91 The provisions of the Third Life Directive in part reflected extensive lobbying undertaken by DTI and GAD throughout the EC in the early 1990s, advocating a more flexible approach to prudential regulation of life insurance companies, which placed greater emphasis on a principles-based approach rather than the very detailed and prescriptive rules which had been used previously by the prudential regulators in a number of member states and by their companies and their actuaries. This lobbying had also sought to explain and promote the Appointed Actuary system as an effective mechanism for allowing such an approach to prudential regulation of life insurance companies, in response to which a number of other EC countries adopted a variant of that system.

92 The provisions of the Third Life Directive were incorporated into UK legislation by way of amendment of the 1982 Act, and the replacement of ICR81 by the Insurance Companies Regulations 1994[713] ('ICR94'). Reporting requirements were also updated with the replacement of ICASR83 with the Insurance Companies (Accounts & Statements) Regulations 1996[714] ('ICASR96').

93 The degree of amendment introduced by these new regulations was in practice relatively modest, reflecting the fact that the old regulations already contained many of the provisions now required by the Third Life Directive. However, significantly, regulation 64 of ICR94 for the first time expressly required the Appointed Actuary to take account of PRE,[715] when assessing a life insurance company's liabilities for the purpose of preparing the regulatory returns; and this was accompanied by new disclosure requirements introduced by paragraph 6(1)(b) of Schedule 4 to ICASR96. Furthermore, a non-exhaustive list of factors to be taken into account in determining the life insurance business liabilities was set out in ICR94, which included: (i) all guaranteed benefits, including guaranteed surrender values; (ii) vested, declared or allotted bonuses to which policyholders were already entitled; (iii) all options available to the policyholder under the terms of the contract; and (iv) expenses including commissions.[716]

94 Some other significant changes were also made to both the 1982 Act and the regulations at this time. A list of 'criteria of sound and prudent management' was introduced into the 1982 Act, together with a requirement for these to be met as a pre-requisite for authorisation[717]. Several new powers of intervention for the prudential regulator were introduced including a power to conduct general investigations[718], and the grounds for the exercise of intervention powers was broadened to include a breach of the criteria of sound and prudent management[719]. Explicit requirements relating to both the adequacy of assets and the adequacy of premiums for life insurance business were also introduced[720]. A significant change introduced by ICASR96 was a new requirement for the regulatory returns to include a 'matching rectangle'[721], which enabled the prudential regulator and GAD to check more easily compliance of the rates of interest used in the valuation with regulation 69 of ICR94.

713 SI 1994 No 1516.
714 SI 1996 No 943.
715 See Regulation 64(1). Contrast the previous provisions of ICR81, Regulation 54.
716 See Regulation 64(3). This effectively implemented Article 18, Amended Article 17(1)A(i).
717 Sections 5(1A), 5(4) and Schedule 2A.
718 Section 43A.
719 Section 37(2)(aa).
720 Sections 35A and 35B.
721 Form 57.

95 Successive changes were also made subsequently to ICR94 in particular. These regulations were amended 8 times during the period 1994 to 2000. Amendments made in 2000 included a significant change to regulation 72, the effect of which was that the reserve held for any policy could not be less than the amount which could reasonably be expected to be paid under an option available to the policyholder to secure a cash payment under the policy. For recurrent single premium contracts of the type written by Equitable Life this amount had to be calculated having regard to both the likely current surrender value and the discounted prospective value of benefits (allowing for expected future annual bonuses under the conditions prevailing at the valuation date)[722]. This amendment established for the first time an explicit reserving standard for contracts of this type, and implicitly (through the resilience test too) required some allowance to be included in the reserve for accrued terminal bonus.

96 Together the 1982 Act, ICR94 and ICASR96 (as successively amended) contained all the statutory provisions relating to the prudential regulation of insurance companies until the coming into force of the FSMA and the introduction of the Interim Prudential Sourcebook by the Financial Services Authority (FSA) on 1 December 2001. These were, however, supported by a number of other documents. These included guidance notes issued by the UK actuarial profession, in particular GN1 and GN8; a series of 'Prudential Guidance Notes' ('PGNs') issued by the prudential regulator to companies[723]; market letters (called 'Dear Director' letters) issued by the prudential regulator to companies; and Dear Appointed Actuary letters issued by the Government Actuary to Appointed Actuaries on specific reserving issues, including the resilience test (as to which see above).

Other developments in the 1990s

97 During the first half of the 1990s, GAD had actively promoted the value of encouraging life insurance companies to carry out dynamic financial analysis. This involved the testing of a company's ability to withstand possible future adverse conditions (in addition to those already required under the regulations and mandatory professional guidance to be considered in the resilience test), making use of cash flow projections on a variety of assumptions. Partly as a result of this encouragement, the UK actuarial profession introduced guidance note GN2 (entitled *'Financial Condition Reports'*) in March 1996.

98 A working party on the net premium method of valuation reported in the spring of 1998. The working party concluded that the net premium method of valuation continued to be an appropriate minimum standard for the valuation of conventional with-profits business for regulatory purposes. This was due to the fact that alternative valuation methods (which had been known about for many years and were widely reported in the actuarial literature) had associated problems, not least from a regulatory perspective, including the capitalisation of future profits. However, the working party recommended that the alternative gross premium method would be more appropriate for non-profit business, and that a new reserving standard should also be introduced for accumulating with-profit contracts. These recommendations were subsequently accepted by the prudential regulator and implemented through amendment of ICR94[724].

722 Regulation 72(4).
723 These included a number of PGNs interpreting 'sound and prudent management' in a variety of different contexts.

99 The annuity guarantees working party was established as current market annuity prices rose during the 1990s, and reported in November 1997. This working party identified a number of possible approaches to reserving for annuity guarantees in relation to with-profits business, which it 'set out for consideration'. These were:

(1) to allow for the guarantees in the same way as for unit-linked business, by setting aside additional reserves related to prudent estimates of the cost over and above existing, unadjusted with-profits business reserves;

(2) to recognise the cost of the guarantees as effectively increasing the guaranteed sum assured on a prudent basis and recalculating net premium reserves on that basis;

(3) to review whether, and to what extent, the guarantees could be covered by terminal bonus adjustments. Providing that such adjustments would be used and were sufficient to cover the guarantees in all circumstances, there was an argument for not reserving for such guarantees.

100 None of these approaches was deemed entirely satisfactory. The first was described as the 'most prudent' but would have an adverse impact on the reported level of cover for the required solvency margin. The second was arbitrary in its effect. The third (which was that which Equitable Life in fact adopted up to 1997) *'could be viewed as unsound because no explicit provision was made for an explicit guarantee'*. The report concluded that, with low interest rates and improving life expectancy (which compounded the effect of falling interest rates), companies would need to give careful consideration to how to reserve for the guarantees.

101 As part of its research, the working party conducted a survey of life insurance companies' actual current practices with regard to reserving for annuity guarantees. The responses provided to that survey were confidential. However, these prompted GAD, which had been represented on the working party, to recommend that the prudential regulator, through GAD, should conduct its own survey on annuity guarantees in June 1998. It was the response of Equitable Life to this survey which revealed its differential terminal bonus policy to the prudential regulator.

Part V – the changing identity of the prudential regulator, and its relationship with GAD

The relevant prudential regulator

102 Until 4 January 1998, DTI was responsible for the prudential regulation of insurance companies. Immediate responsibility rested with DTI's Insurance Directorate. This worked closely with GAD as its actuarial adviser.

103 Following the Government's decision to establish a single financial services regulator, the functions and powers which had formerly been carried out by DTI were transferred to HM Treasury (HMT) by the Transfer of Functions (Insurance) Order 1997[725]. From 5 January 1998 until 1 January 1999, HMT assumed direct responsibility for the prudential regulation of insurance companies. Staff in the former DTI Insurance Directorate temporarily joined HMT pending transfer to the Financial Services Authority. GAD continued to perform the same advisory role to HMT as it had done with DTI.

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724 The amendment introduced with respect to accumulating with-profit contracts is as described in paragraph 95.
725 SI 1997 No 2781.

104 Responsibility for the prudential regulation of insurance companies was, in most respects, contracted out to FSA from HMT with effect from 1 January 1999 (although some of the regulatory powers under the 1982 Act remained exercisable by HMT). The Contracting Out (Functions in Relation to Insurance) Order 1998[726] effected the transfer, backed by a Service Level Agreement between HMT and FSA. GAD continued to provide advice to FSA.

105 On 1 December 2001 the FSMA came into force, at which time FSA became the prudential regulator.

The relationship of GAD with the relevant prudential regulator

106 GAD began to provide actuarial advice on insurance matters to the prudential regulator in the 1960s. This included advice on individual companies, on new applications for authorisation to write life insurance business and on policy issues, either of a general nature or relating to the affairs of particular companies. This continued up to the transfer of the GAD actuaries involved in this work to FSA in April 2001.

107 Throughout this period, GAD acted solely as an adviser to the prudential regulator. All powers under the statute were retained by the prudential regulator, with GAD having no authority to instruct a company or its Appointed Actuary to take any actions, but only to provide advice to the prudential regulator to assist it in the fulfilment of its regulatory responsibilities.

108 In 1984 DTI Insurance Division entered into a Service Level Agreement with GAD. This laid down the respective responsibilities of DTI and GAD. It was the responsibility of GAD to monitor the financial position of each life insurance company, including examination of annual regulatory returns, quarterly regulatory returns (where applicable, generally in relation to newly authorised companies) and other information; and to discuss matters with the company, and in particular with the Appointed Actuary, to clear up any uncertainties and, if possible, to resolve any disagreements. GAD would then report to DTI with an assessment of the financial situation of the company and the extent of its compliance with the relevant regulations, including any recommendations for further action.

109 The main output of GAD's scrutiny of each life insurance company's regulatory returns was a 'detailed scrutiny report' for the prudential regulator. These reports were prepared throughout the year in an order of priority determined shortly after receipt of all the returns as part of an 'initial scrutiny' process and agreed with the prudential regulator. For the majority of companies submitting their returns by the end of June (6 months after the valuation date as provided for by the legislation)[727] GAD aimed to complete all the initial scrutinies by the end of August. Detailed scrutiny reports were then prepared on a rolling basis, with the aim being to complete reports in all cases classified as urgent (priority 1 or 2) by the end of October. The detailed scrutiny reports were intended to provide the prudential regulator with a means of identifying and considering actions it might take in relation to those companies which were found not to be complying with the regulations, had failed to meet regulatory solvency requirements or were in danger of not meeting them in the near future, or appeared not to be meeting PRE.

[726] SI 1998 No 2842.

[727] A minority of companies had accounting year ends other than 31 December and for these there was a corresponding timetable for initial scrutinies and detailed scrutinies.

110 As part of a programme of strengthening the regulatory process, a much expanded new style of detailed scrutiny report was introduced from 1993. This was accompanied by a revised Service Level Agreement signed in 1995, and an increase in the resources GAD was permitted to apply to this work in the later years.

111 A further revised Service Level Agreement was put in place in 1998 following the transfer of DTI' s responsibility for prudential regulation of insurance companies to HMT.

112 Satisfying the requirements of the primary legislation, regulations and mandatory professional guidance was unequivocally the responsibility of the Appointed Actuary. In considering whether the Appointed Actuary had met his statutory and professional obligations, GAD had regard to standards generally accepted within the UK actuarial profession and to specific research carried out by the profession. In some key areas of interpretation of the determination of liabilities regulations, GAD developed its own working rules to define what was acceptable. These were issued as guidance to Appointed Actuaries in the form of Dear Appointed Actuary letters and set out details of what GAD considered to be good practice in relation to particular actuarial issues.

113 Following on from the implementation of the 1973 Act, GAD was proactive in establishing, and was represented on, a number of professional working parties. It was also proactive in initiating market surveys, and in speaking at major actuarial events to ensure that the prudential regulatory perspective was presented.

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Fax: 020 7217 4061

Email: equitable.investigation@ombudsman.org.uk

General enquiries
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Fax: 020 7217 4000

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This report contains references to, and extracts from, legal opinions and advice and their contents obtained by the Equitable Life Assurance Society and provided by it to -

(a) the public bodies responsible for the prudential regulation of insurance companies in the course of normal exchanges between a regulated body and its regulators for the specific purpose of allowing those regulators to fulfil their regulatory functions; and

(b) Lord Penrose in the course of normal exchanges between the Society and Lord Penrose and his Inquiry team for the specific purpose of allowing Lord Penrose to fulfil his terms of reference.

After the House of Commons had ordered the report of Lord Penrose to be published on 8 March 2004, all the documents obtained by Lord Penrose were retained by the Treasury.

In turn, I obtained this material from the Treasury for the specific purpose of carrying out my investigation into the prudential regulation of the Society, following my decision to carry out such an investigation which was reported to Parliament on 19 July 2004.

I acknowledge that the Society has waived privilege in this material only for the above specific purposes and that the Society does not intend any wider or general waiver of privilege by not objecting to the inclusion of, or extracts from or references to, this material in this report as published.

Contents

Introduction

In this Part of my report, I set out a chronology of events.

The aim of this chronology is to describe the information, exchanges, meetings and discussions which occurred during the period covered by this report.

The account given in this Part of my report has been derived from the policy and operational files of the bodies whose actions were under investigation, as well as from the working documents, email accounts, and other electronic records of some of the officials, actuaries, and legal advisers who were involved in the prudential regulation of the Society during the relevant period.

The chronology does not include every event of potential relevance to the subject matter of this report. It is focused only on the information that those involved in the prudential regulation of the Society had before them at the relevant time or on the actions of those regulators during the period covered by this report.

Thus, while we have reviewed the internal papers of the Society, of the auditors of the Society, and of a range of other relevant parties (including the administrators of the Principal Civil Service Pension Scheme), this material is only included within the chronology where we have established conclusively that it was before those undertaking the prudential regulation of the Society, either by being provided to them or being known by them through other means.

There are three other stylistic matters which the reader should bear in mind. These are:

(i) that, while every effort has been made to ensure that the language cited from documents or discussions remains as close to the original as is possible, certain editorial or linguistic changes have had to be made on occasion for the sake of clarity. I am satisfied that these minor changes do not detract from the accuracy of the account provided;

(ii) that, except where changes have had to be made to ensure clarity, we have retained within direct quotations the acronyms used by others. The reader is referred to the Glossary and List of Acronyms set out in Part 1 of this report, if any of those acronyms are unclear; and

(iii) that notes have been included within a number of the entries set out within the chronology. Those notes provide further explanation of the subject matter of the relevant entry or entries and/or give cross-references to other entries on the same subject and/or record subsequent submissions made to me in respect of the content of those entries. For the avoidance of doubt, it is not suggested by including notes in this fashion that the subject matter or content of those notes was known to the relevant officials and/or advisers at the time.

There are two final important considerations which should be borne in mind by the reader concerning the content of this Part of my report.

The first is that most of the material which is cited within this chronology was never intended to be placed in the public domain, with much of it being of the nature of contributions to a drafting process or to emerging thinking.

While I have included everything that I consider to be relevant in order to show the full consideration that was given at the time of the matters within the terms of reference for the investigation, the reader should bear in mind that draft documents or opinions do not reflect the concluded views of those writing those documents or expressing those opinions.

No greater reliance on this material should therefore be placed than that intended by its inclusion within this chronology – namely, as part of a series of events, discussions, and other actions relevant to the prudential regulation of the Society.

Finally, the chronology of events contains numerous references to what could be seen as strong or controversial opinions held by those involved in the prudential regulation of the Society about other people.

Those references, again, were not intended to have a wider circulation nor, often, were those who were the subject of the views expressed given any notice at the time that such opinions were held about them and their actions.

Thus, the reader should bear in mind that those holding the opinions that were expressed and are recounted in this report did not have the benefit of any response to them from those affected, which might have informed their view or led to those opinions being qualified or changed.

Such opinions as are set out within this chronology cannot therefore be taken to be a factually accurate record of or concluded judgement about the actions or qualities of those other persons.

1982–1988

01/01/1982	The Insurance Companies Regulations 1981 (ICR 1981) come into effect.
04/01/1982	The Equitable Life Assurance Society (Equitable) write to inform the Department of Trade and Industry (DTI) that they had appointed a new Appointed Actuary, with effect from 1 January 1982.
29/06/1982	**Equitable submit their 1981 regulatory returns to DTI.** Accompanying those returns are copies of the Society's annual report and accounts for 1981, prepared in accordance with the provisions of the Companies Acts 1948 to 1980 and dated 14 April 1982.
28/01/1983	The Insurance Companies Act 1982 (ICA 1982) comes into force.
02/02/1983	**DTI carry out an examination check of the Society's 1981 returns.** DTI conclude that this *'does not reveal anything unsatisfactory'*. They recommend that the Society's priority rating remains at 3. An official (Officer A) passes the initial check to the regulatory line supervisor with responsibility for Equitable (Line Supervisor A).
07/02/1983	Officer A passes some further comments on the 1981 returns to Line Supervisor A. These include: *This is a mutual and there is no information on the free assets position for 1981, while for the last four years the profits realised is shown under "capital and free reserves". The position of the company appears to be sound with long term assets at £773,026K. Net premium income is up by £28,511K. Major part of the premium income during the last four years (1977–1980) was based on single premium business but the current year's (1981) was mainly derived from regular premium business.* The Line Supervisor responds that he has no comments.
25/02/1983	**The Government Actuary's Department (GAD) complete their scrutiny of the Society's 1981 regulatory returns.** GAD tell DTI that they have no comments on the returns.
June 1983	**Equitable submit their 1982 regulatory returns to DTI.** (Note: the relevant DTI file is no longer available.)
15/03/1984	The Insurance Companies (Accounts and Statements) Regulations 1983 (ICAS Regulations 1983) come into force.
16/06/1984	Every insurance company is sent by DTI a letter setting out new arrangements between DTI and GAD for the scrutiny of returns.
28/06/1984	**Equitable submit their 1983 regulatory returns to DTI.** Accompanying those returns are copies of the Society's annual report and accounts for 1983, prepared in accordance with the provisions of the Companies Acts 1948 to 1981 and dated 11 April 1984.
September 1984	Every insurance company is sent by DTI a copy of their *'Guidance Notes on the Preparation of Annual Returns'*. These notes are reproduced in Part 4 of this report. DTI say that the guidance is *'designed to assist insurance companies and their advisers in the preparation of returns to the Department and attempt to clarify points which may not be immediately apparent from the relevant legislation'*.

19/09/1984	**GAD complete both the A1 and A2 'Initial Scrutiny' key checks on the Society's 1983 regulatory returns.** GAD note that the company have maintained their required solvency margin. They reduce Equitable's priority rating from 4 to 5 and note that mortality rates are *'a little tight in places but there are adequate margins elsewhere'*. They identify no items of concern and no items to notify to DTI, to be taken up immediately with Equitable. GAD add the comment that: *'The company's investment reserve is £345m compared with* [non-linked liabilities] *of £1023m and* [linked liabilities] *£37m – massively solvent!'*. GAD also prepare a *'Form B'*, tabulating some key figures disclosed in the 1982 and 1983 returns. (Note: Initial Scrutiny checks comprised: form A1 (key checks, usually carried out by a trainee actuary at GAD, covering completeness of returns, certificates, solvency and compliance); Form A2 (key checks (Actuary), carried out by the GAD scrutinising actuary, which included new rating and a space to record any aspects of the returns which caused concern (from 1988, aspects which *'look worrying'*) or which needed to be notified to DTI, to be taken up with the company immediately); Form B (some key statistics drawn from the returns). The design of the forms changed over time.)
27/06/1985	**Equitable submit their 1984 regulatory returns to DTI.** Accompanying those returns are copies of the Society's annual report and accounts for 1984, prepared in accordance with the provisions of the Companies Acts 1948 to 1981 and dated 3 April 1985.
23/07/1985	**GAD complete the A1 Initial Scrutiny check on the Society's 1984 returns.** GAD note the cover for the required minimum margin is 8.53. They do not identify any concerns.
24/07/1985	**GAD complete the A2 Initial Scrutiny check on the Society's 1984 returns.** GAD raise Equitable's priority rating from 5 to 4 and note that the question *'Do the reserves for maturity guarantees look reasonable?'* is not applicable. GAD identify some missing and inadequate information in the returns, but record some of this as *'trivial'*. GAD note that only a *'trivial'* proportion of the major classes of business is reinsured. They also note some queries about unit-linked policy expense charges and about the expense reserve, but also that these need not be pursued. GAD identify no items of concern and no items to notify to DTI, to be taken up immediately with Equitable. GAD also prepare a *Form B*, tabulating some key figures disclosed in the 1982, 1983 and 1984 returns.
02/08/1985	GAD write to Equitable highlighting the new procedure under the 1984 Service Level Agreement whereby GAD have responsibility for scrutinising returns in respect of long term insurance business. GAD continue: *In order to assist us in providing advice to Insurance Division on your society's returns for the year ending 31 December 1984 we would be grateful for the comments of the actuary appointed to your society under section 19 of the Insurance Companies Act 1982, on the matter set out in the remainder of this letter. We would be glad to hear directly from him if that would be more convenient for your society. This matter has come to our attention during our initial scrutiny of the returns; further matters may arise when a detailed scrutiny is carried out.* GAD then set out the issue on which the Appointed Actuary is asked to comment: *The reply to paragraph 5 to Schedule 4 (which refers us back to the 1982 returns) indicates that no explicit provision for tax on unrealised capital gains was made, nor was any explicit provision made for any mismatching between the nature and term of the assets held and the liabilities valued. It was no doubt considered that the excess of available assets (Form 14.51) was sufficient to meet these liabilities.*

With the implementation of the long-term business solvency margin, operative from 15 March 1984, it is necessary to make a clear distinction between liabilities and margins, and foot note 3 to Form 14 is designed to achieve this where the long term fund in the Revenue account is brought in at less than the full value allowed by the Asset Valuation Regulations.

GAD continue:

Would the actuary please state the provision, included in line 51 of Form 14, which should be shown as a foot note to that form and included in (a)(ii) of the actuary's certificate and in the mathematical reserve shown in Form 9. Alternatively if the actuary is satisfied that provision is made for tax on unrealised capital gains, in the circumstances of the society ceasing to transact new business, and for any mismatching reserve in relation to assets taken at their Form 13 value within the mathematical reserves established in Schedule 4, paragraph 5 would need to be rewritten.

GAD conclude by asking Equitable to:

Please send to the Department of Trade any amendments to the 1984 returns which are made as a result of the points in this letter, so that they can be placed on public record.

GAD also state that:

It would be helpful, for the 1985 returns, if detailed answers to question 5 of Schedule 4 could be given, rather than referring back to a previous return. This will enable specific replies to questions 5(1) (a) to (g) and 5(2) (a) and (b) to be clearly identifiable.

09/08/1985 Equitable's Appointed Actuary responds to GAD. The Appointed Actuary explains:

When making the statement in the 1982 returns that no explicit provision for tax on unrealised capital gains was made it was not intended that this should be taken to mean that provision was made in the excess of available assets.

This applies also to the 1983 and 1984 returns as indicated by the absence of a foot note to Form 14.

He continues: *'In my opinion no additional reserve for tax on unrealised capital gains or for mismatching of assets and liabilities was necessary'*.

The Appointed Actuary then provides amended answers to question 5 of Schedule 4, saying:

I note that it would be helpful if specific replies to questions 5(1)(a) to (g) and 5(2)(a) and (b) could be given. I attach as an appendix to this letter answers to question 5 of Schedule 4 in this form. I have taken the opportunity to expand on the answer to 5(1)(e) to reflect the above and in 5(1)(a) to take account of your comments.

Against this, a Chief Actuary at GAD (Chief Actuary A) writes: *'? Not formal amendments to returns'*. He also records a number of queries on the amended information. Against the statement that no mismatching reserve is required, he notes *'???'*. Against the statement that no additional reserve has been made for prospective liability for tax on unrealised capital gains, he notes *'why not?'*.

(Note: no reply to this letter was sent at the time, but see 18/08/1986, 04/03/1987 and 23/03/1987.)

14/11/1985 Every Appointed Actuary is sent by the Government Actuary a copy of his first Dear Appointed Actuary letter (DAA1) on valuation returns in relation to solvency margins. The Government Actuary says that scrutiny of the 1984 returns has shown that many actuaries had not appreciated the impact of the changes brought in from March 1984. Actuaries had been

	sent letters drawing their attention to aspects of the 1984 returns which did not meet the relevant requirements, and DTI, with GAD, are following these up on a company by company basis. He draws attention to guidance issued by DTI in September 1984; he explains more fully the background and expresses the hope that misunderstandings can be cleared up in time for the preparation of the 1985 returns.
27/05/1986	**GAD complete their examination of the Society's 1984 regulatory returns.** GAD write to DTI, saying: *The Society is in a strong financial position, with the required minimum margin being covered 8½ times, though this overstates the excess since the society did not show any provision for capital gains in mismatching reserves.* [Chief Actuary A] *wrote to them in August 1985.* *The actuary's main report used a bonus reserve method to value the liabilities but he has provided a supplementary report using a net premium valuation on a strong basis complying with* [Regulations 55-64 of the ICR 1981]. *This society distributes surplus generally every three years in the form of reversionary bonuses, the last distribution being in 1982. The long term fund is currently providing surpluses of £40m or so every year without any transfer from investment reserves so that the distribution as at 31 December 1985 is likely to need only a moderate transfer.* *I have no further questions for the society.*
26/06/1986	**Equitable submit their 1985 regulatory returns to DTI.** Accompanying those returns are copies of the Society's annual report and accounts for 1985, prepared in accordance with the provisions of the Companies Act 1983 and dated 2 April 1986.
30/06/1986	Equitable send DTI £5,000 in respect of Insurance Fees for their 1985 returns.
21/07/1986	**GAD complete the A1 Initial Scrutiny check on the Society's 1985 returns.** GAD note that the cover for the required minimum margin is 5.15. They do not identify any concerns.
30/07/1986	**GAD complete the A2 Initial Scrutiny check on the Society's 1985 returns.** GAD reduce Equitable's priority rating from 4 to 5. They note that the parameters used in valuing or testing unit-linked contracts are too low, but that there is not much of this business in force compared with the total. GAD note that Equitable have again not provided sufficient information in relation to any explicit provision for tax on unrealised capital gains or any mismatching reserve (see 02/08/1985) and suggest *'Possibly take up* [this issue] *at early stage'*. They identify no other items of concern and no items to notify to DTI, to be taken up immediately with Equitable. The relevant GAD file includes a computerised *Form B*, tabulating some key figures disclosed in the 1981 to 1985 returns. GAD also produce a computerised *Form C1 – Non-linked companies*. This Form includes further key figures disclosed in the 1981 to 1985 returns.
18/08/1986	GAD write to Equitable's Appointed Actuary with one query on the Society's 1985 returns, explaining that *'we are paying particular attention to the replies to Question 5(1)(a) of Schedule 4 of companies' 1985 returns'*. That question asked for *'the basis of the provision made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued'*.

GAD state:

> *It would be most helpful if you could clarify one aspect of your company's answer to that question. Does the answer mean that in the assumed changed investment conditions the Society would be able to set-up mathematical reserves which satisfy the relevant Regulations without making any call on the excess value of admissible assets of £445,456,000 shown in line 51 of form 14? In other words is the assumed fall in asset values covered entirely by the reduction in the amount of the liabilities in the changed conditions compared with the mathematical reserves actually set up in Schedule 4.*

08/09/1986 Equitable apply to DTI for a section 68 Order to allow them to make returns on business identified as 'personalised funds' in aggregate form. Equitable explain that they have recently extended their range of 'personalised funds' and, as they are required to show each fund separately in four different forms in the returns, this *'could result in a significant increase in the content of these Forms'*. The Appointed Actuary says that a section 68 Order *'would simplify the preparation of the returns and in my opinion would not detract from the information given'*.

(Note: a section 68 Order was made by the prudential regulators on the application, or with the consent, of an insurance company which directed that all or any of the relevant statutory requirements should not apply or should apply with modified effect to that company for a specified period.)

09/09/1986 Equitable's Appointed Actuary replies to GAD's letter of 18/08/1986. He confirms that:

> *... in the assumed changed investment conditions the Society would be able to set up mathematical reserves which satisfy the relevant Regulations without making any call on the then value of the assets represented by the excess value of admissible assets shown ...*

He continues:

> *I am sorry this was not clear. I had taken it that the answer to Question 5(2)(a) covered this point. I can, however, now see that my answer to this question could be taken as indicating the book values would be maintained at current levels in changed investment conditions by recourse to the excess value of admissible assets. When answering Question 5(2)(a) I had assumed that the book value would be written down to reflect the changed investment conditions.*

GAD note that:

> *The answer to* [our] *letter of 18/08 looks satisfactory. He appears to say that* [the] *Society could set up adequate reserves without recourse to* [the Investment] *Reserve ...*
>
> *In* [the returns] *he says that assets are taken at book value in Form 58* [valuation result and distribution of surplus]. *He had assumed that then book values would be written down under the new investment conditions and no recourse to* [the Investment] *Reserve would be needed i.e. these revised book values would exceed mathematical liabilities.*
>
> *It seems that the answer* [in the returns] *needs amending to make it clear what he is saying.* (See 23/03/1987 and 15/09/1987.)

12/09/1986 A GAD actuary who has taken on responsibility for Equitable (Scrutinising Actuary A) informs DTI that GAD have no objection to Equitable's 'personalised funds' being aggregated for the purpose of the returns. (See 08/09/1986.)

14/10/1986 DTI send Equitable the section 68 Order allowing Equitable to include details of their 'personalised funds' in aggregate form. The Order is subject to the following conditions:

a) The actuary shall state in his annual report that the nature of the contracts relating to Personalised Funds is such that there is absolute matching between assets and liabilities for each individual fund.

b) The Society shall include a note stating the existence of this Order in any accounts and statements deposited with the Secretary of State in accordance with section 22 of the Act.

17/10/1986	GAD inform Equitable's Appointed Actuary that they will consider the 1985 returns, with DTI, in the light of the additional information provided in Equitable's letter of 09/09/1986. GAD copy the letters of 18/08/1986 and 09/09/1986 to DTI. GAD state that they wish DTI to: *... consider whether some amendments to the returns are required. In my view para 5(1)(a) is not as clear as it might be and* [the Appointed Actuary] *admits that it relies on a particular interpretation of the answer in paragraph 5(2)(a). I do not think that his interpretation is the normal one because it is not usual to write down the book values of assets until the market values fall below them.* GAD continue: *If you agree with my thoughts perhaps you would advise me how you would wish matters to proceed. Will you take up the matter with the company or would you prefer me to do it? Alternatively could you accept the 1985 returns as they stand provided the company undertakes to make suitable alterations to the wording in preparing the 1986 returns?*
29/10/1986	DTI reply to GAD to say that they agree that: ... [the Appointed Actuary's] *interpretation ... does not appear to be the normal one. In the circumstances we would be content for the company to make amends in the 1986 returns. Since you are already in touch with* [the Appointed Actuary] *about this may I accept your offer to take up the point directly with him.*
12/11/1986	GAD write to Equitable's Appointed Actuary, saying: *Further to my letter of 17 October the Department of Trade and Industry has advised me that it would be content for the company to make amends in the 1986 returns. If you are agreeable to reconsider the answers to paragraphs 5(1)(a) and 5(2)(a) when preparing the next set of returns it would not be necessary to pursue the matter in relation to the 1985 returns.* *Could you please let me know if this method of proceeding is acceptable to you so that I may advise DTI accordingly* [?]
27/11/1986	Equitable's Appointed Actuary replies to GAD, saying that he is happy to proceed as was proposed in their letter of 12/11/1986.
04/03/1987	Scrutinising Actuary A sends a note to Chief Actuary A headed *'Equitable Life – 1985 Returns'*. The Scrutinising Actuary refers to queries raised in 1986 about the 1985 returns and to two points arising from the 1984 returns, namely: • a query about sterling reserves; and • Equitable's letter of 09/08/1985, which did not explain why no capital gains provision had been made and to which GAD had not replied. The Chief Actuary records on the note that he recalls that a letter had gone missing and that he and the Scrutinising Actuary have discussed and now agree to leave the point about sterling

reserves to the next set of returns, to take up some minor points on the telephone, and to reply in writing to the letter of 09/08/1985.

23/03/1987 [entry 1]	GAD write to Equitable's Appointed Actuary referring to a telephone conversation on 13 March 1987 about the letter of 09/08/1985. GAD note that: *... you consider there are sufficient margins in the mathematical reserves to cover any potential tax on unrealised capital gains, taking into account that the major proportion of the liabilities relate to gross funds. I understand that you are happy to make specific reference to this in the next set of Returns.*
23/03/1987 [entry 2]	**GAD complete their detailed scrutiny of the Society's 1985 regulatory returns.** GAD provide DTI with a one and a half page *'final report'*. GAD state: *The Society declared a triennial bonus at the end of 1985. The cost of these bonuses (which included a transfer of £125 million from investment reserve) has resulted in a reduction of available free assets. At the same time the required minimum margin increased during the year by 35% due to a corresponding increase in the mathematical liabilities. These changes have resulted in a reduction in the cover for the* [required minimum margin] *to 5.2 X (previously 8.5 X). The society has announced that it will be declaring bonuses on an annual basis in future ...* *The Company has valued its liabilities on a bonus reserve basis as in previous years. It has also provided details of a net premium valuation in accordance with the regulations.* With reference to the letter to Equitable (12/11/1986), GAD say: *'After consultation with D.T.I. it was agreed to leave the 1985 returns unchanged subject to an undertaking to amend this paragraph* [about their mismatching reserve] *in the 1986 Returns'*. As regards the lack of an additional reserve for tax on unrealised capital gains, GAD explain: *The actuary has pointed out that as most of the liabilities relate to gross funds, any tax provision would be small and is amply covered by the margins in the valuation basis. He intends to refer to this in the next set of Returns. We recommend that DTI should accept the Returns as they stand on this point.*
11/05/1987	DTI provide briefing for a visit by a Minister to Equitable. DTI describe Equitable as *'probably the oldest and most respectable of all UK life insurance companies'*. They note that there are *'no supervisory questions outstanding with the Society, with which we are content to have little contact'*.
26/06/1987	**Equitable submit their 1986 regulatory returns to DTI.** Accompanying those returns are copies of the Society's annual report and accounts for 1986, prepared in accordance with the provisions of the Companies Act 1983 and dated 2 April 1987. Equitable also send DTI a declaration under section 94A of ICA 1982 (note: this gave DTI the power to charge fees from insurance companies to recover, to the extent possible, the costs of the prudential regulation of such companies). Equitable pay Insurance Fees of £5,200 in respect of their 1986 returns.
08/09/1987	**GAD complete the A1 Initial Scrutiny check on the Society's 1986 regulatory returns.** GAD note that the cover for the required minimum margin is 5.38. They do not identify any concerns.
15/09/1987	**GAD complete the A2 Initial Scrutiny check on the Society's 1986 regulatory returns.** GAD give Equitable a priority rating of 5 (unchanged from the previous year). They note that

Equitable have provided the information needed on unrealised capital gains and any mismatching reserve (see 23/03/1987). GAD identify no items of concern and no items to notify to DTI, to be taken up immediately with Equitable. GAD produce two forms (*'Form B'* and *'Form C1'*), tabulating key figures disclosed in the 1982 to 1986 returns.

22/09/1987 **GAD provide DTI with their final report on the Society's 1986 regulatory returns.** GAD state that the point raised with Equitable on the 1985 returns (see 12/11/1986) has been dealt with. GAD record that cover for the required minimum margin has increased to 5.38 and that they have no new questions for Equitable. GAD say:

> *It is interesting to note that for 1986 the Society has made reductions in the bonus rates for reversionary bonuses on all classes of policies. To compensate for these reductions the Society has increased the rates of Terminal Bonuses paid on all policies. We understand that this means that there is unlikely to be any overall reduction in benefits payable at maturity of a policy.*
>
> *The Society has valued its liabilities on a bonus reserve basis as in previous years, and has provided full details of an alternative net premium valuation basis in accordance with the regulations.*

13/10/1987 DTI provide briefing for the Permanent Secretary of the Treasury, prior to a lunch with Equitable on 19/10/1987. DTI repeat that Equitable are *'probably the oldest and most respectable of all UK life insurance companies'*. They provide some core statistics for 31/12/1986 (being free assets of £475m, long term business fund of £2,305m and net premium income of £397m). DTI add:

> *The Society appears to be sound and has expanded steadily with the underlying trend of expenses being satisfactory. Its strong solvency position makes it low priority in the companies supervised by* [DTI]. *Consequently contact with the Society is infrequent and there appear to be no important current issues.*

DTI suggest two issues which might be pursued at the meeting – Equitable's assessment of changes in the industry following the FS Act 1986, and what growth in business Equitable foresee when new personal pensions begin.

29/04/1988 The FS Act 1986 regulatory regime comes into force.

28/06/1988 **Equitable submit their 1987 regulatory returns to DTI.** Accompanying those returns are copies of the Society's annual report and accounts for 1987, prepared in accordance with the provisions of the Companies Act 1983 and dated 30 March 1988.

Equitable send DTI a declaration under section 94A of ICA 1982 and pay Insurance Fees of £6,000 in respect of their 1987 returns.

30/06/1988 On the introduction of new personal pension policies in response to changes to the legal framework for pensions, Equitable cease to offer guaranteed annuity rates on new policies sold after this date (other than in respect of a small number of group schemes). Certain classes of policyholders continue to enjoy the right to pay further premiums in the future to which the annuity guarantee contained within their original policy would apply.

(Note: I understand that Equitable's move was consistent with a general industry trend away from including such guarantees in pension policies.)

22/07/1988 **GAD complete the A1 Initial Scrutiny check on the Society's 1987 regulatory returns.** GAD note that cover for the required minimum margin is 3.95.

23/08/1988	**GAD complete the A2 Initial Scrutiny check on the Society's 1987 regulatory returns.** GAD raise Equitable's priority rating from 5 to 4. They identify no items that are worrying and no items to notify to DTI, to be taken up immediately with Equitable. They note three other matters:

> *(1) AIDS reserve not set up ... Write about this!*
>
> *(2) Look* [at] *much higher cost of bonus in 1987?*
>
> *(3) Query Form 48* [analysis of assets which are matching liabilities in respect of property-linked benefits other than holdings in authorised unit trusts or internal-linked funds] *assets and related benefits with* [a named company] *(these look to be linked ...).*

GAD also complete an *'AIDS Category – Initial scrutiny'*. They note that the *'Sums assured at risk'* are £7,798m and the Society's free reserves are £390m. In the notes section, GAD write:

> *No specific AIDS reserve set up. Actuary states margins are sufficient. Query basis.*

GAD produce two forms (*'Form B'* and *'Form C1'*), tabulating key figures disclosed in the 1983 to 1987 returns.

26/08/1988	GAD write to Equitable's Appointed Actuary and ask about the reserving basis used in the 1987 returns to provide for future AIDS mortality. On GAD's copy of the letter, someone has written: *'You might get a dusty answer!'*.
21/09/1988	Equitable's Appointed Actuary replies to GAD's letter of 26/08/1988. He explains that Equitable have not set up an explicit reserve as:

> *The question of whether or not an explicit reserve against a contingency should be established at the present time for the Society's business seems to me a matter of equity. To take such action effectively retains monies from policyholders now leaving the fund which may, in the event, not be required ... In my view the information currently available on the effects of AIDS is so speculative that I find it difficult to justify penalising contracts leaving the fund at this time.*
>
> *I did of course check that such action was prudent and can confirm that the additional reserve ... in respect of all of the sums at risk is only a small percentage of the future bonus reserve within the valuation. It is thus clear that future bonuses would comfortably be able to take the additional strains which would arise on that basis. You may also take reassurance from the point that a significant proportion of the Society's procuration expenses are written off in the year of acquisition. The loadings fall into surplus as the contract matures but could have been anticipated.*

14/11/1988	Every Appointed Actuary is sent by GAD a copy of DAA2 on reserving for AIDS.

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18/01/1989 GAD write to Equitable's Appointed Actuary in reply to his letter of 21/09/1988. GAD head the letter *'Returns as at 31 December 1987'*. GAD explain: *'I understand from your letter that there are sufficient margins between your published valuation basis and a corresponding net premium valuation basis to make overall provision for future additional mortality on Projection F of AIDS Bulletin No 2'*. GAD continue by saying: *'We would be interested to learn what mortality basis your experience corresponds to?'*

GAD also refer to the considerable sums assured in certain categories – Level Term Assurance and Miscellaneous (mainly Income Benefits and Temporary Assurances) – and state:

> *In view of the large sums assured at risk we suggest that these categories of contract are significant for the purpose of Section 2.1.1 of Guidance Note GN8. In keeping with the Government Actuary's recent letter to all appointed actuaries* [see 14/11/1988], *we will be looking for you to set up reserves for these categories in the 1988 returns which would include specific provision for future AIDS mortality ...*

GAD ask Equitable to provide further details of their new approach to temporary assurance business.

14/03/1989 DTI provide briefing for the visit of a Minister to Equitable on 22 March 1989. This follows the format that was used for the visit by the Permanent Secretary of the Treasury on 19/10/1987 (see 13/10/1987). DTI set out some updated statistics for 31/12/1987 (being free assets of £390m, long term business fund of £2,862m and net premium income of £500m) and state that:

> *The Society appears to be sound and has expanded steadily with the underlying trend of expenses being satisfactory. Its strong solvency position makes it low priority in the companies supervised by Insurance Division. Consequently contact with the Society is infrequent and there appear to be no important current issues.*

20/03/1989 Equitable's Appointed Actuary and another of the Society's actuaries (who later becomes Appointed Actuary) present *'With Profits Without Mystery'* to the Institute of Actuaries.

The abstract to the paper is as follows:

> *The paper describes the philosophy of with-profits business which has been developed in the authors' office, as a practical illustration of the running of such business in modern conditions. A description is given of how the philosophy is implemented in the main areas of actuarial management, including valuation methods, bonus distribution, product design and expense control. The discussion is extended to address a number of topics which are the subject of current debate including the financial strength of offices, future bonus prospects and disclosure of expenses.*

The paper is published on the website of the actuarial profession at http://www.actuaries.org.uk/files/pdf/library/JIA-116/0301-0345.pdf

(Note: in his witness statement to the Penrose Inquiry (provided in May 2003), Directing Actuary A stated:

> *I read "With Profits Without Mystery" and attended the debate at the Institute of Actuaries just before being promoted to Directing Actuary* [in April 1989]. *(By way of background, I should explain that Institute papers were distributed to members about two to three weeks before they were presented for discussion. After an initial brief introduction by the President, a previously appointed "opener" would give his views on the paper, and this would be followed by other members of the profession who wished to*

speak. There would also be an official "closer" of the discussion. GAD did not hold a formal discussion of Institute papers amongst themselves, but papers like that on the Equitable would be discussed by those members of staff with a direct interest in the company.) The Equitable was generally seen as being a special company due to its historical significance as the first life insurance company, and the fact that actuarial thinking basically started with William Morgan, its first actuary. Nevertheless, I concluded that the culture of the Equitable, as expressed in the Paper, did not fit easily with the new solvency margin regime introduced in 1984, and it would need careful monitoring. While I sympathised with the philosophy that the current generation of policyholders owned the company (being a mutual), nevertheless the fact that the Equitable's culture also meant that policyholders would receive a reasonable approximation to the value they had built up in the company on the maturity of their policies, thereby inhibiting the building up of an estate, meant that the solvency margin (or at least the explicit component of the solvency margin) would need to be met largely from the investment reserve held back to fund terminal bonuses.

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He continued:

With other mutuals, an estate had normally been built up by past under-distributions of bonuses to policyholders, whether deliberately or otherwise – for example, in the latter case through perhaps not having some kind of asset share technique – while in a proprietary company the solvency margin could also be covered by shareholders' funds, and in extremis through calls for increased levels of shareholder capital, although raising this has its own difficulties. The irony was that those companies which had under-distributed to policyholders and shareholders in the past were most able to meet the new solvency margin requirements. I did not participate in the debate as I felt, as a regulator, it would not be appropriate to discuss the affairs of an individual company in public.

I could envisage that, in the event of a deep, sustained fall in the stock market, the "With Profits Without Mystery" culture, in relation to bonus declarations, might need to change, much more quickly than for other companies with an estate, if the company were to maintain its required solvency margin. In the event of closure to new business, other issues would have to be confronted, including the need to adjust the investment mix so that the assets closely matched the likely incidence of outgo. The Equitable would be no different in this regard from any other company. The Appointed Actuary of a company transacting long term business has to set up reserves which enable the company to be run off satisfactorily in the event of closure to new business, including any cost overruns in the first few months of closure due to redundancies and the costs of the closure of branches. Most of the Equitable's business was recurrent single premium business. By the nature of single premium business, no future premiums can be deemed to be collected under the contract, and the Institute paper indicates that the Equitable wrote off all their new business expenses in the year of inception, thus causing no strains of that nature in future.)

03/04/1989 Equitable's Appointed Actuary writes to GAD in reply to their letter of 18/01/1989. The Appointed Actuary explains that he has some difficulty in saying with precision what the Society's AIDS mortality experience is, due to the limited sample size, but over recent years it has been considerably lighter than the valuation basis. The Appointed Actuary provides information about the Society's approach to temporary assurance and says that he notes *'your comments about the Government Actuary's recent memorandum and will take appropriate action in respect of the 1988 returns'.*

13/04/1989	GAD acknowledge Equitable's letter of 03/04/1989. GAD thank the Appointed Actuary for the helpful and interesting information on the Society's actual mortality experience and note *'that you will be making some changes on the reserving basis for term assurances in the 1988 returns'*. There appears to be no other correspondence on the 1987 returns.

Submission of the 1988 regulatory returns

29/06/1989 **Equitable submit their 1988 regulatory returns to DTI.** Accompanying those returns are copies of the Society's annual report and accounts for 1988, prepared in accordance with the Companies Act 1985 and dated 29 March 1989. Equitable also send DTI a declaration under section 94A of ICA 1982 and pay Insurance Fees of £6,500 in respect of their 1988 returns.

These documents include the following information about Equitable's business and their financial position as at 31 December 1988.

Companies Act annual report and accounts
In the *President's Statement*, Equitable say that growth of new premium income at £320m had exceeded their target. They say that such growth in the business can be accommodated financially primarily because of the Society's relatively low selling costs.

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Equitable say that they had adjusted final bonus rates slightly by increasing payments on older policies and decreasing payments on newer ones. The President explains: *'I can assure members of the care taken by your Board in the discussions leading to bonus decisions aimed at achieving a proper balance between the interests of members whose policies are due for payment in the near future and of those whose interest in the financial well-being of the Society is longer term'.*

Equitable explain that they believe it is increasingly important that *'existing and new clients should understand the nature of the policies they buy and the business principles which we adopt in relation to those policies. We hope that, through our sales literature, and the information provided by our representatives, there are few policyholders who are unclear about their policies'.*

In the *Management Report*, Equitable say that one element of their philosophy is to provide *'unit-linked policies for those who wish to take their own investment risk and to offer for those requiring a higher degree of security a with-profits range of products where that risk is both shared and controlled'.*

Equitable say that they carry out a full examination of their expense position every year and this continues to demonstrate that *'the Society's expenses are properly covered by the allowances contained in the premiums paid under new and existing policies'.*

Equitable set out the new regular premium income for 1987 and 1988, which shows a total increase over the period of 43%. They explain:

> *Much of this success lies in the fact that, unlike many competitors, the Society saw distinct advantages in clients having an "old style" retirement annuity policy as a part of their portfolio of retirement benefits and we brought the benefits of retirement annuities to the attention of existing policyholders and the public alike. Awareness of those attractions led to an unprecedented volume of business in the weeks prior to the introduction of personal pensions, sales of which have been at a healthy level. The personal pension contract itself is in all essentials the same as its predecessor, enabling those in our traditional self-employed market and the newly created employee market alike to have confidence in its "no penalty" nature and the consistent track record of performance.*

In the *Statement of Bonuses* section of the report and accounts, Equitable state that their with-profits business is essentially a *'managed fund'*, with investment returns passed to policyholders through reversionary and final bonuses. Equitable say that the level of guaranteed benefits including declared reversionary bonuses tended to impose constraints on the proportion of the portfolio that could be invested in assets other than fixed interest stocks. Equitable say that they have considered recent and prospective investment conditions and have taken into account the balance of liabilities and assets when deciding to maintain reversionary bonuses at the same level as for 1987. For its recurrent single premium pensions business, which constitutes the bulk of its business, the Society's declared reversionary bonus has been maintained at 7.5%.

<u>The returns</u>
Equitable's regulatory returns are submitted in two parts. The first part covers Schedules 1, 3 and 6 to the ICAS Regulations 1983, being: balance sheet and profit and loss account; long term business revenue account and additional information; and certificates. The second part of the returns covers Schedule 4 and is the abstract of the valuation report prepared for the Society by its Appointed Actuary. This part of the returns includes various forms that provide details and analysis of mathematical reserves, long term business, composition and distribution of surplus and the calculation of solvency margins.

<u>Schedule 1 (Balance sheet and profit and loss account)</u>
Schedule 1 of Equitable's returns is made up of Forms 9, 10, 13, 14 and 16. Form 9 (Statement of solvency), drawing on figures presented in other parts of the returns, summarises the Society's financial position at 31 December 1988 as follows:

Long term business admissible assets	*£4,214,952,000*
Total mathematical reserves (after distribution of surplus)	*£3,544,522,000*
Other insurance and non-insurance liabilities	*£52,722,000*
Available assets for long term business required minimum margin	*£617,708,000*
Required minimum margin for long term business	*£160,755,000*
Explicit required minimum margin	*£26,793,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£590,915,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	*£456,953,000*

<u>Schedule 3 (Long term business: revenue account and additional information)</u>
Schedule 3 of Equitable's returns consists of Forms 40 to 51. Equitable include various notes to the Forms giving further information about and/or explanation for the figures provided.

Form 45 (Expected income from admissible non-linked assets) shows that 45% of Equitable's non-linked admissible assets are invested in equities, 14% in land and 35% in fixed and variable interest securities.

Equitable disclose in Form 46 (Analysis of admissible non-linked fixed interest securities) that the gross redemption yields on assets invested in fixed interest securities issued or guaranteed by any government or public authority and with durations of less than 15 years are consistently higher than for those not issued or guaranteed by any government or public authority.

The notes to this part of the returns include a statement that no provision has been made for the contingent liability for corporation tax on unrealised capital gains for non-linked business, which is estimated not to exceed £10m.

Equitable also state that they have been granted a section 68 Order which permits them to include in aggregate form details of their *'Personalised Funds'* in Forms 49, 50, 51 and 57, instead of the separate details for each individual Personalised Fund required by the ICAS Regulations 1983. (See 14/10/1986.)

Schedule 6 (Certificates by directors, actuary and auditors)
Three Equitable Directors provide the certification required by Regulation 26(a) of the ICAS Regulations 1983. Equitable's Appointed Actuary provides the certification required by Regulation 26(b) of the ICAS Regulations 1983. As required by Regulation 27 of the ICAS Regulations 1983, Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

Schedule 4 (Abstract of valuation report prepared by the Appointed Actuary)
Equitable present two valuations of their long term liabilities. The results of the first valuation, which in this report I have called their *main valuation*, are carried forward unadjusted from Form 58 to Forms 9 and 14 in Schedule 1 of the returns. This valuation uses a bonus reserve (or gross premium) method. This appears in the body of Schedule 4 of the returns. They carry out the second valuation, which I have called their *appendix valuation*, using a net premium method. Equitable state that the purpose of this second valuation is to demonstrate that the aggregate mathematical reserves in the main valuation are not less than the amount calculated in compliance with Regulations 55 to 64 of ICR 1981. This second valuation appears as an appendix to Schedule 4.

Schedule 4 – main valuation (text)
Equitable's main valuation provides the information required by paragraphs 1 to 19 of Schedule 4 to the ICAS Regulations 1983 and includes Forms 55 to 58 and Form 60. Equitable state that this valuation conforms to Regulation 54 of ICR 1981.

In response to paragraph 3 of Schedule 4 – which required that the following information should be given: *'For each category of non-linked contract, other than those fully described by the entry in column 1 of Form 55, a full description of the benefits including any premium rate guarantees and options'* – Equitable provide ten pages of information about their non-linked contracts.

Paragraph 3(xi) includes:

> *The details of the general annuity and pensions business described as with profit immediate annuity are as follows.*
>
> *The basic contract provides guaranteed benefits increasing at 3½% per annum, which are enhanced by the addition of bonuses, including final bonus.*
>
> *Under an alternative version of the contract earnings in excess of 3½% per annum up to a maximum of 10% per annum may be anticipated. Annuity payments will remain level if the specified level of earnings were precisely achieved in practice.*

In paragraph 3(xiii), Equitable provide a description of their retirement annuity contract, stating:

> *Pensions business with profits contracts described as retirement annuity, individual or group pension are deferred annuities, the premiums being of the recurrent single premium (or variable premium) type. The premiums provide a cash fund at the pension date, to which is applied a guaranteed annuity rate.*

In paragraph 3(xiv), Equitable provide a description of their personal pension plan contract. The description includes:

> *With profits retirement benefit segments are deferred annuities, the premiums being of the recurrent single premium (or variable premium) type. The premiums provide a cash fund at the pension date used to purchase benefit. There is no guarantee of annuity rates to be applied to the cash fund.*

In paragraph 3(xv), Equitable provide a description of their *'Pensions business termed 2nd series individual pension'*, explaining that they are contracts effected since 1 July 1988. The description includes the same statement as for their personal pension plan contract (see above) that premiums provide a cash sum to which no guarantee of annuity rates apply.

At the end of this section, Equitable set out the *'principal guarantees of terms'* that apply to their policies. The first of these is *'Guaranteed annuity options',* which are described as follows:

> *These are associated both with endowment assurances and certain deferred annuities. In the case of endowment assurances an extra premium is charged.*

The other principal guarantees set out are: *'Conversion option'*; *'Option to maintain or increase sum assurance without evidence of health'*; *'Protection option'*; *'Option to effect further policies without evidence of health'*; *'Guarantee of rates'*; *'Guarantee of terms on taking benefits other than at the prescribed terminal date'*; and *'Waiver of contribution facility'*.

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For their *'Guarantee of rates'*, Equitable explain:

> *Recurrent single premium or variable premium with profits deferred annuities issued to individuals and* [certain other policies] *carry a guarantee of terms for future premiums.*

For their *'Guarantee of terms on taking benefits other than at the prescribed terminal date',* Equitable explain:

> *Recurrent single premium or variable premiums with profits deferred annuities carry a guarantee of the terms that will apply in the event of retirement, whenever it occurs, or death.*

In response to paragraph 4 of Schedule 4, Equitable provide 31 pages of information about their linked contracts.

Under paragraph 5 – which required that information be provided on the general principles and methods adopted in the valuation – Equitable disclose that they have tested the ability of the Society to hold reserves which satisfy Regulations 54 and 56 to 64 of ICR 1981 in the changed investment conditions described in DAA1 (see 14/11/1985). Equitable state:

> *In these conditions the Society would be able to set up reserves which satisfy* [Regulations 54 and 56 to 64 of ICR 1981] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued.*

(Note: the entry at line 51 of Form 14 was the excess of the value of admissible assets representing the long term fund over the amount of those funds and represented the difference between the market value and book value of those funds.)

In addition, Equitable state that, in determining the provision needed for resilience reserves and tax on unrealised gains, they have taken account of the fact that the long term fund has been valued at book value.

In paragraph 5(1)(e), Equitable disclose that a reserve for the prospective liability to tax on unrealised capital gains is held in respect of policies where benefits are linked to the Society's internal funds. They also disclose that the contingent liability for tax on unrealised capital gains in respect of other business is estimated not to exceed £10m. The returns state that the Society consider that there are sufficient margins in the valuation basis to cover this amount and, accordingly, they hold no specific reserve.

In paragraph 5(1)(f), Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on unit-linked annuities.

In paragraph 6(1) – which required that information be provided on the rates of interest and tables of mortality and disability assumed in the valuation – Equitable disclose that, for certain non-profit deferred annuities – which does not constitute a large proportion of its business – the valuation rates of interest used were those assumed in the premium basis. Equitable do not elsewhere in the returns disclose the rate used in the premium basis.

Paragraph 7(b) of Schedule 4 required that information be provided on *'the method by which provision is made for expenses after premiums have ceased or where no future premiums are payable or where the method of valuation does not take credit for future premiums as an asset'*. In response to this, Equitable disclose that they maintain a general expense reserve of £10.5m but that this mainly relates to any shortfall of future premium loadings to meet future expenses on regular premium business. They state that no other explicit provision is made for future expenses on their recurrent single premium business or for business where premiums had ceased or were no longer payable. Equitable do not explain the method by which they have made provision in the main valuation for expenses on recurrent single premium business.

In paragraph 7(d) – which required that information be provided where contracts have not been valued in accordance with Regulation 57(1) – Equitable state:

> *A further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 55 to 64 of the Insurance Companies Regulations 1981. The resultant aggregate liability is less than the aggregate liability on the methods and bases described in this report. The report on the net premium valuation is given in an appendix following Form 60 of this report.*

In response to paragraph 11 of Schedule 4, the returns state:

> *The Society has no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund.*

In response to paragraph 12 of Schedule 4 – which asked: *'Whether there is any reference to the principles on which the distribution of profits among policyholders and shareholders is made in the constitution of the company or in provisions made thereunder, in any policy issued by the company or in any advertisement by the company and, if so, a description of the principles and a reference to the document in which they are expressed'* – the returns state:

> *The Society has no shareholders and the principles upon which the distribution of profits among the policyholders is made are determined by the Directors in accordance with the Society's Articles of Association.*

Paragraph 13 of Schedule 4 asked for *'Particulars of the bonus allocated to each category of contract, including the basis of calculation and the circumstances and the form in which the bonus is payable'*. In response, Equitable set out the level of bonus declared for 1988 and record that they had set reversionary bonus for the main policy classes at 7.5%.

In paragraph 13(b), Equitable also disclose that some retirement annuity and individual pension policyholders have been offered loans under a *'loanback'* arrangement.

Paragraph 16 asked for *'A statement of the practice regarding any bonus payments (in addition to those for which the company had become contractually liable) to be made on claims arising in the period up to the next investigation together with the rates at which such bonus payments are to be determined'*. In response, Equitable set out how final bonuses are calculated for the various classes of business.

Schedule 4 – main valuation (forms)
In Form 55 (Valuation summary of non-linked contracts), Equitable set out the mathematical reserves held for the various types of non-linked contracts along with information on the number of contracts in force, the benefits guaranteed and the rates of interest and mortality assumptions used in valuing them.

In Form 56 (Valuation summary of linked contracts), Equitable set out the mathematical reserves held for the various types of linked contracts along with information on the number of contracts in force, the benefits guaranteed and the rates of interest and mortality assumptions used in valuing them. Equitable disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 58 (Valuation result and distribution of surplus), Equitable set out the valuation result and the composition and distribution of the fund surplus.

Schedule 4 – appendix valuation (text)
Equitable explain that the appendix valuation:

> *... was undertaken solely for the purposes of demonstrating that in aggregate the mathematical reserves determined by the valuation undertaken using the gross premium method, the results of which are reported on the preceding pages, are not less than an amount calculated in accordance with Regulations 55 to 64 of the Insurance Companies Regulations 1981.*

Equitable's appendix valuation provides the information required by paragraphs 1, 5, 6, 7, 9, 17 and 18 of Schedule 4 to the ICAS Regulations 1983. They say that the information required for the other paragraphs (apart from paragraph 19 – being a statement of the required minimum margin in the form set out in Form 60 of Schedule 4 – which, having had *'regard to the purpose of the valuation'*, has not been provided) is identical to that given in the main valuation.

In response to paragraph 5(1)(a), Equitable make the same statement as in the main valuation, that: *'In these conditions the Society would be able to set up reserves which satisfy* [Regulations 54 and 56 to 64 of ICR 1981] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued'*.

As in the main valuation, Equitable state, in paragraph 5(1)(e), that a reserve for the prospective liability for tax on unrealised capital gains is held in respect of policies where benefits are linked to the Society's internal funds. They also disclose that the contingent liability for tax on unrealised capital gains in respect of other business is estimated not to exceed £10m and they consider that there are sufficient margins in the valuation basis to cover this amount and, accordingly, no specific reserve is held.

As in the main valuation, in paragraph 5(1)(f) Equitable state that they do not consider it necessary to hold a specific reserve for the guarantee they offered on unit-linked annuities.

In paragraph 5(1)(g), unlike in the main valuation report, Equitable disclose that retirement benefits on their retirement annuity business could be taken at any age between 60 and 75. The Society explains that policyholders normally select a retirement age at the outset of the policy but can choose to change this subsequently without penalty. Equitable state that they have valued this business on the basis that benefits will be taken at age 60 (or on the valuation date for those aged 60 or over). Equitable also explain that personal pension business has a similar option, but that this is exercisable between the ages of 50 and 75. They state that this business has been valued on the basis that benefits will be taken at age 50 (or on the valuation date for those aged 50 or over).

As in the main valuation, in paragraph 7(b) Equitable disclose that they maintain a general expense reserve of £10.5m but that this relates mainly to regular premium business. Equitable again disclose that they make no other explicit provision for future expenses on their recurrent single premium business or for business where premiums had ceased or were no longer payable. Equitable do not explain the method by which they have made provision in the appendix valuation for expenses on recurrent single premium business.

Schedule 4 – appendix valuation (forms)
In the appendix version of Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts on the appendix valuation basis.

In the appendix version of Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts on the appendix valuation basis.

24/07/1989	**GAD complete the A1 Initial Scrutiny check on the Society's 1988 regulatory returns.** GAD note that the cover for the required minimum margin is 3.84. They do not identify any concerns. (Note: GAD's A1 and A2 Initial Scrutiny checks (and accompanying forms) and the detailed scrutiny reports for the 1989 to 1999 returns are reproduced in Part 4 of this report.)
11/09/1989	**GAD complete the A2 Initial Scrutiny check on the Society's 1988 regulatory returns.** GAD reduce Equitable's priority rating from 4 to 5. GAD answer '*yes*' to the question '*Do the interest rates used look supportable in terms of Regulation 59?*'. They identify no items that are worrying and no items to notify to DTI, to be taken up immediately with Equitable. Accompanying the Initial Scrutiny check are two forms ('*Form B*' and '*Form C1*'), tabulating key figures disclosed in the 1984 to 1988 returns. There appears to be no other correspondence on the 1988 returns.
07/12/1989	Every Appointed Actuary is sent by GAD a copy of DAA3 on reserves for HIV and AIDS.

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10/01/1990	DTI provide briefing to the Permanent Secretary of the Treasury, ahead of his dinner with Equitable the following day, in the form of an extract of Equitable's reports and accounts. DTI explain that the general comments in their earlier briefing for the Permanent Secretary's previous visit to Equitable (see 13/10/1987) still apply.
19/02/1990	Equitable's Appointed Actuary and another of the Society's actuaries (who later becomes Appointed Actuary) present '*With Profits Without Mystery*' to the Faculty of Actuaries. The official record of the discussion that took place on this paper is published on the website of the actuarial profession at http://www.actuaries.org.uk/files/pdf/library/TFA-042/0139-0186.pdf
22/05/1990	A DTI official provides a Minister with a copy of Equitable's latest accounts and a short background note, ahead of the Minister's lunch the next day with some of the Society's Board Members. The note reiterates comments made in advance of the previous ministerial visit (see 14/03/1989), namely: *The Society appears to be sound, and has expanded steadily, with the underlying trend of expenses being satisfactory. Its strong solvency position makes it low priority in the companies supervised by Insurance Division. Consequently, contact with the Society is infrequent, and there appear to be no important issues.*

Submission of the 1989 regulatory returns

29/06/1990 **Equitable submit their 1989 regulatory returns to DTI.** Accompanying those returns are copies of the Society's annual report and accounts for 1989, prepared in accordance with the Companies Act 1985 and dated 28 March 1990. These documents include the following information about Equitable's business and their financial position as at 31 December 1989.

<u>Companies Act annual report and accounts</u>
In the *President's Statement*, Equitable again say that they have experienced significant increases in new business and that the total value of assets under management increased by £1.5bn to £5.7bn.

Equitable's President says that recurrent single premium policyholders had been sent with their bonus notice a letter outlining the Society's change in approach to determining final bonus. The President explains:

> *The Society has taken a positive lead within the life assurance industry in trying to strip away the cloak of mystery behind which the with-profits bonus system has been hidden. So far we have received high marks for effort but less uniformly high acclaim for simplicity of explanation. We accept that we have a duty to enable the public to know what they are being offered and we are confident that the public will buy good products they understand.*

Equitable's President continues:

> *Our principles for operating with-profits business are essentially very simple. The policy results we can pay depend on our investment performance and the efficiency of our business operations. The investment returns are averaged over time to provide a greater degree of security than is sought by those investing in either unit-linked policies or unit trusts and to avoid very large differences in policy results over short periods of time. We also aim to give a fair return to each policyholder whether the policy runs the originally planned term or not and to hold back the minimum by way of reserve consistent with prudent management.*

In the *Management Report 1989*, as in the President's Statement in the 1988 annual report and accounts, Equitable state that they are *'unusual in that our relatively low cost of sales has enabled us to expand fast without financial burden to our existing members'*. Under *'New Business'*, the report says that new regular premium business for the year was £234m and new single premium business was £408m, the latter being an increase of 212% on the previous year. Equitable provide a table illustrating the growth in new premium income over recent years and explain that:

> *... by far the major contributor to new business was the Society's personal pension plan which benefited immensely from the public's increased awareness of pensions. In addition the Society received a significant amount of new premium income in the form of increments on old style retirement annuity contracts which are no longer available to new policyholders, vindicating, as the President has reported, the Society's strategy of telling policyholders of the advantages to be gained from such contracts.*

The report also sets out developments on *'Investments'*, *'Services and Systems'* and *'Staff'*.

The *Statement of Bonuses* section of the report runs to two pages and covers the levels of bonus declared and the changes that have been made to the system of allocating final bonus. For their main line of business, Equitable again maintain declared reversionary bonus at 7.5%.

On final bonus, Equitable write:

> *The addition of final bonus is intended to increase the guaranteed policy benefits and attaching declared bonuses to the appropriate total level having regard to the Society's experience over the period for which the policy in question has been in force. An important feature of our approach is that the Directors aim to achieve the highest possible benefits. In particular, we do not consciously retain earnings to build up the "strength" of the office or to maintain unnecessary reserves ...*
>
> *Under recurrent single premium contracts the policy is essentially building up a fund of money, although the contractual benefits may be expressed as payable at some future date (e.g. at age 60). Part of that fund at any time will consist of the value of the guaranteed benefits (those secured by the premiums paid and declared bonus additions). The remaining, unguaranteed, part represents the final bonus that would be paid if the policy benefits became payable immediately.*

Equitable then go on to explain the new system, saying:

> *Previously the Society has determined the final bonus element under a recurrent single premium contract at any time by reference to a specific scale of rates. That has now been changed to bring the system more into line with the "accumulating fund" nature of the contract. Each year the Society will announce a rate of growth at which the total policy benefits were built up over the year of the declaration, together with a second rate to apply for the period beyond the date of the declaration.*
>
> *The guaranteed part of the total benefits continues to grow, as before, through the operation of the basic contract terms and declared bonus additions. The final bonus element of the policy value at any time is the difference between the total value and the value of the guaranteed part.*

Equitable provide illustrations of how the new system works for a personal pension contract and a bond. The illustration for the personal pension states that the contract includes a guaranteed *'roll-up rate'* of 3.5%.

Equitable state that policy proceeds for policies maturing after 1 April 1990 will be greater than was the case for comparable policies maturing the previous year.

The returns
Equitable's returns are again submitted in two parts covering Schedules 1, 3 and 6 and Schedule 4 to the ICAS Regulations 1983.

Schedule 1 (Balance sheet and profit and loss account)
As in previous years, Schedule 1 of Equitable's returns consists of Forms 9, 10, 13, 14 and 16. Form 9 summarises the Society's financial position at 31 December 1989 as follows:

Long term business admissible assets	*£5,805,205,000*
Total mathematical reserves (after distribution of surplus)	*£4,703,112,000*
Other insurance and non-insurance liabilities	*£128,083,000*
Available assets for long term business required minimum margin	*£974,010,000*
Required minimum margin for long term business	*£204,385,000*
Explicit required minimum margin	*£34,064,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£939,946,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	*£769,625,000*

Schedule 3 (Long term business: revenue account and additional information)
As in previous years, Schedule 3 consists of Forms 40 to 51, which have been supplemented by various notes providing further information about/explanation for the figures provided.

Form 45 shows that 55% of Equitable's non-linked assets are invested in equities, 12% in land and 26% in fixed and variable interest securities (compared with 45%, 14% and 35%, respectively, in 1988).

As in their 1988 returns, Equitable disclose in Form 46 that the gross redemption yields on fixed interest securities issued or guaranteed by any government or public authority and with durations of less than 15 years are consistently higher than for those not issued or guaranteed by any government or public authority.

The notes to this part of the returns include a statement that no provision has been made for the contingent liability for corporation tax on unrealised capital gains for non-linked business, which is estimated not to exceed £28m.

Equitable also state again that they have been granted a section 68 Order which permits them to include in aggregate form details of their *'Personalised Funds'* in Forms 49, 50, 51 and 57, instead of the separate details for each Personalised Fund required by the ICAS Regulations 1983.

Schedule 6 (Certificates by directors, actuary and auditors)
Three Equitable Directors provide the certification required by Regulation 26(a) of the ICAS Regulations 1983. Equitable's Appointed Actuary provides the certification required by Regulation 26(b) of the ICAS Regulations 1983. As required by Regulation 27 of the ICAS Regulations 1983, Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

Schedule 4 (Abstract of valuation report prepared by the Appointed Actuary)
As in previous years, Equitable present two valuations of their long term liabilities (their main and appendix valuations). The results of the main valuation are carried forward, unadjusted, from Form 58 to Form 14 and on to Form 9.

Schedule 4 – main valuation (text)
Schedule 4 of Equitable's returns answers the questions set out in paragraphs 1 to 19 of Schedule 4 to the ICAS Regulations 1983 and includes Forms 55 to 58 and Form 60. Equitable state that this valuation conforms to Regulation 54 of ICR 1981.

In response to paragraph 3 of Schedule 4, Equitable provide ten pages of information about their non-linked contracts. Most of the information about the contracts remains unchanged from the previous returns.

The description of Equitable's with-profits immediate annuity business (paragraph 3(xi)) is changed from the previous year's returns and no longer mentions that guaranteed benefits increase by 3.5% each year. The relevant part reads:

> *The basic contract provides level guaranteed benefits, which are enhanced by the addition of bonuses, including final bonus.*
>
> *Under alternative versions of the contract the guaranteed payments may be arranged to increase at 3½% per annum or to decrease at a rate of up to 6½% per annum (in ½% steps).*

The descriptions of Equitable's retirement annuity, personal pension plan and individual pension plan contracts (paragraphs 3(xiii), 3(xiv) and 3(xv)) are the same as the previous year's returns.

The description of Equitable's principal guarantees of terms at the end of paragraph 3 is the same as the previous year's returns. As in their 1988 returns, Equitable disclose that certain deferred annuity policies carry guaranteed terms under which future premiums could be paid. Equitable also, again, disclose that they applied a guaranteed annuity rate to the accumulated cash fund generated by these policies.

In response to paragraph 4, Equitable provide 31 pages of information about their linked contracts. Most of the information about the contracts remains unchanged from the previous returns.

As in their 1988 returns, in paragraph 5 Equitable disclose that they have tested the ability of the Society to hold reserves which satisfy Regulations 54 and 56 to 64 of ICR 1981 in the changed investment conditions described in DAA1. Equitable state:

> *In these conditions the Society would be able to set up reserves which satisfy* [Regulations 54 and 56 to 64 of ICR 1981] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued.*

(Note: the entry at line 51 of Form 14 was the excess of the value of admissible assets representing the long term fund over the amount of those funds and represented the difference between the market value and book value of those funds.)

Equitable again state that, in determining the provision needed for resilience reserves and tax on unrealised gains, they have taken account of the fact that the long term fund has been valued at book value.

In paragraph 5(1)(e), Equitable disclose that a reserve for the prospective liability to tax on unrealised capital gains is held in respect of policies where benefits are linked to the Society's internal funds. Equitable also repeat here that the contingent liability for tax on unrealised capital gains in respect of other business is estimated not to exceed £28m. They consider there are sufficient margins in the valuation basis to cover this amount and, accordingly, they again hold no specific reserve.

As in their 1988 returns, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity.

As in their 1988 returns, in paragraph 6(1) Equitable disclose that for certain non-profit deferred annuities, the valuation rates of interest used were those assumed in the premium basis. Equitable, again, do not elsewhere disclose the rates used in the premium basis.

As in their 1988 returns, in paragraph 7(b) Equitable disclose that they maintain a general expense reserve of £10.5m, which relates mainly to any shortfall of future premium loadings on regular premium business. Equitable again disclose that they make no other explicit provision for future expenses on their recurrent single premium business or for business where premiums had ceased or were no longer payable. Equitable again do not explain the method by which they have made provision in the main valuation for expenses on recurrent single premium business.

As in the previous returns, at paragraph 7(d) Equitable say:

> *A further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 55 to 64 of the Insurance Companies Regulations 1981. The resultant aggregate liability is less than the aggregate liability on the methods and bases described in this report. The report on the net premium valuation is given in an appendix following Form 60 of this report.*

As in their 1988 returns, in paragraph 11 Equitable state that they have *'no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund'*.

As in their 1988 returns, in paragraph 12 Equitable simply state that *'the principles upon which the distribution of profits among policyholders is made are determined by the Directors in accordance with the Society's Articles of Association'*.

In paragraph 13 of Schedule 4, Equitable set out the levels of declared bonus and disclose that they again had set the reversionary bonus for the main policy classes at 7.5%.

As in their 1988 returns, in paragraph 13(b) Equitable disclose that some retirement annuity and individual pension policyholders have been offered loans under a *'loan back'* arrangement.

In response to paragraph 16, Equitable describe their new system for determining final bonus. For the Society's main policy classes (being: *'retirement annuities, personal pension retirement benefits, individual and group pension arrangements, annuities in payment and recurrent single premium deferred annuities'*), Equitable state the following:

> *... the final bonus entitlement as at 31 December 1989 is that amount required to increase the proportion remaining in force on the date of benefit payment of the annuity entitled to participate in course of payment or of annuity or other benefit ranking for bonus from 31 December 1989 or earlier and existing bonus additions (included new declared bonus) valued at that date in accordance with the contract terms to a total policy value on that date calculated as the sum of:*
>
> > *(a) The proportion remaining in force on the date of benefit payment of the annuity entitled to participate in course of payment or of annuity or other benefit ranking for bonus from 31 December 1988 or earlier and declared bonus additions valued as at that date in accordance with the contract terms, together with final bonus additions calculated on the scale introduced on 1 April 1989, increased by 20% for the calendar year 1989;*
> >
> > *(b) The sum of the proportion remaining in force on the date of benefit payment of all the purchases of annuity entitled to participate in course of payment or of annuity or other benefit applied for bonus in the calendar year 1989, valued at the date of application, each increased by 20% p.a. for the proportion of the year from the date of application of the individual purchase to 31 December 1989.*

<u>Schedule 4 – main valuation (forms)</u>
In Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts along with information on the number of contracts in force, the benefits guaranteed and the rates of interest and mortality assumptions used in valuing them.

In Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity and the rates of interest and mortality assumptions used in valuing them. They again disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 58, Equitable set out the valuation result and the composition and distribution of the fund surplus.

Schedule 4 – appendix valuation (text)
As in the 1988 returns, Equitable explain that the appendix valuation:

> *... was undertaken solely for the purposes of demonstrating that in aggregate the mathematical reserves determined by the valuation undertaken using the gross premium method, the results of which are reported on the preceding pages, are not less than an amount calculated in accordance with Regulations 55 to 64 of the Insurance Companies Regulations 1981.*

Equitable's appendix valuation provides the information required by paragraphs 1, 5, 6, 7, 9, 17 and 18 of Schedule 4 to the ICAS Regulations 1983. Equitable say that the information required for the other paragraphs (apart from paragraph 19 – being a statement of the required minimum margin in the form set out in Form 60 of Schedule 4 – which, having had *'regard to the purpose of the valuation'*, has not been provided) is identical to that given in the main valuation.

In response to paragraph 5(1)(a), Equitable make the same statement as in the main valuation, that: '*In these conditions the Society would be able to set up reserves which satisfy* [Regulations 54 and 56 to 64 of ICR 1981] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued'*.

As in the main valuation Equitable state, in paragraph 5(1)(e), that a reserve for the prospective liability to tax on unrealised capital gains is held in respect of policies where benefits are linked to the Society's internal funds. Equitable disclose that the contingent liability for tax on unrealised capital gains in respect of other business is estimated not to exceed £28m. Equitable say that they consider there to be sufficient margins in the valuation basis to cover this amount and, accordingly, they again hold no specific reserve.

As in the main valuation, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offered on unit-linked annuities.

As in their 1988 returns, in paragraph 5(1)(g) Equitable disclose the ages that retirement benefits could be taken on their personal pension and retirement annuity business.

As in their main valuation, in paragraph 7(b) Equitable disclose that they maintain a general expense reserve of £10.5m but this relates mainly to regular premium business. They again disclose that they make no other explicit provision for future expenses on their recurrent single premium business or for business where premiums had ceased or were no longer payable. Equitable do not explain the method by which they have made provision in the appendix valuation for expenses on recurrent single premium business.

Schedule 4 – appendix valuation (forms)
In the appendix version of Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts on the appendix valuation basis.

In the appendix version of Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts on the appendix valuation basis.

06/07/1990 **GAD complete the A1 Initial Scrutiny check on the Society's 1989 regulatory returns**. GAD note the cover for the required minimum margin is 4.77. They do not identify any concerns.

10/07/1990 **GAD's new scrutinising actuary with responsibility for Equitable (Scrutinising Actuary B) completes the A2 Initial Scrutiny check on the Society's 1989 regulatory returns**. He gives Equitable a priority rating of 5 (unchanged from the previous year) and identifies no items that are worrying and no items to notify to DTI, to be taken up immediately with Equitable. GAD note a drop in the yields of the assets shown on Form 45 (expected income from admissible non-linked assets). No answer is given to the question *'Do the maturity guarantee reserves look reasonable?'*. Accompanying the Initial Scrutiny check are two forms (*Form B* and *Form C1*), tabulating key figures disclosed in the 1985 to 1989 returns.

11/07/1990	GAD note that Equitable's 1989 returns show a rise in premiums receivable, compared with their 1988 returns, of £418m. GAD's new Chief Actuary for Equitable (Chief Actuary B – who had been the previous Scrutinising Actuary) queries this with Scrutinising Actuary B, asking *'Can you reconcile Equitable's increase of £418,000k in premiums receivable!'*.
23/07/1990	In response to Chief Actuary B's question, the Scrutinising Actuary says: *'We will query this* [at] *the detailed scrutiny stage'* (see 04/12/1990).
07/11/1990	Every insurance company is sent by the Government Actuary a letter announcing the introduction of a rolling programme of visits by DTI and GAD officials to life insurance companies.
14/11/1990	GAD meet Equitable's Appointed Actuary and another actuary (who later becomes the Society's Appointed Actuary). According to GAD's note of the meeting, prepared on 22 November 1990, the purpose of the meeting was:

> *... simply to obtain information about the financial position at the year end ie amount of available assets,* [required minimum margin]*, cost of 1990 bonus, amount of new business written in 1990. I had asked for the meeting as a result of comments made by* [Equitable's Appointed Actuary] *to* [a Directing Actuary at GAD (Directing Actuary A)] *and by other people.*

Equitable state at the meeting that, at a recent date (GAD note that this possibly refers to the end of October 1990), their total assets exceeded liabilities and mathematical reserves by £55m. GAD note that '[the] *1989 returns showed a margin between the published bonus reserve basis and a net premium valuation basis of £340*[m]. *This would be higher at 31 December 1990 (say £375m)'*. Equitable say that they consider that some £325m new business strain could be released in a net premium valuation. They also consider that higher valuation rates of interest could be used in this valuation, thus releasing more free assets. Making these adjustments would increase the excess of liabilities over assets, before declaring any bonus, from £55m to £755m.

Equitable explain that they are considering not paying any reversionary bonus for 1990 (but would pay an interim bonus to policies maturing in 1991). They ask if GAD would be revising the resilience test in the light of the fall in market values of assets since the beginning of 1990. Equitable raise the possibility of applying for a section 68 Order.

GAD's note of the meeting continues:

> *When he informed me of the current position, ie that free assets were £55m assuming the same valuation basis as last year,* [the Appointed Actuary] *asked me whether I had any qualms about the position of Equitable. I had to say that I did. He asked why? I replied that I had not looked at the figures in detail although I knew it was possible to weaken the valuation basis. However, the society had to comply with the valuation regulations and my main concern was whether it would be able to do this if the market fell any further (or even remained at its present level). What about next year, for example?* [The Appointed Actuary] *said he took my point and he thought that if the market fell by a further 20% they would have problems and he would have to consider what action should be taken. He implied that at such a point he would have to consider reducing the level of new business taken on.*

GAD's note concludes with two comments:

> *1.* [Equitable's Appointed Actuary] *states that the Society is solvent. However, as he is considering not paying a reversionary bonus this year (while at the same time paying terminal bonuses) he must be feeling very uneasy about the current position of the Society.*
>
> *2. We are carrying out a detailed scrutiny of the 1989 returns in order to get a better feel for the position of the society, and in particular for what margins there are in its current valuation basis and in the alternative net premium basis.*

22/11/1990 GAD send DTI the note of the meeting held on 14/11/1990. GAD add, in a covering note marked '*Confidential*':

> *From what* [the Appointed Actuary] *says it appears that if he valued the assets on a weaker basis, which still complied with the regulations, there would currently be adequate free assets to cover the* [required minimum margin], *without a S68 order for implicit items being taken into account. Even if the Society declared reversionary bonuses for 1989 at the same rate as those for the previous year there would appear, on a weaker valuation basis, to be sufficient free assets remaining to cover the* [required minimum margin]. *Whether the Society is strong enough to declare a reversionary bonus for 1989 and still have sufficient available assets to provide for future contingencies is a matter for the Society's Actuary and its Board.* [Note: the references to '1989' should have read '1990'.]
>
> *We are carrying out a detailed scrutiny of the 1989 returns, and will advise you if any further points arise.*

Following receipt of this, a DTI official notes:

> *If the Equitable is not going to declare a bonus we need to warn the Minister before it becomes public. Will there be publicity? What about Equitable's advertising? Does it need to be changed?*

04/12/1990 GAD write to Equitable's Appointed Actuary with some queries arising from the **1989 returns**, including why the number of 'Other Creditors' and pension surrenders has increased considerably, whether there are any surrender/transfer guarantees relating to pension business fund contracts and '*... what investment return is required to support (i) the current reversionary bonus rates and (ii) the current reversionary and terminal bonuses*'.

05/12/1990 GAD provide DTI with a one page note explaining that they have completed their scrutiny of the **1989 returns**. (A copy of this scrutiny report is reproduced in full within Part 4 of this report.) GAD say that 1989 was exceptional for Equitable because, during the year, new business growth had set a record. GAD continue:

> *The Society declared unchanged bonus rates and 94% of the total cost of the bonus was financed by a transfer from the investment reserves. If the property values remain depressed and the equity market does not show any bullish tendencies in the* [1990s] *and beyond, we think that the Society may have problems in maintaining the current bonus rates on its with-profit life and pensions contracts.*
>
> *The 1989 valuation basis was satisfactory. There was a significant margin in the published mathematical reserves.*

Against the last sentence an official has written an unclear comment which reads '*not* [unclear] [unclear] *now*'.

GAD enclose a copy of their letter to Equitable of 04/12/1990 but add: '*... we do not anticipate that the replies will affect our view of the solvency position*'. Behind this note are two pages of manuscript calculations. On the first of these is written '*156 – loss on 1990 investments!*'.

17/12/1990 Equitable's Appointed Actuary replies to the various queries raised in GAD's letter of 04/12/1990. He says that the increase in the amount of pension surrenders arises for two main reasons. First, because of '*a general increase in the level of retirements under our pension contracts. The cash commutations paid at retirement are included in the ... figure*'. Secondly, because of:

> *A relatively high level of internal transfers from one type of pension arrangement to another – in particular, transfers from individual FA70 schemes* [i.e. defined contribution occupational pension schemes pursuant to the terms of the Finance Act 1970] *to personal pensions, which is being encouraged for the smaller cases because personal pensions are simpler to operate than FA70 schemes.*

Equitable explain that:

> *Our pensions contracts generally carry guarantees of the amount that will be paid in the event of actual retirement (whether on the originally stated pension date or otherwise) or death. There are, however, no guarantees on withdrawal in other circumstances, e.g. transfer to another pension provider. It is our aim to pay full value in those circumstances also but there are no guarantees in the matter.*

In response to the question about the required investment return, Equitable say:

> *(i) The rates of declared bonuses announced at 31 December 1989 require earnings of 11¼% p.a. for our pensions business and around 8% net for our life business.*
>
> *(ii) As you know, for the bulk of our business we do not have final bonus scales in conventional form. Rather, we announce a "total growth rate" in policy values which gives the total accumulated policy value at the declaration date. The final bonus element in that value is the difference between the total value and the value of the guaranteed policy benefits at that date. The question of what rate of growth is needed to support "current reversionary and final bonuses" is not, therefore, meaningful in our case. The "total growth rates" for 1989 were 20% gross and 16½% net. There is no implication, however, that these rates will be repeated in future years. Indeed for actual payments out under pensions business we have been rolling forward 31.12.89 values at 15% pa for most of this year but have recently cut that to 12% pa. You will also have seen from our With Profits*
> *Brochure that we emphasise that future bonuses must depend primarily upon future investment returns.*

19/12/1990 [entry 1] GAD thank Equitable for their letter of 17/12/1990 and say: '*The information you have provided is most helpful and we have no further queries on your 1989 returns*'.

19/12/1990 [entry 2] GAD send DTI's Head of Life Insurance Division (Head of Life Insurance) two notes. The first is from Chief Actuary B, following the meeting with Equitable on 14/11/1990. The note begins by saying that:

> *There is one point which we think you may need to consider following our meeting with Equitable. If, as seems possible, the society decides not to declare reversionary bonuses this year you would need to consider whether or not there is a risk that the society may be unable to fulfil the reasonable expectations of present and future policyholders.*

1990

It continues:

In the event of the society not paying the reversionary bonuses this year, we understand that the intention is to pay interim reversionary bonuses at the 1989 rates in respect of 1990 on all policies maturing in 1991, thus making up for the effect of not declaring reversionary bonuses in 1990. The society intends to maintain payment of terminal bonuses at the appropriate level on policies maturing. This means that for policies maturing in 1991 there would be no adverse effect apart from any changes in the rates of terminal bonuses that might occur. We do not have any information at this stage about the society's likely intentions in respect of policies maturing later than 1991. In our view what happens at the end of 1991 and later will be largely determined by what happens to the stock market during 1991 and later.

The note then says:

So far as policies maturing in 1991 are concerned, in our view the course of action which the society has suggested it may take does not affect their reasonable expectations – there is likely to be no big change in total bonus payments at maturity. The total bonus payments added to policies maturing in 1992 or later are likely to be more affected by stock market changes occurring in 1991 and later years than by whether or not the society pays a reversionary bonus at the end of 1990. The society may be able to declare a double reversionary bonus at the end of 1991 if the fund can afford it through good investment performance, or again, a special maturity bonus for 1990 may be awarded for claims in 1992, and so on. In effect, total maturity proceeds would be maintained though (on the latter scenario) less would come from reversionary bonuses, with the company having missed awarding one such bonus in 1990.

Chief Actuary B concludes:

Hence, on balance, we do not think that the society's possible course of action, in itself, leads to a risk that the society may be unable to fulfil the reasonable expectations of such policyholders. If the society had another bad year (or this year's performance is worse than anticipated) and the company was unable to establish sufficient mathematical reserves on current guaranteed levels of benefits (including past reversionary bonuses) within the resources of the company, that would be a different matter.

At present we do not have enough information about the society to be more specific and indeed, unless the society makes more signals, we do not suggest that further information should be sought. The society is our longest established life company and is well respected in the market.

The second note is from Directing Actuary A. He begins by stating:

After the meeting held yesterday with the actuarial profession, in which there was general agreement that the resilience test under regulation 55 would continue to be calculated on the basis of a 25% fall in the value of equities in current market conditions and present economic and political circumstances, we discussed the position of Equitable, given that decision. You mentioned that you were concerned about their current advertising. This was in the context that, if the Equitable were unable to pay a reversionary bonus this year, policyholders who had taken out policies on the basis of recent advertisements (which highlighted the returns achieved by the Equitable over the past 10 years), might have justification for wondering whether their reasonable expectations would be, or were being, met. You would like the Equitable to examine their advertising to ensure no such complaint could be justified.

It was agreed, therefore, that the most appropriate way of getting this point over to the Equitable would be for me to telephone [the Chief Executive]*, informing him both about the decision taken at the meeting yesterday and also to put the point to him about the company's current advertising.*

The note continues:

When I telephoned [Equitable's Chief Executive] *earlier this morning, his secretary told me that he was in a Board meeting which would last most of the day. I wondered then if in fact the Board meeting was deciding on what reversionary bonuses should be paid this year.* [The Chief Executive] *eventually telephoned me back late in the afternoon, and I explained that I was telephoning him, rather than* [the Appointed Actuary] *because, although the first point was one on which I would normally speak to* [the Appointed Actuary]*, the second was one on which it would be more appropriate to speak to him.*

I explained that, on the first issue, I wanted as a matter of courtesy to tell him the result of yesterday's discussions, which confirmed the conversation I had with him a week ago at the Actuaries Club Dinner when I told him what I thought would be the outcome of our discussions with the profession. He said that he was very grateful for letting him know.

The note continues:

I then went on to say that, on the second point, some officials in DTI had expressed some concern that, if the Equitable were to forego a reversionary bonus this year, some policyholders might wish to complain that they had been misled by the Equitable's recent advertising. I said that I was sure that he, [the Chief Executive]*, would be very mindful of the question of advertising and marketing, with his intimate connections with LAUTRO. I told him that what I was trying to indicate in general terms was that if the company was of the view that it was unlikely to declare a reversionary bonus at the year end, it would be helpful if the company were to examine its advertising and marketing literature to ensure that it felt it was not misleading prospective policyholders in the run-up to the announcement.*

[The Chief Executive] *took these comments in the kindest possible way. He said that he was clearly anxious that the company did not mislead any potential policyholders, that it had been their intention to concentrate on the actual payouts over the last 10 years and it was the company's continued intention to ensure that policyholders maturity proceeds continued to reflect the full performance of the company over the period of the policy, even if a year's reversionary bonus were foregone. However, as a result of the Board meeting which he had just left, he thought he could put my worries at rest by telling me what the outcome of the meeting was.*

The note goes on to say:

It appears that [Equitable's Appointed Actuary] *had presented a paper to the Board which sets out the constraints on bonus policy which emanate from the valuation of liabilities regulations themselves. The company accepts that the regulations are a matter of fact, and have to be abided by. (He also told me that he had passed on to the Board my comments at last week's dinner that it would be very difficult for the UK to weaken its valuation regulations at the present time when we are having to defend them to other Member States in the context of the Single Market after 1992.)*

He then went on to tell me that the view of the Board was that the crunch position for the company would really probably come next year. The Board had received a report from their investment committee which examined the most likely, and the worst likely, outturn for 1991. As far as the most likely outturn was concerned, the view of the

Committee was that the investment performance of the company would be quite strong. While there were some pessimistic underlying economic indicators for next year, the report concluded, and the Board accepted, that the most likely outturn for the year was likely to be optimistic. What the company wishes to avoid is to declare a reversionary bonus this year, and then to be unable to declare a reversionary bonus next year when there is an investment upturn. In his view, although the board has not taken any final decisions yet, he considers that it is "pretty unlikely to be in a position of not being able to declare a bonus this year" given the optimistic assessment of investment returns achievable by the company next year.

[Equitable's Chief Executive] *told me that there was clearly a risk in this strategy, but there is a risk in all bonus declarations taken in similar circumstances. I did not enquire of* [the Chief Executive] *what the likely financial position of the company would be at the end of this year in terms of Form 9 solvency margin – I know that* [the Chief Executive] *had to go to another urgent meeting at that time and also I do not consider the telephone to be the best medium for discussing such matters.*

1990

The note concludes:

In summary, therefore, it seems most likely that the Equitable will declare a reversionary bonus this year, having taken an optimistic view of investment return likely to be achieved by the company in 1991. On that scenario, they would anticipate that they will be able to continue to pay a reversionary bonus next year. There is clearly some risk in this strategy, and if the Equitable goes ahead with a bonus distribution this year and the market subsequently falls considerably, we will need to hold some urgent talks with the company's actuary, as we would, of course, with other companies that take similar decisions and who are in a similar financial position to (or an even less strong position than) the Equitable.

20/12/1990 Equitable's Appointed Actuary applies to DTI for a section 68 Order for a future profits implicit item of £250m, for possible use in their 1990 returns. He provides financial calculations in support of this application, suggesting that Equitable could seek an Order up to the value of £562.8m.

These calculations include, for the estimated annual profits, the following:

Year ending	*(A) Total surplus*	*(B) Exceptional items*	*(C) Surplus arising from solvency margin*	*(A)-(B)-(C) Ordinary surplus*
	£m	*£m*	*£m*	*£m*
31.12.85	*92.2 (a)*	*–*	*56.2*	*36.0*
31.12.86	*153.9*	*–*	*56.1*	*97.8*
31.12.87	*254.7*	*65.0 (b)*	*65.3*	*124.4*
31.12.88	*259.2*	*–*	*61.4*	*197.8*
31.12.89	*337.4*	*–*	*89.9*	*247.5*
				703.5

Average annual profit = 703.5/5 = £140.7m

Notes: *(a) £92.2m represents one-third of the surplus for the triennium ending 31 December 1985.*

(b) £65.0m of the surplus arising in 1987 was an exceptional item arising from a change from a policy year to a calendar year method of bonus allocation for the bulk of the Society's with profits business.

GAD tick the figures supplied in column (A).

The calculations state that the average period to run for the Society's in-force contracts is eight years. The Appointed Actuary explains:

The periods to run have been reduced to take account of premature withdrawals based on the Society's recent experience of such withdrawals. In respect of retirement annuity and personal pension contracts for which a range of retirement ages is available, it has been assumed that retirement benefits are taken at the lowest possible age, or immediately if that age has already been attained.

The calculations suggest that the maximum figure permissible for future profits is 50% of £140.7m multiplied by eight years – that being £562.8m.

27/12/1990 DTI ask GAD for their views on Equitable's application for a section 68 Order.

1991

04/01/1991	GAD provide their views to DTI on the Society's application for a section 68 Order and state that the amount requested '*... is less than 50% of the maximum amount allowed in accordance with the calculations based on the guidance notes. We are satisfied with the calculations and advise you to issue the order*'. GAD attach copies of Equitable's letter of 17/12/1990 and their reply of 19/12/1990. They state that GAD are satisfied with Equitable's answers to their questions in the letter of 04/12/1990 and '*... consequently our detailed scrutiny of Equitable's 1989 returns is closed*'.
11/01/1991	DTI send Equitable's Appointed Actuary a section 68 Order for a future profits implicit item of £250m, for use in the 1990 returns.
31/01/1991	DTI write to Equitable's Appointed Actuary with a set of papers that DTI had received from a policyholder concerning his complaint about the information he had been given when seeking to clarify two policies he had with Equitable. DTI comment that: *The various administrative errors evidently gave* [the policyholder] *little confidence in your Society. Moreover it is of concern that these errors and the faults in the administration system and records of the Society may have affected other policyholders of the Society.* *I should be grateful for confirmation of the measures taken by the Society to rectify the position and to ensure that none of the policyholders of the Society were adversely affected. I look forward to receiving your comments.*
21/02/1991	Equitable's Appointed Actuary writes to DTI in reply to their letter of 31/01/1991. He acknowledges that the policyholder is justified in his complaint. Equitable explain the steps taken to rectify the problems that affected him and a '*small number*' of other contracts. They assure DTI that their actions have kept the effect on policyholders to a minimum.
28/03/1991	Equitable write to DTI to give notice of the appointment of their Appointed Actuary as Chief Executive with effect from 31 July that year, following the retirement of the current Chief Executive on 30 June 1991. Equitable state that the Appointed Actuary is currently Deputy Chief Executive and Joint Actuary. DTI forward the letter to GAD.
04/04/1991	Scrutinising Actuary B passes the letter of 28/03/1991 to Chief Actuary B with a note: '*I think GAD's policy (as far as I know) is against the two offices of Chief Executive and Actuary to be combined. We should inform* [the Government Actuary] *about it*'.
10/04/1991	Chief Actuary B advises the Government Actuary of the forthcoming appointment of a new Chief Executive at Equitable and that the person already holds the post of Appointed Actuary. The Chief Actuary says: '*I understand that you have written about a similar position at* [another major life company]'.
11/04/1991	Equitable provide DTI with the Form A declaration (required under section 60 of ICA 1982, which provided that insurance companies must notify changes of controllers or senior managers of such companies to the prudential regulators for approval) in respect of the appointment of their new Chief Executive.
17/04/1991	In response to the note of 10/04/1991, the Government Actuary writes:

> *I think we would certainly want to discourage him from holding both positions, other than on a very temporary basis. It would be appropriate for DTI to write asking what* [Equitable's] *intentions are regarding the appointed actuary position, bearing in mind the fact that it is not now generally thought desirable for the same person to be* [Chief Executive] *and* [Appointed Actuary]. *If they get a dusty response I will speak to* [him].

19/04/1991	GAD's Chief Actuary B writes to DTI about the letter of 28/03/1991: '*As it is not now thought desirable for the same person to be both Chief Executive and Appointed Actuary I think it would be best to clarify the society's intentions*'. Line Supervisor A notes on DTI's copy of this memorandum that consent (i.e. to the appointment of the person as Chief Executive) should be withheld until the position is clarified with Equitable.
26/04/1991	DTI's Line Supervisor A writes to Equitable. He says: *Since* [the person] *is currently the Appointed Actuary for the Society and it is considered desirable that the same person should not be both Chief Executive and Appointed Actuary, please would you confirm what the Society proposes regarding the Appointed Actuary.*
30/04/1991	Equitable's Appointed Actuary telephones in response to DTI's letter of 26/04/1991. Line Supervisor A notes that the Appointed Actuary explained that, although Equitable have several good in-house actuaries, it was considered they needed 12 months or so senior management experience before assuming the role of Appointed Actuary. Accordingly, Equitable would prefer the proposed Chief Executive to retain the role of Appointed Actuary for about 12 to 18 months.
02/05/1991	Equitable write to DTI to confirm their position, following the telephone call. The Society say that they are of the view that the Appointed Actuary role should be regarded and operated at a senior and influential level. Equitable confirm that the Society does not currently have an actuary with the desired seniority but that they expect to have an appropriate person for the role of Appointed Actuary in 12 to 18 months' time: *Accordingly, rather than moving away from the general approach and resorting to a purely technical interpretation of the Appointed Actuary's role, we regard it as substantially more satisfactory in professional and business terms for* [the person] *to continue to undertake the Appointed Actuary role for a limited period longer, as mentioned above.*
08/05/1991	DTI pass Equitable's letter of 02/05/1991 to GAD with a note: '*Provided it is a limited period I am prepared to accept the proposed arrangement. Have you any further comments*'.
10/05/1991	Chief Actuary B passes the letter to the Government Actuary and comments: '*This letter confirms that* [the person] *intends to keep the* [Appointed Actuary] *role for 12-18 months, which I think can be regarded as temporary (just)*'. The Government Actuary in turn comments: '*Thank you. I think we can accept this*'.
13/05/1991	GAD inform DTI that Equitable's new Chief Executive intends to retain the Appointed Actuary role for a further 12 to 18 months, in addition to the new post. GAD conclude: '*As this is intended to be for a limited period we have no further comment to make*'.
16/05/1991	DTI reply to Equitable's letter of 02/05/1991 to say that the Secretary of State has no objection to the proposed appointment of the new Chief Executive '*... subject to the understanding that*

[the incumbent] *will only retain the Appointed Actuary role for a further 12 to 18 months as indicated in your letter*'.

31/05/1991	Equitable write to DTI in reply to the letter of 16/05/1991. Equitable say that it appears that the Secretary of State's acceptance of the Society's appointment of Chief Executive is conditional on the person only continuing in the role of Appointed Actuary for a further 12 to 18 months. Equitable state:

> *Whilst it is certainly the Society's current intention to separate the roles and appoint another Appointed Actuary in that timescale, we would not wish a condition to that effect to apply to* [the person's] *appointment as Chief Executive.*
>
> *In making no objection to* [the] *appointment, the Secretary of State appears to accept that* [the individual] *is a "fit and proper person". We cannot see that this will change if for some at present unforeseen reason,* [the person] *does not cease to be the Appointed Actuary within the timescale mentioned. There is, we believe, a point of principle here.*
>
> *Naturally we recognise certain advantages in splitting the roles, which as I have indicated we intend to do, but would appreciate your acceptance of* [the person's] *appointment of Chief Executive without the condition implied by your letter of 16 May 1991.*

Line Supervisor A passes the letter to the DTI Line Manager with responsibility for Equitable (Line Manager A), with a note:

> *I do not think we can accede to* [DTI's acceptance of the appointment without condition]. *GAD consider 18 months is exceptional! Suppose* [he] *falls ill – no Chief Executive – no Appointed Actuary – a successor should have been groomed by now to take on role of Appointed Actuary. I suggest we initially telephone* [Equitable] *to express our views – I could not contact* [the company] *today.*

11/06/1991	Equitable's Appointed Actuary writes to GAD's Directing Actuary A, marking the letter '*PRIVATE AND CONFIDENTIAL*'. The Appointed Actuary refers to discussions they had had, when sitting together at lunch during a recent Institute of Actuaries seminar, about a number of things, including:

> *... the recent valuation and bonus declarations. It is very difficult, if not impossible, for your colleagues and yourself to get any "feel" from the published results of the kinds of discussions about actuarial management going on within life offices and it occurred to me that you would find copies of some of our relevant board papers helpful "background" reading. They extend beyond the purely appointed actuary role to that of financial and actuarial management. Some of the figures were seen by* [Chief Actuary B] *at a meeting before the year end* [see 14/11/1990].
>
> *The papers are of course confidential and offered as a good will gesture to promote greater understanding and I should prefer restricted circulation within your department.*
>
> *I realise, of course, that you cannot forget your supervisory role when reading these papers but I hope you will be able to accept them as an example of "steering" a board to acceptable conclusions. I have to hope also that I have not given a hostage to fortune!*

The Appointed Actuary encloses with the letter Board papers from September and November/December 1990 (referred to by Equitable's Chief Executive in the conversation on 19/12/1990) and from January and February 1991, which were relevant to Equitable's recent valuation and bonus declarations. He also encloses a paper, dated March 1991, to the Equitable Board on investment considerations for 1991. These papers are reproduced in full in Part 4 of this report.

In the disclosed September 1990 paper entitled '*Valuation and Bonus Declaration at 31 December 1990*', the Appointed Actuary explains: '*The recent falls in world stockmarkets could mean that we may face a more difficult position at the end of this year than has applied for some time. Although the current position is very uncertain, it seems highly likely that the earnings on the fund at market value will represent a negative return over 1990. In view of that position, I feel it appropriate to begin discussion of some possible alternative courses of action rather earlier than normal*'.

The Appointed Actuary goes on to discuss: the Society's approach to smoothing the return on the with-profits fund; the rate of bonus that he would like to declare; and the benefits of allotting bonus in the form of final bonus. On the final point, the Appointed Actuary advises that final bonus:

> *... is not guaranteed, requires no capital to finance it and is only paid out on policies leaving the fund. Hence it is very well suited to the situation where future earnings are being anticipated. If it eventually emerges that we have "got it wrong" the damage is limited and room for future manoeuvre is retained.*

The Appointed Actuary then advises the Board:

> *In technical terms, any presentational problems created by declaring a bonus can almost certainly be mitigated by weakening the valuation basis. There are, however, constraints on the extent to which that can be done. Once done there is then also no leeway available in a future year. Further technical measures are also available to help the DTI Return presentation (but not the Company Act balance sheet). The use of such measures has to be publicly stated and could be construed as a sign of weakness. Again, these are largely "one off" measures.*

The Appointed Actuary says that, if Equitable choose to allocate the entire bonus in the form of final bonus, their solvency position would be around £300m stronger.

The Appointed Actuary concludes by summarising the points made, as follows:

- *unless there is a significant upturn in markets, it will be an uncomfortable year end for bonus purposes*
- *interest rates have been relatively high for the whole year and policyholders might expect benefits based on returns ranging from about 12% to about 15%*
- *that could argue for maintenance of declared rates at last year's level of £7.50%*
- *it might be possible technically to produce the required surplus for such a declaration but this would necessarily be a "one off" operation. A bad year in 1991 would almost certainly lead to even greater discomfort at the end of 1991*
- *declaration of a marginally lower rate would not really provide adequate savings in surplus. Declaration at a significantly lower rate would be difficult to justify and would inevitably look weak*
- *we now show policyholders how their policy values roll up from year to year at an overall rate of return. It should not really matter to what extent that roll up rate is consolidated by way of declared bonus or left in unconsolidated or final bonus form providing policyholders have confidence in us*
- *allotting the 1990 return in wholly unconsolidated form would retain a significant amount of freedom, freedom which might eventually be required in respect of 1991*
- *it seems to me, at this point in the year, that a case could be made either for maintaining declared rates at £7.50% or for having no declared bonus at all. Both courses of action contain significant risks. Maintaining declared rates would result in*

> *a significant technical and financial weakening of the Society whilst having no declared rate would run significant public relations risks. There seems no objective basis for an intermediate position and such a position would bring in train both types of risk.*

In the introduction to the disclosed November/December 1990 paper entitled '*Valuation and Declaration at 31 December 1990*', the Appointed Actuary says that there has been no significant improvement in investment conditions since his last paper to the Board. He says that '*consequently, it becomes increasingly likely that we shall not be "*[bailed]* out" by a dramatic improvement in conditions before 31 December 1990*'.

Under *'Solvency and DTI requirements'*, the Appointed Actuary writes:

> *The current regulatory regime does not permit the sort of action taken at the end of 1974; there are now significant constraints. Any consideration of the position needs to begin with an understanding of those constraints.*

(Note: in response to the economic conditions during 1974 and in order to be able to maintain consistent rates of bonuses whilst maintaining an adequate solvency position, Equitable had changed their valuation basis. These changes included increasing the valuation rates of interest used from an average rate of just under 6% in the 1973 valuation to 10% in 1974. In his witness statement to the Penrose Inquiry, Directing Actuary A said: *'I do not know what specific sort of action, as happened in 1974, is referred to ... but I can guess ... In general terms, the paper is referring to the fact that, since 1974, the UK had adopted new regulations governing the value of assets and liabilities, and had introduced a solvency margin regime. These placed considerable constraints on companies which did not exist in 1974; similarly, in 1974, a degree of flexibility was given to supervisors not allowed when the paper was written in 1990. I believe that regulators in 1974 allowed companies to value liabilities on a much weaker basis than would be allowed today, consistent with the yields available then. Reading from current newspapers, it seems the FSA is making some special arrangements now, to stop companies from having to sell equities at the present time and so further depress the market. No similar action was envisaged by DTI in 1990'*.)

Equitable's Appointed Actuary explains:

> *The primary requirement is for the office to demonstrate an excess of assets over valuation liabilities. In fact there must be excess assets at least equal to the so-called "minimum guarantee fund" which, in the Society's case, is 1/6th of the solvency margin (i.e. around £40m out of some £240m projected at 31 December 1990). If the actual excess of assets over liabilities is greater than the "minimum guarantee fund" but less than the required solvency margin, then a special dispensation can be obtained from the DTI (called a S68 order) to bring so-called "implicit items" into account. In our case we could use an estimate of future surplus. The use of such orders might be regarded as showing a weak position by external commentators.*
>
> *Assets must be valued on the basis set out in regulations which is, effectively, a market valuation. There is no room to manoeuvre on that side of the comparison. Any difficulties on the public presentation can, therefore, only be overcome by changing the value placed on the liabilities.*

The Appointed Actuary says that he has:

> *... freedom in the value placed on the liabilities, subject to the following regulatory constraints:*

(a) the reserves established must, in my professional opinion as the Appointed Actuary, represent a proper level of provision for the liabilities based on "prudent assumptions";

(b) the reserves must, in any event, be no lower than those produced on a basis laid down in regulations, coupled with additional requirements specified by the Government Actuary in relation to AIDS and "mismatching". Mismatching is concerned with looking at the situation if there is a ±3% change in interest rates associated with a 25% fall in the value of equities and property. We must demonstrate that our reserves are at a level such that the assets backing those reserves would still cover reserves satisfying the valuation regulations in the changed conditions.

It is not necessarily the case that a valuation satisfying constraint (b) above will also satisfy constraint (a). In current conditions it is, however, unlikely that, given a free hand, I should want to place a value on the liabilities higher than that on the statutory basis.

Equitable's Appointed Actuary states that he has:

... carried out projections on a range of bases to assess the effect of further market movements over the remainder of the year. These indicate that, except in the event of a further sharp fall in markets before 31 December 1990, I should be able to set liability reserves at a level which would enable a bonus to be declared at last year's level and still satisfy all the regulatory requirements. Looking at this year alone, it is, therefore, fairly unlikely that we shall be unable to do what we should like.

Under the heading '*Looking ahead to 31 December 1991*', the paper includes projections of the position in the following year under different capital movement assumptions. The Appointed Actuary explains: '*In the projections I have assumed capital movements of -10%, 0% and +10%, in 1991. The income yield on the fund will be around 7% at current levels and so these movements are broadly equivalent to overall earnings of -3%, 7% and 17% respectively*'. The projection for 1991 is presented as follows:

		Capital movements in 1991		
		+10%	*0%*	*-10%*
	+5%	*90 and 91 declarations covered*	*90 and 91 declarations covered*	*90 or 91 declarations covered (but not both)*
Capital movement in December 1990	*0%*	*90 and 91 declarations covered*	*90 or 91 declarations covered (but not both)*	*neither declaration affordable but still solvent at 31.12.91*

The Appointed Actuary goes on to discuss the Society's approach to smoothing the returns and the form of the allocation of bonuses.

In the disclosed January 1991 paper entitled '*Valuation and Declaration at 31 December 1990*', the Appointed Actuary re-examines the issues discussed in his earlier papers. He reports that the first draft figures show a return on the Society's investments of -8½%.

Equitable's Appointed Actuary states:

> *As previously discussed, it is intended to increase the rate of interest used to value the liabilities in order to reflect the high asset yields resulting from current depressed asset values. I anticipate that the reduction in liability reserves arising from that will enable bonuses to be declared at 1989 levels without any transfer from the Investment Reserve. Indeed, I would expect the liability reserves, including new declared bonuses, to be substantially below the closing fund of £5582m. That is, there will be a larger margin between asset and liability values in the DTI "Form 9" than simply the amount of the Investment Reserve. Work is in progress on a detailed evaluation of the position and it is intended to provide further figures at the board meeting.*

The Appointed Actuary sets out a '*Review of the market*'. From the bonus declarations already made by certain other companies, he says that:

> *(a) There is no evidence of an industry-wide move to cut declared bonus rates.*
>
> *(b) Offices generally are acting to smooth out, to a significant extent, the effects of low 1990 earnings. Indeed,* [a named other insurance company] *has publicly spoken of earnings of 14% p.a. over each of the next 4 years and their 1991 results appear to imply at least that level of earnings deemed for 1990.*

Under the heading '*Considerations of the appropriate action for the Society*', Equitable's Appointed Actuary reports the following:

> *In previous discussions we have felt that a deemed rate of growth in the region of 11/12%, which is consistent with the earnings underlying our declared rates, might be appropriate for 1990. The actual outcome for 1990 and the actions of our competitors to date reinforce my view that this would represent a degree of smoothing consistent with our stated approach to with profits business and the market ...*
>
> *Application of a total growth rate of 12% for pensions and endowment assurance business would give the following changes in total policy proceeds on 1 April 1991 compared with those a year earlier:*

Term	*Change in policy results 1990 – 91*	
	Personal pension	*Endowment assurance*
	%	*%*
5	*-8.1*	*N/A*
10	*-9.4*	*-1.3*
15	*-2.6*	*+0.3*
20	*+0.4*	*+2.3*
25	*+1.4*	*+3.4*

> *From the results quoted for other offices in paragraph 6 it would appear that these results should broadly maintain our competitive position, and might marginally improve it.*
>
> *As noted above, there is no general market move to cut declared rates. Dramatic action, such as passing the declaration altogether, would, in my view, carry an unacceptably high risk of a collapse in confidence. The only circumstances in which it might be appropriate to re-open that question would be in the event of a dramatic collapse in markets during*

the next few weeks. (One office ... has publicly stated that it is awaiting further developments in the Gulf before finalising its bonus announcement.)

I have previously argued that current conditions give no logical basis for a cut in declared rates. That remains my view. If we were to be one of the few offices to make a reduction in declared rates whilst maintaining the overall level to be allotted, then the publicity that would attract could well counteract the effects of the overall announcement which, as noted above, seems likely to be reasonably competitive. We might, therefore, attract considerable adverse publicity for a relatively trivial financial benefit this year.

The course of action described above is not, of course, without risk. Although it has been possible to reduce the liability valuation to permit a declaration at last year's level, the scope for further weakening in the face of another year of low earnings would be seriously constrained. In crude terms, the viability of the action described above relies upon the achievement of better investment returns in the relatively short-term future. We are at risk of needing to take drastic action if those better returns do not materialise.

As discussed in December, one can look at projected scenarios for 1991 in order to put those risks into perspective. In broad terms 1991 earnings would need to be:

(a) At around 15% to allow the Society to declare again at 1989 rates and present a similar level of strength to that at 31 December 1990.

(b) At least 8% to enable a declaration to be made at the 1989 level, but showing a weaker position than at 31 December 1990.

(c) At least 0% to avoid problems in demonstrating solvency. This would imply no 1991 declaration.

Our discussion of the investment outlook in December led to the firm view that an estimated return of 13.6% for 1991 should be used as the basis for the consideration of bonus and solvency matters. That view then leads to the conclusion that it is appropriate to take the risks inherent in the course of action described above in current conditions.

The Appointed Actuary concludes by saying that he expects to be recommending to the Board at the following month's meeting that declared bonuses should be the same as for 1989 and that final bonuses should be based on a total rate of return of 12% (11.5% for recurrent single premium business).

In the disclosed February 1991 paper entitled '*Valuation and Bonus Declaration at 31 December 1990*', the Appointed Actuary provides an update on the valuation and makes recommendations regarding the bonus declaration.

The disclosed March 1991 '*Investment Considerations 1991*' Board paper includes a section under the heading of '*Comparison with our competitors*', in which the Appointed Actuary reports:

As in previous years, [a named company] *and* [another company] *stand out as taking a more "aggressive" stance than other offices with all, or virtually all, their with profit funds invested in equities and properties. Because of that approach, the market conditions of 1990 are likely to have resulted in a lower return for them than for offices, such as the Society, holding a proportion of their assets in fixed interest stock, deposits etc. However, as we have seen from previous analyses, their ability to take this more aggressive stance has, over longer periods, been to their advantage. No doubt that is a major contributory factor to their ability to produce competitive with profits results. Both these offices have* *a strong balance sheet or "Form 9" position and should have had little difficulty weathering the poor investment conditions of 1990.*

Equitable's Appointed Actuary notes:

The Society does not currently have, nor is likely, given our policy of full distribution, to attain the strength to pursue such an aggressive investment policy as [those companies]. *We shall, for the foreseeable future, need to continue with a more "balanced" portfolio. A recent survey of the With Profits Guides of 17 offices indicated that at 31 December 1989 the Society's investment mix was fairly typical of the group as a whole.*

Under the heading '*Implications of and risks associated with the recent bonus decisions*', the report states:

In putting the Society's financial position into context at the recent declaration, I indicated that a return of around 15% would be needed in 1991 in order to "stand still". That is, to be able to declare again at the same bonus rates at 31 December 1991 and present a no weaker position to the DTI than at 31 December 1990. If the 1991 return fell to around 8% we would begin having problems in maintaining declared bonuses and demonstrating solvency. In those circumstances the balance sheet position would clearly be significantly weaker than at the end of 1990.

At the December 1990 Investment Committee, the firm view was expressed that the most likely return for 1991 was around 13½%. On that basis, it was agreed that the risks associated with the declaration decisions were acceptable. It is, however, clear that a return much below the most likely estimate could lead to an uncomfortable position in the sense of our published position being sufficiently weak to attract adverse comment, unless most other offices were similarly placed. At some point we could also begin to attract closer scrutiny from the DTI.

1991

Equitable's Appointed Actuary says:

The signs so far this year are, of course, encouraging. If at some point, however, achievement of a return of the order of 13-14% began to appear in jeopardy, then we should need to take a serious look at the potential solvency position at the year end. That may lead to the need to increase the yield on the fund rapidly so as to increase the rate of interest that can be used to discount the liabilities. For example, it may then be necessary to direct new money towards fixed interest stocks, possibly combined with some switching of existing holdings. Clearly such action, which may be in conflict with other investment objectives, would only be taken if absolutely necessary.

The weakening of the liability valuation at 31 December 1990 reflected the depressed asset values at that time. As capital values regain a more normal relationship with, say, their 31 December 1989 values, I shall be forced by the regulations to begin strengthening the basis again since the liability valuation discount rate is related to the running yield on the assets. That will imply writing-up of the fund by amounts in excess of those needed merely to cover new declared bonuses at future declarations. Clearly, the higher the income yield on the fund in any one year, the greater the room for manoeuvre we shall have in the liability valuation.

He continues:

The above discussion is essentially concerned with declared bonuses and the solvency implications. The position on overall policy proceeds also carries investment implications. These are now considered.

If, in broad terms, we regard the 31 December 1989 position as one of balance between policy values and asset values, then in 1990 we allocated growth of 12% against actual *fund earnings of around -8½%. There is, thus, a shortfall of some 20% for the year to be recovered from future earnings in order to restore a position of balance. If we allocated 12% again for 1991 then actual earnings would need to be around 30% to achieve a balanced position again by 31 December 1991. In practice the "recovery" is likely to be achieved over a number of years. It is, however, important to remember where we are. The fact that we have got through the difficulties of 1990, and smoothed a substantial part of the effects of that for our policyholders, does not mean that we are starting 1991 from a neutral base.*

The conclusion to be drawn is that the higher the return at market value achieved this year and next the more comfortable. A balance, therefore, needs to be struck between selecting assets expected to perform well in the short-term and those where the returns will emerge over longer timescales. That is, the deliberate sacrifice of return in the short-term needs to be controlled.

The Appointed Actuary's report concludes with the following recommendations to the Board:

(a) There is no need at the present time for any re-arrangement of the portfolio on actuarial grounds.

(b) The level of investment in index-linked securities should continue to be monitored against the growing liabilities under index-linked annuity contracts.

(c) In determining strategy, we clearly need to look to maximise overall returns. Whilst continuing our usual approach of balancing long and short-term considerations, a reasonable degree of emphasis should be placed on producing high returns in the short-term. That implies, for example, that whilst committing a "normal" proportion of new money to assets like property with an initially low, or zero, yield would be consistent with that view, investing an unusually high proportion in that way would be inconsistent.

(d) There need be no specific actuarial constraints on investment strategy at present, beyond that mentioned in (b) above. If at any point there appears a risk of not achieving a return at least of the order of 13-14% there should be an immediate formal reassessment of investment strategy for the remainder of the year. In such circumstances some actuarial constraints may need to be imposed.

(e) If investment considerations are neutral, higher-yielding stocks should be purchased in preference to lower-yielding, as this will assist the solvency position.

The Directing Actuary, in an undated note to Chief Actuary B, says:

To respect [the Appointed Actuary's] *"preference" I don't think we need show these to DTI unless the situation in due course warrants it.*

I will need to review them again before I go to the President's "appointed actuaries" meeting on 27/9. Please bring them forward on 23/9.

14/06/1991 GAD's Directing Actuary A writes to Chief Actuary B about the issue of the appointment of Equitable's Chief Executive while remaining Appointed Actuary. The Directing Actuary says that '*Reading the papers through, I am struck by how this exchange has got out of hand simply by slightly changing the emphasis of certain phrases*'. The Directing Actuary points out that the Government Actuary's statement '*Bearing in mind the fact that it is not now generally thought desirable for the same person to be* [Chief Executive] *and* [Appointed Actuary] ...' (see 17/04/1991) had been changed by the Chief Actuary to read '*As it is not now thought desirable for the same person to be both Chief Executive and Appointed Actuary ...*' (see 19/04/1991).

Directing Actuary A continues:

> *What is required is a mechanism to defuse the situation, and especially* [DTI's Line Supervisor A's] *latest note on the Equitable's letter of 31/5. I have already spoken to* [Equitable's Appointed Actuary] *at the Institute seminar on 6/6, not knowing of this correspondence. I told him that provided plans were being put in place to bring along a new actuary in a year or two, I was relaxed (NB* [the Appointed Actuary] *retires – or is of retiring age – in the not too distant future). He knows our concerns and respects them. However, if someone hasn't matured as quickly as they had hoped, there is no point DTI getting up-tight.* [The Appointed Actuary] *now sees this issue as a point of principle for him – and I take his point.*
>
> *We should explain to* [Line Supervisor A] *that Equitable is not a one-man show, likely to be dominated by* [the Appointed Actuary]. *There are several good actuaries in the company, and they are unlikely to fall into the kinds of problems we have seen elsewhere purely because he holds two key posts. DTI should accept the company's assurances that they will separate the two posts as quickly as it is prudent to do so.*

17/06/1991 DTI write to Equitable, noting the Society's:

> *... current intention to separate the roles of Appointed Actuary and Chief Executive within the time frame suggested by* [Line Supervisor A]. *In the light of that and the points made during our conversation I am happy to confirm our acceptance of* [the person's] *appointment without condition.*

18/06/1991 DTI's Line Manager A replies to Line Supervisor A's manuscript note on Equitable's letter of 31/05/1991. He explains that he had spoken to Equitable the previous evening and that, during that discussion, the Society had again raised objections to the imposition of a condition. The Line Manager says:

> *If the Appointed Actuary is also the Chief Executive and therefore responsible for taking the decisions on the direction of the company there is, almost by definition, a conflict of interest. The Appointed Actuary is most unlikely to blow the whistle on his own decisions taken as Chief Executive!* [Equitable] *took the point but said that* [they] *would still prefer our acceptance to be unconditional. I said we were prepared to lift the condition but nevertheless we noted the company's intention to find a new Appointed Actuary within 12-18 months and that we would not be constrained from raising the point again at the end of that timescale if no appointment had been made. On that basis I wrote the letter* [of 17/06/1991].

Submission of the 1990 regulatory returns

27/06/1991 **Equitable submit their 1990 regulatory returns to DTI.** Accompanying those returns are copies of the Society's annual report and accounts for 1990, prepared in accordance with the Companies Act 1985 and dated 27 March 1991.

Equitable also send DTI a declaration under section 94A of ICA 1982 and pay Insurance Fees of £10,000 in respect of their 1990 returns.

These documents include the following information about Equitable's business and their financial position as at 31 December 1990.

Companies Act annual report and accounts
In the *President's Statement,* Equitable note that the Society continues to grow rapidly with the President being '*in no doubt that this is a direct consequence of the confidence existing and new policyholders have in the quality and integrity of the Society's approach to business*'. Equitable say that their recent bonus declaration *'demonstrated vividly the way the with-profits system protects policyholders from the full effect of short-term falls in asset values',* while noting that: *'Over a long period bonus additions to policies must reflect actual trends in investment and operating experience of the Society. Those who choose with-profits rather than unit-linked policies clearly recognise that smoothing out of peaks is a price worth paying for the avoidance of a trough'.*

In the *Management Report,* Equitable state that new premium income had increased by 30% to £836m, breaking previous levels, with single premium new business policies increasing by 42% to £578m. On investment performance, Equitable say that investment returns for 1990 had been negative for the first time since 1974. However, Equitable also say that policyholders are protected by the with-profits bonus system from the full effect of short-term falls in asset values.

In the section on bonuses in the *Directors' Report*, Equitable disclosed that, in the light of poor investment returns and having regard to prudent actuarial principles, they have valued their liabilities using a higher valuation rate of interest than in 1989.

Equitable's *Annual Report* no longer contains a *Statement of Bonuses* giving detail on specific rates of bonus for major classes of business. Instead, policyholders are directed to one of Equitable's booklets, available from branch offices on request. Policyholders are also directed to the Society's *With-profits Guide* for a description of its approach to with-profits business.

The returns
Equitable's returns are submitted in three parts, covering: Schedules 1, 3 and 6; Schedule 4; and Schedule 5 (Statement of long term business by the appointed actuary). Schedule 5, required to be submitted every five years, sets out in detail the Society's in-force business.

Schedule 1 (Balance sheet and profit and loss account)
As in previous years, Schedule 1 of Equitable's returns consists of Forms 9, 10, 13, 14 and 16. Form 9 summarises the Society's financial position at 31 December 1990 as follows:

Long term business admissible assets	*£5,932,451,000*
Total mathematical reserves (after distribution of surplus)	*£5,361,777,000*
Other insurance and non-insurance liabilities	*£157,748,000*
Available assets for long term business required minimum margin	*£412,926,000*
Required minimum margin for long term business	*£233,182,000*
Explicit required minimum margin	*£38,864,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£374,061,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	£179,744,000

Schedule 3 (Long term business: revenue account and additional information)
As in previous years, Schedule 3 consists of Forms 40 to 51, which have been supplemented by various notes providing further information about/explanation for the figures provided.

Form 45 shows that 47% of Equitable's non-linked assets are invested in equities, 13% in land and 27% in fixed and variable interest securities (compared with 55%, 12% and 26%, respectively, in 1989).

Equitable disclose in Form 46 that the gross redemption yields on fixed interest securities issued or guaranteed by any government or public authority and with durations of less than 15 years are consistently higher than for those not issued or guaranteed by any government or public authority.

In the notes to this part of the returns, Equitable disclose that they have estimated their contingent liability for corporation tax on unrealised capital gains for non-linked business to be nil.

Equitable state that they have been granted a section 68 Order which permits them to include in aggregate form details of their *'Personalised Funds'* in Forms 49, 50, 51 and 57, instead of the separate details for each Personalised Fund required by the ICAS Regulations 1983.

Schedule 6 (Certificates by directors, actuary and auditors)
Three Equitable Directors provide the certification required by Regulation 26(a) of the ICAS Regulations 1983. Equitable's Appointed Actuary provides the certification required by Regulation 26(b) of the ICAS Regulations 1983. As required by Regulation 27 of the ICAS Regulations 1983, Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

Schedule 4 (Abstract of valuation report prepared by the Appointed Actuary)
As in previous years, Equitable present two valuations of their long term liabilities (their main and appendix valuations). The results of the main valuation are carried forward, unadjusted, from Form 58 to Form 14 and on to Form 9.

Schedule 4 – main valuation (text)
Schedule 4 of Equitable's returns answers the questions set out in paragraphs 1 to 19 of Schedule 4 to the ICAS Regulations 1983 and includes Forms 55 to 58 and Form 60. Equitable state that this valuation conforms to Regulation 54 of ICR 1981.

In response to paragraph 3, Equitable provide ten pages of information about their non-linked contracts. Most of the information about the contracts remains unchanged from the previous returns.

Equitable again disclose, in paragraph 3(xii), that they applied a guaranteed annuity rate to the accumulated cash fund generated by certain types of with-profits pension policies, stating for the first time that the guarantees applied to policies issued prior to 1 July 1988.

The description of Equitable's principal guarantees of terms at the end of paragraph 3 remains unchanged from the previous year, with the exception of a minor amendment to the description of *'Options to effect further policies without evidence of health'*. As in previous years, Equitable disclose that recurrent single premium and variable premium deferred annuity policies carry guaranteed terms under which future premiums could be paid.

In response to paragraph 4, Equitable provide 31 pages of information about their linked contracts. Most of the information about the contracts remains unchanged from the previous returns.

As in previous years, in paragraph 5 Equitable disclose that they have tested the ability of the Society to hold reserves which satisfy Regulations 54 and 56 to 64 of ICR 1981 in the changed investment conditions described in DAA1. Equitable state:

> *In these conditions the Society would be able to set up reserves which satisfy* [Regulations 54 and 56 to 64 of ICR 1981] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued.*

(Note: the entry at line 51 of Form 14 was the excess of the value of admissible assets representing the long term fund over the amount of those funds and represented the difference between the market value and book value of those funds.)

Equitable again state that, in determining the provision needed for resilience reserves and tax on unrealised gains, they have taken account of the fact that the long term fund has been valued at book value.

In paragraph 5(1)(e), Equitable disclose that a reserve for the prospective liability to tax on unrealised capital gains (losses) is held in respect of policies where benefits are linked to the Society's internal funds. Equitable state that the contingent liability for tax on unrealised capital gains in respect of other business is estimated to be nil, and accordingly no other additional reserve is made for any prospective liability for tax on unrealised capital gains.

As in previous years, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity.

As in previous years, in paragraph 6(1) Equitable disclose that for certain non-profit deferred annuities, a small class of business, the valuation rates of interest used were those assumed in the premium basis. Equitable, again, do not elsewhere disclose the rates used in the premium basis.

As in previous years, in paragraph 7(b) Equitable do not explain the method by which they have made provision in the main valuation for expenses on recurrent single premium business. Unlike in previous years, Equitable do not maintain a general expense reserve for any shortfall of future premium loading on regular premium business.

As in previous years, at paragraph 7(d), Equitable state:

> *A further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 55 to 64 of the Insurance Companies Regulations 1981. The resultant aggregate liability is less than the aggregate liability on the methods and bases described in this report. The report on the net premium valuation is given in an appendix following Form 60 of this report.*

As in previous years, in paragraph 11 Equitable state that they have *'no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund'.*

As in previous years, in response to paragraph 12 of Schedule 4 Equitable simply state that they distribute profits in accordance with the principles determined by their Directors and their Articles of Association.

Paragraph 13 sets out the level of bonus declared for 1990 and records that Equitable had again set the reversionary bonus for its main policy classes at 7.5%. As in previous years, Equitable disclose that some retirement annuity and individual pension policyholders have been offered loans under a *'loanback'* arrangement.

In response to paragraph 16, Equitable again describe their system for determining final bonuses. (See 29/06/1990.)

<u>Schedule 4 – main valuation (forms)</u>
In Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts along with information on the numbers of contracts in force, the benefits guaranteed and the rates of interest and mortality assumptions used in valuing them.

In Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity and the rates of interest and mortality assumptions used in valuing them. Equitable disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 58, Equitable set out the valuation result and the composition and distribution of the fund surplus.

<u>Schedule 4 – appendix valuation (text)</u>
Equitable explain that the appendix valuation:

> *... was undertaken for the purposes of demonstrating that in aggregate the mathematical reserves determined by the valuation undertaken using the gross premium method, the results of which are reported on the preceding pages, are not less than an amount calculated in accordance with Regulations 55 to 64 of the Insurance Companies Regulations 1981.*

Equitable's appendix valuation provides the information required by paragraphs 1, 5, 6, 7, 9, 17 and 18 of Schedule 4 to the ICAS Regulations 1983. They say that the information required for the other paragraphs (apart from paragraph 19 – being a statement of the required minimum margin in the form set out in Form 60 of Schedule 4 to the ICAS Regulations 1983 which, having had *'regard to the purpose of the valuation',* has not been provided) is identical to that given in the main valuation.

In response to paragraph 5(1)(a), Equitable make a similar statement to that made in the main valuation and in previous years, that: *'In these conditions the Society would be able to set up reserves which satisfy* [Regulations 54 and 56 to 64 of ICR 1981] *without needing to have recourse to assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued'.*

As in the main valuation, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity.

As in previous years, in paragraph 5(1)(g) Equitable disclose the ages that retirement benefits could be taken on their recurrent single premium with-profits pension business.

As in the main valuation, in paragraph 7(b) Equitable do not explain the method by which they have made provision for expenses on recurrent single premium business. Unlike in previous years, Equitable do not maintain a general expense reserve for any shortfall of future premium loadings on regular premium business.

Schedule 4 – appendix valuation (forms)
In the appendix version of Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts on the appendix valuation basis.

In the appendix version of Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts on the appendix valuation basis.

Schedule 5 (Statement of long term business by the appointed actuary)
For the 1990 returns, Equitable provide the information required by Schedule 5 to the ICAS Regulations 1983. The Schedule requires a statement – *'in such one of the forms set out in Forms 65 to 70 as is appropriate to that category of contract, or, in the case of a category of contract to which none of these forms is appropriate, in such form and containing such particulars as are sufficient to enable an independent assessment of the liabilities of the company's long term business to be made'* for each product listed in Form 55 and Form 56 of the returns. The Schedule runs to 130 pages.

1991

Most of the information provided by Equitable uses Forms 65 to 70 set out in the Regulations. Some of the forms completed include supplementary notes.

For the *'General Annuity Fund, Deferred annuities with guaranteed cash options – with uniform premiums'*, Equitable include the following notes:

> *The policy is written for cash with a guaranteed annuity option.*
>
> *The terms of the annuity option are such that they would not be exercised under foreseeable conditions.*
>
> *Typical rates of guaranteed annuity applicable to this business are:*
> *Men at 65 – £9.92%*
> *Women at 65 – £8.56%*

The returns show that this class of business totals more than £29m. The same note is included for the *'Pension Business Fund, Deferred annuities with guaranteed cash options – with uniform premiums'.* The returns show that this class of business totals more than £98m.

For the *'Pension Business Fund, Individual pension arrangements – variable premiums'*, Equitable include the following notes:

> *Examples of the guaranteed annuity rates applicable to this business are:*
> *Men – at 60 £10.26%, at 65 £11.55%*
> *Women – at 60 £9.34%, at 65 £10.33%*
>
> *These rates are for a single life annuity payable monthly in advance payments guaranteed for 5* [years].

The returns show that this class of business totals more than £771m. For *'Pension Business Fund, Retirement annuities – variable premiums'*, Equitable do not provide any notes on the rates of annuity guarantee applicable.

01/07/1991	Equitable's Appointed Actuary also becomes Equitable's Managing Director and Chief Executive.
24/07/1991	**GAD complete the A1 Initial Scrutiny check on the Society's 1990 returns.** GAD note the cover for the required minimum margin is 1.77 (reduced from 4.77 the previous year). They do not identify any concerns.
26/07/1991	GAD's Directing Actuary A writes to Equitable's Appointed Actuary to acknowledge receipt of the papers sent on 11/06/1991. The Directing Actuary marks the letter *'Private and Confidential'*. He says that he looks forward to seeing the Appointed Actuary at the President's meeting at the end of September and thanks him *'for the insight your papers give us; I will ensure they get an extremely limited circulation'*.
29/07/1991	**GAD complete the A2 Initial Scrutiny check on the Society's 1990 returns.** GAD raise Equitable's priority rating from 5 to 3 but identify no items that are worrying and no items to notify to DTI, to be taken up immediately with Equitable. As part of the check, GAD note: *(1) Deteriorating cover for the* [required minimum margin] *(2) Loss of working capital for future expansion.* Accompanying the Initial Scrutiny check are two forms (*Form B* and *Form C1*) tabulating key figures disclosed in the 1986 to 1990 returns.
27/08/1991	Equitable write to Scrutinising Actuary B at his home address, following a telephone call he made to the Society posing as a potential policyholder. Equitable provide the Scrutinising Actuary with details about their with-profits bonds.
29/08/1991	An actuary at GAD (who later becomes the Directing Actuary with responsibility for Equitable) attaches a note to the letter of 27/08/1991 addressed to Scrutinising Actuary B and Chief Actuary B: *I do not see how this contract can be valued by a net* [premium valuation] *method as there are no overall guaranteed benefits on maturity (only accrued benefits from past premiums). A rate of interest of 5½% would in any case be extremely weak, leaving much reduced scope for future bonuses.*
12/09/1991	The same GAD actuary as in the entry for 29/08/1991 above writes to DTI about the introduction by a named other life insurance company of a guarantee on their with-profits bond that no market value adjustment would be applied if the policy were surrendered after ten years. The GAD actuary says: *Generally we are aware that a number of companies are now issuing this type of contract. These include for example Equitable Life and others which apparently held reserves below the face value of the units at the end of last year.* *This practice can only be justified if they currently apply market value adjustments on surrenders, and can reasonably hope to earn a positive rate of return (in addition to future bonus declarations that may be "reasonably expected") over the period to death or "maturity" of the policy.* *Furthermore, we have to be satisfied that they can still set up adequate reserves under changing investment conditions, including a 25% fall in the value of equities and a 3% variation in yields on fixed interest securities.*

08/11/1991	Equitable's Appointed Actuary applies to DTI for a section 68 Order for a future profits implicit item of £300m, for possible use in their 1991 returns. The Appointed Actuary provides financial calculations in support of the application, suggesting that the Society could seek an Order up to the value of £405.2m.

These calculations include, for the estimated annual profits, that:

Year ending	*(A) Total surplus*	*(B) Exceptional items*	*(C) Surplus arising from solvency margin*	*(A)-(B)-(C) Ordinary surplus*
	£m	*£m*	*£m*	*£m*
31.12.86	*153.9*	*–*	*56.1*	*97.8*
31.12.87	*254.7*	*65.0 (a)*	*65.3*	*124.4*
31.12.88	*259.2*	*–*	*61.4*	*197.8*
31.12.89	*337.4*	*–*	*89.9*	*247.5*
31.12.90	*422.5*	*557.0 (b)*	*26.6*	*(161.1)*
				506.4

Average annual profit = 506.4/5 = £101.3m

Notes: *(a) £65.0m of the surplus arising in 1987 was an exceptional item arising from a change from a policy year to a calendar year method of bonus allocation for the bulk of the Society's with profits business.*

(b) Surplus was increased by £557.0m as a result of changes in valuation bases during 1990.

GAD circle the figure of £557m included in column (B).

The calculations state that the average period to run for the Society's in-force contracts is eight years. The Appointed Actuary explains:

> *The periods to run have been reduced to take account of premature withdrawals based on the Society's recent experience of such withdrawals. In respect of retirement annuity and personal pension contracts for which a range of retirement ages is available, it has been assumed that retirement benefits are taken at the lowest possible age, or immediately if that age has already been attained.*

The calculations suggest that the maximum figure permissible for future profits is 50% of £101.3m multiplied by eight years – that being £405.2m.

13/11/1991	DTI's new line supervisor (Line Supervisor B) asks GAD for their views on the Society's application for a future profits implicit item.
19/11/1991	GAD's Chief Actuary B writes to Equitable's Appointed Actuary with a series of questions on the Society's 1990 returns. The Chief Actuary asks:

(1) for details of figures shown in the returns for debts due from other companies;

(2) why Equitable, for the first time, have split the long term business returns for premiums and expenses, revenue and claims into various sub funds, and whether GAD are correct in assuming that the change will not reflect the previous methods of distributing surplus to with-profits policyholders. GAD's Chief Actuary B notes: '*... that you have not completed separate Forms 58 for these sub-funds. Would you please confirm that this is correct bearing in mind the requirements of Section 18 (2) (b) of I.C.A. 1982?*';

(3) why there has been an increase in Equitable's '*other management expenses*';

(4) why Equitable have not included any contingency reserves in the 1990 valuation (when £10.5m had been included in 1989);

(5) for the product details of Equitable's with-profits bond and if there were any guarantees within the first five years of this contract;

(6) '*In paragraph 5(a) of the Appendix to Schedule 4 of your report you refer to the resilience test which you have carried out in connection with the valuation using the net premium method. I note your comments and that you would not need to have recourse to assets shown at line 51 of Form 14 of the Returns. There is however a substantial difference in the mathematical reserves shown at line 11 of Form 14, and the amount of the reserves arrived at using the net premium method of valuation. I would therefore like to know the amount of the mismatching reserve which you would have needed to set up had you used the net premium method in arriving at the amount shown in line 11 of Form 14*';

(7) what the cost was of the change in the published valuation basis as at 31/12/1990, when compared with the basis used for publication at the previous valuation; and

(8) '*I am wondering what the figures for the Society will look like in the December 1991 Returns. Can you advise us what the position is likely to be at the year end, including the likely amount of the available assets shown at line 25 of Form 9?*'

20/11/1991 **GAD complete their detailed scrutiny of the Society's 1990 regulatory returns.** GAD send DTI a two page note setting out their findings. (A copy of this scrutiny report is reproduced in full within Part 4 of this report.) GAD explain that Equitable have continued to expand rapidly, with new premium income rising by 30%, new regular premiums by 10% and single premiums by 42%, the latter due to the success of the with-profits bond.

GAD explain that, in common with other companies, Equitable have experienced falls in the market values of equities and other assets. As a result:

> *... the actuary has decided to weaken the valuation basis of the with-profits business. The rates of interest he has used are within the limits laid down in the regulations and could be supported by the yields shown* [in the returns] *although the margin is small. We are asking a few questions about the valuation basis and we will comment in detail after the replies from the Society.*

GAD also explain that:

> *The cover for the required minimum margin is reduced from 477% (1989) to 177%* [for] *this year. The main reason for this is the fall in value of the assets (referred to ... above). Part of the fall has been covered by a release of £214m from the mathematical reserves arising from the weakening in the valuation basis. Other reasons for the reduction in cover for the* [required minimum margin] *are (a) growth of new business and (b) maintenance of unchanged bonus rates on with profit policies.*

GAD conclude that Equitable are a major player in the recurrent single premium personal pensions market. They attach a copy of their letter to Equitable of 19/11/1991.

22/11/1991	Equitable's Appointed Actuary writes to GAD in reply to the queries in their letter of 19/11/1991. In relation to the questions, as numbered in the earlier entry, the Appointed Actuary:

(1) provides the details requested;

(2) explains that the Society has split the long term business returns for premiums and expenses, revenue and claims into various sub funds to ensure that changes in reserves during 1990 resulting from changes in valuation bases did not affect Equitable's liability to corporation tax. He adds that all with-profits policyholders continue to participate in the surplus of Equitable's long term business fund, and the Appointed Actuary says that he is *'able to confirm that it was correct to complete only one Form 58 for 1990 in compliance with Section 18(2)(b) of I.C.A. 1982'*;

(3) explains that *'other management expenses'* have risen in absolute terms, but, in relative terms, the rise from 1989 to 1990 was only from 34% to 38% of total expenses. The Appointed Actuary says that he is *'satisfied that, taking account of the level of expenses in 1990, the Society's reserves continue to make sufficient provision for future expenses'*;

(4) explains that, from 1976 to 1989, the Society held a general reserve which was primarily for the estimated shortfall of future premium loadings to meet future expenses on contractual regular premium contracts effected before 1976. But:

> *Since 1976 the composition of the Society's business has changed substantially from being mainly contractual premium business to the current position in which recurrent single premium contracts comprise the major part of the business. At the 1990 year-end I came to the conclusion that there was sufficient provision in total reserves for future expenses without the need for a separately identifiable reserve in respect of contractual premium contracts which had become an unnecessary complication;*

(5) encloses a copy of the Society's booklet for the product particulars of the with-profits bond and says: *'There are guarantees within the first 5 years of the contract, details of which can be found in the enclosed booklet ... and* [in the 1990 returns]';

(6) states: *'If the Society had shown mathematical reserves in line 11 of Form 14 of the amount calculated using the net premium method of valuation, I would have needed to set up an additional mismatching reserve of £450m'*;

(7) explains that, if their published reserves had been calculated as at 31/12/1990 using the basis used for publication at the previous valuation, the Society's reserves would have been £557m higher;

(8) explains that the Society would:

> *... need to publish a substantially stronger valuation at the end of 1991, either by explicit strengthening of the basis or the inclusion of an explicit mismatching reserve, than at 31 December 1990 reflecting the reduction in yields during the year.*
>
> *My current view is that it is unlikely that the* [solvency] *position at the end of 1991 will be any stronger than at 31 December 1990, although the underlying liability valuation will, of course, be substantially stronger.*

Equitable's Appointed Actuary undertakes to provide more detailed information about the year end position when this becomes available (see 12/05/1992). GAD subsequently forward a copy of this letter to DTI (see 23/12/1991).

25/11/1991	GAD write to Equitable's Appointed Actuary to say that the information supplied *'is most helpful, and we will be studying this in more detail a little later'*.

1991

11/12/1991	GAD provide DTI with their views on Equitable's application for a section 68 Order (08/11/1991). GAD state that the amount requested: *... is less than the maximum allowed in accordance with the calculations based on the guidance notes.* *We have no comments on the calculations and we recommend you to issue the S68 order for the implicit item of £300m as requested by The Society.*
16/12/1991	DTI send Equitable's Appointed Actuary a section 68 Order for a future profits implicit item of £300m, for use in the 1991 returns.
23/12/1991	GAD forward a copy of Equitable's letter of 22/11/1991 to DTI.

1992

17/01/1992 GAD write to Equitable's Chief Executive to announce that they intend to visit in the near future. GAD explain that this is part of the DTI's and GAD's rolling programme of visits to insurance companies authorised to write long term business, that it is the intention to visit all offices within three years, and that no significance should be attached to the order in which the visits take place.

GAD say:

> *We would like to discuss the following main areas:*
>
> 1. *Board of Directors*
> 2. *Management Structure*
> 3. *Future Plans and Strategy*
> 4. *The role of the Appointed Actuary*
> 5. *Decision Taking*
> 6. *Corporate Structure*
> 7. *Administration*
> 8. *Distribution Systems*
> 9. *Investment Policy*
> 10. *Bonus Policy*

29/01/1992 Equitable's Chief Executive and Appointed Actuary writes to GAD to confirm the visit for 05/03/1992. The Chief Executive adds: '*Have you asked* [Directing Actuary A] *whether he wants to attend? At one time he did express an interest in so doing but this is essentially a domestic matter for yourselves*'.

(The meeting is postponed (see 02/03/1992). It takes place on 19/05/1992 and the Directing Actuary does attend.)

31/01/1992 [entry 1] **GAD write to DTI with a *'Post Scrutiny Report'* on the Society's 1990 regulatory returns**, in the light of Equitable's letter of 22/11/1991. GAD explain that:

- they have no additional comments on the figures that Equitable have provided for debts due from other companies;
- the long term business returns for premiums and expenses, revenue and claims were split for tax reasons and '*will not affect the distribution of surplus to with-profits policyholders. This is reasonable*';
- they are satisfied with Equitable's *'assertion'* that sufficient provision has been made in the valuation of liabilities for future expenses;
- that, as the last two years' returns have shown that most of Equitable's business is now recurrent single premiums and regular premium business is dwindling, '*the need for a general reserve to augment the mathematical reserve is not necessary*';
- they are seeking more information on with-profits bonds, enclose a copy of their letter to the Society (see 31/01/1992 [**entry 2**]) and undertake to comment on the valuation basis of the bonds when Equitable have replied;
- they are satisfied with the information Equitable have given about the mismatching reserve and the cost of the change in the valuation basis; and
- they will be in touch again when they hear further about the position as at 31 December 1991.

31/01/1992 [entry 2] GAD write to Equitable's Appointed Actuary, to ask about the Society's with-profits bonds:

> *I note that the current practice on surrender is to pay the full value of the guaranteed fund and bonuses standing to the credit of the policy ... Although you do not guarantee to pay this amount I am surprised that the reserves held are lower than the current surrender values. I would be glad if you would please comment on this.*

GAD continue:

> *I wonder what your surrender experience is like on these Bonds and also whether you have any limit in mind on the amounts of single premiums which your Society will undertake on these contracts?*

13/02/1992 Equitable's Appointed Actuary replies to GAD's letter of 31/01/1992. The Appointed Actuary explains that the guarantee of '*full value*' payment on the with-profits bond applies only at certain specific dates set out in the policy document and that the valuation basis takes account of those dates. However, although Equitable's current practice is to pay out *'full value'* on early surrender:

> *... we do not guarantee this. I do not see that the reserving basis for the bonds needs to take any particular account of this practice.*
>
> *For 1990 business it was convenient to value this class on similar bases to other business which obviously led to some release of premiums into surplus. We could, of course, easily have done something different since this class is trivial in relation to the whole. For 1991 we shall be valuing new business of this type so as to avoid such releases.*

The Appointed Actuary explains that the Society is currently experiencing a very low rate of surrender on this business and that:

> *We incur no initial strains on this business and, since we have told our policyholders that future bonuses will be at a level which can be supported by future investment conditions, there should be no commercial reason to put limits on the volume of business transacted. If our surrender experience deteriorates or if financial conditions worsened significantly, we should certainly impose surrender penalties.*

Equitable's Appointed Actuary says that the Society will not view this class of business as a source of surplus. He adds that the 1990 valuation basis *'needs to be considered over the total business and not class by class'.*

The GAD actuary who had commented previously on this type of business (see 29/08/1991 and 12/09/1991) passes Equitable's letter to Scrutinising Actuary B with a note:

> *We cannot insist that he uses reserves* [equal to or greater than surrender values] *where latter are not* [guaranteed]. *Would be a different matter if <u>all</u> business were like this.*

14/02/1992 GAD acknowledge Equitable's letter of 13/02/1992. GAD say that they have no further points on the Society's 1990 returns.

24/02/1992 GAD write to DTI, enclosing copies of the letters of 31/01/1992 and 14/02/1992. GAD say that they '*are satisfied with the valuation basis of with-profits bonds and this may please be treated as the end of our scrutiny of 1990 returns*'.

25/02/1992 DTI's Director of Insurance writes to GAD's Directing Actuary A about life companies' bonus rates. The Director of Insurance says that he and Directing Actuary A had *'discussed briefly whether it would be possible to compile a simple table showing the changes between 1991* *and 1992 in the major life companies' bonus rates (reversionary and terminal), as a cross indicator of current and prospective pressures on life funds*'.

The Director of Insurance says that DTI do not routinely receive the with-profits guides of all the insurance companies they regulate. He asks GAD to put together a table showing the main bonus rates for with-profits policies. The Director says: '*I foreswear judgement on what precisely we will do with this information until I have seen what it reveals. But I would not rule out using this comparative data as an input into the questioning of life companies' future plans on our visit programme*'.

02/03/1992	GAD telephone DTI's Head of Life Insurance to say that the proposed visit to Equitable on 05/03/1992 has been postponed. (It is not clear by whom.) GAD suggest a new date in May 1992.
04/03/1992	GAD confirm with Equitable the arrangements for the rearranged meeting on 19/05/1992.
12/03/1992	DTI's Line Manager A writes to the Director of Insurance, having seen a copy of his minute (see 25/02/1992 about companies' bonus rates. The Line Manager provides the Director with a copy of the most recent *Money Management* survey on endowment policies. He says that DTI have contacted the magazine and were told that the bonus rates for 1992 would appear in their May 1992 edition. On 7 April 1992 the Director of Insurance informs Line Manager A that he would like to see the article when it is available. An undated subsequent note records this as being '*done*'.

12/05/1992 Equitable's Appointed Actuary writes to GAD about the forthcoming 1991 returns and, in particular, to advise them of the Society's likely solvency position, as requested by GAD in their letter of 19/11/1991. The Appointed Actuary says that the '*Form 9 position as at 31 December 1991 was as follows*':

	£m
Admissible assets	*7,452*
Mathematical reserves	*6,991*
Other liabilities	*112*
Available assets for minimum margin	*349*
Implicit items	*–*
Total of available assets and implicit items	*349*
Required minimum margin	*298*
Excess of available assets and implicit items over required minimum margin	*51*

The Appointed Actuary states:

> *During 1991 the Society continued to attract relatively large volumes of new annual premium and single premium business (including additional recurrent single premiums). The total amount of such premiums in 1991 was about £1400m. Taking account of this fact I decided to strengthen the valuation bases for recurrent single premium policies in order to ensure that there was no immediate release of surplus in respect of 1991 premiums. In effect we put the valuation of 1991 new business back on to the premium basis which has been our traditional approach. That strengthening of the valuation bases increased reserves by about £150m. The general basis is also fairly strong because new business expenses are effectively written off as incurred. They will be recouped as the business matures but there is no accepted method of "zillmerising" recurrent single premium business, which is about 80% of our business in force.*

> *As in previous years I will be publishing a net premium valuation as an appendix to my valuation report to demonstrate compliance with the Valuation of Liabilities Regulations. The total net premium reserves shown will be £6,459m which, if they were to be shown in line 11 of Form 14, would require an additional mismatching reserve of £450m.*

He continues:

> *I am monitoring on a regular basis the Society's expenses and the effect of new business on the Society's financial position, and continue to be satisfied that no undue strain is being caused. New business will, of course, provide little or no contribution in the short-term to the Society's solvency margin. I believe that the underlying strength of the Society's business is being masked in* [the returns] *by our success in attracting business.*

Equitable point out that they are not using the future profits implicit item of £300m approved in December 1991. They say that an implicit item up to £650m could have been justified and continue:

> *If we were to compare the excess of available assets and future profits implicit item (for which credit could have been but was not taken) over the required solvency margin at the 1990 and 1991 year-ends, there was an increase from £580m as at 31 December 1990 to £701m as at 31 December 1991. Although a somewhat artificial measure in some respects, I believe it helps to demonstrate the underlying soundness of the Society's financial position.*
>
> *I regard my prime professional role as ensuring that prudent provision has been made for meeting future liabilities, that the various statutory and non-statutory requirements have been satisfied and that a demonstration of solvency can be achieved. I do not regard it as a priority to show the best possible position in Form 9* [i.e. the statement of solvency] *even though there is the real possibility of attracting adverse comments from so called "financial experts". This is, of course, comment to which we are well used.*

The Appointed Actuary continues:

> *Having said that, however, we monitor regularly the Society's ongoing financial position and possible positions in the future. In particular, the investment policy and its appropriateness taking account of the financial constraints of the business are reviewed. We have decided, for example, that in view of some uncertainty that equities will "perform" over the next year or so to invest the greater proportion of new monies into fixed interest investments during 1992. That will increase investment income and reduce the dependence upon capital appreciation for bonus declaration purposes at the year-end.*

Equitable invite GAD's comments on their letter before Equitable finalise their 1991 returns.

14/05/1992 Chief Actuary B passes Directing Actuary A a copy of Equitable's letter of 12/05/1992. The Chief Actuary sets out background comments in preparation for the forthcoming meeting with Equitable, along with their solvency position using Equitable's bonus reserve valuation and the alternative position using net premium reserves.

Chief Actuary B attaches a note of the interest rates used in the 1989 and 1990 valuation bases. He notes that '*the margins were very thin in 1990, with an average interest rate used of 7.12%*'. He says that GAD do not know the basis used in 1991 but they could seek this information during the meeting with Equitable, now arranged for 19/05/1992. He notes that the strengthening of the valuation basis in 1991 increased reserves by £150m whereas the weakening in 1990 reduced reserves by £557m.

In relation to initial expenses of new business, Chief Actuary B says:

A comment made in [the Appointed Actuary's] *letter is that 80% of the business is single premium business. He states that initial expenses will be recouped as the business matures as there is no accepted method of "zillmerising" single premium business. The business is mainly with profits pensions. I thought that a reasonable valuation rate of interest would allow the company to recover initial expenses right away – the main danger being a release of the bonus loading. We should query this.*

Regarding the level of new business, the Chief Actuary notes:

Comment is made about the effect of the new business on the Company's financial position, and [the Appointed Actuary] *states that new business provides little or no contribution to the solvency margin. Could it be that the level of new business is reducing the solvency margin too much?*

He also notes:

At the end of 1990 the company had over £100m of single premium With Profits Bonds in force. These were valued on an acceptable basis, although the reserves held were less than current surrender values (not guaranteed). This led to some release of premiums into surplus. I do not know how much of this class of business was written in 1991. We should ask about the effect of this on surplus.

Chief Actuary B adds that he had expected to see an increase in the excess assets in 1991 with the increase in market values and was surprised to see a fall. He suggests they discuss this with Equitable. He also raises the continuing position of one person holding the dual positions of Chief Executive and Appointed Actuary: '*This was queried by DTI and the company hoped to appoint a new Appointed Actuary in 12-18 months after 1 July 1991. I wonder what is happening on that issue?*'.

Scrutinising Actuary B, in an attachment to the note, records some further comments about Equitable:

1. Strength of Equitable: It provides a good service at a reasonable cost. Expenses are the lowest in the industry. It does not pay commission. Adverse publicity about commission and its associated problems have made Equitable very attractive to a lot of investors.

2. Weakness: Free asset ratio is low and when 1991 results are published a lot of [Independent Financial Advisers] *will question the strength of Equitable. We will be asked to comment about it by the National Health Service and the Treasury because Equitable underwrites both* [Additional Voluntary Contribution] *schemes.*

3. Equitable has used up investment reserves quickly in paying very good bonuses.

4. [Equitable's Appointed Actuary] *says that single premium business will release profits when it matures but with-profits business will probably be surrendered early rather than reach maturity when the interest rates will rise.*

5. Recurrent single premium business is exposed to cancellation as soon as there is adverse publicity about the strength of Equitable.

6. [The Appointed Actuary's] *position as Chief Executive and Actuary may create problems because there is nobody to blow the whistle when things go wrong.*

Behind this note are two pages from '*With Profits Without Mystery*', the paper that two of Equitable's actuaries presented to a meeting of the Institute of Actuaries on 20/03/1989 and to the Faculty of Actuaries on 19/02/1990. The paper had included, as an appendix, historical data setting out the market value of Equitable's fund and their investment reserve, for 1972 to 1987. GAD's copy of this appendix is annotated with figures for 1988 to 1991.

GAD copy their note to DTI's Line Supervisor B. The Line Supervisor adds her own comments in manuscript. She notes that the alternative position showing net premium reserves is '*to meet the requirements in the* [Regulations]'. She highlights that the total reserve in the net premium valuation, including the resilience reserve, is £6,909m, which compares with Equitable's published reserve of £6,991m. Line Supervisor B adds:

> [Chief Actuary B] *thinks they have been paying too much in bonuses ...*
>
> [The Regulations] *require a net premium reserve valuation. But* [the Appointed Actuary] *can use the bonus reserve method providing it can be demonstrated that* [the] *published basis gives as big reserves as* [the] *net basis.*

15/05/1992

DTI prepare briefing for their forthcoming visit to Equitable (on 19/05/1992). They note that Equitable '*is the oldest of all UK life insurance companies. Mutual company, founded in 1762. Transacts life assurance, annuity and pension business in the form of guaranteed, participating and unit linked contracts*'. DTI attach GAD's note of 14/05/1992 and comment:

> *... considerable reduction in Excess Assets between 1989 and 1991. 1990 Returns showed rapid expansion – total new premium income increased 30% to £836m. New regular premiums, at £258m, were up 10% on previous year and single premiums increased 42% to £578m (due partly to success of Society's with profits bond).*
>
> *Society has experienced falls in the market value of equities and other assets, and the actuary has decided to weaken valuation basis of* [with-profits] *business. Reduction in cover for* [required minimum margin] *is due to fall in value of assets, growth in new business, and maintenance of unchanged bonus rates on* [with-profits] *policies.*
>
> *GAD meeting with Equitable on 14.11.90 noted that they were considering not paying any reversionary bonuses for 1990. In the event a bonus was declared for 1990 at same rate as for 1989.*

DTI's note also highlights some other recent issues, including: that Equitable have set up branches in the Republic of Ireland and Germany (note: GAD's scrutiny report on the 1993 returns recorded that a new branch was not established in Germany until 1993 – see 15/11/1994); that they do not appear to be using the future profits implicit item of £300m, agreed in December 1991, in their 1991 returns; and that:

> [One individual] *is* [Managing Director]*/Chief Executive and Appointed Actuary as from July 91 ... We were not happy with one person holding both positions, and regarded this as a temporary situation – see attached correspondence. Perhaps we could ask about this at the meeting.*

19/05/1992

DTI (Head of Life Insurance and Line Supervisor B) and GAD (Directing Actuary A and Chief Actuary B) meet Equitable's Appointed Actuary to discuss a number of issues. DTI prepare a note of the meeting, which is then amended by GAD. The note records discussion of a number of matters, including the following.

<u>The role of the Appointed Actuary</u>
Both DTI and GAD express concern that the Managing Director is also the Appointed Actuary, as this could lead to a conflict of interest, as '[where] *the jobs were separate, and the Appointed Actuary thought that management was not doing its job, he could come direct to DTI*'. However:

> [The Appointed Actuary and Chief Executive] *did not perceive any conflicts of interest but said that if a conflict arose he would drop one of the jobs. His view was that the* [Appointed Actuary] *should be a generalist rather than a backroom "number cruncher". He felt that the position of* [Appointed Actuary] *was weakening in some companies, and*

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> *that the calibre of the newer entrants was lower because their job was so specialised and fragmented.*
>
> [The Appointed Actuary and Chief Executive] *was due to retire in 3 to 4 years time, by which time the* [Managing Director] *and* [Appointed Actuary] *roles would be separated again. He was considering whether any of the present actuaries was qualified to take on the* [Appointed Actuary] *role but the appointment of a new* [Appointed Actuary] *was at least a year off. He agreed with* [Directing Actuary A] *that the* [Appointed Actuary] *should be part of the senior management team. The problem was that there was at present nobody within the company to take over this role. The Equitable usually found the* [Appointed Actuary] *from its in-house actuarial team, but was prepared to recruit someone from outside if necessary.*
>
> [The Appointed Actuary and Chief Executive] *had been an executive director for some time, and had been a member of the investment committee, which was a "sub-set" of the Board, for about 14 years.*

<u>Equitable's investment strategy</u>
After an outline is given of Equitable's process of devising their investment strategy, GAD ask if Equitable found their investment policies were constrained by the valuation regulations. The Appointed Actuary responds that *'the liability regulations were only an irritant, i.e. a constraint, in the sense that they had to comply with them, but their main problem was funding the amount of surplus they needed at the right time'*.

<u>Equitable's bonus policy</u>
Equitable's Appointed Actuary says that 80-85% of their business was single premium with-profits policies which included a guaranteed interest rate of 3.5%. DTI ask if Equitable reserved for future terminal bonuses. The Appointed Actuary responds that:

> *... the company knew at all times the terminal bonus for each policy on the books. There was a notional terminal bonus reserve earmarked which was called the investment reserve. All the with-profits pension customers had annual statements which showed the notional accrued terminal bonus figure, but they were told that this bonus was not guaranteed.*
>
> [The Appointed Actuary] *explained that all the assets belonged to the current generation of members, and that they did not want to build up reserves for future generations.*

The note records that:

> [Chief Actuary B] *noted that if the value of equities had fallen, the company would need to cover their solvency margin.* [The Appointed Actuary] *said they would first look after their members' interests, and check that there would be enough surplus. They would then do the solvency tests.*
>
> [Directing Actuary A] *asked what the mechanism was for determining bonuses.* [The Appointed Actuary] *explained that he presented a paper to the Board in April. In September/October a further paper was presented about bonuses, and the actual bonus declaration from the Board issued in the following February. In 1992 the bonus was expected to be about 9½-10%.*
>
> *It was necessary to look at what was being notionally earned on fixed interest in respect of the Fund. In 1990 the rate that could be earned on deposits (gilts) was 12%. The bonus was 11%, which comprised 3½% guaranteed bonus, and 7½% declared bonus, totalling 11%. This included a 1% terminal bonus. In 1991 the notional rate earned was 14% and the bonus was 12%, which included a 2% terminal bonus.*

The note records that:

> [The Appointed Actuary explained that at] *the end of 1990 the valuation of the liabilities was weakened but in 1991 the liabilities had been valued more strongly, but were still well within the DTI regulations.* [Directing Actuary A] *noted that he liked Equitable's philosophy for its policyholders, but felt that its solvency strength was arguable.*
>
> [Directing Actuary A] *asked if there was a built-in mechanism for reducing reversionary bonuses if the need arose.* [Equitable's Appointed Actuary] *said they looked at the following options available: (i) non-declaration of bonuses; (ii) implicit items; (iii) to stop writing new business.*

On '*Future Plans*', Equitable say that they prepared a plan of their future objectives every three years. They agree to provide a copy of the current version to the regulators once it was finalised; it was only in draft at that time. DTI's note records that: '*The plan emphasised four important concepts that the Equitable stood for: (i) It was a mutual company; (ii) It operated at the top end of the market; (iii) It only sold direct, and (iv) It was innovative, and aimed for growth*'.

Under '*Distribution Systems*', DTI record that '*Out of the first premium, 10% went to the salesman, 20% to the branch, 5% to admin, and 5% to marketing*'.

At the conclusion of the meeting, Directing Actuary A '*noted that he would be concerned about Equitable's performance if there were dramatic falls in the market. Also there was the problem of who would take over when* [the Appointed Actuary and Chief Executive] *retired*'.

(Note: the meeting note contained no reference to 'zillmerising' or any explicit reference to the reason for the fall in excess assets in 1991 — see 14/05/1992.)

21/05/1992

GAD's Directing Actuary A writes to Equitable's Appointed Actuary to thank him for the '*valuable insights which you gave us at our meeting*', but also to express disappointment that GAD and DTI had not met some of Equitable's management team '*which is a prime purpose of these company visits*'. Directing Actuary A goes on to say: '*Nevertheless, I think we all came away knowing a lot more about the company's approach to mutuality, while reinforcing in our minds the unique position of the Equitable in the UK life industry*'.

28/05/1992

Equitable's Appointed Actuary sends GAD information about the Society's management structure, management company accounts and corporate objectives, as provided at the meeting on 19/05/1992. He explains that the '*actuarial management*' area is under the control of a very experienced, practical senior actuary who has four actuaries reporting to him, and expresses the wish that this will give GAD a feel of how the actuarial management is now being spread.

The Appointed Actuary writes: '*With hindsight, it might have been better to have some junior colleagues present at our meeting, but nothing we discussed would have been unfamiliar to them. I do try to run a very open area*'.

He explains that the Society has developed a new form of internal '*management company accounts*', saying that these are:

> *... an attempt to pull together into one document the various financial implications of what we do and which previously would have appeared, either directly or indirectly, in various papers to the board on a variety of topics.*

The Appointed Actuary continues:

> *The various loadings on which the "management expenses fund" is based are well documented internally and have effectively been in the current form for many years ...*

The accounts will be produced for me on a monthly basis, before the end of the following month, and submitted to the board on a formal basis each quarter.

The documentation enclosed with the letter includes information about the Society's management structure, a profit and loss account for the period ended 30 April 1992, the balance sheet as at 30 April 1992 and notes on the account.

Equitable's Appointed Actuary provides GAD with a copy of a Board paper entitled '*Revenue – Report on First 3 Months*', dated 22 April 1992. On the market value of the fund, the paper says:

The estimated market value of the fund at 31 March 1992 was £7,748m. That compares with a figure of £7,368m at 31 December 1991.

The increase in the market value of the fund over the first 3 months of 1992 represents an annualised rate of return of around 6.9%. That reflects the improvement in capital values during January and February followed by a decline during March. If at 31 March 1992 market values had been at the levels to which they increased following the General Election, the assets would have been around £125m higher. In that event, the increase in the market value of the fund since 31 December 1991 would have represented an annualised rate of return of about 14%.

The excess of market value of assets over liabilities at 31 December 1991 was £375m. By 31 March 1992 that was estimated to have grown very slightly to £377m before allowing for any accrued declared bonus cost.

He encloses a copy of the draft corporate objective, saying that, once finalised, it would then be sent to the regulators. The Appointed Actuary also encloses a copy of their current '*statement of intent*'.

The Society's Appointed Actuary concludes by saying that:

I enjoyed the meeting and hope that you and your colleagues got out of it what they were looking for. As you know, I am normally prepared to be very open about all of our activities and no doubt you will come back to me if anything needs further explanation or expansion.

15/06/1992 Equitable's Appointed Actuary writes to GAD about the forthcoming 1991 returns, following their letter of 12/05/1992. He explains that, after taking account of possible adverse comment on the unnecessarily 'weak' solvency position, the Society has looked again at its presentation in the annual returns for 31 December 1991 and has decided to make some changes. The Appointed Actuary says that he has concluded that the value for published mathematical reserves contains margins which were not necessary on the grounds of reasonable prudence. He had therefore reduced the mathematical reserves by £139m to £6,852m. The Appointed Actuary explains:

That reduction in reserves has been facilitated primarily by retaining the same valuation bases for general annuity and pensions recurrent single premium business as was used at 31 December 1990. The strengthened basis which I described in my letter of 12 May 1992 has been retained for recurrent single premium life business including with-profits bonds.

The Appointed Actuary summarises the position at 31 December 1991, taking into account the reduced mathematical reserves, as follows:

	£m
Admissible assets	*7,452*
Mathematical reserves	*6,852*
Other liabilities	*112*
Available assets for minimum margin	*488*
Implicit items	*–*
Total of available assets and implicit items	*488*
Required minimum margin	*298*
Excess of available assets and implicit items over required minimum margin	*195*

The Appointed Actuary explains that the appendix to the returns would show net premium reserves of £6,453m. If these reserves were shown in the body of the returns, an additional mismatching reserve of £390m would be required. He states that the reduction of the mismatching reserve, compared with that shown in their letter of 12/05/1992:

> *... arises because we have looked again at the minimum reserves we should need to establish in the revised conditions of the mismatching test. From that review we concluded that, in our previous calculations, we had applied the regulations in an unduly stringent manner so as to produce reserves above those indicated by the minimum basis.*

Equitable's Appointed Actuary concludes:

> *Having taken the view previously that it was not a priority to show the best possible* [solvency position], *I have on reflection come to the conclusion that there is nothing to be gained from presenting such an apparently weak ... position as set out in my letter of 12 May 1992. The revised presentation will show a position of broadly comparable "strength" to last year. The mathematical reserves to be shown in our annual return continue to represent prudent provision for meeting future liabilities and satisfy the various statutory and non-statutory requirements governing the valuation of liabilities.*

19/06/1992 GAD write to Equitable's Appointed Actuary to state that they have no need for more information on the forthcoming 1991 returns prior to their submission and that '*any further queries will come up after we have studied the full returns*'.

Submission of the 1991 regulatory returns

29/06/1992 **Equitable submit their 1991 regulatory returns to DTI.** Accompanying those returns are copies of the Society's annual report and accounts for 1991, prepared in accordance with the Companies Act 1985 and dated 25 March 1992.

Equitable also send DTI a declaration under section 94A of ICA 1982 and pay Insurance Fees of £13,100 in respect of their 1991 returns.

These documents include the following information about Equitable's business and their financial position as at 31 December 1991.

Companies Act annual report and accounts
The *President's Statement* reports that:

> *1991 was a year of impressive progress. Total new business figures for the first time went above £1bn, up a third on 1990. Such success during a period of economic recession demonstrates the validity of the Society's approach to business.*

Equitable also report that their ratio of expenses to total premium income had reduced for the third year running from 7.6% in 1990 to 7.2%. Equitable also say that they had established a branch operation in the Republic of Ireland and state their intention to become a major force in the European market.

In the *Management Report,* Equitable state that they had pursued a relatively cautious investment policy in 1991 and that the longer term perspective did not lead them to make any other significant changes to their asset mix brought forward from 1990. In the section on bonuses in the *Directors' Report*, Equitable disclose that, in the light of prevailing investment conditions and having regard to prudent actuarial principles, they had undertaken some strengthening of the liability valuation.

The returns
Equitable's returns are submitted in two parts covering Schedules 1, 3 and 6 and Schedule 4 to the ICAS Regulations 1983.

Schedule 1 (Balance sheet and profit and loss account)
As in previous years, Schedule 1 of Equitable's returns consists of Forms 9, 10, 13, 14 and 16. Form 9 summarises the Society's financial position at 31 December 1991 as follows:

Long term business admissible assets	*£7,452,253,000*
Total mathematical reserves (after distribution of surplus)	*£6,851,959,000*
Other insurance and non insurance liabilities	*£112,063,000*
Available assets for long term business required minimum margin	*£488,231,000*
Required minimum margin for long term business	*£292,829,000*
Explicit required minimum margin	*£48,805,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£439,426,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	*£195,402,000*

Equitable do not use in their returns the future profits implicit item that has been agreed by DTI.

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Schedule 3 (Long term business: revenue account and additional information)
As in previous years, Schedule 3 consists of Forms 40 to 51, which have been supplemented by various notes providing further information about/explanation for the figures provided.

Form 45 shows that 51% of Equitable's non-linked assets are invested in equities, 11% in land and 27% in fixed and variable interest securities (compared with 47%, 13% and 27%, respectively, in 1990).

As in previous years, Equitable disclose in Form 46 that the gross redemption yields on fixed interest securities issued or guaranteed by any government or public authority at certain durations are consistently higher than for those not issued or guaranteed by any government or public authority.

As for the previous year, in the notes to this part of the returns Equitable disclose that they have estimated their contingent liability for corporation tax on unrealised capital gains in respect of non-linked business to be nil.

Equitable state that they have been granted a section 68 Order which permits them to include in aggregate form details of their *'Personalised Funds'* in Forms 49, 50, 51 and 57, instead of the separate details for each Personalised Fund required by the ICAS Regulations 1983.

Schedule 6 (Certificates by directors, actuary and auditors)
Three Equitable Directors provide the certification required by Regulation 26(a) of the ICAS Regulations 1983. Equitable's Appointed Actuary provides the certification required by Regulation 26(b) of the ICAS Regulations 1983. As required by Regulation 27 of the ICAS Regulations 1983, Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

Schedule 4 (Abstract of valuation report prepared by the Appointed Actuary)
As in previous years, Equitable present two valuations of their long term liabilities (their main and appendix valuations). The results of the main valuation are carried forward, unadjusted, from Form 58 to Form 14 and on to Form 9.

Schedule 4 – main valuation (text)
Schedule 4 of Equitable's returns answer the questions set out in paragraphs 1 to 19 of Schedule 4 to the ICAS Regulations 1983 and includes Forms 55 to 58 and Form 60. Equitable state that this valuation conforms to Regulation 54 of ICR 1981.

In response to paragraph 3, Equitable provide 13 pages of information about their non-linked contracts. This section is longer than for the previous returns, due to Equitable's new overseas contracts. Most of the information about the existing contracts remains unchanged from the previous year.

As in previous years, in paragraph 3(xiii) Equitable again disclose that they applied a guaranteed annuity rate to the accumulated cash fund generated by certain types of with-profits pension policies, stating that the guarantees applied to policies issued prior to 1 July 1988.

As in previous years, Equitable provide a description of their principal guarantees of terms. Equitable disclose that recurrent single premium and variable premium deferred annuity policies carry guaranteed terms under which future premiums could be paid.

In response to paragraph 4, Equitable provide 33 pages of information about their linked contracts. Most of the information about these contracts remains unchanged from the previous year.

As in previous years, in paragraph 5 Equitable disclose that they have tested the ability of the Society to hold reserves which satisfy Regulations 54 and 56 to 64 of ICR 1981 in the changed investment conditions described in DAA1. Equitable state:

> *In these conditions the Society would be able to set up reserves which satisfy* [Regulations 54 and 56 to 64 of ICR 1981] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued.*

(Note: the entry at line 51 of Form 14 was the excess of the value of admissible assets representing the long term fund over the amount of those funds and represented the difference between the market value and book value of those funds.)

Equitable again state that, in determining the provision needed for resilience reserves and tax on unrealised gains, they have taken account of the fact that the long term fund has been valued at book value.

In paragraph 5(1)(e), Equitable disclose that a reserve for the prospective liability to tax on unrealised capital gains (losses) is held in respect of policies where benefits are linked to the Society's internal funds. Equitable state that the contingent liability for tax on unrealised capital gains in respect of other business is estimated to be nil, and accordingly no other additional reserve is made for any prospective liability for tax on unrealised capital gains.

As in previous years, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity.

As in previous years, in paragraph 6(1) Equitable disclose that, for certain non-profit deferred annuities, the valuation rates of interest used were those assumed in the premium basis. Equitable, again, do not elsewhere disclose the rates used in the premium basis.

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As in previous years, in paragraph 7(b) Equitable do not explain the method by which they have made provision in the main valuation for expenses on recurrent single premium business.

As in previous years, at paragraph 7(d) Equitable state:

> *A further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 55 to 64 of the Insurance Companies Regulations 1981. The resultant aggregate liability is less than the aggregate liability on the methods and bases described in this report. The report on the net premium valuation is given in an appendix following Form 60 of this report.*

As in previous years, in paragraph 11 Equitable state that they have *'no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund'*.

As in previous years, in response to paragraph 12, Equitable simply state that they distribute profits in accordance with the principles determined by their Directors and their Articles of Association.

Paragraph 13 sets out the level of bonus declared for 1991 and records that Equitable has set the reversionary bonus for the main policy classes at 6.5%. This compares with 7.5% reversionary bonus in the previous three years. As in previous years, Equitable disclose that some retirement annuity and individual pension policyholders have been offered loans under a *'loanback'* arrangement.

In response to paragraph 16, Equitable describe their system for determining final bonus.

<u>Schedule 4 – main valuation (forms)</u>
In Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts along with information on the number of contracts in force, the benefits guaranteed and the rates of interest and mortality assumptions used in valuing them.

In Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity and the rates of interest and mortality assumptions used in valuing them. Equitable again disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 58, Equitable set out the valuation result and the composition and distribution of the fund surplus.

<u>Schedule 4 – appendix valuation (text)</u>
Equitable explain that the appendix valuation:

> *... was undertaken for the purposes of demonstrating that in aggregate the mathematical reserves determined by the valuation undertaken using the gross premium method, the results of which are reported on the preceding pages, are not less than an amount calculated in accordance with Regulations 55 to 64 of the Insurance Companies Regulations 1981.*

Equitable's appendix valuation provides the information required by paragraphs 1, 5, 6, 7, 9, 17 and 18 of Schedule 4 to the ICAS Regulations 1983. They say that the information required for the other paragraphs (apart from paragraph 19 – being a statement of the required minimum margin in the form set out in Form 60 of Schedule 4 which, having had *'regard to the purpose of the valuation',* has not been provided) is identical to that given in the main valuation.

As in previous years, in response to paragraph 5(1)(a), Equitable make the same statement as in the main valuation, that: *'In these conditions the Society would be able to set up reserves which satisfy* [Regulations 54 and 56 to 64 of ICR 1981] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued'.*

As in the main valuation, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity.

As in previous years, in paragraph 5(1)(g) Equitable disclose the ages that retirement benefits could be taken on their recurrent single premium with-profits pension business.

Unlike in the main valuation and the appendix valuation in the previous year, in paragraph 7(b) Equitable explain the method by which they had made provision for future expenses on their recurrent single premium business:

> *General annuity and pension business: An annual loading of 1% increasing by 5% per annum compound of the basic benefit was reserved for with profits retirement annuity, United Kingdom personal pension retirement benefit, United Kingdom group and individual pension business, deferred annuities of the recurrent single premium or variable premium type, Guernsey personal pensions and group pensions, International personal pensions and Irish personal pensions.*

<u>Schedule 4 – appendix valuation (forms)</u>
In the appendix version of Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts on the appendix valuation basis.

In the appendix version of Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts on the appendix valuation basis.

30/07/1992	GAD's Directing Actuary A sends DTI's Director of Insurance a note on *'Free Asset Ratios at 31December 1990 & 1991'*. Directing Actuary A attaches tables setting out the free asset ratios of certain major with-profits companies. On mutual companies, the Directing Actuary says: *The companies on whom we have been keeping a close watch for a number of years – e.g. Equitable Life,* [and two other named companies] *– remain companies which cause serious concern.* The Directing Actuary concludes: *... I should add that in preparing this minute, it has not been possible to examine the reserving basis used by each actuary. That will need to be done at the detailed scrutiny stage. It would seem quite likely, however, that when free asset ratios are as low as they are at the present time, there are not likely to be large hidden margins in the valuation bases after the resilience test has been taken into account.*
31/07/1992	Every Appointed Actuary is sent by the Government Actuary a copy of DAA4 in which the Government Actuary sets out the two scenarios against which Appointed Actuaries should test the resilience of the valuation basis. He states that full details of the assumptions used should be provided in companies' returns.
03/08/1992	**GAD complete the A1 Initial Scrutiny check on the Society's 1991 regulatory returns.** GAD note the cover for the required minimum margin is 1.67 (reduced from 1.77 the previous year). They do not identify any concerns.
10/08/1992	**GAD complete the A2 Initial Scrutiny check on the Society's 1991 regulatory returns.** GAD raise Equitable's priority rating from 3 to 2. In response to question 3, *'Do the interest rates used look supportable in terms of Regulation 59'*, GAD answer *'Yes'*. GAD also write: *'10% for* [immediate annuities] *very high – query'.* GAD identify three aspects that look worrying: *(1) Low* [free asset ratio] *(2) Other management expenses* *(3) Transfer from* [investment reserve]. GAD identify no items to notify to DTI, to be taken up immediately with Equitable. Accompanying the Initial Scrutiny check are two forms (*Form B* and *Form C1*) tabulating key figures disclosed in the 1987 to 1991 returns.
19/08/1992	Line Supervisor B sends the Head of Life Insurance a draft note (which was copied to GAD) to the Secretary of State for Trade and Industry's Private Office, in relation to a proposed visit to Equitable. Under the heading *'Background'*, Line Supervisor B says: *The 1990 returns showed rapid expansion in new premium income, due partly to the success of the Society's with-profits Bond. Its solvency margin, whilst well covered, has reduced in recent years mainly due to falls in the market value of equities.*
21/08/1992	GAD's Directing Actuary A provides comments to DTI's Head of Life Insurance on the draft note of 19/08/1992. The Directing Actuary says: *There is one aspect of* [Line Supervisor B's] *minute to you ... which makes me feel uncomfortable.*

... when referring to the December 1990 solvency position, it is stated that the solvency margin was well covered, but that it had reduced in recent years mainly due to falls in the value of equities. Since 1990, however, the solvency margin position has worsened, and is a cause for some concern, as I indicated in my minute of 30 July 1992 to [the Director of Insurance] *on free asset ratios. Equitable Life will be one of the first companies we will be talking to in our imminent discussions with appointed actuaries.*

26/08/1992 DTI amend the note to the Minister's Private Office to state that Equitable's solvency margin *'which had reduced in recent years has been further eroded this year mainly due to falls in the market value of equities, and we will be discussing the company's position with its Appointed Actuary in the next week or so'.*

27/08/1992 GAD write to Equitable's Appointed Actuary about the effect of current market conditions on life insurers. GAD point out that, if the current weakness in investment and foreign exchange markets continues, it could lead to a further reduction in the free asset ratios of companies. GAD say that they are, therefore, arranging meetings with a number of Appointed Actuaries to discuss the circumstances of their particular companies, and those meetings may be followed up in due course by meetings with DTI.

GAD continue:

We would like to hold a meeting with you, the purpose of which would be to discuss, on a technical basis, the current and projected financial position of your company given the present economic conditions and what actions you might contemplate. We [would] *also like to discuss your company's bonus policy in the context of the company's intended investment strategy, and of the methods that you use to determine the appropriate levels of bonus rates and resilience reserves.*

GAD say that the meeting is to cover the following four broad topics:

1. Under the heading *'Financial Position'*:

[We] *would like to see and discuss both the current and projected financial positions of your company (including the effect on the financial position of assuming a pessimistic investment scenario over the next two years). We would also like to discuss the possible courses of action contemplated that could if necessary be taken to improve the company's financial situation. It would be helpful if we could have a copy prior to the meeting of any relevant report or business plan that has been prepared for this purpose.*

2. Under the heading *'Bonus Policy'*:

[We] *would like to discuss the methods that you use to set the level of your bonus rates (including how you calculate asset shares and how they relate to total payouts), the investment return required to support current bonus rates (including unitised with-profit) and how you satisfy yourself that those levels are justified. We also wish to discuss with you the level of bonuses that you expect to recommend for 1992 and their sustainability over the next few years in the event of only low rates of investment return being available.*

3. Under the heading *'Investment Policy'*:

[We] *would like to know what investment return has been earned on the with-profits fund over the last five years and discuss the expected rates of return over the next few years that are being assumed. Also, we would like to know whether any significant changes of investment mix or policy are planned or have taken place this year.*

4. Under the heading *'Resilience Reserves'*:

> [We] *wish to understand better how you currently perform the resilience test and what margins remain in your valuation bases after applying the test. We would also like to discuss what modifications you may wish to make to that test at the end of 1992.*

28/08/1992 GAD's Directing Actuary A circulates a note within GAD, following the letter to Equitable of 27/08/1992 (and similar letters sent to other companies). The Directing Actuary says that DTI wish to attend the meetings with Appointed Actuaries.

Behind this note on the relevant GAD file is an undated note about these meetings. On the timings of the meetings, the note says:

> *For many companies, the present criteria for the allocation of a Priority rating is adequate, but in the present state of the market, and in light of the fact that many with profits offices have been over-distributing surplus in recent times, we should give greater consideration to the amount of asset cover provided.*
>
> *If* [the free assets ratio is greater than] *10%, allocate priority #3*
>
> *If* [the free assets ratio is less than] *5%, arrange to talk to* [the Appointed Actuary] *before end September*
>
> *If* [the free assets ratio is less than] *10%, arrange to talk to* [the Appointed Actuary] *before end November*

On the issues that GAD should cover at the meetings, the note says:

> *Ask what plans the* [Appointed Actuary] *has to cope with the situation where equities do <u>not</u> yield the 11% or so assumed by dividend policy over the next few years.*
>
> *Apply pressure to the* [Appointed Actuary] *to provide realistic reports to the Board on future earnings aspirations, and through the* [Appointed Actuary] *to the Board to reduce bonus levels*
>
> *Enquire about asset share technology and methodology*
>
> *Discuss investment mix, strategy, "what if?" scenarios*
>
> *Refute argument (at least for the larger companies) that they can sell equities and go into gilts*
>
> *Ask for a plan of operations to restore a satisfactory asset-cover situation*
>
> *Suggest that the company might <u>apply</u> for an Implicit Item to provide a fall-back in the event that the situation deteriorates still further*

08/09/1992 [entry 1] GAD confirm with Equitable the meeting arranged for 15/09/1992.

08/09/1992 [entry 2] DTI's Line Supervisor B telephones an Independent Financial Adviser who has heard that DTI are investigating Equitable and are requiring them to submit quarterly returns because of their solvency position. The Line Supervisor explains that the cover for Equitable's solvency had reduced and suggests that the Adviser should compare the Society's 1991 returns with previous ones. The Line Supervisor's note of the call concludes: *'Said I couldn't comment on quarterlies situation. Said all* [companies] *had been affected by fall in equities, including Equitable'.*

10/09/1992 Equitable send GAD ten pages of financial data as background for the meeting on 15/09/1992. This includes the following information:

1) Equitable's valuation position at 31 July 1992

Equitable provide information about their estimated solvency position as at 31 July 1992 under the valuation methods used in their appendix and main valuations, being:

a) Minimum statutory reserves (including mismatch)

	£m
Market value of assets	*8,012.5*
Estimated liabilities	*7,255.6*
Available assets	*756.9*
Required minimum margin	*308.0*
Excess (deficiency) of available assets	*448.9*
Yield on assets hypothecated to minimum statutory reserves	*7.9%*

The position is, therefore, somewhat stronger than that at 31.12.91. It should also be remembered that no account is being taken of "future profits".

b) Published reserves (31.12.91 basis)

	£m
Market value of assets	*8,012.5*
Estimated liabilities	*7,630.4*
Available assets	*382.1*
Required minimum margin	*323.0*
Excess (deficiency) of available assets	*59.1*

On this basis the published position would look weaker than at 31.12.91 due to the low investment return experienced so far this year.

2) the projected positions for 31 December 1992 and 31 December 1993

On the projected position to 31 December 1992, Equitable provide the following information:

Assumptions: – asset values and yields at 31.7.92 levels i.e. no capital growth on existing and new investments

– all new monies invested in gilt-edged stocks during the period 1.8.92 to 31.12.92

a) Minimum statutory reserves (including mismatch)

	£m
Market value of assets	*8,552.4*
Estimated liabilities	*7,646.1*
Available assets	*906.3*
Required minimum margin	*322.6*
Excess (deficiency) of available assets	*583.7*
Yield on assets hypothecated to minimum statutory reserves	*8.1%*
Cost of £1% bonus	
– increase in liabilities	*71.2*
– increase in minimum margin	*2.8*
	74.0

5.5% bonus could be declared whilst maintaining a similar "Form 9" position to that published at 31.12.91.

b) Published reserves (31.12.91 basis)

	£m
Market value of assets	*8,552.4*
Estimated liabilities	*8,166.8*
Available assets	*385.6*
Required minimum margin	*343.5*
Excess (deficiency) of available assets	*42.1*
Cost of £1% bonus	
– increase in liabilities	*62.3*
– increase in minimum margin	*2.5*
	64.8

Only a minimal bonus could be declared if it was decided to publish on this basis.

On the projected position to 31 December 1993, Equitable provide the following information:

Assumptions: – asset values and yields at 31.7.92 levels i.e. no capital growth on existing and new investments

– all new monies invested in gilt-edged stocks during 1993

– bonus rate of 5.5% declared for 1992

a) Minimum statutory reserves (including mismatch)

	£m
Market value of assets	*10,065.9*
Estimated liabilities	*9,111.0*
Available assets	*954.9*
Required minimum margin	*378.3*
Excess (deficiency) of available assets	*576.6*
Yield on assets hypotheticated to minimum statutory reserves	*8.4%*
Cost of £1% bonus	
– increase in liabilities	*86.0*
– increase in minimum margin	*3.4*
	89.4

A reasonable level of declared bonus could again be supported.

b) Published reserves (31.12.91 basis)

	£m
Market value of assets	*10,065.9*
Estimated liabilities	*9,968.6*
Available assets	*97.3*
Required minimum margin	*412.6*
Excess (deficiency) of available assets	*–315.3*
Cost of £1% bonus	
– increase in liabilities	*80.0*
– increase in minimum margin	*3.2*
	83.2

3) declared bonuses from 1985 to 1991

Equitable give the rates of declared bonus for 1985 to 1991. They say that they have actively managed the rates of bonus in the light of falling interest rates. The rates of declared bonus are:

1985	*13.00%*
1986	*12.25%*
1987	*11.25%*
1988	*11.25%*
1989	*11.25%*
1990	*11.25%*
1991	*10.25%*

4) policy values set against their asset shares for the years 1989 to 1991

Equitable provide the following information on '*Policy Values v Asset Shares*':

	31.12.89	*31.12.90*	*31.12.91*
	£m	*£m*	*£m*
Assets at market value	*5,705*	*5,785*	*7,368*
[Proportion] *of unrecouped strains (1)*	*150*	*150*	*179*
	5,855	*5,935*	*7,547*
Aggregate policy values (2)	*6,100*	*7,340*	*9,086*
– as % of assets	*104%*	*124%*	*120%*

A position of balance at 31.12.89 led to total policy values above asset values following the poor 1990 earnings.

Alternative view of 31.12.91 position:

	£m
Adjusted assets	*7,547*
Office reserves	*6,852*
Discounted future bonus	*627*
	7,479

This presentation indicates that asset values cover the discounted face value of total policy values. A charge on future earnings would, therefore, enable nominal policy values to be maintained.

Notes:

(1) The unrecouped strains are the as yet unrecouped new business financing strains accumulated with interest, which are deemed to be a loan repayable when members leave the fund.

(2) Aggregate policy values are the present values of guaranteed benefits plus final/terminal bonuses at the rates then current.

GAD highlight some of the information provided. GAD mark with a question mark Equitable's statement that total policy values as at 31 December 1991 are £9,086m and represent 120% of Equitable's assets at market value. GAD also note that the *'alternative view of 31.12.91 position'* involves the discounting of terminal bonus values.

5) the investment return for with-profits policyholders for the years 1987 to 1993
Equitable provide the investment returns deemed to be available to the with-profits fund. These are:

Year	*Return*	
1987	*8.9%*	
1988	*15.1%*	
1989	*26.0%*	
1990	*–11.3%*	
1991	*14.0%*	
1992	*4.3%*	– *implicit in projection* [for 31 December 1992]
1993	*7.1%*	– *implicit in projection* [for 31 December 1993]

Under these figures, Equitable note that: *'A significantly higher return is being earned on 1992 new money due to the concentration on fixed interest investments this year'.*

6) their investment strategy
Equitable set out the proportion of assets allocated to the different types of investments. This shows a change in the distribution of their assets towards a larger proportion held as fixed interest assets.

1992

7) some commercial factors
Under the heading '*Commercial Factors*', Equitable state:

a) Contracts incorporate modest guarantees (3.5% for pensions, 0% for life).

b) Expenses are rigorously controlled to be within the contract loadings.

c) The Society has stated consistently that future bonuses will reflect future investment conditions.

8) their mismatching reserve calculations
Equitable set out the mathematical reserves required:

a) under their *'Published net premium'* valuation;

b) in investment conditions where interest rates increase by 3% and equity and property values decrease by 25%; and

c) in investment conditions where interest rates decrease by 3% and equity and property values decrease by 25%. Equitable state that the total reserves required in a) are £6,452.57m.

For the scenario set out in b), Equitable state:

The total reserves required are £6,843.00m. Therefore a mismatching reserve of £390.43m is required in addition to the published net premium reserves.

For the scenario set out in c), Equitable state:

The total reserves required are £6,816.58m. Therefore a mismatching reserve of £364.01m is required in addition to the published net premium reserves.

Under the heading '*Summary*', Equitable say:

> *As the mismatching reserve required in the +3%/–25% test is greater than that required in the –3%/–25% test, the mismatching reserve is £390.43m.*

	£m
Published net premium reserves	*6,452.57*
Mismatching reserve	*390.43*
Minimum statutory reserves	*6,843.00*
Published gross premium reserves	*6,851.96*

15/09/1992 DTI (Line Supervisor B) and GAD (Scrutinising Actuary B and Chief Actuary B) meet Equitable's Appointed Actuary. GAD open the meeting by explaining that:

> *... DTI were concerned about the position of with profit offices in the event of a poor investment performance in 1992 and 1993.*

The Appointed Actuary brings to the meeting papers setting out financial projections and information about past performance. A note of the meeting is prepared by GAD following receipt of Equitable's letter of 17/09/1992 (see entry below). GAD's note includes comments on that letter.

In their note, GAD draw out some of the figures in the financial projections provided, including that:

> *... the projected position at 31 December 1992 assuming that assets/yields are at July 1992 levels i.e. no capital growth on existing and new investments. These figures assume all new monies are invested in gilts and take into account the effect of new business in the rest of 1992. On the minimum statutory basis there would be mathematical reserves of £7646M (*[excluding] *1992 bonuses) against assets of £8552M. Available assets would be £906M to cover a* [required minimum margin] *of £323M and to meet the cost of bonuses (estimated at £400M at current levels).*
>
> *On a similar basis the projected figures at end of 1993 were provided, but assuming a bonus rate of 5.5% is declared at 1992. The result at the end of 1993 is available assets of £955M, to cover a* [required minimum margin] *of £378M and to meet the cost of 1993 bonuses (estimated at £492M at current levels).*

GAD also note that the projections show that:

> *... when equities are at a FTSE level of 2200 and properties fall by about 8% from their July levels ... In this scenario at the end of 1992 available assets would be £608M to cover* [the required minimum margin of] *£321M and the cost of 1992 bonuses. The excess would* <u>*not*</u> *be sufficient to maintain bonuses at their current level.*
>
> *Under similar assumptions, but assuming no bonuses declared for 1992, the position at the end of 1993 would be available assets of £1073M to cover* [the required minimum margin of] *£360M and bonuses (the cost of 1 years bonus at current levels is £440M).*

GAD's note continues:

> [The Appointed Actuary] *said that the society believed in active management of declared bonus rates in the light of falling interest rates. Bonus rates had been reduced in the past years and they felt able to reduce them again if necessary (they did not use* [independent

1992

financial advisers]). *He mentioned that so far no decision had been taken on 1992 bonus rates. The Board of Equitable has been briefed on all eventualities including a nil bonus rate scenario for this year.*

On Investment Policy [the Appointed Actuary] *said that currently all new monies were being invested in gilts and other fixed interest securities. There had also been a switch in 1992 of £300M of assets from equities to fixed interest.*

There had been a negative return on investment in 1990 of –11.3%. So far this had not been recovered, although the return in 1991 was 14%.

[The Appointed Actuary] *included in the papers he gave to GAD, a note of how the calculations for the resilience test were carried out. We raised the question of whether the society would be likely to seek modifications to the test at the end of 1992, [the Appointed Actuary] had given little thought to this issue.*

[The Appointed Actuary] *refers in his letter of 17 September to possible changes that might be made at the end of 1992 to weaken the valuation basis. He thinks that possible weakening in the basis could release up to £150M. An implicit item for future profits would provide them with an additional margin of at least £500M.*

GAD conclude their note by saying:

In [the Appointed Actuary's] *view the society incorporates modest guarantees into its contracts (3½% per annum growth on pensions). He implied that the liability valuation regulations were too stringent. Hence they forced the society into safeguarding themselves by investing in fixed interest securities when they felt that equities were a better long-term investment.*

Our view is that the society has over-distributed in the last few years, compared with the return on investments. This has eroded the level of free assets available in the society, which are needed to provide for market changes in the value of assets.

1992

17/09/1992 Equitable's Appointed Actuary writes to GAD following the meeting. He provides additional information about the possible 1992 and 1993 year end positions, assuming that the FTSE 100 Index stands at 2200 at those dates. The Appointed Actuary says that, in these projections, *'the Society is well able to meet the regulatory requirements though the implications for bonuses would have to be considered carefully'*. The Appointed Actuary notes that GAD had asked at the meeting about *'the extent to which the Society's minimum statutory reserving basis might be weakened by removing "unnecessary" margins'*. In response, the Appointed Actuary says that:

- the AIDS reserve of £50m might be excessive, given downward revision of estimated mortality;
- some weakening might be possible *'on account of zillmerisation though I would not expect any resulting release of reserves to exceed more than about £100m'*; and
- there could be some margins in the application of the resilience test arising from the Government Actuary's letter of 31/07/1992 and from the process of asset hypothecation.

GAD sideline the point about some weakening potentially being possible on account of zillmerisation.

Equitable's Appointed Actuary also points out that, looking ahead to the end of 1992 and 1993, the Society has available a more substantial margin through a future profits implicit item. The Appointed Actuary anticipates that, even on the assumptions in the projections provided, an implicit item of at least £500m could be justified at 31 December 1992.

The additional projected financial positions provided are as follows. For 31 December 1992:

Assumptions: – asset values and yields at 31.7.92 levels except that equities/properties at FTSE 100 "2200" level no capital growth on existing and new investments

– all new monies invested in gilt-edged stocks during the period 1.8.92 to 31.12.92

Minimum statutory reserves (including mismatch)

	£m
Market value of assets	8,221.9
Estimated liabilities	7,614.3
Available assets	607.6
Required minimum margin	321.4
Excess (deficiency) of available assets	286.3
Cost of £1% bonus	
– increase in liabilities	76.6
– increase in minimum margin	3.0
	79.6

For 31 December 1993:

Assumptions: – asset values and yields at 31.7.92 levels except that equities/properties at FTSE 100 "2200" level no capital growth on existing and new investments

– all new monies invested in gilt-edged stocks during 1993

– no bonus declared for 1992

Minimum statutory reserves (including mismatch)

	£m
Market value of assets	9,734.9
Estimated liabilities	8,661.9
Available assets	1,073.1
Required minimum margin	360.3
Excess (deficiency) of available assets	712.8
Cost of £1% bonus	
– increase in liabilities	77.2
– increase in minimum margin	3.1
	80.3

29/10/1992 **GAD complete their detailed scrutiny of the Society's 1991 regulatory returns.** GAD write to DTI with a report on the results of their work. (A copy of this scrutiny report is reproduced in full within Part 4 of this report.) GAD note:

The company continued to expand rapidly in 1991. Total premiums received amounted to £1,715m [against £1,345m in 1990 and £1,040m in 1989]. *Most of these premiums are either single premiums or renewable single premiums on pension schemes. Contractual annual premiums in force at the end of 1991 amounted to only £75m.*

The total assets of the company were £7,452m at the end of 1991. It is difficult to give a picture of growth of the company in terms of total assets as there have been fairly large changes in the market values of assets in the past 2 years. However if we exclude transfers from investment reserve [the return] *shows an increase in the fund of £953m in 1990 and £1,208m in 1991.*

GAD report that the 1991 returns show that the Society had total available assets of £488m to cover a required minimum margin of £293m (compared with £413m to cover the required minimum margin of £233m in the 1990 returns, and £974m to cover the required minimum margin of £204m in the 1989 returns). GAD point out that Equitable were *'one of the companies which we have seen recently in connection with their low cover for the* [required minimum margin] *in 1991 and future prospects'*. GAD explain the Society's approach of publishing its valuation result using a bonus reserve basis with an alternative net premium basis shown as an appendix, *'in order to comply with the regulations'*. GAD say that their comments relate to the appendix net premium valuation.

GAD advise DTI that:

At the end of 1991 the U.K. equity market was at about the same level as that at the end of 1989. Also some guilt prices were at a higher level in 1991. It is therefore reasonable to compare these two year ends rather than the 1990 position when markets were very depressed.

Total available assets in 1991 were £488m compared with £974m in 1989. The net transfer from investment reserve in non-linked funds in the two years was £185m. Hence total non-linked assets must have fallen in value by £301m.

GAD say that:

A comparison of the net premium valuation bases used at the end of the year shows a weakening in the 1991 bases as compared with 1989. This is true of a number of companies. What we have compared here is the average valuation rate of interest employed by the actuary with the average rate of interest earned on the corresponding hypothecated assets (using the highest yielding assets first).

GAD advise DTI that:

There appears to be little or no margin in the interest rates used in the 1991 valuation and we have asked the actuary a question relevant to this point.

GAD continue:

Why has this situation arisen? We know from our recent talks with [the Appointed Actuary] *that the with profits assets earned –11.3% in 1990 and +14.0% in 1991. These rates take into account both capital changes and interest earnings, so the return on with profit assets was only about +3% for the two years. This is after making allowance for the high rates of interest that the company needs to earn on its non-profit contract (up to 10%) and the 3½% p.a. guarantees given on with profit contracts.*

Total bonuses paid to policyholders cost £432m in 1989 and £456m in 1991. The actual net transfer from investment reserve to the fund on non-linked assets in the two years was £185m.

In order to pay bonuses in the two years the company needed to earn 11¼% per annum on the assets backing the with profit contracts. The amount earned would include interest income and capital gains. In fact the company earned about +3% over the two years instead of the required +23%, and this is the main reason why the available assets have been reduced and the valuation basis has been weakened. A major part of the bonuses have been paid out of (i) a weakening of the valuation basis and (ii) transfers from investment reserve.

GAD note that:

... despite the lower cover for the [required minimum margin]*, the company still had over 60% of its non-linked assets invested in equities and property. We understand from recent discussions with* [the Appointed Actuary] *that they are now investing more in gilts.*

The company's new business figures have increased in the past few years and we wonder whether this has given rise to any significant strains on the fund. We have asked a question about this in our letter to the company.

On the same day, GAD write to Equitable's Appointed Actuary to explain that GAD have completed their examination of the 1991 returns. GAD ask the Society to:

(1) [explain] *... how the with profit immediate contract works in practice? How do the reversionary bonuses and final bonus payments affect the amount of annuity paid each year?*

(2) [explain why the return] *shows that the proportion of reserves not matched by assets in the same currency is 7.7% whereas in the previous year it was shown as nil. Is this a change in policy and, if so, may we please have an explanation for this? What currencies and what types of investment are represented by the 7.7% figure, and what liabilities are they deemed to cover?*

(3) [clarify a paragraph of the returns.] *Would you please provide us with an example of how this works in practice including the effect of both reversionary and final bonuses?*

(4) [provide] *a matching rectangle showing what assets you would hypothecate to the net premium mathematical reserve shown in the appendix of Schedule 4?*

(5) [advise] *... the amount of the valuation strain in respect of the additional business written in 1991. Please include in this category all the additional benefits and their related premiums undertaken in 1991 including those on existing contracts where these additional benefits and the premiums received in 1991 were not taken into account in the 1990 valuation. This should include all new annual premium business, all single premiums business and all regular premiums received in 1991 on policies which were undertaken in earlier years but where reserves set up in 1990 did not take account of future premiums.*

On the last point, GAD state: '*... we wish to know (i) the reserves set up at the end of 1991 (ii) the total cost of any bonuses allocated during 1991 and provided for in the 1991 returns (iii) the cost of any claims paid in 1991 (iv) the total premiums received in 1991 and (v) the total related expenses incurred in 1991*'.

GAD attach a copy of this letter to their note to DTI. Line Supervisor B, on her copy of GAD's note, comments that the fall in total available assets from £974m in 1989 to £488m in 1991 is a '*big difference!*'.

04/11/1992 DTI's Head of Life Insurance passes his copy of GAD's note of 29/10/1992 to DTI's new Line Manager with responsibility for Equitable (Line Manager B) and adds:

This paints a worrying picture. Over-distribution by a company with a (deliberately) small coverage of its [required minimum margin] *and a (continuing) policy of high equity exposure. I think we should ask GAD for a fuller assessment of the position and of the options available to the company in the event of a significant further downturn in the market (unless we have this already, in which case I should like to see it).*

Line Manager B adds a further note to Equitable's line supervisor:

[Please] *ask one specific question. If the investment yield (dividend + capital) is zero in 92 what would the position of the company be at end 92? How long could it continue with present bonuses in the face of a zero yield?*

These comments are later passed on to GAD (see 14/01/1993).

06/11/1992 Equitable's Appointed Actuary writes to GAD with a detailed reply to their letter of 29/10/1992 about the 1991 returns. In response to the five questions posed by GAD in their letter, the Society's Appointed Actuary:

(1) provides details of Equitable's immediate annuity with-profits product, including an example of how annuity payments are determined by bonus rates. The Appointed Actuary explains: *'You will see from the example of an annuity anticipating future bonuses of 6½% p.a. that the guaranteed benefits are reduced by a factor of 1/1.065 each year in anticipation of 6½% per annum bonuses. The total annuity value carried forward from one 31 December to the next is also divided by 1.065 for the same reason and by 1.035 to take account of 3½% interest guaranteed implicitly in the annuity rate used to calculate the initial level of annuity'*;

1992

(2) explains that the proportion of reserves not matched by assets in the same currency had been overstated and the correct figure should have been 2.9% (or zero in their appendix valuation). He says:

There has been no change of policy as regards the Society's investment policy which had led to sterling liabilities exceeding sterling assets for non-linked business. The proportion of non-linked assets comprising non-sterling assets was about 15% at both 31 December 1990 and 31 December 1991. The increase in the proportion required in paragraph 9 of my valuation report is the result of differences between the relative changes in asset values and reserves during 1991.

We do not in general hypothecate specific assets to specific liabilities. For your information, however, the distributions by investment type and country of origin of the £1,075m of non-linked assets held on 31 December 1991 are shown below.

Fixed interest	*13%*	*Europe*	*39%*
Cash	*4%*	*North America*	*21%*
Equities	*83%*	*Far East/Australia*	*38%*
		Other	*2%*
	100%		*100%*

(3) provides the following example:

For each with profits policy or benefit a total value as at 31 December 1990 was held (for policies or benefits effected in 1991 this value was zero). That value was increased by the overall rate of return of 12% to which was added for each premium paid in 1991, the immediate value of guaranteed benefit secured by the premium increased by a proportionate part of 12% corresponding to the proportion of 1991 for which the benefit *participated in profits. The value calculated in this way is the total value as at 31 December 1991, and is used to calculate claim values in the period 1 April 1992 to 31 March 1993. At the next bonus declaration the 31 December 1991 will be rolled forward to 31 December 1992 in the same way as described above.*

Total claim values are calculated in the period 1 April 1992 to 31 March 1993 by increasing the 31 December 1991 total value by the additional final bonus rate on a proportionate daily basis. To this value is added for each premium paid after 31 December 1991 the value of the guaranteed benefit at the premium payment date increased by growth at the additional final bonus rate for the period of participation in profits.

The amount by which the total claim value exceeds the value of guaranteed benefits (including declared bonus) at the claim date is the final bonus element of that total claim value.

For example if a pension policy had a total value brought forward of £10,000 as at 31December 1990 and a premium payment secured guaranteed fund of £7,300 on 1December 1991, the total value as at 31 December 1991 would have been

10,000 x 1.12 + 7,300 x (1 + 0.12 x 30/365) = £18,572

If a further premium had been paid on 2 March 1992 securing guaranteed fund of £3,050, the total claim value on 1 April 1992 would have been

$$18{,}572 \text{ x } \left(1 + 0.11 \text{ x } \frac{92}{366}\right) + 3{,}050 \text{ x } \left(1 + 0.11 \text{ x } \frac{30}{366}\right) = £22{,}163.02$$

A couple of additional examples are also to be found in Appendix B attached to this letter.

1992

(4) provides the following table of ‘Assets hypothecated to net premium reserves’:

Year ending	*(A) Total surplus*	*(B) Exceptional items*	*(C) Surplus arising from solvency margin*	*(A)-(B)-(C) Ordinary surplus*
	£m	*£m*	*£m*	*£m*
Land	–	–	*708.76*	*708.76*
Gilts and other fixed interest	*605.29*	–	*1,207.31*	*1,812.60*
Variable interest securities	–	*79.63*	*6.52*	*86.15*
Equities	–	–	*2,793.17*	*2,793.17*
Debts	–	–	*22.39*	*22.39*
Other income producing assets	–	–	*530.37*	*530.37*
	605.29	*79.63*	*5,268.52*	*5,953.52*
Linked assets				*499.13*
				6,452.57

(5) explains that:

For valuation purposes the Society's records are in general held in grouped form according to the year of maturity or retirement. The data which you have requested is not, therefore, readily available and would take a great deal of time and effort to produce for you.

It seems to me that you are trying to assess the effect of new business on the Societys financial position in 1991. To assist you in this respect, therefore, we have compiled an analysis of the financial impact of 1991 new business. Please find that analysis in Appendix D of this letter.

New business is defined as new level annual premium and single premium business and new and incremental recurrent single premium business. Regular recurrent single premium renewals are not included.

The results of that analysis shows that new business did not produce a strain during 1991. This was due mainly to the fact that the valuation bases for recurrent single premium business released monies at outset in a similar way to the release produced by a zillmer adjustment.

The information set out in Appendix D is as follows:

New Business Analysis	*£m*
New business premiums received less expense loadings	*1,062.7*
Initial expense loadings from new business premiums received	*14.3*
Cost of reserves/benefits	*(984.3)*
Acquisition expenses	*(72.6)*
	20.1

12/11/1992 GAD reply to Equitable's Appointed Actuary saying that they will consider his letter of 06/11/1992 in detail shortly. GAD's Chief Actuary B asks Scrutinising Actuary B to review Equitable's letter.

11/12/1992 Equitable's Appointed Actuary writes to DTI to apply for a section 68 Order for a future profits implicit item of £360m, for possible use in their 1992 returns. The Appointed Actuary provides financial calculations in support of the application, suggesting that the Society could seek an Order up to the value of £766.8m.

These calculations include, for the estimated annual profits, that:

Year ending	*(A) Total surplus*	*(B) Exceptional items*	*(C) Surplus arising from solvency margin*	*(A)-(B)-(C) Ordinary surplus*
	£m	*£m*	*£m*	*£m*
31.12.87	*254.7*	*65.0 (a)*	*65.3*	*124.4*
31.12.88	*259.2*	*–*	*61.4*	*197.8*
31.12.89	*337.4*	*–*	*89.9*	*247.5*
31.12.90	*422.5*	*557.0 (b)*	*26.6*	*(161.1)*
31.12.91	*596.5*	*(13.2) (c)*	*59.5*	*550.2*
				958.8

Average annual profit = 958.8/5 = £191.7m

Notes: *(a) £65.0m of the surplus arising in 1987 was an exceptional item arising from a change from a policy year to a calendar year method of bonus allocation for the bulk of the Society's with profits business.*

(b) Surplus was increased by £557.0m as a result of changes in valuation bases during 1990.

(c) Surplus was reduced by £13.2m as a result of changes in valuation bases during 1991.

The calculations state that the average period to run for the Society's in-force contracts is eight years. The Appointed Actuary explains:

> *The periods to run have been reduced to take account of premature withdrawals based on the Society's recent experience of such withdrawals. In respect of retirement annuity and personal pension contracts for which a range of retirement ages is available, it has been assumed that retirement benefits are taken at the lowest possible age, or immediately if that age has already been attained.*

The calculations provided suggest that the maximum future profits permissible is 50% of £191.7m multiplied by eight years – that being £766.8m.

15/12/1992 DTI ask GAD for their views on the application. DTI query whether the request should have been made earlier in the year, around the time that the Society submitted its 1991 returns to the regulators.

23/12/1992 GAD inform DTI that they have '*... no comments on this application and it should be reasonable for you to issue the relevant S68 Order*'.

1993

07/01/1993	Equitable, in error, send DTI's Line Supervisor B a letter addressed to a financial adviser. Equitable ask DTI to destroy the letter. DTI nevertheless retain a copy of a paper attached to the letter, setting out some observations by Equitable on the financial strength of life companies. The paper, dated September 1992, had been prepared as a result of '*a growing preoccupation amongst intermediaries and financial commentators with the "financial strength" and the solvency ratio of life offices, and the implications for future bonuses*'. The Society's paper discusses free asset ratios, concluding in summary that it '*depends upon a number of complex variables and is not necessarily a reliable indication of anything*'. Line Supervisor B sends a copy of Equitable's paper to Line Manager B and to GAD. The Line Supervisor says that she retained the paper because '*it looked interesting. It's basically saying that having a low free asset ratio doesn't necessarily mean that a life office is in trouble*'. There is no record of any reaction by GAD.
12/01/1993	DTI send Equitable the section 68 Order for a future profits implicit item of £360m, for use in the 1992 returns. DTI remind Equitable that, in accordance with the Guidance Notes which were issued in 1984, before including the item in the forthcoming returns the company must update the calculations to demonstrate that they still support the amount used.
14/01/1993	DTI check with GAD to see if they had received a reply to their letter to Equitable of 29/10/1992. DTI ask GAD for their comments on the point made by the Head of Life Insurance on 29/10/1992, which was: *This paints a worrying picture. Over-distribution by a company with a (deliberately) small coverage of its* [required minimum margin] *and a (continuing) policy of high equity exposure. I think we should ask GAD for a fuller assessment of the position and of the options available to the company in the event of a significant further downturn in the market.* DTI also ask for GAD's comments on the point made by Line Manager B, which was: *If the investment yield (dividend + capital) is zero in 92 what would the position of the company be at end 92? How long could it continue with present bonuses in the face of a zero yield?*
18/01/1993	GAD's new scrutinising actuary (Scrutinising Actuary C) passes DTI a copy of Equitable's letter of 06/11/1992 to DTI. He says: *I also understand that you would like our comments on this response. I will try to let you have that as soon as I can. As you know, I have only just taken on responsibility for this company and it may take a little while to become adequately familiar with it.* *I also have your note of 14 January quoting comments from* [Head of Life Insurance and Line Manager B]*, which I will also deal with.*
05/02/1993	Line Supervisor B passes GAD's note of 18/01/1993 and the copy of Equitable's letter of 06/11/1992 to Line Manager B. In response, the Line Manager comments: '*I hope* [the Scrutinising Actuary's] *advice will be more digestible*'.
19/02/1993	DTI chase GAD for their comments on Equitable's response of 06/11/1992.
23/02/1993	GAD's Scrutinising Actuary C prepares a brief note of the Society's position. He sets out Equitable's cover for the required minimum margin from 1987 to 1991, along with the bonuses declared for 1990 and 1991, and notes that:

- 80-85% of policies are single premium with-profits;
- there is a 3.5% guarantee on pensions business;
- investment reserve is a notional terminal bonus reserve; and
- annual premiums in force only £75m at 31 December 1991.

02/03/1993	Equitable write to DTI asking for a certificate to confirm that they meet the minimum solvency requirements. Equitable say that they need the certificate to support a tender for an unspecified contract that they are submitting. DTI discuss this with Equitable and agree to provide '*a* [very] *basic certificate saying solvency was OK*'.

03/03/1993 [entry 1] GAD provide DTI with their comments on Equitable's response of 06/11/1992. GAD say that Equitable's replies to their questions (about the 1991 returns):

> *... seem satisfactory. The operation of the bonus system (as described in the responses to Questions 1 and 3) seems complex, and even more difficult for policyholders to understand than that of most companies, but there is nothing inherently unsound about it.*

In response to the comments by DTI, passed on in the note of 14/01/1993, GAD say that they think it is useful to draw attention to some '*unusual features*' of Equitable. GAD explain that Equitable are the leading non-commission-paying office and a mutual with a reputation for one of the lowest cost ratios in the UK industry. GAD point out that Equitable have a very high proportion of with-profits business and, even more unusually, that 80%-85% of their with-profits business is by single or recurrent single premiums, with the annual premiums in force being very modest in relation to the size of the office. GAD state this can be:

> *... both a strength and a weakness. A strength because it has only to secure the benefits bought by premiums already paid, and needs less by way of protection for the future premiums to be received under the contracts. A weakness because it will have less by way of "free reserves" and is therefore more vulnerable to changes in asset values.*

GAD note that Equitable have always published a bonus reserve valuation, and that the above feature of their products makes this more appropriate than the net premium approach. GAD add:

> *It also means that, although in general a bonus reserve valuation will reveal an <u>apparently</u> weaker position, in terms of* [the required minimum margin] *cover, than a net premium valuation, in the case of the Equitable the two results will be similar. This is borne out by the reported results in Schedule 4 and its Appendix.*

GAD note from reports of earlier meetings that, in setting bonus rates, Equitable have considerable regard to gilt yields. GAD comment that this is not entirely consistent with the bonus system or the asset mix but conclude that it no doubt explains what in retrospect was an overdistribution in 1990. GAD add:

> *It seems possible from the* [required minimum margin] *cover ratios that the overdistribution followed a period of some <u>under</u>distribution; but without going back into previous history in detail I could not be sure.*

GAD continue:

> *As a result the company will have downward pressure on bonuses even in years when there are adequate investment returns (income plus capital). We have written to the company (copy attached) asking for an estimate of the position at the end of 1992, together with details of their bonus distribution and the rate earned on the fund in 1992.*

GAD discuss the options for Equitable in the event of a significant downturn in the market. GAD explain:

> *Clearly to reduce declared bonuses, perhaps even to zero, is their first line of defence. They have reduced bonuses before and have clearly thought about doing so again. They could do this without substantially reducing payouts (which might not be justified by stock market levels) through changes to Terminal Bonus rates. (However they appear not to have the protection against market falls that most companies have in their* [terminal bonuses]*, because these do not represent a high proportion of their total payouts. Again this stems from the contract design.) As we have seen in earlier discussions, in adverse conditions there is some scope to weaken the valuation basis and the company could use the Section 68 Order that it has received (it will no doubt continue to apply for such an Order each year as a precaution).*

GAD conclude by saying:

> *Overall, I suspect that Equitable could survive a short-term fall in market levels, even a substantial one, as well as most companies. Their portfolio, however, must leave room for concern, were there to be a prolonged period of depressed share values. Their recent shift towards fixed interest securities will ease the difficulties, although they would argue at the expense of the expected ultimate benefit to policyholders.*

Line Supervisor B passes GAD's note to Line Manager B with her own note, which says: '*Below is a helpful update on Equitable's position. It will be interesting to see what their solvency looks like at the end of 92*'. The Line Supervisor also notes that she had recently read in the press that Equitable were reducing their bonuses.

03/03/1993 [entry 2] GAD write to Equitable's Appointed Actuary. GAD apologise for the fact that GAD had not written since their letter of 12/11/1992. GAD say:

> *There seems little point in asking further questions on the matters relating to the 1991 Returns. However we should be interested in your initial estimate of the actual position at the end of 1992 – in particular, what is the required minimum margin and what assets are available to cover this? What rate was actually earned on the fund in 1992? We would also like details of your bonus distribution, now or when it is announced (I have not spotted any announcement from The Equitable, but such things are easy to miss).*
>
> *In your letter of 6 November to* [Chief Actuary B]*, in Appendix C, you gave details of the hypothecation of assets to the net premium reserves. In due course we shall be asking for similar information as at 31 December 1992, and in addition will be seeking details of the yield on the various assets thus hypothecated. We shall also be interested in the corresponding analysis to Appendix D* [New Business Analysis] *for 1992. I thought it might be helpful to you to mention these matters now.*

09/03/1993 Equitable's Appointed Actuary responds to GAD's letter of 03/03/1993. He sets out the Society's estimated solvency position at the end of 1992, '*which as one would expect has improved since the end of the previous financial year. We have strengthened the liability valuation by around £100m this year and the 1992 figures are after that strengthening*'. The figures provided are:

	[Estimated] *31.12.92*	*31.12.91*
	£m	*£m*
Market value of assets	*9,414*	*7,340*
Liabilities	*8,554*	*6,852*
Available assets	*860*	*488*
Required minimum margin	*355*	*293*
Excess assets	*505*	*195*

The Appointed Actuary explains that Equitable had earned 17% on their assets in 1992 and he adds:

> *We have traditionally followed an internal discipline of linking the earnings passed on through declared bonuses to the general level of fixed interest rates. This year we have reduced declared rates further to a level equivalent to earnings of 8¾% pa.*

Equitable's Appointed Actuary encloses with his letter a copy of the press release on bonus rates for 1992, issued on 3 March 1993. He explains that, for pension policies, the Society had awarded an overall rate of return of 10% in respect of benefits bought on or before 31 December 1991 and 12% for benefits bought in 1992. The Society had reduced the reversionary bonus for pension business from 6.5% to 5%. The Appointed Actuary also encloses a copy of the Society's '*Bonuses*' booklet, '*which may be of help in providing further detail on our bonus systems*'. The Appointed Actuary explains that the information GAD would be seeking later in the year will be readily available from Equitable's internal analysis.

11/03/1993 [entry 1] GAD send DTI a copy of Equitable's letter of 09/03/1993. GAD do not enclose a copy of the booklet on bonuses, '*which is in any case similar to ones we have seen before*'. GAD add:

> *The letter does not, in my view, call for any further comment, and I do not propose to write to the company again until we carry out the scrutiny as at 31 December 1992. In the meantime, we regard the 1991 scrutiny as fully completed.*

DTI's Line Supervisor B notes that the estimated solvency position for 1992 '*looks a lot healthier than last year's*'.

11/03/1993 [entry 2] DTI write to Equitable, in reply to the Society's letter of 02/03/1993, enclosing the required solvency certificate.

26/04/1993 DTI's new Head of Life Insurance and another official meet Equitable for lunch, prompted by their announcement of a new branch in Germany. They discuss a number of technical matters associated with Equitable's business in Europe but also the issue of the FS Act 1986 and cost disclosure. On the latter, DTI record that:

> [Equitable] *have done their own "mock up" of a specimen disclosure statement, slightly modifying that in the OFT's blue report and will send us a copy. The effect of a company's current surrender philosophy could be illustrated by projections using own charges, own surrender philosophy and standard rates of return assumptions. They seemed less concerned than some that these indications would, by reason of market pressure or otherwise, amount to effective guarantees.*

29/04/1993 A DTI official writes to the Head of Life Insurance and Line Manager B, following a telephone call she had received from Equitable about the asset valuation reserve guidance notes. Equitable had said that the company has some index options which did not fall within the current admissible assets and wanted to know how they should go about getting a section 68 Order in order to be able to take these into account.

Submission of the 1992 regulatory returns

29/06/1993 **Equitable submit their 1992 regulatory returns to DTI.** Accompanying those returns are copies of the Society's annual report and accounts for 1992, prepared in accordance with the Companies Act 1985 and dated 24 March 1993.

Equitable also send DTI a declaration under section 94A of ICA 1982 and pay Insurance Fees of £17,000 in respect of their 1992 returns.

These documents include the following information about Equitable's business and their financial position as at 31 December 1992.

Companies Act annual report and accounts
In their *President's Statement*, Equitable explain that, in common with most other financial institutions, Equitable believe they are probably entering a period of low investment returns and that bonuses, particularly reversionary bonuses, would have to reflect this. Equitable say the reductions in bonus they are making are in line with the market and that they are maintaining their competitive position in terms of the real returns provided to policyholders.

Equitable's President goes on to say:

> *In The Equitable we pride ourselves on allocating earnings from our investments across all classes and durations of contract in as fair and consistent a manner as possible. The fundamental philosophy is that each generation of policies should receive benefits commensurate with the earnings produced during its lifetime. Beyond the bounds of normal commercial prudence, it would be alien to our culture to hold back benefits from one generation to build reserves for a future generation. As we say in our literature, for new policyholders future bonuses must depend primarily upon the earnings produced on the investment of the new premiums. Any deliberate cross subsidies between generations would not be "equitable". I believe that we can rightly claim that for as long as comparative tables of policy results have been published, the Society can demonstrate that it has provided consistently good value across all types and durations of product.*

In their *Management Report*, Equitable explain that they had recently sent with-profits policyholders notices of their bonuses and statements together with a letter explaining Equitable's approach to bonuses for 1992. They state that the 1992 bonus declaration had once again demonstrated how the with-profits system smoothed fluctuations in investment performance and that Equitable had taken the opportunity of the good investment returns in 1992 to recover part of the '*support*' previously given by the smoothing process, particularly in respect of 1990 when investment returns were poor and below the returns allocated to policies.

In their *Directors' Report*, Equitable state that, in light of the current investment conditions, in particular the lower gilt yields, they had reduced reversionary bonuses to a level consistent with these gilt yields, which was their traditional approach.

The returns
Equitable's returns are again submitted in two parts covering Schedules 1, 3 and 6 and Schedule 4 to the ICAS Regulations 1983.

Schedule 1 (Balance sheet and profit and loss account)
As in previous years, Schedule 1 of Equitable's returns consists of Forms 9, 10, 13, 14 and 16. Form 9 summarises the Society's financial position at 31 December 1992 as follows:

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Long term business admissible assets	*£9,564,764,000*
Total mathematical reserves (after distribution of surplus)	*£8,557,223,000*
Other insurance and non-insurance liabilities	*£164,195,000*
Available assets for long term business required minimum margin	*£843,346,000*
Required minimum margin for long term business	*£356,625,000*
Explicit required minimum margin	*£59,438,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£783,908,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	*£486,721,000*

Equitable do not use in their returns the future profits implicit item that has been agreed with DTI.

Schedule 3 (Long term business: revenue account and additional information)
As in previous years, Schedule 3 consists of Forms 40 to 51, which have been supplemented by various notes providing further information about/explanation for the figures provided.

Form 45 shows that 43% of Equitable's non-linked assets are invested in equities, 8% in land and 40% in fixed and variable interest securities (compared with 51%, 11% and 27%, respectively, in 1991).

As in previous years, Equitable disclose in Form 46 that the gross redemption yields on fixed interest securities issued or guaranteed by any government or public authority are, for certain durations, higher than for those not issued or guaranteed by any government or public authority.

In the notes to this part of the returns, Equitable disclose that a provision has been made for the contingent liability for tax on unrealised capital gains in respect of non-linked business, which they estimate to be £1.2m.

Equitable state that they have been granted a section 68 Order which permits them to include in aggregate form details of their '*Personalised Funds*' in Forms 49, 50, 51 and 57, instead of the separate details for each Personalised Fund required by the ICAS Regulations 1983.

Schedule 6 (Certificates by directors, actuary and auditors)
Three Equitable Directors provide the certification required by Regulation 26(a) of the ICAS Regulations 1983. Equitable's Appointed Actuary provides the certification required by Regulation 26(b) of the ICAS Regulations 1983. As required by Regulation 27 of the ICAS Regulations 1983, Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

Schedule 4 (Abstract of valuation report prepared by the Appointed Actuary)
As in previous years, Equitable present two valuations of their long term liabilities (their main and appendix valuations). The results of the main valuation are carried forward, unadjusted, from Form 58 to Form 14 and on to Form 9.

Schedule 4 – main valuation (text)
Schedule 4 of Equitable's returns answers the questions set out in paragraphs 1 to 19 of Schedule 4 to the ICAS Regulations 1983 and includes Forms 55 to 58 and Form 60. Equitable state that this valuation conforms to Regulation 54 of ICR 1981.

In response to paragraph 3 of Schedule 4, Equitable provide 14 pages of information about their non-linked contracts. Most of the information about the contracts remains unchanged from previous years.

As in previous years, in paragraph 3(xii) Equitable again disclose that they applied a guaranteed annuity rate to the accumulated cash fund generated by certain types of with-profits pension policies, stating that the guarantees applied to policies issued prior to 1 July 1988.

As in previous years, Equitable provide a description of their principal guarantees of terms. Equitable disclose that recurrent single premium and variable premium deferred annuity policies carry guaranteed terms under which future premiums could be paid.

In response to paragraph 4, Equitable provide 35 pages of information about their linked contracts. Most of the information about the contracts remains unchanged from the previous year.

As in previous years, in paragraph 5 Equitable disclose that they have tested the ability of the Society to hold reserves which satisfy Regulations 54 and 56 to 64 of ICR 1981 in the changed investment conditions described in DAA1. Equitable state:

> *In these conditions the Society would be able to set up reserves which satisfy* [Regulations 54 and 56 to 64 of ICR 1981] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued.*

(Note: the entry at line 51 of Form 14 was the excess of the value of admissible assets representing the long term fund over the amount of those funds and represented the difference between the market value and book value of those funds.)

Equitable again state that, in determining the provision needed for resilience reserves and tax on unrealised gains, they have taken account of the fact that the long term fund has been valued at book value.

In paragraph 5(1)(e), Equitable disclose that a reserve for the prospective liability to tax on unrealised capital gains (losses) is held in respect of policies where benefits are linked to the Society's internal funds. Equitable also disclose that the contingent liability for tax on unrealised capital gains in respect of other business is estimated not to exceed £1.2m. The returns state that the Society considers that there are sufficient margins in the valuation basis to cover this amount and, accordingly, they hold no specific reserve.

As in previous years, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity.

As in previous years, in paragraph 6(1) Equitable disclose that, for certain non-profit deferred annuities, the valuation rates of interest used were those assumed in the premium basis. Equitable, again, do not elsewhere disclose the rates used in the premium basis.

As in previous years, in paragraph 7(b) Equitable do not explain the method by which they have made provision in the main valuation for expenses on recurrent single premium business.

As in previous years, at paragraph 7(d) Equitable state:

> *A further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 55 to 64 of the Insurance Companies Regulations 1981. The resultant aggregate liability is less than the aggregate liability on the methods and bases described in this report. The report on the net premium valuation is given in an appendix following Form 60 of this report.*

As in previous years, in paragraph 11 Equitable state that they have '*no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund*'.

As in previous years, in response to paragraph 12, Equitable simply state that they distribute profits in accordance with the principles determined by their Directors and their Articles of Association.

Equitable disclose in paragraph 13 that they had set the reversionary bonus for the main policy classes at 5.0%, compared with 6.5% in 1991. As in previous years, Equitable disclose that some retirement annuity and individual pension policyholders have been offered loans under a '*loanback*' arrangement.

In response to paragraph 16, Equitable describe their system for determining final bonus.

<u>Schedule 4 – main valuation (forms)</u>
In Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts, along with information on number of contracts in force, the benefits guaranteed and the rates of interest and mortality assumptions used in valuing them.

In Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity and the rates of interest and mortality assumptions used in valuing them. Equitable again disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 58, Equitable set out the valuation result and the composition and distribution of the fund surplus.

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<u>Schedule 4 - appendix valuation (text)</u>
Equitable explain that the appendix valuation:

> *... was undertaken for the purposes of demonstrating that in aggregate the mathematical reserves determined by the valuation undertaken using the gross premium method, the results of which are reported on the preceding pages, are not less than an amount calculated in accordance with Regulations 55 to 64 of the Insurance Companies Regulations 1981.*

Equitable's appendix valuation provides the information required by paragraphs 1, 5, 6, 7, 9, 17 and 18 of Schedule 4 to ICAS Regulations 1983. They say that the information required for the other paragraphs (apart from paragraph 19 – being a statement of the required minimum margin in the form set out in Form 60 of Schedule 4 which, having had '*regard to the purpose of the valuation*', has not been provided) is identical to that given in the main valuation.

As in previous years, in response to paragraph 5(1)(a) Equitable state: '*In these conditions the Society would be able to set up reserves which satisfy* [Regulations 54 and 56 to 64 of ICR 1981] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued*'.

As in the main valuation, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity.

As in previous years, in paragraph 5(1)(g) Equitable disclose the ages that retirement benefits could be taken on their recurrent single premium with-profits pension business.

Unlike in the main valuation, in paragraph 7(b) Equitable explain the method by which they had made provision for future expenses on their recurrent single premium business.

Schedule 4 – appendix valuation (forms)
In the appendix version of Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts on the appendix valuation basis.

In the appendix version of Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts on the appendix valuation basis.

30/06/1993 **GAD complete the A1 Initial Scrutiny check on the Society's 1992 regulatory returns.** GAD note that the Society's cover for the required minimum margin is 2.36 (increased from 1.67 the previous year, and compared with the 2.42 estimated by Equitable on 09/03/1993). GAD do not identify any concerns.

05/07/1993 [entry 1] **GAD complete the A2 Initial Scrutiny check on the Society's 1992 regulatory returns.** GAD reduce Equitable's priority rating from 2 to 3 and note that a trivial amount of reinsurance is not with UK authorised companies. Under '*Aspects which look worrying*', GAD identify the valuation basis for unit-linked business, although they note that this is not a major class. Under '*Other notes*', GAD note that the proportion of assets invested in fixed interest securities has risen from 26% to 38%. GAD identify no items to notify to DTI, to be taken up immediately with Equitable.

Accompanying the initial scrutiny check are two forms (*Form B* and *Form C1*) tabulating key figures disclosed in the 1988 to 1992 returns. GAD also produce a new '*Form B – Initial Scrutiny Form*'. As with the previous version, this includes certain key figures disclosed in the returns.

05/07/1993 [entry 2] Equitable's Chief Executive/Appointed Actuary writes to the Government Actuary following a press report that GAD are to launch an investigation into the way life companies distribute bonuses to their policyholders. The Chief Executive says that the Society has a very open bonus system and so the consequences of such a survey are likely to be to their advantage. However, he expresses concern that the intended survey was announced first in the press rather than direct to companies' Chief Executives, that it may further weaken confidence in the industry, and that it may be a precursor of tighter regulation, for example of bonus rates.

The relevant press article quotes the Government Actuary as saying:

> *The Department of Trade and ourselves are considering sending out a questionnaire to get information on two fronts – what companies say to policyholders when they market the contracts, and what their actuaries actually do when deciding on bonus allocation and distribution among their different types of policyholder.*

The article also reports:

> *There are two main areas of concern, says* [the Government Actuary]. *First, the Department of Trade is worried that proprietary companies, those that have outside shareholders, may be putting the interest of shareholders above those of policyholders and giving them more than their fair share of company profits ...*
>
> *Second, it will investigate whether marketing pressures may be causing certain groups of policyholders to receive less than they deserve, while other groups may be getting more.*

07/07/1993 [entry 1] The Government Actuary replies to Equitable's letter of 05/07/1993. He explains that the survey had been announced at a recent conference on current issues in life assurance and that there was no intention to weaken confidence in the industry or to introduce tighter regulation. The Government Actuary adds:

In one sense there is nothing new in this, since GAD and the DTI have always taken a close interest in policyholders' reasonable expectations. Indeed, this has been the central issue in many Section 49 Transfers [i.e. transfers of the whole or part of a company's long term business]*, in the setting up of sub-funds, in changes to the proportion of surplus going to shareholders and in a number of other areas. We have been signalling for some time that asset share calculations would be one of the aspects on which we would seek to focus during the next round of company visits. On top of this, there have been particular pressures on companies because of falling investment returns and some evidence that proprietary companies are under more than usual pressure to demonstrate value to shareholders. These and other factors pointed to the need to focus on this area and for DTI to be seen to be doing something positive to indicate that it has policyholders' reasonable expectations very much in mind.*

The Government Actuary concludes by saying:

It is certainly no part of our remit to weaken confidence in the industry, but we do want to ensure that policyholders' reasonable expectations are given their due place in the thinking of all life offices, and not just the best ones. In my view a debate on these issues can only be a healthy thing.

Lastly, I should reassure you that there is no intention of making any fundamental changes to the style of supervision. As I have already mentioned, PRE has always played an important part in the thinking of DTI and GAD and will continue to do so. We are keen to ensure that best practice prevails but have no intention of introducing statutory regulation on bonus rates.

07/07/1993 [entry 2] Equitable's Appointed Actuary writes to DTI seeking their views on the possibility of raising subordinated loan capital from policyholders through the issue of bonds.

09/07/1993 Every insurance company is sent by DTI's Head of Life Insurance a letter in which he explains:

The Department has an ongoing responsibility to keep itself informed of developments within the life insurance industry, and a particular responsibility to protect policyholders' reasonable expectations. In this context we wish to gain a clearer picture of current industry practice in respect of bonus methodology.

We have therefore asked the Government Actuary's Department to conduct a survey of leading UK offices which write with-profits business, in order to obtain more detailed information about companies' bonus philosophies, and the actuarial techniques used in assessing bonus payments.

DTI enclose a letter from GAD to Appointed Actuaries, giving more detail on the survey and attaching the questionnaire. In that letter, GAD explain:

As I am sure you are aware, there is a growing debate within the life insurance industry over the most appropriate method for determining the distribution of surpluses arising in the long-term funds of with-profit offices. Actuaries have introduced some new methodologies for assessing bonuses including the technique known as "asset shares", although there is no clearly accepted definition of how these asset shares are calculated, and the art or science of asset shares is still not fully developed in actuarial literature. Moreover, there is no information available in the DTI returns about how appropriate rates of bonus are assessed.

GAD continue:

Accordingly, we have decided to conduct a survey of leading U.K. offices transacting with-profits business to ascertain how they determine and distribute surplus arising in their *long-term funds for policies becoming payable on surrender, death or maturity. This survey is intended to obtain more detailed information about companies bonus philosophies and the actuarial techniques applied in the assessment of appropriate final or terminal bonuses to be paid on (non-group) with-profit policies than is available elsewhere.*

The survey is sub-divided into two broad headings, (i) the content of current marketing literature, combined with information on the principles of distribution in the constitution of the company and (ii) the company's actual methodology in respect of the determination of appropriate levels of final or terminal bonus payable on with-profit policies.

Within the first heading, we are seeking information about references in current marketing literature, including those contained in offices' with-profit guides, to a number of specific aspects regarding the allocation of surplus to policyholders. For the purpose of this section of the survey, we are asking by way of example about references in any specific or general marketing literature and product particulars in respect of the current series of endowment assurance contracts. However, if there have been recent changes of significance in your marketing literature to references to the allocation of surplus between policyholders and shareholders, we would be grateful if you would draw this to our attention by suitable responses to the relevant questions, as we would also if different principles are applied for other classes of with-profits policies (both conventional and unitised, if appropriate).

Under the second heading of the survey, we have asked a number of questions about the methods and rationale by which rates of final or terminal bonus are assessed for endowment assurance contracts (though, again, additional information should be provided if differences of approach apply to other contracts). We have included some specific questions about the methods of determination and allocation of surplus arising from various potential sources.

GAD also state that they '*would not wish to rule out the possibility of publication of a summary of the results, though, if we did so, we would ensure that the responses of individual participating offices could not be identified*'.

20/07/1993 Equitable write to GAD enclosing their completed questionnaire for the with-profits survey. Within their responses to part (i) of GAD's survey (about marketing literature and principles of distribution), Equitable say that their Articles of Association give:

... the Society's Directors absolute discretion as to bonus allocations. Beyond that, there is no statement of bonus philosophy in the Society's constitution.

... The main statement of the Society's long-standing philosophy on bonus distribution in marketing literature is contained in ... the With Profits Guide ...

The Society explains further that their With-Profits Guides give no specific information on the period and magnitude of smoothing or the likely frequency of changes to final bonus rates. However, general comments in the Guide could be expected to lead policyholders to expect relatively infrequent changes to the latter.

Equitable enclose copies of their Articles of Association, their With-Profits Guide (dated May 1993), product particulars for endowment assurances (dated March 1993) and for personal pensions (dated October 1992), and the current version of their leaflet on bonuses (dated May 1993).

Equitable provide the detailed information sought in part (ii) of GAD's survey (about actual methodology for determining final or terminal bonuses). Equitable explain in particular:

- that, for surrenders, '*the full policy value (including final bonus) is normally adjusted to ensure that the surrender value paid does not exceed the underlying asset share. The level of adjustment required is monitored monthly*';
- that, when determining the annual expense level attributed to with-profits contracts for recurrent single premium business, '*allowance is made for an implicit fund charge of ½% pa. That is, the gross rate of accumulation ... is taken to be ½% pa higher for conventional contracts, such as endowment assurances, than for recurrent single premium contracts*';
- that, when assessing appropriate final or terminal bonuses, Equitable make no allowance for a charge for the guarantee provided in respect of benefits payable on maturity or for a contribution to an '*estate*';
- that Equitable do not discriminate between different contracts in their smoothing process;
- that the smoothing of final or terminal bonuses '*is determined by the relationship between the accumulation rates determined each year and actual investment earnings. That smoothing is also reflected in the comparison of the aggregate total policy values with actual asset values. In normal circumstances the Directors look to apply a 3 to 5 year averaging cycle but expect to apply that more flexibly in more unusual circumstances*'; and
- that, when valuing their assets for the above comparison, '*allowance is made for the accumulated new business strains which will be recouped from future premium loadings*'.

Equitable add: *'Part of the Society's stated philosophy is to achieve a reasonable degree of stability in proceeds with gradual, rather than sudden, changes in proceeds. The approach to smoothing needs to reflect that philosophy, particularly in volatile investment conditions'.*

21/07/1993	GAD thank Equitable for replying so quickly to the with-profits survey. GAD tell the Society that it was the first to respond.
23/07/1993 [entry 1]	DTI write to Equitable in response to their letter of 07/07/1993 about subordinated loans. DTI explain that, in principle, what Equitable suggest does not pose any fundamental problems, but Equitable would need to pursue specific issues with their DTI supervisor.
23/07/1993 [entry 2]	DTI's Line Manager B writes to an Equitable policyholder who had complained that Equitable's bonus policy was fundamentally flawed (in relation to the final bonuses paid on policies of different terms) and that their President's statements and published final bonus tables had been calculated to mislead investors. The Line Manager points out that '*life companies are in general reducing their bonuses and Equitable Life are not out of line with industry trends*'. Line Manager B explains that more sophisticated analytical methods have '*convinced many companies that their bonus policy has been tilted against longer-term policyholders*' and that companies are now redressing the balance to ensure equity for all policyholders.
03/08/1993	DTI's Line Manager B writes again to an Equitable policyholder (see 23/07/1993 [**entry 2**]). He explains that: '*The Secretary of State does have extensive powers to intervene in the affairs of insurance companies if, in his opinion, this is necessary to protect the reasonable expectations of policyholders*'. However, the Line Manager says that he does not consider on this occasion that it would be appropriate to use these powers, as '*Equitable appear to have taken the view that equity amongst all policyholders is best served by setting final bonus rates which are very similar (in terms of % per year of policy term) for policies of all terms*'.

Line Manager B continues that he '*would be very surprised if this turned out to be an unreasonable approach*' and that '*it is very much in line with the approach taken by the market generally*'. Line Manager B suggests that the policyholder may wish to pursue the matter with the Insurance Ombudsman and he provides their details.

16/08/1993 Following a similar exercise in the previous year, GAD's Directing Actuary A sends DTI's Director of Insurance details of the free asset ratios for companies as at 31 December 1992. In relation to mutual insurance companies, the Directing Actuary says that there are ten companies that they should have discussions with (being those with the lowest free asset ratios). Equitable are one of those companies.

The Directing Actuary concludes by saying:

> *Finally, and very importantly, free asset ratios as published in the DTI returns reflect the reserving basis used by the actuary in determining the company's liabilities. The ratios shown in the tables, therefore, do not take account of the varying strengths in those reserves, and some caution should be expressed when using them to indicate the relative financial strengths of companies.*

09/09/1993 Equitable's Appointed Actuary writes to DTI (wrongly addressed to GAD's Scrutinising Actuary C), enclosing a copy of the correspondence he has had with the department about hybrid capital/subordinated loans. The Appointed Actuary explains that Equitable are not short of capital for their business expansion and are not particularly attracted to paying 1.5% or 2% over gilt rate to the normal investment market just to '*strengthen*' the balance sheet. He says, however, that there would be:

> *... a significant attraction to policyholders in having access to an interest paying deposit type contract – and I would certainly rather give our members fatter returns rather than fund managers generally. The ensuing strengthening of the balance sheet would be a useful by product.*

The Appointed Actuary asks if DTI would be willing to support an application for a section 68 Order.

23/09/1993 DTI copy the letter of 09/09/1993 about hybrid capital to GAD's new Chief Actuary with responsibility for Equitable (Chief Actuary C) and ask for his advice.

24/09/1993 DTI's Director of Insurance asks officials for a list of those companies where the 1992 returns show a significant deterioration in solvency cover. The Directing Actuary says:

> *I leave it to your judgement as to how precisely to define "significant", but for non-life companies I am thinking of at least a five percentage point deterioration, and for life at least two or three. Clearly "significance" becomes greater if the company is actually close to the minimum required margin (or double it for non-life).*

The Director says that he is not concerned for this purpose with:

- *companies that are already on our lists of companies causing concern;*
- *subsidiaries in groups where group accounting concessions operate, unless there are particular problems in a group you want to draw to my attention;*
- *very small companies which are not of commercial or regulatory significance.*

30/09/1993 [entry 1] Every Appointed Actuary is sent by the Government Actuary a copy of DAA5 on reserving for AIDS.

30/09/1993 [entry 2]	Every insurance company is sent by the Government Actuary a copy of DAA6 on the resilience test. This supplements DAA4 sent on 31/07/1992. The letter is issued because the investment outlook has changed following the UK's departure from the Exchange Rate Mechanism. The Government Actuary explains that, for with-profits offices, the resilience of the valuation should now be tested against three rather than two scenarios, and that the revised guidance is to be used for the returns submitted in respect of 31 December 1993. An associated briefing note says that the new test does not represent a weakening over the previous test recommended by GAD.
01/10/1993	Equitable write to the Parliamentary Under-Secretary of State for Corporate Affairs, confirming the invitation to lunch with the Board on 27 April 1994. A handwritten note on the letter records that the visit is subsequently postponed until 26 October 1994.
08/10/1993 [entry 1]	GAD's Chief Actuary C seeks the views of GAD's three Directing Actuaries on Equitable's proposal in their letter of 09/09/1993. He suggests that the proposal could be contrary to the intentions of *'the Directive'* and hence in breach of section 16 of ICA 1982.
08/10/1993 [entry 2]	The office of the President of the Board of Trade writes to confirm acceptance of Equitable's invitation to attend a lunch with Equitable's Board on 23/02/1994.
14/10/1993 [entry 1]	GAD provide DTI with some preliminary thoughts on hybrid capital, in the light of Equitable's letter of 09/09/1993. GAD query if such deposits might be banking business and thus in breach of section 16 of ICA 1982. GAD state that it would be particularly important to subordinate the rights of depositors to those of policyholders. They suggest that the requirements of the conduct of business regulators may be of significance, particularly with regard to the way the product is marketed. GAD also set out some specific questions for Equitable, including: '*As the rate of interest would presumably need to be fairly high, perhaps above the market rate, how would the issue of these deposits benefit the security and, more importantly, the reasonable expectations of members generally?*'.
14/10/1993 [entry 2]	GAD write to Equitable to explain that GAD have passed the letter of 09/09/1993, together with their comments, to DTI for them to reply.
20/10/1993	In response to DTI's request of 24/09/1993, GAD send DTI information on the changes in insurance companies' solvency cover as between the 1991 and the 1992 returns. Of the 22 mutual companies listed, Equitable are recorded as having the third most improved cover for their required minimum margin from the 1991 to the 1992 returns – a percentage change of 41.83%.
22/10/1993	Gibraltar's Financial Services Commission write to DTI about the way that Equitable's branch in Guernsey are marketing a product in Gibraltar. The Commission express concern that Equitable are not offering *'best advice'* but that they can do nothing about this.
26/10/1993	A DTI official (and former Line Manager with responsibility for Equitable (Line Manager A)) writes to the Head of Life Insurance with the results of the exercise to establish which companies had shown a significant deterioration in their 1992 solvency cover compared with 1991. (See 24/09/1993.) The official attaches a list of companies supervised and explains that slightly less than half have experienced a reduction in their solvency margin. He suggests that the Director of Insurance's criteria for identifying companies should be modified to exclude:

> *a. companies in "intensive care". These are slightly different from those we report as "causing concern". Rather they are the companies which we recognise as weak or as having special problems, but which we do not actually report to the Minister, mainly because they have managed to struggle on over a number of years, mainly on the strength of "drip fed" capital. Reporting that they are in difficulties would be misleading. We nevertheless regard them as high priority and are in regular touch. Such companies are* [five named companies] *and many others. Almost all fall into* [the Director of Insurance's] *third category – small without much commercial significance (although their regulatory significance is high); and*
>
> *b. managed pension fund subsidiaries; these cause few problems. The business they do results in very little financial strain and they can, in fact, survive on very thin margins.*

Using this modified criteria and GAD's note of 16/08/1993, the official highlights 16 companies which *'we should be paying special attention to in the remainder of 1993 and 1994'*. This list includes Equitable, with a note that they are one of eleven companies *'from* [Directing Actuary A's] *free asset ratio list'*, but also one of four from this list which have shown a marked improvement in terms of solvency.

The official draws attention to Directing Actuary A's *'disclaimer about the various reserving bases used by different actuaries making it difficult to compare the strength of one office with another'*.

29/10/1993 Line Supervisor B writes to Line Manager B in response to GAD's note of 14/10/1993 about Equitable's hybrid capital proposal. She states that another DTI official does not think the proposed deposits could be regarded as banking business, but: *'His advice generally is to tread carefully ... (unless we as supervisors are totally convinced that Equitable is so strong that* [the] *proposal will be 100% beneficial)'*. She notes that, as supervisors, DTI would need to consider any section 68 Order. She states that there is no harm in getting more information from Equitable, and she attaches a draft letter to the company.

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01/11/1993 DTI write to Equitable's Appointed Actuary in response to his letter of 09/09/1993. DTI seek fuller details of Equitable's proposal, including how interest rates would be determined, how Equitable would finance the interest payments and what the repayment rights of both the depositor and Equitable would be. DTI also ask:

> *As the rate of interest would presumably need to be fairly high, perhaps above the market rate, how would the issue of these deposits benefit the security and, more importantly, the reasonable expectations of members generally?*

DTI conclude by saying:

> *Our view is that it would be particularly important that the rights of the* [depositors] *should be subordinated to those of the with-profits policyholders in respect of their reasonable expectations to future bonuses, not just their guaranteed benefits, and that this was clearly understood by the* [depositors].

05/11/1993 GAD write to Equitable's Appointed Actuary. GAD refer to the very useful series of discussions on the effect of market conditions on life insurers which they have held with a number of Appointed Actuaries towards the end of 1992 (see 15/09/1992). GAD seek a further meeting with Equitable to take account of any developments over the last year. GAD set out the matters they wish to pursue under four main topics:

<u>Financial position</u> – saying GAD wish to discuss both the current and projected position. GAD ask for a copy, prior to the meeting, of any relevant report or business plan.

Bonus policy – saying GAD wish to confirm their understanding of how Equitable set their annual reversionary bonus rates and the investment return required to support current bonus rates; to discuss the likely bonuses for 1993 and their sustainability over the next few years in the event of low rates of investment return; and to obtain information about the relationship of current payouts to asset shares and the period over which it is intended to smooth these payouts. GAD add that they may wish to clarify some points from Equitable's response to the with-profits survey.

Investment policy – saying GAD wish to discuss what rates of return Equitable are assuming for their projections and bonus policy.

Resilience reserves – saying GAD wish to discuss the potential effect of the modifications to the resilience test, as set out in the Government Actuary's letter of 30/09/1993.

The meeting takes place on 30/11/1993 (see entry below).

15/11/1993 Equitable ask DTI whether the questions in their letter of 01/11/1993 are of general application to any life company or just to Equitable.

18/11/1993 A DTI official advises, in relation to the letter of 22/10/1993 from the Gibraltar Financial Services Commission, that this is an issue of marketing rather than prudential regulation and, if there is a regulatory gap, then this would be a matter for Gibraltar.

25/11/1993 Equitable's Appointed Actuary provides GAD with some background documents ahead of the meeting on 30/11/1993. Those documents are in five categories, being:

1) Standard & Poor's insurance rating analysis for Equitable dated November 1993

The rating given is *'AA (Excellent)'*, which is explained as: *'Insurers rated "AA" offer excellent financial security. Capacity to meet policyholder obligations is strong under a variety of economic and underwriting conditions'*.

The rationale for the rating includes that:

> *On the basis of its published valuation, ELAS appears to have relatively weak free asset and investment leverage ratios: 2%-5% (since 1990) and above 920%, respectively. However, free assets are understated by the use of a very conservative valuation basis. Adjusted to a more conventional reserving basis, the free asset ratio is much stronger, near 10% in 1992, with investment leverage at a much more moderate level around 480%.* [Standard & Poor's] *expects these levels of strength to continue.*

It continues:

> *Because of substantial holdings of equity assets, high profit distribution to policyholders, and mutual status, ELAS's free asset base appears slightly more susceptible to sharp investment or economic fluctuations than some peers. However,* [Standard & Poor's] *believes this apparent susceptibility is balanced by ELAS's existing capital strength, limited sales of products with significant reserving strain, and the ability to maintain a favourable balance between policyholder reversionary and terminal bonuses.*

Under the heading *'Management and Corporate Strategy'*, the report says:

> *The Society minimizes any cross-subsidy of one group of policies by another. Its commitment to fairness has led to a high level of distribution and a strict limitation on any retention of today's policyholder profits for the security of future policyholders. This implies a lower level of published free assets than some competitors, though* [Standard & Poor's] *notes the use of a relatively strong valuation basis that significantly understates the level of the Society's free assets compared with other major U.K. offices.*

Under the heading *'Capitalisation'*, and in relation to Equitable's main valuation presented in their regulatory returns, the analysis says:

> *... on the basis of the published valuation, which uses a gross premium basis, ELAS had a modest free asset ratio at December 1992 of 5.1%* [and a] *ratio of available asset/minimum required margin of 236.5% ...*

The analysis goes on to say that Equitable's main valuation basis:

> *... understates the level of the Society's free assets, and that underlying financial strength is considerably stronger than published figures suggest.*

The analysis explains that the reason for this view is because:

> *Using an appropriate alternative net premium valuation for year-end 1992, ELAS would have a much stronger free asset ratio of about 10%* [and] *ratio of available assets/minimum margin near 340% ...*

<u>2) Monthly business statistics for the period ending 31 October 1993 (presented to the Equitable Board on 25 November 1993)</u>

These monthly business statistics comprise of seven reports, being:

- Revenue Analysis – Global Business
- The Equitable Life Assurance Society Balance Sheet
- "Equitable Management Company" – Global Business Profit & Loss Account
- "Equitable Management Company" – Non UK Business Profit & Loss Account
- Investment of net addition to fund
- UK with profits investment performance
- UK Linked business investment performance.

<u>3) Paper entitled *'Bonus Declaration at 31 December 1993'* (presented to the Equitable Board on 25 November 1993)</u>

The paper says that earnings on the with-profits fund are expected to be high at around 20 to 25%. However, it says that, due to the fall in interest rates, some of the return is spurious, and: *'If we took, as a board measure of the <u>intrinsic</u> return on assets for 1993, a weighted mix of the overall equity returns and the income yield only on fixed interest, the outcome would be a return of around 17%'*. The paper then advises that:

> *The relatively high level of nominal earnings in 1993, coupled with some relaxation on the regulatory side, as described in the quarterly review of revenue considered last month, means that, virtually irrespective of the bonus decisions taken this year, our published position at 31 December 1993 will be significantly "stronger" than last year. The presentational implications of our decisions are therefore much less important than has been the case in recent years. This year we can focus predominantly on fundamentals in formulating decisions and that is to be welcomed.*

Under the heading *'Total policy values'*, the paper says:

> *For our main classes of business, total policy values and, hence, final bonuses, are determined by rolling forward the value at the end of the previous year, together with subsequent premiums, at a "total growth rate". The key decision which the board needs to take regarding bonuses is the level of that total growth rate which then needs breaking up into declared and final bonus rates. The determination of appropriate bonus rates for other products is essentially a technical exercise.*

For 1990 and 1991 the total growth rate was 12% p.a. For 1992 a rate of 10% was applied to the benefits in force at the start of the year and 12% to premiums applied within the year i.e. for new money. That was in reflection of the relatively high earnings in 1992 and the need, on the older business, to recover part of the over-distribution in respect of 1990. Policy pay-outs are currently being determined by rolling forward 31 December 1992 values, together with subsequent premiums, at 10% p.a.

It continues:

For 1993 we need to decide what is the appropriate rate or rates in the light of the earnings position described ... above. An intrinsic return comparable to that earned in 1992 would indicate that similar total growth rates are appropriate – i.e. around 12% p.a. we also need to bear in mind that total policy values are still above the value of the underlying assets. To some extent 1993 might be regarded as the converse of 1990. Allocation of a relatively modest rate of around 12% when "usable" earnings are about 17% will restore a position of balance between assets and policy values. If earnings in future years are at relatively low levels the opportunity for such action may not recur for some time.

4) Paper entitled *'Revenue – Review of First 9 Months'* (presented to the Equitable Board on 27 October 1993)

The paper sets out the premium and investment income received and the payments made to policyholders.

Under the heading *'Earnings and solvency position'*, the paper says that the earnings on the with-profits fund for the first nine months of 1993 is 17.3%. The paper then explains that:

The relatively high earnings level to date has been associated with corresponding falls in income yields on both fixed interest securities and equities. The board are reminded that, in solvency terms, the effect of high earnings can be offset by the effects of the corresponding reduction in the income yield on the assets. As income yields fall, the discount rate which can be used in valuing the liabilities also falls. Purely on technical grounds, therefore, the liability valuation can grow as the capital values of the assets rise.

As discussed on previous occasions, the statutory minimum basis for liability reserves is laid down in regulations. These regulations have been supplemented by informal requirements specified by the Government Actuary. Although those requirements are not mandatory, most offices, including the Society, have chosen to set reserves at a level which meant the informal requirements were satisfied. That is, the requirements have led to an effective minimum basis somewhat stronger than the bare statutory minimum. That is the basis on which we have discussed "Form 9" presentations. The Government Actuary has recently announced a modification to those requirements in the face of a general view that the original requirements were unduly stringent in current investment conditions.

The paper continues:

As mentioned above, these additional requirements are not mandatory and [the Appointed Actuary] *may consider it appropriate either to challenge the requirements as inappropriate or set a basis somewhat stronger than that indicated by the requirements. To paint a picture of the range of outcomes the estimated "Form 9" position is shown below on 3 different bases – the valuation basis used at 31.12.92, the minimum indicated by the new requirements, and the traditional "premium basis" valuation used in 1989 and earlier years. The actual 31.12.92 position is also shown for comparison:*

	31.12.92 basis	30.9.93 positions Current GAD "minimum" basis	31.12.89 basis	31.12.92
	£m	*£m*	*£m*	*£m*
Assets at market value	*11772.9*	*11772.9*	*11772.9*	*9496.6*
– inadmissible assets and other adjustments	*–111.1*	*–111.1*	*–111.1*	*–96.1*
Asset value for DTI purposes	*11661.8*	*11661.8*	*11661.8*	*9400.5*
– mathematical reserves	*–9671.8(a)*	*–10136.7(a)*	*–10591.1(a)*	*–8557.2(b)*
Available assets	*1990.0*	*1525.1*	*1070.7*	*843.3*
– minimum statutory solvency margin	*–396.5*	*–411.2*	*–434.2*	*–356.6*
"Free" assets	*1593.5*	*1113.9*	*636.5*	*486.7*
Cost of £1% declared bonus	*56.4*	*59.3*	*63.4*	*N/A*

(a) excluding accrued declared bonus

(b) including cost of declared bonus

Continued use of the 31.12.92 basis is probably not tenable in view of the reduction in yields this year. If [the Appointed Actuary] *considered that use of a basis of similar strength to that indicated by current guidelines was appropriate, then that represents a point broadly mid-way between the 31.12.92 and 31.12.89 bases. At this level our published "strength" would be substantially greater than at 31.12.92. The figures indicate that a move back to our traditional basis is now possible but might result in an unacceptably "weak" published position at this stage. It should, however, be remembered that there is a hidden margin in the inadmissible assets. If either we sold the FTSE option before the year end or obtained a dispensation allowing us to bring it into account, some £60-70m would be added to the DTI value of assets and, consequently, the "free" assets.*

5) Paper entitled *'Cost Management and Control – Report on the First Nine Months'* (presented to the Equitable Board on 27 October 1993)

The paper comments on the accounts of the Equitable Management Company.

30/11/1993 GAD (Chief Actuary C and Scrutinising Actuary C) and DTI (Line Supervisor B) meet Equitable's Appointed Actuary. Scrutinising Actuary C's note of the meeting records the documents sent by Equitable prior to the meeting, including the *'recent very full report (paid for by Equitable!) from Standard & Poor's ... giving the company a very good rating'*. He also records the Appointed Actuary's view that some of the topics set out in GAD's letter of 05/11/1993 *'were not areas about which we as regulators had the right to enquire. Having said that, he was willing in practice to discuss anything we wished'*.

The Scrutinising Actuary notes that the meeting first discussed the likely bonus at the end of 1993 and that the Appointed Actuary had reported a further reduction in the declared rate of at least 1% leading to a bonus rate of 4% or less. This would need 7.5% to support, which approximated to the return on the gilt portfolio. The Scrutinising Actuary notes that the Appointed Actuary had said that he was expecting this to eliminate the recent excess of payouts over asset shares and that future bonuses would depend primarily on the returns earned on future premiums. The Scrutinising Actuary comments that this indicated possible further reductions and that Equitable *'appeared to be moving to a lower proportion of the total bonus payout being guaranteed (ie declared as distinct from terminal)'*.

Scrutinising Actuary C records that the meeting then turned to valuation issues and that the Appointed Actuary had indicated that the position at the end of 1993 would be significantly stronger than at the end of 1992, and that the new business strain expected in 1993 was only approximately £25m. GAD's note continues:

> *There was a discussion on the resilience test and* [the Appointed Actuary] *commented that as markets were currently moving the new tests were becoming tighter. Pensions business has a guaranteed annuity rate at about 7% but this was not as onerous as it appeared since, because "old" policies had been given the benefit of more modern features and options, it would be reasonable (in his view) for the allocation of final bonus to be conditional on the waiving of this guarantee.* [Chief Actuary C] *asked particularly about the resilience test in the context of the net premium valuation described in the Appendix to Schedule 4, since it was not explicitly mentioned there;* [the Appointed Actuary] *was sure that resilience had been allowed for, but promised to investigate and confirm.*

Scrutinising Actuary C notes that, in conclusion, the meeting had discussed investment policy and that the Appointed Actuary had explained that Equitable's investment decisions were *'a result of the judgement of the investment team and not driven by resilience concerns'*. At the meeting Equitable undertake to provide GAD with some further papers (see 07/04/1994).

DTI's copies of the papers Equitable provided to GAD prior to the meeting contain annotations made by Line Supervisor B at the meeting.

On the Board paper entitled *'Cost Management and Control – Report on the First Nine Months'*, Line Supervisor B notes:

> *Solvency position will be tightening. Guarantees – don't reserve for them ... We have no guarantees that bite.* [Chief Actuary C]*: PRE?*

On the Board paper headed *'Revenue – Review of First 9 Months'*, Line Supervisor B notes that the current GAD minimum basis incorporates the resilience reserve.

On the Board paper headed *'Bonus Declaration at 31 December 1993'*, Line Supervisor B notes that Equitable are likely to declare a reversionary bonus rate for 1993 of around 4% and that *'GAD said they'd be happy with* [this]*'*.

03/12/1993 Equitable apply for a section 68 Order for a future profits implicit item of £420m, for possible use in their 1993 returns. Equitable provide financial calculations in support of the application, suggesting that they could seek an Order up to the value of £966m.

These calculations include, for the estimated annual profits, that:

Year ending	(A) Total surplus	(B) Exceptional items	(C) Surplus arising from solvency margin	(A)-(B)-(C) Ordinary surplus
	£m	£m	£m	£m
31.12.88	259.2	–	61.4	197.8
31.12.89	337.4	–	89.9	247.5
31.12.90	422.5	557.0 (a)	26.6	(161.1)
31.12.91	596.5	(13.2) (b)	59.5	550.2
31.12.92	330.5	(89.4) (c)	46.4	373.5
				1207.9

Average annual profit = 1207.9/5 = £241.5m

Notes: (a) Surplus was increased by £557.0m as a result of changes in valuation bases during 1990.

(b) Surplus was reduced by £13.2m as a result of changes in valuation bases during 1991.

(c) Surplus was reduced by £89.4m as a result of changes in valuation bases during 1992.

The calculations state that the average period to run for the Society's in-force contracts is eight years. The Society's Appointed Actuary explains:

> *The periods to run have been reduced to take account of premature withdrawals based on the Society's recent experience of such withdrawals. In respect of retirement annuity and personal pension contracts for which a range of retirement ages is available, it has been assumed that retirement benefits are taken at the lowest possible age, or immediately if that age has already been attained.*

The calculations suggest that the maximum future profits permissible is 50% of £241.5m multiplied by eight years – that being £966m.

07/12/1993 [entry 1] DTI inform the Society's Appointed Actuary that the questions in the Department's letter of 01/11/1993 apply to all life companies seeking to raise hybrid capital. DTI say that the questions are '*particularly relevant to with-profit offices, because of the need to take into account policyholders' reasonable expectations*'. There is no evidence of a further reply by Equitable.

DTI ask GAD for their views on Equitable's application for a section 68 Order.

07/12/1993 [entry 2] GAD produce a question by question summary of the responses to the survey on bonus distribution practice (see 09/07/1993). GAD's summary is largely factual and does not refer to companies by name. GAD do not include any further analysis of the responses or seek to draw any general conclusions.

09/12/1993 GAD provide DTI with comments on the application made on 03/12/1993. GAD say that it is Equitable's regular practice:

> *... to apply for such an Order shortly before the year end as a precautionary measure. So far as I can see they have never used it, and are most unlikely to do so as at 31 December 1993, but no doubt they feel that it is a useful protection against adverse market movements (for example) right at the end of the year. As usual the amount of the implicit item sought is well below the maximum allowed by the Regulations; on this occasion it is under half that maximum.*

1993

We suggest that you issue the Order in the usual way.

13/12/1993 DTI send Equitable the section 68 Order for a future profits implicit item of £420m, for use in the 1993 returns. DTI remind Equitable that, in accordance with the Guidance Notes which were issued in 1984, before including the item in the forthcoming returns, the company must update the calculations to demonstrate that they still support the amount used.

14/12/1993 Equitable apply to DTI for a section 68 Order to allow them to value a call option related to the FTSE 100 Index. Equitable give the current value of the option as approximately £35m.

21/12/1993 DTI write to Equitable in response to their letter of 14/12/1993. DTI state that they do not anticipate any undue difficulty in granting the requested Order. They ask, however, why Equitable have purchased this option and what part it plays in their portfolio management. DTI say that they understand from a report of the meeting on 30/11/1993 that Equitable may have some corresponding written options and seek details of these also.

23/12/1993 DTI's Head of Life Insurance writes to the Chief Executives of all life companies to ask for an assessment of their potential liability to compensation claims from policyholders who had received inappropriate advice about transfer or opt-out from occupational pension schemes. DTI seek in particular:

- the best available indication of the total policies sold since 1988;
- the percentages obtained through a direct sales force, independent financial advisers and appointed representatives;
- the percentages of business represented by both transfers and opt-outs from occupational schemes; and
- the best provisional estimate of the potential cost of compensation.

30/12/1993 Equitable write to DTI to explain that their Chief Executive is on holiday and will reply to the letter of 23/12/1993 on his return.

1994

01/01/1994	The Personal Investment Authority (PIA) becomes responsible for the regulation of the conduct of business by its member companies.

04/01/1994 Equitable write to DTI in response to their letter of 21/12/1993 about the requested section 68 Order. Equitable explain that they had set up the call option to provide some protection against substantial falls in UK equity values during the months leading up to the end of 1993. Equitable say this provides them with additional exposure to the benefits accruing from increasing equity values, but with limited downside risk. Equitable add that there is no corresponding written option.

05/01/1994 DTI's Line Manager B sends a note to the Head of Life Insurance headed *'1992 Returns – "Problem Companies"'*. The Line Manager notes that a meeting has been arranged for 6 January 1994 about these companies (which are those listed in Line Manager A's note of 26/10/1993). Line Manager B explains that he supervises two of them, including Equitable, but advises that the meeting clashes with another meeting he has already arranged. He explains that GAD held a mainly actuarial discussion with Equitable that Line Supervisor B had attended (see 30/11/1993). The Line Manager continues:

> *At the time* [Line Manager A's] *list was drawn up, both* [Equitable and the other company] *seemed rather marginal candidates for inclusion, a view confirmed by the recent contacts. They are both well-managed and reasonably successful; neither appears to be anywhere near the slippery slope at present. I believe that they need no special attention before submission of the 1993 returns.*

Line Manager B concludes: *'In the light of the above I have not asked* [Line Supervisor B] *to attend your meeting in my place although I believe she is available if you should need her'*.

18/01/1994 DTI write to the Chief Executives of all life companies, following up their letter of 23/12/1993 about potential liabilities in respect of pension mis-selling. DTI explain:

> *This letter gives you guidance on how the Department expects companies (including branches where appropriate) to reserve for any such mis-selling of personal pension contracts in future Companies Act accounts and DTI returns.*

DTI state:

> *Where a life office believes that it is likely to have a liability in respect of the mis-selling of pension business, the Department believes that such liability should be recognised in one or both of the following ways, depending on the specific circumstances:*
>
> - *the liability may be recorded as part of the mathematical reserves;*
> - *a provision may be made in the accounts, in accordance with generally accepted accounting practice.*

DTI go on to clarify that:

> *Such liabilities should not be omitted on the understanding that they can be covered by the solvency margin.*

DTI add: *'It is recognised that there may be considerable difficulty in assessing the extent of any liability, but this does not remove the obligation of the office to compute the best estimate of the amount, based upon available data and reasonable enquiries'*.

They advise that companies and Appointed Actuaries should consider if sums should be set aside to cover expenses in carrying out investigations into mis-selling.

DTI state:

> *Where the accounts or returns do not show explicitly the amount of the provision made resulting from mis-selling (eg. because it is included, in whole or in part, within the appointed actuary's valuation basis), companies will need to supply this additional information to the Department, and the directors and auditors will, of course, need to satisfy themselves as to the total provision made in accordance with normal procedures.*

Finally, DTI advise:

> *If the position when the DTI returns are submitted (no later than six months after the balance sheet date) is significantly different from the position when Companies Act accounts are drawn up, the returns should be adjusted as appropriate for such post-balance sheet events or other factors which result in changes being required to the provision estimates. Reference should also be made to any action taken by the shareholders to maintain the required solvency margin, if that has been necessary.*

20/01/1994 Equitable's Chief Executive writes to DTI in response to their letter of 23/12/1993. He provides the following answers to the questions raised by DTI:

- the total number of transferred personal pension plans currently in force is 37,678;
- Equitable sell only through their own directly employed sales force but *'much of the business was unsolicited and in "execution only" form'*;
- Equitable cannot provide the detail requested, but they expect the number of opt-outs from occupational pension schemes to be minimal, as their policy is not to accept such cases in normal circumstances; and
- Equitable currently have no known liability for transfer compensation, and consequently no provision will be allowed for in their 1993 returns. He points out that they *'do, of course, have significant free assets since our business is predominantly with-profits'*.

The Chief Executive adds that he believes:

> *... the impact on the Society's business caused by personal pensions transfers will not be significant. We ensure as far as we can that the policies for which we have a liability are valid policies which satisfy client needs. If there is any subsequent information to suggest otherwise, I will, of course, let you know.*

01/02/1994 Equitable's Chief Executive writes to DTI, having now received the further letter of 18/01/1994. The Chief Executive says:

> *The Society has no known liability for compensation for mis-selling of personal pension transfers and I see no need to make any provision in the Companies Act accounts. Given the general standard of the sales process in the Society, I should be very surprised if there were any significant liabilities anyway. If one did emerge, I should expect to include it in the mathematical reserves. Your point about informing the Department of any such provision in the DTI returns is noted.*

03/02/1994 Line Supervisor B writes to a DTI legal adviser enclosing the correspondence on Equitable's requested section 68 Order for their call option. The Line Supervisor asks the adviser to prepare the appropriate Order.

1994

09/02/1994 The DTI legal adviser raises with Line Supervisor B some queries about Equitable's requested section 68 Order. The adviser says that she assumes Equitable's need for a section 68 Order derives from the fact that the financial instrument is a contract for difference, rather than an option and she suggests, therefore, that it might be helpful to see the terms of the agreement. The adviser continues:

> *Before I let you have a draft Order, I think we need further confirmation that* [the bank] *is an "approved counterparty" as defined in the draft 1994 Regulations (Reg 50(1)).*

15/02/1994 DTI telephone Equitable regarding the queries DTI have about Equitable's requested section 68 Order (see 09/02/1994). DTI are told they will be called back. (There is no record of such a follow-up call. However, also see 17/02/1994 [**entry 1**].)

16/02/1994 DTI's Line Supervisor B provides the office of the President of the Board of Trade with briefing for his lunch with Equitable on 23/02/1994.

17/02/1994 [entry 1] Equitable provide DTI with the documentation requested on the call option. Equitable also explain:

> *Several of the forms in the Society's annual returns to the DTI are dependent on the outcome of the Society's application for this Section 68 Order. As work on the 1993 returns is in progress, it would be helpful if you could indicate when you expect to be able to let us know whether or not our application has been successful so that we may plan accordingly.*

(Note: Equitable recorded internally that other offices had obtained section 68 Orders and that it was surprising that DTI were not being more efficient in dealing with their request.)

17/02/1994 [entry 2] DTI's Director of Insurance writes to the Head of Life Insurance in response to the briefing of 16/02/1994. The Director asks whether the Head of Life Insurance knows anything about Equitable's overseas business or their future plans, as this is what the President of the Board of Trade was likely to be interested in.

DTI's Line Supervisor B provides slightly expanded briefing for the President (which is agreed with the Head of Life Insurance). In the background section, DTI state:

> *The latest returns submitted to DTI show its solvency position to be strong. In late 1993, the company received an "AA" rating from Standard & Poor's for its excellent claims paying ability.*

On mis-selling, DTI refer to the survey on possible mis-selling of pensions and note Equitable's response that they *'did not see a need to make any provision for compensation in its accounts, given the high standard of selling techniques in the Society'*.

Under the heading *'Deregulation'*, DTI state:

> *BACKGROUND – Insurance division deregulation subjects put forward are:*
>
> > *a) removal of the need for a five-yearly statement of life assurance business* [i.e. Schedule 5 of the returns]
> >
> > *b) removal of the need for an annual statement of insurance companies' connected intermediaries.*
>
> *LINE TO TAKE – we have consulted interested parties on these proposals and have received universal support for the removal of (b) above. Regarding (a), some consulting*

1994

actuaries have argued for its retention. We are considering the possibility of retaining some information from the present statement in the annual returns.

22/02/1994 DTI's Line Supervisor B provides the Head of Life Insurance with further briefing for the visit on 23/02/1994, which the Head is now attending on behalf of the President. She supplies solvency figures for 31 December 1991 and 31 December 1992. She refers to Equitable's correspondence about hybrid capital and a section 68 Order on their call option. She notes the visit to Equitable on 30/11/1993, which had been to discuss:

> *... financial issues, eg resilience testing, bonus policies, investment strategy (follow-up to similar meeting a year before).*

Line Supervisor B adds:

> *Managerial issue:* [The same person] *is currently* [Managing Director] *and* [Appointed Actuary]. *At our visit in May 1992, we expressed concern about possible conflict of interests of two roles. He did not see this as a problem. He is due to retire in c1995/6, by which time the two roles would be separated again.*

The Line Supervisor attaches to the note a copy of Equitable's 1992 annual report and accounts, prepared in accordance with the Companies Act 1985, and a copy of Standard & Poor's rating report for the Society.

23/02/1994 [entry 1] The Head of Life Insurance attends the lunch with Equitable. In a note to Line Supervisor B, the Head of Life Insurance records that he was asked to talk about supervision and he *'touched briefly on our philosophy of supervision; the way we operated; and current issues such as the Third Directives, FSA-related topics such as disclosure and personal pensions, and deregulation'*. The Head of Life Insurance's note continues:

> *I also described our interest in the future structure of the life industry, and our concern that the apparent over-capacity in the market should be reduced in as orderly a way as possible. This last point aroused considerable interest; several Board members (notably* [Equitable's President]*) were in favour of the Department taking a very active and interventionist approach to reduce the number of companies. Their motives were not entirely disinterested;* [Equitable's President] *said that he thought there was too much competition in the life insurance sector, and that Equitable would be glad if the DTI removed some competitors, so that the Equitable's market share could go up! I said that I did not see this as the DTI's role, a better response was greater disclosure, which a company like the Equitable, with low costs and no commission paid to intermediaries, should be able to benefit from.*

He also records: '[Equitable's Appointed Actuary] *had not realised that it was DTI rather than GAD which supervised his company. I explained the position, and told him that you were his supervisor. He was grateful for this information!'*.

23/02/1994 [entry 2] DTI's Line Supervisor B writes to the legal adviser in response to her queries of 09/02/1994. She provides the documentation sent by Equitable on 17/02/1994. She comments that the American bank which wrote the option satisfies the draft 1994 regulations. She asks the official to prepare the section 68 Order.

02/03/1994 The DTI legal adviser sends Line Supervisor B a draft section 68 Order.

09/03/1994 DTI send Equitable the section 68 Order in respect of the call option, to be used in Equitable's 1993 returns and with effect until 30 June 1994.

24/03/1994	GAD's Scrutinising Actuary C prepares some *'Detailed Scrutiny Notes'* for Equitable's 1992 returns.

Under *'Standard reporting items'*, the Scrutinising Actuary notes the cover for the required minimum margin. He also includes two tables providing a *'recent history'* of new business and of expenses. The tables cover the years 1989 to 1992.

Under *'Initial scrutiny notes'*, the Scrutinising Actuary reiterates the comments provided in the *'Aspects which look worrying'* and *'Other notes'* sections (see 05/07/1993 [**entry 1**]), those being: '[Unit-linked] *parameters include a generously high real growth assumption (however this is not a major class)'* and *'Fixed Interest proportion has risen to 38% (was 26%)'*.

Under *'Review of file'*, the Scrutinising Actuary notes that the minute of 3 March 1992 and the note of the meeting held on 30 November 1992 *'should be noted in particular'*. (Note: It appears that the correct references are to the comments to DTI on 03/03/1993 and the note of the meeting on 30/11/1993.)

Scrutinising Actuary C includes the remarks '*Nil*' under the headings of *'Report & Accounts'* and *'Returns – Schedules 1 – 3'*.

Under *'Returns – Schedule 4'*, the Actuary notes that, according to Equitable's letter of 09/03/1993, they had strengthened their valuation basis by about £100m. He also notes that reversionary and terminal bonus rates have again been reduced.

Finally, under *'Miscellaneous'*, the Scrutinising Actuary notes that Equitable consider their liabilities for mis-selling of personal pensions to be negligible. The Scrutinising Actuary states that he has checked Equitable's reply to GAD's survey on *'With Profits Policies: Distribution of Surpluses'* and there is *'nothing to note'*.

28/03/1994	**GAD complete their scrutiny of the Society's 1992 regulatory returns.** GAD write to DTI with a report on the results of their work. (A copy of this scrutiny report is reproduced in full within Part 4 of this report.) GAD provide a two page report and say that Equitable have *'again had a successful year overall'*. GAD note that Equitable:

> *... publish, rather unusually, a Bonus Reserve Valuation (BRV) and then, as an Appendix to Schedule 4, a Net Premium Valuation (NPV) in accordance with the Regulations. The reserves on the BRV are always demonstrated to be higher than those required using the NPV.*

GAD explain that the bonus reserve valuation shows cover for the required minimum margin of 2.36 (compared with 1.67 in 1991). GAD note that the net premium valuation shows cover of about 3.9. However, they *'have one or two questions about the NPV valuation basis'*. GAD state they are:

> *... satisfied that the BRV (and hence the overall returns as formally deposited) is, in aggregate, adequate according to the Regulations. As at the end of 1992 it was on a similar basis to 1991 but with some minor strengthening, amounting to some £100m overall.*

GAD draw attention to the fact that Equitable's business is largely with-profits and nearly all on a single or recurrent single premium basis. GAD say: *'As we have discussed before – see in particular my minute of 3 March 1992 – this makes it difficult to compare Equitable with other with profits companies'*.

GAD continue:

> *We have been concerned in the past that they have over-distributed and weakened their reserves. More recently matters seem to have been brought under better control. The*

situation as at 31 December 1992 is more satisfactory than the previous year, and as you will know from recent reports (eg the notes of the meeting held on 30 November last) we expect the position as at the end of 1993 to have improved still further. Reversionary and terminal bonus rates were reduced at the end of 1992 and it has just been confirmed that reversionary bonuses have been reduced again from the end of 1993.

GAD set out two tables showing the recent history of new United Kingdom business and of expenses. GAD explain that Equitable have responded to the letters about liability for mis-selling of personal pensions *'indicating that they expect any such liability to be negligible; from our knowledge of the company we would have no reason to doubt this'*. GAD conclude that they still had some questions on the 1992 returns:

... relating to particular features of the NPV basis which might appear somewhat weak. We have also asked the actuary for some formal information about bonuses, and also for his indication of the position as at the end of 1993.

On DTI's copy of this note, they have underlined the words *'formal information'* and written *'OK'*.

GAD attach a copy of their letter to Equitable, in which they take up outstanding questions on the 1992 returns. GAD say that they have noticed recent press comment regarding Equitable's bonus announcement and ask for a copy of all the new rates of bonus. GAD also ask to be provided with a copy of the Society's most recent With-Profits Guide. GAD add: *'It occurs to me that you may have regular mailing lists of recipients of these two items, and if you could add my name to those lists it might save some routine correspondence in the future'*.

GAD refer to *'a most useful meeting here last November* [see 30/11/1993] *at which several points were cleared up'*. GAD ask Equitable:

(1) *'In the Appendix (where the net premium results are set out) you mention in para. 5(a) on page 98 that resilience reserves could be set up without recourse to the Form 14 line 51 assets. However you do not give an indication of the amount of any resilience reserve which would be required on the* net premium *basis and which is not covered by the* net premium *liabilities. Could you please advise this amount as at 31 December 1992, and ensure that the corresponding figure is disclosed in future returns'*;

(2) to provide the figure for the growth rate of non-unit reserves, if the real rather than gross rate of return were used;

(3) to explain the origin of a deduction in the capital gains tax reserve shown in Form 56, column 12; and

(4) *'Finally, the rate of 9% used to value the non-profit immediate annuities seems on the high side. Could you please supply more details of the assets that are deemed to be backing these liabilities, and their yields, having regard to Regulation 59(2) and (6)(a).'*

GAD conclude:

It would also be helpful if you could let me have a preliminary estimate of the position as at the end of 1993, in a similar form to that in your letter of 9 March 1993; that is to say, an estimate of your Required Minimum Margin and the available assets, and also the rate earned on your fund during 1993. An indication of the quantum of strengthening of the valuation basis, as referred to in ... the documents we had for the November meeting, would be appreciated also.

31/03/1994 Every Appointed Actuary is sent by the Government Actuary a copy of DAA7 on the Appointed Actuary certificate and compliance with Guidance Notes 1 and 8.

07/04/1994 Equitable's Appointed Actuary responds to GAD's letter of 28/03/1994. The Appointed Actuary encloses a copy of the Society's booklet entitled *'Bonuses'* which details the most recent bonus rates. He explains that the Society will supply the With-Profits Guide when it has been updated and that, as they do not have a mailing list for this, he has added GAD's name to the distribution list for all future press releases which would include one on the bonus declaration each year.

The Appointed Actuary also encloses copies of the Board papers he had undertaken to send at the meeting with GAD on 30/11/1993, being reports on Equitable's valuation and bonus declarations for 1993 prepared for the Board's meetings in November 1993 and January and February 1994. The Appointed Actuary explains that he has included only the actuarial part of the January report, as the rest deals with commercial aspects of the declaration which he considers it would not be appropriate to release.

In response to GAD's four questions in their letter of 28/03/1994, Equitable's Appointed Actuary explains that:

(1) The resilience reserve required on the net premium basis would have been £462m.

GAD's Chief Actuary C annotates the letter at this point: '[Scrutinising Actuary C], *What was the difference between the* [bonus reserve valuation] *and* [net premium valuation] *reserves. Your minute to DTI implies £450m. Perhaps you should ask* [the Appointed Actuary] *to explain the statement in para 5(a)* [regarding Equitable's provision for long-term liabilities] *on* [page 98]'. Someone adds two further annotations: *'After adding "cost of* [reversionary bonus] *allocated" (see attached sheet) the difference is £476m which is (just) OK'* and *'(This is now OK)'*.

The Appointed Actuary adds that he is supplying this figure on a confidential basis, but is not prepared to publish it in future returns. The Appointed Actuary explains that the resilience of the office's mathematical reserves is a matter for his professional judgment, subject to the required disclosure in the regulations and to require publication of the precise level of reserves needed to satisfy the GAD 'test' would impose a far more explicit level of disclosure on them than on offices publishing net premium office valuations. He says that *'GAD have previously indicated that they feel the Society provides much fuller information than the norm in this area. To require even more from us seems unreasonable'*. (Note: I have seen no evidence of any correspondence in the files which suggests that GAD had previously indicated this.)

Equitable's Appointed Actuary concludes: *'In any event, we may well change this form of presentation and move away from publishing a full net premium valuation when the new regulations are implemented with effect from 1 July 1994'*.

(2) No additional non-unit reserves would have been necessary if a real rate of return of 2% rather than 3% had been assumed. GAD's Chief Actuary C annotates the letter at this point: *'I am surprised by this statement. But let it pass?'*.

(3) It is the Society's practice to set up a specific reserve for tax on unrealised capital gains on life funds. But, at 31 December 1992, the figure for unrealised capital gains was negative and accordingly the returns showed a deduction in the tax reserve.

Chief Actuary C annotates the letter at this point:

> [Scrutinising Actuary C], *We have challenged this in the past. He is effectively treating losses* [brought forward] *as an asset. If all units were liquidated at the valuation date there would be insufficient assets available to cover the amount paid out. It may be more equitable to price in this way but it is not prudent when setting reserves to give a value to* [brought forward] *losses. I think you should challenge* [the Appointed Actuary] *on this issue.*

(4) The valuation of the assets backing the non-profit annuities in the 'office' reserve was based on the Appointed Actuary's professional judgment. The Appointed Actuary explains that, within this group, there are different categories of annuities. He considers that the valuation rate used is suitable, as some assets actually yield a higher rate. Chief Actuary C annotates the letter at this point: *'I suggest that you ask him to comment in relation to the net premium basis'*.

Finally, the Appointed Actuary provides the following current estimate of the Society's Form 9 solvency position at the end of 1993:

	£m
Admissible assets	*13,385*
Mathematical reserves	*11,448*
Other liabilities	*218*
Available assets	*1,719*
Implicit items	*–*
Available assets + implicit items	*1,719*
Required minimum margin	*458*
Excess assets	*1261*

19/04/1994 GAD's Scrutinising Actuary C writes to DTI, enclosing a copy of Equitable's letter of 07/04/1994. The Scrutinising Actuary says that Equitable have:

> *... provided full answers to our questions, but we are asking further questions (copy enclosed) although we are generally satisfied with* [the Appointed Actuary's] *response. We note his comments regarding disclosure of some of this additional information.*

Scrutinising Actuary C comments:

> *If the resilience reserve of £462m is added to the net premium reserves ... the total ... is almost the same as the reserve on the "office" basis. Accordingly the cover for the* [required minimum margin] *on the corrected net premium basis is almost identical to that on the Bonus Reserve basis of 2.36 times. However, this is based on a net premium valuation basis which is weaker than that used by most offices.*

He concludes:

> *Based on the figures at the end of the letter, the published cover for the* [required minimum margin] *(on the Bonus Reserve Valuation) at the end of 1993 will be about 3.75 times. The Board papers supplied reveal that bonus rates were reduced by less than was justified by the Equitable's usual approach of relating declared rates to prevailing interest rate levels, primarily on account of the good performance of the assets during 1993. The actuary recommended a smoothing of the reduction but has warned his Board that further reductions will be needed at the end of 1994 if interest rates do not rise during the year.*

GAD write to Equitable's Appointed Actuary to pursue some further questions arising from Equitable's response to points (3) and (4) in their letter of 07/04/1994.

On (3) (the deduction in the capital gains tax reserve), GAD say that:

> *... for statutory reserving purposes it does not seem to us to be prudent to take credit for tax relief on unrealised losses. If the amount had instead been treated as an asset it would have been inadmissible, and if all units had had to be liquidated on the valuation date there would be insufficient assets to cover the amounts paid out. I hope that you will agree to follow our interpretation if the point should arise again.*

On (4) (the valuation of the assets backing non-profit annuities), GAD say:

> *You will appreciate, I am sure, that our primary concern is with the net premium valuation published in the Appendix to Schedule 4, rather than with the office basis. This question was posed in the context of the net premium assumption (where 9% was also used), and I am sorry if that was not clear. Could you please now provide the information that we are seeking; the yields shown in Forms 45 and 46 do not, after allowing for the 7½% margin, seem to support the 9% assumption.*

25/04/1994	Equitable's Appointed Actuary writes to GAD in response to their further questions on the 1992 returns. On GAD's original question (3) (28/03/1994), the Appointed Actuary says that the Society's approach is *'mainly a consequence of the requirements for compiling the returns and is designed to avoid linked assets and unit liabilities being brought forward into Form 9* [of the returns] *at different values'*. He does not agree that it is not prudent for either statutory or commercial purposes. On GAD's original question (4), the Appointed Actuary provides the information sought for the net premium valuation. The Appointed Actuary explains that the average valuation rate used is supported by the average yield on assets. He repeats that valuation of the assets backing the non-profit annuities was based on the Appointed Actuary's professional judgment. In an undated note on the letter, GAD's Scrutinising Actuary C writes '[no further action] *agreed with* [Chief Actuary C]'.
27/04/1994	The Life Assurance and Unit Trust Regulatory Organisation (LAUTRO) write to Equitable in reply to their letter of 05/04/1994. LAUTRO assure Equitable that the verification visit to check Equitable's Training and Competence Scheme will be conducted as quickly and efficiently as possible and with the aim of causing minimum disruption.
24/05/1994	Equitable send GAD an updated copy of their With-Profits Guide (dated May 1994).
25/05/1994	Equitable write to DTI to notify them of the Society's intention to take advantage of the Third Life Directive to provide life insurance throughout Europe and to add to the range of products offered by its existing branches in the Republic of Ireland and Germany. As required by the Regulations, Equitable provide notice of their proposed changes to the requisite details of each branch and ask DTI to take the necessary action to enable them to begin writing the new business from 1 July 1994.
27/05/1994	DTI acknowledge Equitable's letter of 25/05/1994 and say that they will be in touch if DTI need any clarification.
07/06/1994	GAD copy Equitable's letter of 25/04/1994 to DTI. GAD say: *'We have no further questions for the actuary, and this scrutiny* [of the 1992 regulatory returns] *is regarded as complete'*. There is no record of a response being sent at this time to Equitable.
15/06/1994	Equitable write to GAD's Directing Actuary A to confirm the arrangements for lunch with their Appointed Actuary on 19/07/1994.

22/06/1994 DTI advise Equitable and the regulatory authorities in the Republic of Ireland and Germany that DTI have no objections to the proposed changes. On the same day, DTI send a copy of Equitable's letter of 25/05/1994 to GAD. DTI explain that they have no guidelines as to how involved GAD should be in the process, but invite them to look at the product particulars. On receipt of the letter, GAD's Scrutinising Actuary C says to Chief Actuary C: *'This is no doubt interesting but I do not see that there is anything for GAD to do here. Do you agree?'*. In reply, the Chief Actuary writes:

> *Maybe not in this case, but we should consider the financial implications of the changes and comment. As it happens the* [information] *supplied ... is inadequate as it does not take* [account] *of the transfer to reserves ...*
>
> *This is typical of* [Equitable's Appointed Actuary]*, to provide only what the legislation strictly asks for when in fact we need the transfer to reserve to be regarded as an expense. Perhaps you should suggest to DTI that the* [information] *supplied is inadequate, therefore they ought to seek our advice before accepting the proposed changes.* (GAD later do this – see 22/08/1994.)

Submission of the 1993 regulatory returns

27/06/1994 **Equitable submit their 1993 regulatory returns to DTI.** Accompanying those returns are copies of the Society's annual report and accounts, prepared in accordance with the Companies Act 1985 and dated 23 March 1994.

Equitable also send DTI a declaration under section 94A of ICA 1982 and pay Insurance Fees of £19,460 in respect of their 1993 returns.

These documents include the following information about Equitable's business and about their financial position as at 31 December 1993.

Companies Act annual reports and accounts
In their *'President's Statement'*, Equitable explain that the 28% investment return in 1993 to some extent masked a significant fall in interest rates. Hence Equitable had decided to increase the overall rate of return granted to policies but reduce the rate of declared bonus to a level broadly supportable by fixed interest securities at current rates of interest.

In their *'Management Report'*, Equitable explain that they had recently sent with-profits policyholders statements of their 1993 bonuses, together with a letter explaining Equitable's approach to bonus allocation. Equitable say that the 28% return for 1993, which took full credit for the changes in market values of fixed interest securities, fell to 17% for the purpose of *'averaging'* once *'transitory'* changes in the market value of fixed interest securities were excluded. Equitable had, for many years, linked reversionary bonuses to yields on fixed interest securities. In the light of the sharp reductions in such yields, the Board had decided to reduce reversionary bonus appropriately.

In their *'Directors' Report'*, Equitable reiterate that they had reduced reversionary bonuses to a level consistent with gilt yields.

The returns
Equitable's returns are again submitted in two parts covering Schedules 1, 3 and 6 and Schedule 4 to ICAS Regulations 1983.

GAD's copy of the 1993 returns (the first year for which their original copy is still available) includes various annotations which were made by GAD's new Scrutinising Actuary with responsibility for Equitable (Scrutinising Actuary D) during the scrutiny programme. I am satisfied that these annotations were made on or around 24/10/1994, at the time Scrutinising Actuary D prepared his *'Detailed Scrutiny Notes'*. These annotations correspond to the items listed in those notes, some of which are notified to DTI and later pursued with Equitable. However, for ease of reference, mention of these annotations is made here.

Schedule 1 (Balance sheet and profit and loss account)
As in previous years, Schedule 1 of Equitable's returns consists of Forms 9, 10, 13, 14 and 16. Form 9 summarises the Society's financial position at 31 December 1993 as follows:

Long term business admissible assets	*£13,382,406,000*
Total mathematical reserves (after distribution of surplus)	*£11,447,681,000*
Other insurance and non-insurance liabilities	*£218,185,000*
Available assets for long term business required minimum margin	*£1,716,540,000*
Required minimum margin for long term business	*£458,014,000*
Explicit required minimum margin	*£76,336,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£1,640,204,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	*£1,258,526,000*

GAD annotate the form with the figures, on the appendix valuation basis, for *'Total mathematical reserves (after distribution of surplus)'* and *'Total of available assets and implicit items',* being, respectively, £11,125,463,000 and £2,038,758,000.

Equitable do not use in their returns the future profits implicit item that had been agreed with DTI.

GAD note with a question mark the figure of £12,443,000 included in Form 13, line 32 (Analysis of admissible assets) for debts in insurance companies not authorised to transact insurance business in the United Kingdom. GAD also note with a question mark the figure of £53,950,000 included for share options and debenture options.

Schedule 3 (Long term business: revenue account and additional information)
As in previous years, Schedule 3 consists of Forms 40 to 51, which have been supplemented by various notes providing further information about/explanation for the figures provided.

In the Form 40 (Revenue account) included in the returns for Equitable's Pension Business Fund, GAD circle and note with a question mark the figure included for taxation of minus £6,970,000.

GAD annotate Form 42 (Analysis of claims) with the corresponding figures from the previous year's returns. For life assurance contracts and the claims payable on death, the figures show that claims are up 29% on the previous year.

Form 45 shows that 43% of Equitable's non-linked assets are invested in equities, 7% in land and 43% in fixed and variable interest securities (compared with 43%, 8% and 40% respectively in 1992). GAD have annotated the returns with these earlier figures. GAD tick the figures provided for the yield on fixed interest securities. GAD also annotate the form with the total yields shown on line 12 that were included in the 1989 to 1992 returns.

As in previous years, Equitable disclose in Form 46 that the gross redemption yields on fixed interest securities issued or guaranteed by any government or public authority are, for certain durations, higher than for those not issued or guaranteed by any government or public authority. Against line 1 of Form 46, GAD note with a question mark the gross redemption yield for securities issued or guaranteed by any government or public authority with a redemption period of one year or less (the figure being 1.40%). These assets are stated to have a value of £238,000.

In the notes to this part of the returns, Equitable disclose that no provision has been made for the contingent liability for tax on unrealised capital gains in respect of non-linked business, which is estimated to be £42m.

Equitable state that they have been granted a section 68 Order which permits them to include in aggregate form details of their *'Personalised Funds'* in Forms 49, 50, 51 and 57, instead of the separate details for each Personalised Fund required by the ICAS Regulations 1983.

Schedule 6 (Certificates by directors, actuary and auditors)
Three Equitable Directors provide the certification required by Regulation 26(a) of the ICAS Regulations 1983. Equitable's Appointed Actuary provides the certification required by Regulation 26(b) of the ICAS Regulations 1983. As required by Regulation 27 of the ICAS Regulations 1983, Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

Schedule 4 (Abstract of valuation report prepared by the Appointed Actuary)
As in previous years, Equitable present two valuations of their long term liabilities (their main and appendix valuations). The results of the main valuation are carried forward, unadjusted, from Form 58 to Form 14 and on to Form 9.

Schedule 4 – main valuation (text)
Schedule 4 of Equitable's returns answer the questions set out in paragraphs 1 to 19 of Schedule 4 to the ICAS Regulations 1983 and includes Forms 55 to 58 and Form 60. Equitable state that this valuation conforms to Regulation 54 of ICR 1981.

In response to paragraph 3, Equitable provide 18 pages of information about their non-linked contracts. Most of the information about the contracts remains unchanged from previous years. The increase in information from the previous returns is largely due to a new section on German policies.

On GAD's version of the returns, they note the changes that have been made and the new information provided. GAD tick the following paragraph (3(xiv)):

> *Pensions business with profits contracts described as retirement annuity, transfer plan, individual or group pension are deferred annuities, the premiums being of the recurrent single premium (or variable premium) type. The premiums provide a cash fund at the pension date, to which (for policies issued prior to 1 July 1988) a guaranteed annuity rate is applicable.*

1994

GAD also tick paragraph 3(xvi), which describes Equitable's personal pension business. This paragraph includes text which says:

> *Pensions business termed individual pension (2nd series) are individual pension plans effected since 1 July 1988 ...*
>
> *With profits retirement benefit segments are deferred annuities, the premiums being of the recurrent single premium (or variable premium) type. The premiums provide a cash fund at the pension date used to purchase benefit. There is no guarantee of annuity rates to be applied to the cash fund.*

As in previous years, Equitable provide a description of their principal guarantees of terms. GAD tick or mark as being new each of the descriptions provided.

In response to paragraph 4, Equitable provide 38 pages of information about their linked contracts. Most of the information about the contracts remains unchanged from the previous year. GAD tick or mark as being new each of the descriptions provided. GAD also write: *'"Special Group Pension Arrangement" omitted'*; and, in relation to the policies issued with links to the Equitable Pelican Unit Trust only: *'Comment re A(v) omitted'*. GAD note that, in relation to the description of unit-linked international personal pension plan retirement benefit, the cross referencing to another type of contract is *'Not Revised'*.

Equitable disclose in paragraph 5 that they have tested the ability of the Society to hold reserves which satisfy Regulations 54 and 56 to 64 of ICR 1981 in the three scenarios of changed investment conditions described in DAA6. The relevant sentences have been marked *'new'* by GAD. Equitable state:

> *In these conditions the Society would be able to set up reserves which satisfy* [Regulations 54 and 56 to 64 of ICR 1981] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued.*

(Note: the entry at line 51 of Form 14 was the excess of the value of admissible assets representing the long term fund over the amount of those funds and represented the difference between the market value and book value of those funds.)

As in previous years, Equitable state that, in determining the provision needed for resilience reserves and tax on unrealised gains, they have taken account of the fact that the long term fund has been valued at book value.

In paragraph 5(1)(e), Equitable disclose that a reserve for the prospective liability to tax on unrealised capital gains (losses) is held in respect of policies where benefits are linked to the Society's internal funds. They also disclose that the contingent liability for tax on unrealised capital gains in respect of other business is estimated not to exceed £42m. Equitable say that they consider there are sufficient margins in the valuation basis to cover this amount and, accordingly, they again hold no specific reserve. GAD tick this paragraph and note that the figure for the previous year was £1.2m.

As in previous years, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity. GAD tick this paragraph.

As in previous years, in paragraph 5(1)(g) Equitable state:

> *The premium rate guarantees and options under the Society's policies are described in paragraph 3. Where the right to effect further policies without medical evidence of health is carried a reserve equal to one year's extra premium deemed or actually charged was set up. It was considered unnecessary in current conditions to make explicit provision for the other guarantees and options described in paragraph 3.*

1994

As in previous years, in paragraph 6(1) Equitable disclose that, for certain non-profit deferred annuities, the valuation rates of interest used were those assumed in the premium basis. Equitable, again, do not elsewhere in the returns disclose the rates used in the premium basis. GAD tick this paragraph.

As in previous years, in paragraph 7(b) Equitable do not explain the method by which they have made provision in the main valuation for expenses on recurrent single premium business.

As in previous years, at paragraph 7(d) Equitable state:

> *A further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 55 to 64 of the Insurance Companies Regulations 1981. The resultant aggregate liability is less than the aggregate liability on the methods and bases described in this report. The report on the net premium valuation is given in an appendix following Form 60 of this report.*

GAD tick this paragraph.

As in previous years, in paragraph 11 Equitable disclose: *'The Society has no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund'.* GAD tick this paragraph.

As in previous years, in paragraph 12 Equitable state: *'The Society has no shareholders and the principles upon which the distribution of profits among the policyholders is made are determined by the Directors in accordance with the Society's Articles of Association'.* GAD tick this paragraph.

In paragraph 13, Equitable disclose that they had set the rates of reversionary bonus for the main policy classes at 4.0% (compared with 5.0% for 1992). GAD annotate this section with figures for the bonuses declared in the previous year. As in previous years, Equitable disclose that some retirement annuity and individual pension policyholders have been offered loans under a *'loanback'* arrangement. GAD tick this paragraph.

In paragraph 16, Equitable describe their system for determining final bonuses. In part (vi), Equitable set out how they allocate final bonus for retirement annuities, personal pension retirement benefits, individual and group pension arrangements and recurrent single premium deferred annuities. Equitable disclose, on page 71 of the returns, that:

> *Where the contract terms guarantee any increase in benefits by way of interest or other addition for the period from 31 December 1993, or such later date of purchase of benefits as applies, to the date of payment of benefits, the amount of final bonus allotted by the operation of (1) and (2) above is reduced by the amount of any such increase.*

Equitable then disclose, also on page 71 but running on to page 72 of the returns, that:

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

Scrutinising Actuary D marks both of these paragraphs as *'New'.* The Scrutinising Actuary also comments on those paragraphs in his *'Detailed Scrutiny Notes',* prepared on 24/10/1994, where he says *'New rules reducing final bonus, see page 71'.*

(Note: this paragraph was also sidelined in pencil (rather than the red ink used by Scrutinising Actuary D). The marking of this paragraph is consistent with those other markings made by Scrutinising Actuary E in respect of the 1995 returns, during his scrutiny of those returns (see 28/06/1996)). (See also the 1994 returns at 30/06/1995.)

<u>Schedule 4 – main valuation (forms)</u>
In Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts along with information on the number of contracts in force, the benefits guaranteed and the rates of interest and mortality assumptions used in valuing them.

In Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity and the rates of interest and mortality assumptions used in valuing them. Equitable disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 58, Equitable set out the valuation result and the composition and distribution of the fund surplus. GAD have annotated this form with equivalent figures from the appendix valuation.

Schedule 4 – appendix valuation (text)
Equitable explain that the appendix valuation:

> *... was undertaken for the purposes of demonstrating that in aggregate the mathematical reserves determined by the valuation undertaken using the gross premium method, the results of which are reported on the preceding pages, are not less than an amount calculated in accordance with Regulations 55 to 64 of the Insurance Companies Regulations 1981.*

Equitable's appendix valuation provides the information required by paragraphs 1, 5, 6, 7, 9, 17 and 18 of Schedule 4 to the ICAS Regulations 1983. Equitable say that the information required for the other paragraphs (apart from paragraph 19 – being a statement of the required minimum margin in the form set out in Form 60 of Schedule 4 which, having had *'regard to the purpose of the valuation',* has not been provided) is identical to that given in the main valuation.

As in previous years, in response to paragraph 5(1)(a), Equitable state: *'In these conditions the Society would be able to set up reserves which satisfy* [Regulations 54 and 56 to 64 of ICR 1981] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued'.* GAD tick this paragraph.

As in the main valuation, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity. GAD tick this paragraph.

As in previous years, in paragraph 5(1)(g) Equitable disclose the ages that retirement benefits could be taken on their recurrent single premium with-profits pension business. GAD tick this paragraph.

As in the previous year but unlike in the main valuation for this year, in paragraph 7(b) Equitable explain the method by which they had made provision in the appendix valuation for future expenses on their recurrent single premium business.

Schedule 4 – appendix valuation (forms)
In the appendix version of Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts on the appendix valuation basis. GAD note changes from the previous year's returns to some of the interest rates and mortality tables used.

In the appendix version of Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts on the appendix valuation basis.

01/07/1994 The Insurance Companies (Third Insurance Directives) Regulations 1994 (the ICTID Regulations 1994), the Insurance Companies Regulations 1994 (the ICR 1994) and the Insurance Companies (Accounts and Statements) (Amendment) Regulations 1994 (the ICASA Regulations 1994) come into force. (See paragraph XX of Part 2 of this report.)

07/07/1994 **GAD complete the A2 Initial Scrutiny check on the Society's 1993 regulatory returns.**

In response to question 3, *'Do the interest rates used look supportable in terms of Regulation 59 – for with profit business?',* GAD answer *'Yes',* and write: *'On NF'.*

In response to question 5, *'Do the unit linked parameters look reasonable?',* GAD answer *'Yes',* and write: *'except g=8%, i=5% again.'*

In response to question 10, *'Is all reinsurance with UK authorised companies?',* GAD answer *'Yes',* and add: *'All but a trivial amount'.*

In response to question 12, *'Have the company set up any identifiable provision to meet potential exposure to Personal Pensions transfer problems?'*, GAD answer *'No'*, and write: *'but* [these are] *very unlikely to be significant'*.

GAD identify no worrying aspects and no items to notify to DTI, to be taken up immediately with Equitable. GAD give Equitable a priority rating of 3 (unchanged from the previous year).

15/07/1994 **GAD complete the A1 Initial Scrutiny check on the Society's 1993 regulatory returns.** GAD note the cover for the required minimum margin is 3.75 (increased from 2.36 the previous year). In response to check number 24, *'Does* [Form] *13.86* equal* [Form]*47.4?'*, GAD answer *'No'* and write *'Equals* [Form]*47 + Line 1 of* [Form] *48'*. They do not identify any concerns. Accompanying the Initial Scrutiny check is a Form B Initial Scrutiny Form, which includes certain key figures disclosed in the 1990 to 1993 returns.

22/08/1994 GAD provide DTI with comments on Equitable's letter of 25/05/1994. GAD say that they do not wish to comment in detail, but:

> *... we notice that in one or two areas the information supplied is not really adequate; for example the projected revenue accounts for the Irish business do not include an entry for "increase in reserves" and therefore give a rather misleading impression of the planned progress.*

GAD suggest that, in future, such applications should be sent to GAD for comment before approval. GAD return the files of *'product particulars etc.'*, having retained copies of some of the material.

08/09/1994 DTI write to Equitable to propose a further visit by DTI and GAD as part of their three year rolling programme of meeting life insurance companies. DTI list the main subject areas they would like to cover as being:

1. *The business plans of the company for the next five years, with particular reference to solvency and any requirements which there might be for additional resources.*
2. *Marketing philosophy.*
3. *Corporate/Management structure.*
4. *Reinsurance programme and security.*
5. *Investment policy and asset management.*
6. *Management systems and procedures.*
7. *Implications of the regulatory changes following the Third Directives — especially sound and prudent management, derivatives, reinsurance of linked liabilities.*
8. *The role of the Appointed Actuary.*
9. *Resilience testing and asset shares.*
10. *Bonus Philosophy.*
11. *Potential liabilities in respect of personal pensions.*

DTI propose that the visit should take the form of a series of meetings in a single day with appropriate members of the Appointed Actuary's team. DTI say they would be pleased to receive any internal papers that would facilitate discussion (for example, structure charts or corporate plans).

15/09/1994 Further to GAD's suggestion of 22/08/1994, Line Supervisor B seeks approval for the policy of asking GAD to comment before DTI grant approval in relation to the establishment by companies of operations overseas.

The following day, Line Manager B agrees, but says that DTI would need to give GAD strict deadlines in which their comments would need to be provided.

30/09/1994	Equitable write to DTI to apply for a section 68 Order to remove the restriction on the level of Eurobonds they can hold. On the same day, Equitable notify DTI that they intend to offer a new product through their Republic of Ireland branch and provide notice of the changes to the requisite details.
03/10/1994	DTI's Line Manager B writes to Line Supervisor B, in response to Equitable's letter of 30/09/1994 requesting a section 68 Order. The Line Manager says: *I don't want to be bothered with s68/s78 orders unless absolutely necessary (i.e. impending year end).* [Please] *reply that we are content for Equitable to proceed on the basis* [Equitable's Appointed Actuary] *proposes and that an order will follow in due course.* *In practice I hope an order won't be necessary because the* [regulations] *will have changed.* (Note: a section 78 Order was the same as a section 68 Order (see 08/09/1986) but applied only to linked long term policies.)
05/10/1994	The regulatory authority in the Republic of Ireland advise DTI that Equitable have notified them of the changes to their requisite details.
11/10/1994	DTI pass Equitable's letter of 30/09/1994 to GAD and seek their comments.
12/10/1994	DTI inform Equitable that a section 68 Order will be issued in due course. (Note: it is not clear if this Order was issued at this time — see 30/11/1994.)
13/10/1994	DTI write to Equitable to seek a response to their letter of 08/09/1994.
14/10/1994	GAD's Scrutinising Actuary D provides DTI with comments on Equitable's letter of 30/09/1994. He observes that the new product Equitable intend to offer is described in the literature provided as a life assurance contract. However, the Scrutinising Actuary says that it is broadly equivalent to Equitable's critical illness policy, but without life cover, and is therefore Class IV (permanent health) business. The Scrutinising Actuary notes that Equitable are authorised to write both Class III (linked long term) and Class IV business and therefore there could be no objection to the changes. The Scrutinising Actuary suggests, however, that DTI should clarify how Equitable regard the product.
17/10/1994	DTI's Line Manager B writes to the Minister for Corporate Affairs, enclosing a draft speech for his visit to Equitable on 26/10/1994. The Line Manager advises that, should the Minister talk about deregulation, this might be met with *'hollow laughter'*, as on the day of his visit the Securities and Investments Board were due to announce details of their policy for compensation to be paid by insurance companies in respect of mis-sold personal pensions. The Line Manager notes: *'We expect that the industry is not going to be very pleased with the* [conduct of business] *regulator on this occasion (although Equitable itself should not be significantly affected)'.*
18/10/1994	GAD's Scrutinising Actuary C informs Equitable's Appointed Actuary of his imminent departure from GAD, and introduces his successor. On the same day, DTI ask Equitable if they regard the new product that they wish to sell in the Republic of Ireland as Class III or IV. DTI explain that they have no objection to the change in details provided by Equitable.

20/10/1994	DTI confirm to Equitable that DTI and GAD would visit on 09/12/1994. DTI add to the list of topics to discuss (see 08/09/1994) *'the likely financial position of Equitable Life at the end of the year'*.

24/10/1994

GAD's Scrutinising Actuary D prepares *'detailed scrutiny notes'* for the 1993 returns. His note contains seven sections:

- *'Standard reporting items'* — under *'New business'*, GAD detail 19 policy types (13 being overseas business), and remark that the Society's expenses are *'still low'*;
- *'Initial scrutiny notes'* — GAD state that there are *'nil of note'*;
- *'Review of file'* — GAD set out details of the section 68 Orders requested or issued and the introduction of operations internationally;
- *'Report & Accounts'* — GAD note some details from Equitable's 1993 Companies Act annual report and accounts, including that Equitable do not consider that they need to make any provision for pension mis-selling and that Equitable have provided comments on their bonus philosophy;
- Under *'Returns — Schedules 1 — 3'*, GAD's note records (with original emphasis):

	Form 41	*Form 44*
General Annuity [single premium]	*50046*	*38049*
Pension [single premium]	*565689*	*460312*

  - ***Above table seems odd.***
  - ***F13.32 new debt from dependant unauthorised insurance company of £12.4m***
  - *Share options and debenture options £53.95m*
  - ***Negative tax on*** [pension business fund] ***does not relate to form 40 note***
  - *Life death claims up 29%, probably in linked business*
  - *Non linked surrenders, forfeitures and pups by about 4.0% life and 6.8% pensions*
  - *Unit linked 10.8% life and n/a pensions.*
  - *Recurrent* [single premium] *figures are not available.*
  - *Doubtful figures in form 46 line 1 but not material.*

Each of these issues is noted on GAD's copy of the Society's returns (see 27/06/1994). The three issues highlighted in bold by GAD are subsequently pursued with Equitable, and notified to DTI, as a part of GAD's scrutiny of Equitable's returns. (See 15/11/1994 [**entry 1**].);

- Under *'Returns – Schedule 4'*, GAD's note records:
  - ***Where is "Special Group Pension Arrangement"?***
  - ***Unit Linked Annuity A(v) link to Pelican*** [unit trust] ***no longer mentioned. This must be an oversight.***
  - *New FTSE link over twelve month periods as determined by Society.*
  - [Capital gains tax] *deduction now 13% (was 10%) on Pelican links*

1994

- ***Description of unit linked international personal pension retirement benefit now refers to terms of Guernsey version whereas previously it was referred to international investment plan benefit.***
- *Comments on the valuation basis:*
  - o *Major Medical Cash reserve for unit linked not stated, but contract may not actually have any in force. But it is described.* ***Check there were no such*** [in-force]***, and that basis will be similar.***
  - o *FTSE links based on value of matching call options and deposits.*
  - o *Interest rates look high ... must be justified by a* ***matching rectangle***
  - o ***Term mortality rates A67/70 -3?*** *This is OK for "2nd series" with the refunds etc, but what about 1st?*
  - o ***Annuity basis a(90)?***
- *Run-off expense provisions:*
  - o ***Unit prices grow at 8% => assets grow at 8.6875% or 8.75%; inflation of expenses is at 5%. No 25% drop referred to.***
- *Bonus rate changes:*
  - o *New rules reducing final bonuses, see page 71.*
  - o *Various changes in bonus rates.*
- *Use of asset shares:*
  - o *Not used in the normal sense.*

Again, each of these issues in bold is noted on GAD's copy of the returns (see 27/06/1994). The eight issues highlighted by GAD in the list above are subsequently pursued with Equitable, and notified to DTI, as part of GAD's scrutiny of Equitable's returns. (See 15/11/1994 [**entry 1**].)

- *'Miscellaneous'* — GAD's note includes:

  Personal pensions liabilities? Not us!!!

1994

25/10/1994 [entry 1] DTI's Line Supervisor B provides briefing for the visit by the Minister for Corporate Affairs to Equitable on 26 October 1994. This briefing is substantially the same as that provided for the proposed visit of the President of the Board of Trade, on 23/02/1994 (see 17/02/1994 [**entry 2**]). The Line Supervisor says:

> *The latest returns to DTI show its solvency position to be strong. In late 1993, the company received an "AA" rating from Standard & Poor's for its excellent claims paying ability.*

The Line Supervisor refers to the survey on possible mis-selling of pensions and notes that Equitable *'did not see a need to make any provision for compensation in its accounts, given the high standard of selling techniques in the Society'.* The Line Supervisor expresses no concerns about Equitable.

On current insurance issues that may arise during the visit, the Line Supervisor says, under the heading *'Deregulation':*

> *Background – DTI has issued a consultative document proposing major changes in the content of the annual prudential returns by insurance companies.*

Line to take – The consultation period ends this month. Feedback so far has been reasonably positive. In particular, we have proposed to abolish the tedious chores of producing a quinquennial statement of long-term business [i.e. Schedule 5 of the returns] *and annual statement of connected parties. Many other changes have been proposed to reflect the requirements of the 3rd Insurance directives and to make returns more relevant to current market conditions and practices.*

25/10/1994 [entry 2] On the same day, DTI's Head of Life Insurance writes to the Chief Executives of all life insurance companies. He notes that the Securities and Investments Board have announced the criteria and procedures for assessing whether compensation should be made to people who were wrongly advised to transfer or opt out of an occupational pension scheme. DTI ask Equitable (and other companies) to submit, by the end of February 1995, a revised estimate of their potential liability for compensation payments in the light of the Securities and Investments Board's requirements.

DTI say that they may seek periodic updates in the light of experience over the next year or so. In relation to who should pay for any compensation, DTI advise:

Each office will also need to consider where the costs should fall on its funds. The precise arrangements will vary according to the circumstances of each office. The first principle is that as a general rule compensation payments should not be made out of funds to the extent that these are required to meet the contractual entitlement of policyholders. Beyond that, the reasonable expectations of participating policyholders must be taken into account. For this purpose, the following general considerations appear to the Department to be relevant (and we would expect directors to follow similar principles in deciding how to attribute losses arising from other instances of compensation or regulatory action):—

i. With profits funds which (in normal circumstances) stand to profit from the sale of pensions business can reasonably be expected to bear a corresponding share of the costs associated with that business. However:-

ii. Compensation costs should not be regarded as a normal expense of the business for the purposes of assessing bonus rates; and

iii. The Department would expect proprietary offices to consider whether it is appropriate that some part of the compensation cost be met from outside the long-term fund, to enable the reasonable expectations of policyholders to be fulfilled.

(DTI later have to chase Equitable for a response to their letter — see 13/04/1995.)

07/11/1994 Equitable write to DTI in reply to their letter of 18/10/1994. Equitable dispute that the new product is Class IV and say that they treat comparable products in the UK as Class I (life and annuity) and Class III and would expect to treat the new product in the Republic of Ireland in the same way.

15/11/1994 [entry 1] **GAD provide DTI with their detailed scrutiny report on the Society's 1993 regulatory returns.** (A copy of this scrutiny report is reproduced in full within Part 4 of this report.) The report follows a new standardised format adopted by GAD and has 13 sections, as follows:

(1) Summary
Under *'Key features'*, GAD state that cover for solvency remains healthy at 3.75, expenses remain low, new business continues to grow (with the emphasis remaining on pensions business), and a new branch was opened in Germany in 1993, adding to existing Guernsey and Republic of Ireland branches.

GAD comment that Equitable, *'no doubt influenced by the favourable figures they can properly demonstrate'*, voluntarily introduced the disclosure regime early in July 1994.

Under *'Action points'*, GAD explain that they have pursued eleven points with Equitable in the light of the Society's returns, including:

- that there is a surprising sum due from a dependant insurance company not authorised in the UK, of which GAD were not aware;
- that the treatment of single premiums in the returns appears inconsistent;
- that interest rates used in the valuation look high;
- that a mortality table looks *'light'*;
- that an annuity table looks *'too heavy'*;
- that the expense reserves are determined on an optimistic basis. GAD note that this has been the case before, and that they are trying to determine how great Equitable's exposure is; and
- that the amount of resilience reserve required is not given, only that it can be met.

(2) <u>Background</u>
GAD refer to Equitable's pride in the Society's position as the oldest mutual life assurance society in the world and the fact that Equitable have never paid commission to third parties. GAD explain that Equitable have a:

> *... somewhat unusual approach to bonuses, unit linked products (which often have discretionary surrender values) and valuation using a gross premium bonus reserve method. The DTI returns also show the results of applying a net premium basis with assumptions close to the minimum permitted by the regulations.*
>
> *Although Equitable applies for a section 68 Order for an implicit item each year, it has never used this order, it being a precaution only. It does however also enjoy an order exempting full description of its personalised funds in the return. There is also an order in relation to* [a] *call option for FTSE links on some policies.*

GAD also note that *'The Appointed Actuary and Managing Director posts are both held by* [the same person]'.

(3) <u>New business</u>
GAD provide details of the new products Equitable have developed and two tables setting out the regular and single premiums which Equitable have received for the various classes of policies sold from 1989 to 1993. GAD add a commentary:

> *These figures are somewhat strange, however, in that a great volume of pension business is regarded as recurrent single premium. This is reported in the year of issue as regular premium, in accordance with the guidance notes, but it does not appear in form 43* [of the returns] *as regular premium. In 1993 the effect was for* [£225.9m] *new regular premium to appear in form 44* [of the returns] *but not in form 43. It is also therefore impossible to reconcile form 41* [of the returns, on analysis of premiums and expenses] *and form 43.*

On her copy of the report Line Supervisor B adds two comments: *'Should we ask for revised forms?'* and *'GAD doesn't mention* [Form] *43 in letter to* [a named company] — *query this with GAD.'*

(4) <u>Expenses</u>
GAD provide a table showing the history of expenses from 1989 to 1993. They comment that, compared with the industry as a whole, Equitable's expenses are low. (Note: following scrutiny of the 1990 returns, GAD had queried a rise in Equitable's management expenses — see

1994

19/11/1991 and 22/11/1991. GAD's A2 Initial Scrutiny check of the 1991 returns had identified Equitable's other management expenses as a worrying aspect, although it appears that this was not pursued at the time.) GAD add:

> *There is no provision for mis-selling of personal pensions. This is due to the selling methods which are based upon largely approaches from prospective policyholders. It remains to be seen whether this is correct, but it is true that their exposure is likely to be very much lower than typical in the industry.*

(5) Claims and withdrawals
GAD note an increase in death claims, but comment that this does not indicate any particular problem. GAD also note that the Society's persistency rates are quite good but that the *'prevalence of recurrent single premium contracts prevents proper analysis ...'*.

(6) Financial results
GAD explain that, on the bonus reserve basis (i.e. the main valuation), a surplus of £481m arose, compared with £331m in 1992.

(7) (Non-linked) assets
GAD provide tables showing Equitable's mix of assets at the year end. GAD reproduce a table from Equitable's 1994 With-Profits Guide showing assets attributable to with-profits business. GAD comment that the most noteworthy feature of the latter is the shift towards a higher fixed interest component. They note that, on Equitable's own figures, the Society's total investment return for 1993 was 28.3%.

(8) Valuation and solvency
Under *'Strengths and/or weaknesses'*, GAD explain:

> *The bases used for the gross premium valuation are primarily a tool to support the method of determining distributions. They are not particularly relevant to supervision. The adequacy of the valuation is demonstrated by publishing a net premium valuation on the minimum basis necessary to meet the regulations and except where explicitly stated otherwise comments and figures in this report are based upon this alternative basis.*

GAD observe that:

> *The net premium bases have a number of apparent weaknesses, though in the light of the cover for the required minimum margin there is little concern as to the solvency. If, however, the reserves are too thin, it may lead to inappropriate conclusions being drawn by policyholders and prospective policyholders as to the financial strength of the society. We are therefore seeking confirmation of the prudence of certain of the assumptions.*

GAD report that:

> *The rates of interest used are somewhat high in comparison with form 45. As this form does not provide sufficient information to draw a firm conclusion, we are seeking further information.*
>
> *Some mortality tables look a little on the optimistic side, and again further information on their justification is required.*
>
> *There is a somewhat weak reserving basis for unit linked expenses, which does not meet the standards this department normally expects. We normally expect the differential between the rate of growth of unit linked assets, and hence the prices, before all changes and taxation to be no more than 2% higher than the rate of inflation of renewal expenses. For this company the difference is about 3.7%. We are trying to determine the extent of exposure here to an adverse experience in costs.*

Under *'Changes since the previous year'*, GAD note that:

- expense allowances on linked business have been increased, but costs are increasing only very slowly and expense allowances on unitised with-profits have also been increased;
- some mortality tables have been strengthened;
- the revised resilience test has been incorporated; and
- interest rates have been reduced, but not generally by quite as much as the fall in asset yields.

GAD provide three tables showing Equitable's liabilities for linked and non-linked business and a valuation summary. The latter contains figures relating to both the bonus reserve (i.e. the main valuation) and the net premium (i.e. the appendix valuation) valuations for the years 1991, 1992 and 1993, and is presented as follows:

	1991 BRV £m	*1992 BRV £m*	***1993 BRV £m***	*1991 NPV £m*	*1992 NPV £m*	***1993 NPV £m***
Non-linked liability	*6,349.1*	*7,864.9*	***10,466.5***	*5,950.1*	*7,388.8*	***10,144.3***
Linked liability	*502.9*	*692.3*	***981.2***	*502.5*	*692.3*	***981.2***
Total liability	*6,852.0*	*8,557.2*	***11,447.7***	*6,452.6*	*8,081.1*	***11,125.5***
Long term assets ... (net of other [liabilities]*)*	*7,340.2*	*9,400.6*	***13,164.2***	*7,340.2*	*9,400.3*	***13,164.2***
Available assets	*488.2*	*843.3*	***1,716.5***	*887.6*	*1,319.4*	***2,038.8***
(% of liability)	*7.0*	*9.7*	***14.7***	*13.5*	*16.0*	***18.0***
Implicit items	*0**	*0**	***0****	*0**	*0**	***0****
Total amount available	*488.2*	*843.3*	***1,716.5***	*887.6*	*1,319.4*	***2,038.8***
Required Minimum Margin	*292.8*	*356.6*	***458.0***	*276.8†*	*337.6†*	***445.1†***
Cover	*1.67*	*2.36*	***3.75***	*3.2†*	*3.9†*	***4.6†***

The notes to the table are:

> ** Section 68 order (for £420m in 1993) not used*
>
> *† Estimated figure. The cover makes no allowance for the absence of a reserve to meet the resilience test. The amount required in 1992 was £462m, which wipes out the difference between the* [bonus reserve valuation] *and* [net premium valuation] *and reduces the surplus under the* [net premium valuation] *to only some £18m without recourse to the investment reserve which was £839m. As a result the cover for the required minimum margin would only have been about the 2.4x shown under the* [bonus reserve valuation].

Line Supervisor B annotates her copy of GAD's report at this point: *'Why does Equitable have to do things different from everyone else?!'*.

Under *'Cover for the solvency margin'*, GAD conclude:

> *... the cover for the required minimum margin remains substantial, and gives no cause for concern in itself. The only issues therefore revolve around whether the valuation basis itself is of sufficient strength. This is covered* [under '*Strengths and/or weaknesses*'] *above, but particular care is needed in reviewing the figures for the* [net premium valuation]*, as the resilience reserve is omitted, and the figure is not known.*

(9) Bonuses
GAD note that the cost of Equitable's declared bonus, under the appendix basis, is £300.4m. GAD say that Equitable's final bonus system *'is somewhat different to the normal terminal bonus'*, and explain that it:

> *... is a little unusual. It consists of a declaration of bonus which is not reversionary, in that it may be withdrawn, and/or reduced in future. However, it has a lot of features in common with reversionary bonuses. It is declared in a similar way as a percentage of benefit, and the amount paid at the end of the policy's normal span is the sum of the annual "declarations", subject to the proviso that a previously granted bonus can be withdrawn.*

GAD quote Equitable's own description of the final bonus system which GAD say is from the Society's With-Profits Guide. (Note: the description was in fact from Equitable's Bonuses booklet (dated February 1994). This mistake was repeated in GAD's scrutiny reports for 1994 and 1995.) The relevant quote reads:

> *Final bonuses are also determined and applied retrospectively. The final bonus is calculated so as to top up the growth arising from the policy guarantees and the declared bonus rate for the year to the overall rate of return announced for the year. Final bonuses do not add a guaranteed element to the contract, and the final bonus element of a policy can be varied up or down in future.*

GAD provide three tables of statistics showing changes in reversionary and final bonus rates. GAD also reproduce a table, from Equitable's With-Profits Guide, of the actual investment returns on gross market value and the rate allocated in fixing bonuses:

	1989	*1990*	*1991*	*1992*	*1993*
Actual	*24.1%*	*-8.3%*	*13.50%*	*17.1%*	*28.80%*
Allocated	*20%*	*12%*	*12%*	*10%**	*13%*

** 12% on new benefits secured during the year*

1994

GAD explain that Equitable follow a policy of full distribution:

> *... with a basis designed to make up the implied guaranteed rate to a total earned rate. Part is in the form of the non-cancellable reversionary bonus and the rest in the form of final bonus.*
>
> *The policy is to link declared reversionary bonus rates to the redemption yields on fixed interest stock. This has produced a series of reductions in recent years as yields have fallen, but the system of final bonus effectively balances this in total returns. Policyholders' reasonable expectations are therefore influenced downwards in line with yields.*

GAD make no reference to the *'New rules reducing final bonuses'* (see 24/10/1994).

(10) Unit-linked funds
GAD set out key statistics about these funds.

(11) Reinsurance
GAD state that Equitable make little use of reinsurance.

(12) Compliance
GAD state that they know of no significant compliance problems.

(13) Miscellaneous
GAD repeat that Equitable have made no provision for mis-selling of pensions.

GAD's scrutiny report runs to 14 pages.

As a result of their detailed scrutiny of the Society's 1993 returns, GAD write to Equitable to ask them to clarify eleven points. These points are those highlighted in their *'detailed scrutiny notes'* dated 24/10/1994. GAD's questioning about Equitable's 1993 returns is as follows:

> *1 Form 13 line 32 includes a sum of £12.4m due from a dependent unauthorised insurance company. Who is this due from, how does it arise, and what is the relationship between this unauthorised insurer and Equitable?*
>
> *2 We are unable to understand the size of discrepancy between form 41 and form 44 for amounts of single premium for General Annuity and Pension business. In the case of Pensions business, this seems to be over £100m. or about 19% of the form 41 figure. What accounts for this difference please?*
>
> *3 There is no note to form 40 regarding the management agreement with University Life. Although we appreciate this is referred to in the Appointed Actuary's report, could it be included as a note to form 40 in future please?*
>
> *4 Can you please confirm that the "Special Group Pension Arrangement" described in previous returns has terminated, or alternatively where does it now appear?*
>
> *5 The Unit-Linked Annuity A(v) is not stated as linked to the Pelican Unit Trust in this year's return. Are we right in assuming this is an oversight?*
>
> *6 The International Personal Pension Retirement Benefit is now cross-referred to the Guernsey version instead of the International Investment Plan benefit (page 47 of Schedule 4 refers). Is this correct?*
>
> *7 The interest rates used in the valuation seem high compared to the rates in form 45 on simple inspection. Could you provide a matching rectangle in respect of the net premium valuation basis in the context of regulation 59?*
>
> *8 The mortality table used for term assurances post 1982 is more optimistic than is normally used in valuations. Whilst this may* [not] *be of relevance particularly to the 2nd series, can you please comment considering the Society's recent experience on the basis used?*
>
> *9 Various annuity contracts are valued on the a(90)* [mortality] *table. How does the society's recent experience compare to this table? Are you satisfied that this table is still sufficiently prudent?*
>
> *10 Can you please advise how much the reserves in the net premium valuation would rise were the following scenario to occur:*
>
> - *An immediate fall of 25% in the value of unit-linked funds*
> - *Future investment returns before tax and management charges of 10% p.a.*
> - *Inflation of maintenance expenses of 8% p.a.*
>
> *11 What was the amount of additional resilience reserve required under the net premium basis in respect of the most onerous scenario tested?*

GAD explain that the first three of their questions are for the Society, with the remaining questions being for its Appointed Actuary.

15/11/1994 [entry 2]	DTI pass Equitable's letter of 07/11/1994 to GAD and seek their comments. Scrutinising Actuary D seeks advice from Chief Actuary C before replying.
18/11/1994	GAD write to DTI to respond to their request for advice on whether a critical illness policy Equitable propose to sell in the Republic of Ireland should fall into insurance Class IV. GAD suggest that DTI may wish to seek legal advice, but their view is that Equitable's policies are Class IV business. GAD recommend that DTI write to Equitable to say that the business appears to be Class IV type. GAD also explain: *The consequences for the company if the business is class IV are that the unit linked version would require a 4% solvency margin instead of 0%, and the treatment for tax purposes would be different for both versions. This may alter the reserves required.*
22/11/1994	Equitable's Appointed Actuary replies to GAD's letter of 15/11/1994. The response to each of the questions about the Society's 1993 returns is as follows: In response to question 1, Equitable say: *'The amount represents the dividend due (together with associated tax credit) from University Life as at 31 December 1993. I regret that this was erroneously included in line 13.32 rather than 13.30'.* GAD tick this response. In response to question 2, Equitable say: *'Under our current range of pension products, the original contract terminates at the point of retirement and, if an annuity is to be secured with the Society, a new contract is issued. The relevant fund appears as a single premium in form 41 and the immediate annuity issued is shown in form 44. Our older contracts, such as retirement annuities, were written to provide an annuity at retirement, although we offer a full "open market option" as for our current products. Our accounting practice is to include the fund available on retirement in claims and the fund retained with the Society (if any) to secure an annuity in premium income – i.e. a consistent treatment to that for our current products. Form 41 reflects that practice. Where, however, funds are left with the Society to secure an annuity, that is normally achieved by endorsement of the original policy and, consequently, the annuity in payment does not appear in form 44'.* GAD tick this response. In response to question 3, Equitable say: '*We will arrange to include an appropriate note to form 40 in future returns'.* GAD tick this response. In response to question 4, Equitable say: *'I confirm that the plan surrendered during 1993'.* GAD tick this response. In response to question 5, Equitable say: *'Subparagraph (d) of A(v) states "Equitable Pelican Unit Trust" (page 24) so I regret that I do not understand this comment'.* GAD note next to this answer: *'My mistake – meant reference to switch to* [international] *fund'.* In response to question 6, Equitable say: *'The cross-reference in paragraph B(xviii)(b) should be to paragraph B(xvii)(b) not to paragraph B(xvi)(b). I apologise for this error'.* GAD tick this response.

1994

In response to question 7, Equitable provide the following information:

> *The non-linked net premium liabilities of £10150.9m can be matched by hypothecated assets from form 45 as follows:*

Asset	*Value*	*Yield*
	£m	*%*
Land	*834.8*	*7.55*
Debts	*17.9*	*6.58*
Fixed interest	*5,000.5*	*6.55*
Other income producing assets	*488.6*	*5.12*
Other [variable] *interest*	*13.8*	*4.72*
Equities	*3,461.3*	*3.28*
Index-linked	*334.0*	*2.66*
	10,150.9	*average = 5.32*

> *The maximum permitted valuation interest rate in accordance with regulation 59 is 4.82% and the actual weighted average valuation interest rate, before tax, is 4.78%*

GAD note: *'Seems OK, but the averaging should only be assets'*.

In response to question 8, Equitable say: *'The bases used are essentially the same as in the premium bases for these contracts. Our analysis of surplus reveals consistent mortality profits from these classes and our returns from the* [Continuous Mortality Investigation] *Bureau indicate an experience consistently lighter than that assumed in the valuation basis. I am, therefore, satisfied that the basis is satisfactory'*. GAD tick this response.

In response to question 9, Equitable say: *'In recent years the Society's mortality experience for purchased life annuities has been quite close to a(90). The analysis of surplus has tended to show either a modest surplus or stain from year to year. I think we are, perhaps, just about at the point were a slight strengthening to a(90) -1 may be appropriate and we are reviewing that as part of our general review of our bases in preparation for the 31 December 1994 valuation'*.

In response to question 10, Equitable say: *'On the basis you describe, an additional sterling reserve of approximately £12m would have been required'*. GAD tick this response.

In response to question 11, Equitable say: *'If we had published our office valuation at the level of the net premium valuation in the appendix to Schedule 4, we should have needed to establish an additional resilience reserve of £236m'*. Against this answer, GAD write that the difference between the main and appendix valuations is £322.2m.

23/11/1994 GAD write to DTI enclosing a copy of Equitable's letter of 22/11/1994. GAD state:

> *In view of the nature of the net premium valuation for this company, which is published to demonstrate the adequacy of the published main bonus reserve valuation, and the undoubted adequacy of the reserves in aggregate, we are satisfied with the replies received.*

GAD conclude: *'We regard this scrutiny as complete'*.

GAD enclose a file note headed *'Effect of Resilience Test on Apparent Solvency'*. This updates the table set out in their scrutiny report (see 15/11/1994 [**entry 1**]) to take account of the further information received from Equitable. The table is as follows:

	1992 BRV	***1993 BRV***	*1992 NPV*	***1993 NPV***
	£m	***£m***	*£m*	***£m***
Non-linked liability	*7,864.9*	***10,466.5***	*7,388.8*	***10,144.3***
Linked liability	*692.3*	***981.2***	*692.3*	***981.2***
Resilience Reserve	*0*	***0***	*462.0*	***263.0***
Total liability	*8,557.2*	***11,447.7***	*8,543.1*	***11,388.5***
Long term assets ...				
(net of other [liabilities]*)*	*9,400.6*	***13,164.2***	*9,400.3*	***13,164.2***
Available assets	*843.3*	***1,716.5***	*857.2*	***1,775.7***
(% of liability)	*9.7*	***14.7***	*10.0*	***15.6***
Implicit items	*0**	***0****	*0**	***0****
Total amount available	*843.3*	***1,716.5***	*857.2*	***1,775.7***
Required Minimum Margin	*356.6*	***458.0***	*356.1†*	***455.6†***
Cover	*2.36*	***3.75***	*2.4†*	***3.9†***

** Section 68 order (for £420m in 1993) not used*

† Estimated figure.

The table shows the resilience reserve figure for 31 December 1993 as £263m rather than £236m. Using the correct figure very slightly increases the estimated cover.

GAD write to Equitable in response to their letter of 22/11/1994. GAD apologise for raising question number 5. GAD explain:

> *The variation I had noticed is in the footnote on pages 19 and 20 referring to the introduction of a switch option in 1984. It is purely a "for the record" comment, and not of great significance.*

GAD say that they are puzzled by Equitable's reference to an average valuation rate of interest in their response to question 7. GAD say:

> *Although regulation 59 provides for the averaging of asset yields, it does not appear to allow the same method to apply to liability interest rates. While I appreciate that your valuation is not attempting to distort the results by using an averaging method, I do feel it does not accord with regulation 59, which requires in paragraph 8 that "In no case shall a rate of interest ... exceed the adjusted overall yield on assets". This requirement is carried forward into the 1994 regulations in regulation 69(11).*
>
> *If you disagree with my interpretation, please let me know. Otherwise, may I suggest that, in setting the bases for the 1994 net premium valuation, you hypothecate assets to each category of contracts for which a different interest rate is used.*

GAD note that Equitable are considering strengthening the mortality basis for annuities in 1994.

29/11/1994 DTI's Line Supervisor B writes to Line Manager B to comment on the visit to Equitable arranged for 09/12/1994. She refers to GAD's scrutiny report (15/11/1994) and their commentary on *'New Business'*. She states:

> *Equitable's method of gross premium valuation (which they translate into a net premium valuation for the purposes of the DTI returns) seems to mean that GAD have to "translate" their figures to double-check on the cover for the* [required minimum margin]

<table>
<tr><td></td><td>— as per [GAD’s scrutiny report]. I don’t know of any other companies that do this — it seems to make more work for GAD! However, GAD’s comments of 23/11 show that they are happy with the adequacy of the reserves. Have you any comments on the scrutiny which I could pass to GAD before the visit?

In response, the Line Manager states that he thinks that just two or three other companies use a bonus reserve valuation. He also refers to GAD’s comment in their scrutiny report (in the section on the strength and/or weaknesses of Equitable’s valuation) on the prudence of certain of the assumptions. The Line Manager queries if GAD have followed this up. He comments:

The point which concerns me a little is that, as from the 1994 returns, it is not sufficient for the actuarial liabilities to be estimated prudently. Each of the assumptions which goes into the actuarial calculation has itself to be prudent. Equitable need to be alive to this.</td></tr>
<tr><td>30/11/1994</td><td>Equitable apply to DTI for a section 68 Order which will exempt them from the limit of Eurobonds they can hold. This is the second application — see 12/10/1994. DTI’s Line Supervisor B passes the letter to Line Manager B with a note: ‘presumably there will be no need to do a S.68 order [because] the [Regulations] amendments are almost there?’. The Line Manager replies: ‘Keep fingers crossed!’. (Note: it appears that no section 68 Order was issued — see the note of the meeting on 09/12/1994.)

Equitable write to GAD in reply to their letter of 23/11/1994. Equitable say that they wished to comment on the interpretation of Regulation 59 of ICR 1981. Equitable write:

I can see how a literal reading of 59(8) has led to the point you make. I have, however, tended to feel that, reading regulation 59 in total, it is reasonable to interpret the “rate of interest” in 59(8) as permitting the possibility that this rate may itself be an average liability valuation interest rate.

If this interpretation is not valid, then the wording of 59(9) is somewhat curious in that it presents hypothecation as something one <u>may</u> chose to do but, by implication, <u>need</u> not. Under your interpretation, except in the unlikely case of there being only one valuation interest rate for all contracts, hypothecation would seem to be mandatory.

Interestingly, 59(9) itself talks of “the rates of interest to be used in valuing a particular category of contracts ...” which seems to imply that, even where one is choosing to hypothecate, that need not be down to a level where there is a single valuation interest rate for the block of business in question.

Equitable say that they would be interested to receive any further comments that GAD may have on this point.</td></tr>
<tr><td>01/12/1994</td><td>Every insurance company is sent by DTI’s Director of Insurance a ‘Dear Director’ letter (DD1994/1). The letter encloses a copy of Prudential Guidance Note 1994/6, ‘Guidance on systems of control over the investments (and counterparty exposure) of insurance companies with particular reference to the use of derivatives’. DTI request a ‘state of play’ report by 31 March 1995 ‘summarising the extent to which your company’s systems already comply with Guidance Note 1994/6 and, if necessary, what remedial action is being undertaken’.</td></tr>
<tr><td>02/12/1994</td><td>GAD write to Equitable to say that GAD disagree with the Society’s interpretation of the regulations on valuation rates of interest. GAD say:

We do not agree with your interpretation of regulation 59. Paragraph 8 is quite specific in saying that in no case shall a valuation rate of interest exceed the weighted average yield on the assets. Paragraph 9 introduces an optional relaxation allowing hypothecation for</td></tr>
</table>

the purposes of valuing a particular category of contracts to prevent paragraph 8 proving excessively onerous. There is no mention anywhere in paragraph 8 or elsewhere in regulation 59 of the restriction applying only to the average valuation interest rate. Any interest rate used in the valuation which exceeds the limit in regulation 59(8) is therefore in [breach] *of the requirement that "in no case shall a rate of interest exceed the adjusted overall yield on assets". The position will be even clearer under the new regulations and the draft professional guidance notes.*

GAD continue:

The points you raise are very interesting, but we feel there are valid explanations without interpreting regulation 59(8) (or what is now 69(11)) in the way you suggest.

Regulation 59(9) does not require hypothecation, in that it is quite acceptable to apply paragraph 8 to all categories of contract based upon the fund yield.

We also do not feel that regulation 59(9), by using rates of interest, conflicts with our interpretation. It is not uncommon for actuaries to use two rates of interest for valuing a single contract, especially where there is a material reinvestment issue involved. This may be particularly relevant for, say, deferred annuities written on younger lives, or widows' annuities in payment, where assets may not be available of long enough term, and a reinvestment covered by 59(9) is unavoidable. It is of course quite acceptable for more than one interest rate to be used for contracts with the same hypothecated assets, provided each rate is less than the maximum supportable in terms of the yield on those assets.

GAD conclude:

For these reasons we believe our interpretation of regulation 59 is correct, and all interest rates used in valuing liabilities should be supportable in terms of the regulation by a particular set of assets, which may be all the assets. We trust that in considering your bases for the net premium test in the 1994 valuation you will verify that each interest rate can be supported in terms of the new regulation 69(11), with the application of paragraph 12 if required.

06/12/1994 [entry 1] DTI ask Equitable to provide details of their critical illness policy.

06/12/1994 [entry 2] DTI's Line Supervisor B writes to Line Manager B to brief him for the visit to Equitable on 09/12/1994. The Line Supervisor identifies five recent issues:

1) The section 68 Order application regarding Eurobond holdings.

2) Whether Equitable's critical illness policy is Class III or IV.

3) In relation to GAD's scrutiny of Equitable's 1993 returns, the Line Supervisor says: *'You had a query about prudence* [see 29/11/1994] *– as from the 94 returns, it will not be sufficient for actuarial liabilities to be estimated prudently – each of the assumptions which goes into actuarial calculation itself has to be prudent, and* [Equitable] *needs to be alive to this. GAD suggests that you bring this issue up – under 3rd* [Life Directive] *item on* [the] *agenda'.*

4) The section 68 Order on the call option (see 09/03/1994), which is effective until 30 June 1994.

5) The solvency cover in the 1993 returns. Line Supervisor B says: *'1993 returns form 9 shows* [the required minimum margin] *covered 3.75 times (ie by* [bonus reserve valuation] *method). Converted to* [net premium valuation method] *method over is 3.9 times'.*

To this list the Line Supervisor adds, in manuscript: *'Role of* [the Appointed Actuary]: *concern re* [Managing Director/Appointed Actuary] *all in one person'.*

07/12/1994	Equitable write to GAD in response to their letter of 02/12/1994. Equitable say that they *'do not wish to prolong this correspondence unduly since, on this occasion, it relates only to our "appendix" demonstrations of compliance with the regulations'.* Equitable say, however, that: *'the issue will become more pertinent under the new regulations and I shall give further consideration to that'.* Equitable make two further observations: *(1) Your interpretation depends on the point that there is no explicit mention that "the valuation interest rate" can be a weighted average. My view, no doubt coloured by the fact that in the actuarial literature the valuation rate of interest typically refers to the average rate, is influenced by the fact that the regulations do not explicitly say that the average rate may not be used for a block of business.* *(2) Looking back through my files I see that a similar presentation to that in paragraph 7 of my 22 November 1994 letter has been provided on a number of occasions in the past without being questioned by your predecessors.* Equitable conclude by saying they will *'give the matter further consideration in relation to the 31 December 1994 valuation'.*
09/12/1994 [entry 1]	Equitable provide DTI with details of their critical illness policy to be sold by their Republic of Ireland branch.
09/12/1994 [entry 2]	DTI (Line Manager B and Line Supervisor B) and GAD (Scrutinising Actuary D and Chief Actuary C) meet Equitable's Appointed Actuary/Chief Executive and their Investments Manager. DTI prepare a note of the meeting. They summarise discussion on 13 broad topics, including: (1) <u>Corporate objectives</u> Equitable provide a copy of their Mission Statement and corporate targets for 1994. They explain that they see themselves as primarily a pensions office. (2) <u>Marketing philosophy</u> Equitable explain that they employ a high calibre sales force. They say there have been: *... no problems with LAUTRO.* [Equitable's Appointed Actuary] *was very pleased with how the PIA was developing. Equitable only had half a compliance officer — no need for any more because each branch manager was a compliance person. They saw no point in over-selling products.* Equitable's Appointed Actuary explains that he keeps an eye on the mix of with-profits and linked business. GAD's Chief Actuary C asks if recurrent single premium products were not *'quasi-annual'.* The Appointed Actuary replies that he *'saw these as effectively annual. All marketing costs were based on the fact that the premium was renewed annually – but there were no penalties if the client stopped paying'.* In response to a question from GAD, Equitable confirmed that they applied a penalty on the surrender of a policy. Equitable provide details of the growth in business between 1984 and 1993: *... annual premiums went from £79m to £323m and single premiums from £45m to £1087m. Equitable was top of the new business league for annual premiums in '93 with £320m. They were about 4th from the top for single premiums ...*

(3) Management systems and procedures
Equitable provide details of their internal structures and IT systems.

(4) Role of the Appointed Actuary
Equitable's Appointed Actuary explains that he would continue in his position as Appointed Actuary and Managing Director until Spring 1996 and that *'there had been no problem combining both roles'*. Chief Actuary C notes that combining the two roles might be more of a problem for a proprietary office. The Appointed Actuary confirms that the two roles would be split after his departure *'more for personality than regulatory reasons — it was difficult to find an all-rounder. The two successors would almost certainly come from within the company'*.

(5) Aetna/Fuji case
Under this heading, DTI's note records: *'For single premium products – from the beginning of 1995 110% of surrender value would be paid – at present it was 101%'*.

(6) Pensions mis-selling
Equitable explain that they had received a lot of business from people contracting out, but these were viewed as 'execution only', i.e. no advice had been given. DTI's note records that the Society *'never advised people to opt out'*.

(7) Overseas activities
Equitable outline their current activities in the Republic of Ireland and Germany and the possibility of writing business in Italy, France, Spain and Austria.

(8) Bonus philosophy
Equitable explain that the declared bonus rate for 1994 would be held at 4% and that there is a guaranteed roll-up in policies of 3.5%. GAD ask what Equitable's technique for smoothing was. The Appointed Actuary explains that Equitable:

> *... looked at what was deemed the return on gilts for the year. They had to meet the guaranteed roll up of 3.5% plus the guaranteed addition of 4%. Any balance of the deemed return was the non guaranteed bonus. For '94 he would be asking the board to deem an intrinsic value of 10%. In '93 they had earned 29% on assets. 17% was available for distribution and 13% was distributed. They took a broad approach to smoothing. Policyholders were notified of the present value of their fund — this consisted of the premiums paid, the guaranteed interest added, and the guaranteed bonus. The terminal bonus element was accrued for the life of the policy.*
>
> [The Appointed Actuary] *said it was expected they would "overshoot" in '94 — they were not worried — but DTI may be! They did not do a market adjustment* – [the Appointed Actuary] *saw this as a "young actuary's idea"! It was determined in relation to indices. They tried to keep the total guarantees in line with what would have come in if investments were wholly fixed interest.*

GAD's Scrutinising Actuary D comments *'that it looked like over-distribution, compared with market values'*. Line Supervisor B's handwritten notes taken at the meeting also record that Chief Actuary C also asks: *'do you raise people's expectations?'*, and record that the answer given is *'No'*.

(9) Solvency
The Appointed Actuary provides an estimate of the solvency position at 31 October 1994. He explains that he:

> *... was not concerned at how small the free assets got. If there was a negative free asset ratio, he would use the implicit item which he applied for every year. If they couldn't declare a bonus, they wouldn't — but he said a well-managed with profit office could not*

go bust! In the past, you minimised the free assets and strengthened other areas. A vigorous expanding office may have a low free asset ratio — yet a dead-end office might have a high one!

(10) Investment management
Equitable outline their investment policies. They explain that *'they had targets to outperform the all-share Index each year by 0.5% without taking significant risks'*, but that in 1994 *'they would not have as good a year against the industry as a whole'*.

DTI refer to their Prudential Guidance Note 1994/6 on systems of controls over investments and say that they would welcome feedback from Equitable on it.

(11) Reinsurance – resilience testing – implicit items – valuation bases
Equitable's Appointed Actuary explains that the Society do not go for financial reinsurance, and that, on resilience testing, *'they followed DTI/GAD guidelines but not slavishly. He thought that some younger* [Appointed Actuaries] *treated them like tablets of stone!'*. GAD ask why Equitable do not show the implicit item in their returns. In reply '[the Appointed Actuary] *said that using it would make them look weak!'*. Equitable also explain that:

> *... they always went for the weakest possible valuation. The weakest one was the gross premium valuation. GAD noted that recurrent single premiums were very similar to the net premium valuation method.* [The Appointed Actuary] *said they took no account that 90% of the recurrent single premiums would be renewed.*

(Note: it does not appear from DTI's note of the meeting that there was any specific discussion of DTI's Line Manager B's concerns about the prudence of each of the assumptions in Equitable's valuation (see 29/11/1994 and 06/12/1994 [**entry 2**]).

At the meeting, Equitable provide the following documents:

– *'Equitable Life – Estimated Solvency Position at 31 October 1994'*
The information in this document is as follows:

> *If the Society had published a "Form 9" at 31 October 1994 the estimated position would have been as follows:*

	£m
Admissible assets less "other insurance and non-insurance liabilities"	*13,088.5*
Mathematical reserves (after distribution of surplus at 1993 rates)	*12,041.3*
Available assets for minimum margin	*1,047.2*
Required minimum margin	*478.9*
Excess of available assets	*568.3*

– *'Equitable Life – Development Expenditure'*
This document sets out the Society's expenditure on information technology over the years 1989 to 1995, totalling £70m, and when repayment of the amounts borrowed to cover that expenditure is expected. Full repayment is anticipated by 1999.

– *'New Business Financing'*
The information in this document is as follows:

> *For "annual premium" type business, acquisition costs exceed the charges in the premium received in the first year and are recouped over the life time of the policy. Loans are required from the main fund to finance the costs of year one.*
>
> *Single premium business requires no such financing.*

The "loan account" has been monitored for some 20 years, from the time the Society developed its current sales force.

The net loan plus interest to the end of 1988 had amounted to £147.9m.

The movement since then has been:

	Interest on brought forward loans	*Strain on new business in year*	*Received from existing business*	*Outstanding loan at year end*
1989	*35.6**	*58.1*	*21.6*	*220.0*
1990	*-18.5**	*44.6*	*27.2*	*218.9*
1991	*30.8*	*37.6*	*32.4*	*254.9*
1992	*28.0*	*58.0*	*51.2*	*289.7*
1993	*22.3*	*55.5*	*66.0*	*301.5*
1994 to end of year	*13.4*	*52.7*	*52.1*	*315.5*

** Based on "fund returns". Now use rate of interest negotiated with our bankers.*

On DTI's copy, Line Supervisor B has written: *'£300m is part of the assets'.*

– *'Equitable Life – Recurrent Single Premium Pension Bonus Rates'*
Equitable provide the following table:

Year	*Declared bonus rate* %	*Equivalent return** %
1985	*9.25*	*13.1*
1986	*8.50*	*12.3*
1987-90	*7.50*	*11.3*
1991	*6.50*	*10.2*
1992	*5.00*	*8.7*
1993	*4.00*	*7.6*

** The "equivalent return" is a combination of the declared rate and the basic accumulation rate of 3½% p.a. guaranteed within the contract.*

– *'Managing Director's Report'*
This document provides a brief summary of certain areas of the business. Under the heading *'New Regulations for Liability Calculation'*, the report states:

The DTI is introducing new regulations which will be effective for the year end. Some of these stem from the Life Directive. There are no points of significance for the Society.

– *'Pension Transfer Problems'*
This note sets out the background to the pension transfers and opt-outs mis-selling review, its effect on Equitable, and the potential number of mis-selling cases.

– *'The Equitable Management Company –Accounts for the Period Ended 30 September 1994'*
This document, which is presented to the Board every three months, is made up of the following reports:

1) *Global business profit and loss account*
2) *Global business balance sheet*
3) *Non-UK business profit and loss account*

4) *Non-UK business balance sheet*
5) *UK business full 'Equitable Management Company' accounts*

– *'Monthly Business Statistics – Period Ending 31.10.94'*
This document, which is presented to the Board every month, is made up of the following reports:

1) *Revenue Analysis – Global Business*
2) *The Equitable Life Assurance Society Balance Sheet*
3) *"Equitable Management Company" – Global Business Profit & Loss Account*
4) *"Equitable Management Company" – Non UK Business Profit & Loss Account*
5) *Investment of net addition to fund*
6) *UK with profits investment performance*
7) *UK Linked business investment performance*

Report 6, *'UK with profits investment performance',* includes:

'Overall Returns 31.12.93 to 31.10.94		*Year to Date*	*Annualised*
Total return (capital & income) of with profits assets		*(4.6)%*	*(5.4)%*
Total return of non fixed interest element of with profits assets		*(2.8)%*	*(3.3)%*
Gross Redemption Yield of 10 year gilt at start of year			*6.3%*
Projected 1994 returns		*– Pessimistic*	*(1.1)%*
(on asset-split at start of year)		*– Most likely*	*11.4%*
		– Optimistic	*20.7%'*

(Note: the figures in brackets in the above table are negative.)

Below these figures, Line Supervisor B, in noting comments made by Equitable's Appointed Actuary, has written: '*If we want to deem 10% earned – above concentrates the mind!*'.

– *'The Society's Corporate Objectives'*
The corporate objectives of the Society include the mission statement of *'Growing more contented customers'* and its principles of operation being:

a) *We are a mutual Society, providing a service at cost to our clients*
b) *We aim to attract clients from the upper end of the market. Through packaged arrangements such as group pension plans we also offer the benefit of Equitable products to a wider community*
c) *We control the selling and marketing of our products, operating only through our own sales force and without payment of commission to third parties*
d) *We are, and are seen to be, an innovative organisation.*

– Standard & Poor's press release of 5 December 1994 entitled *'The Equitable Life Assurance Financial Strength Rated "AA" (Excellent) By S&P'*
The press release says:

> *The rating reflects the society's strong market position where a very focused approach and highly efficient distribution system have fostered excellent new business growth and contributed towards ELAS' remarkably good expense performance. Furthermore, S&P regards capital strength as excellent, while investment performance over recent years has continued to be strong.*

On Equitable's regulatory solvency position, Standard & Poor say:

> *Although ELAS uses a conservative valuation methodology, S&P still believes that it shows a significant degree of capital strength. The Society's published returns display a strong level of capitalisation, despite a significant strengthening of the valuation in 1993, with the free asset ratio rising to 9.40% and coverage of the required minimum margin to 3.7 times (x), from 5.09% and 2.4x, respectively, in 1992. An alternative net premium valuation, more comparable with peers, would increase the free asset ratio to almost 12% and coverage of the required minimum margin to over 4.4x. While these levels can be expected to decline in 1994, as investment values fall, S&P believes that the society's capital strength will remain substantial.*

<u>– Insurance Security Analysis Service's analysis of Equitable and comparative market data</u>
The rating given is *'B+'*. The commentary explains that *'The company continues to perform well, although its free assets are relatively low for a with-profits office. A repeat of last year's rating has been made'.*

Under *'Solvency & Security'*, commenting on the Companies Act accounts for 1993 the rating states:

> *A transfer of £1.18 billion of capital appreciation was made in 1993 from investment reserve to the long-term business fund to support a significant strengthening of the liability valuation in the light of markedly lower interest rate levels and to enable bonuses at the appropriate levels to be declared, but the amount of Investment Reserve remaining at 31st December 1993 had doubled to £1.7 billion. The free asset ratio increased and the adjusted ratio, allowing for with-profits business, almost doubled to twelve per cent, although this is still well below the level for most with-profits offices.*

13/12/1994 [entry 1] DTI thank Equitable for their hospitality on 09/12/1994. DTI's letter ends:

> *Looking at our files, it appears that we have not yet received a request for a Section 68 Order for a future profits implicit item. If you require such an Order for the 1994 returns, grateful if you could send in the necessary information as soon as possible.*

13/12/1994 [entry 2] Equitable's Appointed Actuary writes to DTI's Line Manager B to express the hope that the visit gave DTI as much information about Equitable as they were expecting. The Appointed Actuary invites DTI staff to visit Equitable's Head Office to look at their new IT systems. He adds: *'You can then meet some other colleagues which would help demonstrate that there are other people here besides myself, just to pick up on* [Chief Actuary C's] *comments!'.*

15/12/1994 Equitable apply to DTI for a section 68 Order for a future profits implicit item of £500m, for possible use in their 1994 returns. Equitable provide financial calculations in support of the application which suggest they could seek an Order up to the value of £2,141.1m. Given the proximity of the year end and to save time, Equitable copy the application to GAD.

These calculations include, for the estimated annual profits, that:

Year ending	*(A) Total Surplus*	*(B) Exceptional items*	*(C) Surplus arising from solvency margin*	*(A)-(B)-(C) Ordinary surplus*
	£m	*£m*	*£m*	*£m*
31.12.89	*337.4*	*–*	*89.9*	*247.5*
31.12.90	*422.5*	*557.0 (a)*	*26.6*	*(161.1)*
31.12.91	*596.5*	*(13.2) (b)*	*59.5*	*550.2*
31.12.92	*330.5*	*(89.4) (c)*	*46.4*	*373.5*
31.12.93	*480.9*	*(1,066.7) (d)*	*178.5*	*1,369.1*
				2,379.2

Average annual profit = 2379.2/5 = £475.8m

Notes: *(a) Surplus was increased by £557.0m as a result of changes in valuation bases during 1990.*

(b) Surplus was reduced by £13.2m as a result of changes in valuation bases during 1991.

(c) Surplus was reduced by £89.4m as a result of changes in valuation bases during 1992.

(d) Surplus was reduced by £1,066.7m as a result of changes in valuation bases during 1993.

The calculations state that the average period to run for the Society's in-force contracts is now nine years. The Society's Appointed Actuary explains:

The periods to run have been reduced to take account of premature withdrawals based on the Society's recent experience of such withdrawals. In respect of retirement annuity and personal pension contracts for which a range of retirement ages is available, it has been assumed that retirement benefits are taken at the lowest possible age, or immediately if that age has already been attained.

The calculations suggest that the maximum future profits permissible is 50% of £475.8m multiplied by nine years — that being £2,141.1m.

19/12/1994 GAD write to DTI, recommending that the section 68 Order is granted. GAD say, however, that they do not agree with Equitable's detailed calculations. GAD explain:

The calculation includes "Exceptional Items" relating to basis changes. The Guidance Note requires that exceptional losses should be omitted to the extent that there are similar exceptional profits. Furthermore it suggests that there is no intention to allow basis strengthening to be allowed as an exceptional item. The note does however talk of "net strengthening", and it would seem a little unreasonable to omit the surplus arising from a weakening and disallow the cost of re-strengthening in a later year; this is made more clear when it is realised that a simultaneous change would be offset. However, the requirement that a loss must only be disallowed to the extent that there is similar profit being disallowed must be right, and we should ensure this is pointed out to [Equitable's Appointed Actuary].

GAD continue:

In the current calculation, there is a large strengthening of reserves added to the surplus for 1993, and only about half this amount in a disallowed profits from weakening. I have reworked the figures to eliminate all the exceptional items, and this permits a maximum implicit item of £1,590.3m, which is still comfortably more than the £500m being requested. If the exceptional profit were eliminated, but the losses were not, then the figure would still exceed the request, being some £1,088.9m.

20/12/1994 [entry 1]	Equitable's Appointed Actuary writes to GAD to raise a query about the use of future profits implicit items. The Appointed Actuary explains that '[for] *various reasons we have, to date, decided not to make use of these orders in preparing our returns. I have, however, felt for some time that it would be professionally sound to recognise the ability to obtain and make use of such an order when considering the application of the resilience test'.* He suggests that, in relation to the Society's 1993 returns, it would have been reasonable to say that the additional margin of £236m indicated by the resilience test was well below the amount of the available future profits implicit item, and thus that no additional explicit reserve was required. He asks GAD for their views.
20/12/1994 [entry 2]	DTI send GAD a copy of Equitable's letter of 09/12/1994 about their Republic of Ireland branch. DTI ask whether, in the light of this further information, GAD still think that the product should be classified as Class IV business.
29/12/1994	DTI send Equitable the section 68 Order for a future profits implicit item of £500m, for use in the 1994 returns. DTI add:

We have the following comment on the calculations supporting your application, which I would be grateful if you could note for future calculations. Your calculation included "exceptional items" relating to basis changes. The DTI Guidance Note (October 1984, paragraph 10) on implicit items requires that exceptional losses should only be omitted to the extent that there are similar exceptional profits.

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03/01/1995 Equitable's Chief Executive writes to DTI's Head of Life Insurance on a taxation problem the Society are having in Germany. The Chief Executive begins his letter: *'As we know each other it seems natural to write to you ... I will, of course, understand if, however, you feel it is appropriate to pass this letter to somebody else for attention'.* The Chief Executive says that his concern is that *'following the 3rd Life Directive and subsequent legislation ... there is discrimination being exercised in Germany against foreign insurance companies which stems from tax rather than insurance law'.* He explains that: *'... unlike German life assurance companies, each year the Society will be liable to tax on the total assets held in respect of our German business';* and *'the reason why German life assurance companies are exempt from the tax seems to be that they are required by their insurance regulators to appoint trustees to look after their assets and where such a framework exists the assets are not subject to tax'.* Equitable's Chief Executive asks the Head of Life Insurance to take the matter up with the German regulators, or in any other way that he feels is appropriate.

04/01/1995 [entry 1] GAD write to Equitable in reply to their letter of 20/12/1994 about future profits implicit items and the resilience test. GAD say they:

> *... have considerable sympathy with the professional argument you have made. There are, however, further explicit requirements in the regulations, some of which derive from European legislation. These will, I think, have the effect of limiting severely your ability to use the future profits implicit item in the way you suggest.*

GAD explain:

> *The principal requirement is that in regulation 64(1) of the Insurance Companies Regulations 1994 which necessitates that the assumptions used in determining the long term liabilities "shall include appropriate margins for adverse deviation of the relevant factors". This needs to be read in conjunction with regulation 75 which further requires that the liabilities "include prudent provision against the effects of possible future changes in the value of the assets".*
>
> *I believe these regulations have the effect of requiring the majority of the professionally required resilience reserve to form part of the mathematical reserves shown in form 14, or else the appropriate part of the entry in line 51 of form 14 needed to make the mathematical reserves sufficient must be stated.*

They continue:

> *This, of course, relates only to the resilience reserve attributable to the liabilities themselves, and the assets supporting those liabilities. This may not be quite as stringent as your suggestion in one respect, namely that this need does not extend to the solvency margin.*

GAD conclude that:

> *The position which meets your definition of "resilient" would seem then to become as follows:*
>
> *a) the assets covering the mathematical reserve, including any resilience reserve necessary, are sufficient to cover at least the liabilities in the changed conditions (except the requirements of regulation 75)*
>
> *and*

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> b) *the assets covering the mathematical reserves and solvency margin in current conditions are sufficient to cover at least the mathematical reserves and the amount of fund required by regulation 22(3) to be covered by explicit items (which for Equitable Life will be one-sixth of the total required minimum margin for the foreseeable future)*
>
> *and*
>
> c) *the future profits position in the changed conditions would be sufficient to support an implicit item to cover the balance between the cover provided by the assets and the required minimum margin.*
>
> *The first of these three paragraphs would seem to be sufficient to cover the requirements of that part of the actuary's certificate covering the determination of the liabilities, whilst the professional responsibilities of the Guidance Notes are, in my view, satisfied by the other two paragraphs.*

04/01/1995 [entry 2] GAD write to DTI to state that, in the light of Equitable's letter of 09/12/1994, GAD are satisfied the policy falls within Class IV.

13/01/1995 DTI's Head of Life Insurance writes to his German counterpart at BAV (the German Supervisory Office for Insurance, based in Berlin) to take up the issue raised by Equitable in their letter of 03/01/1995 (having first checked that this does not cause another DTI official any difficulty). The Head of Life Insurance also writes to Equitable to say: *'I have put a ferret down the BAV rabbit hole and will let you know what emerges'.*

25/01/1995 Equitable write to DTI in reply to their letter of 29/12/1994. Equitable confirm that, in the calculation of average profits, exceptional losses were only excluded to the extent that those losses could be set against similar exceptional profits.

Equitable say: *'As you are aware, in 1990 the Society moved from an approach using valuation bases which reflected the assumptions made in the premium bases to a more active approach in which the valuation bases reflected the yield on assets at market value. As a result of that change reserves decreased by £557.0m in 1990'.*

Equitable continue:

> *When in 1991, a figure for average profits over the five years 1986 to 1990 was calculated in support of the Society's application to take credit for a future profits implicit item, it was not clear as to whether an adjustment should be made to profits for the £557.0m release of reserves described above.*
>
> *On the one hand, surplus had been increased by £557.0m from a change in valuation approach and, in accordance with the Guidance Notes on implicit items, such an exceptional profit should be excluded. It would then be consistent to also exclude any exceptional losses resulting from changes in valuation bases in subsequent years from the calculation.*
>
> *On the other hand, however, paragraph 10 of the Guidance Notes state that "it is not intended, however, that any adjustment should be made for the effect on surplus of a net strengthening of reserves". If, therefore, the effect on surplus arising from a strengthening of reserves should be excluded then, on the grounds of consistency, it would seem logical that the effect on surplus arising from a weakening of reserves should also be excluded.*

Equitable ask for DTI's advice *'so that, in future, the Society's calculations will accord with the DTI's views on this subject'.*

30/01/1995	DTI copy Equitable's letter of 25/01/1995 to GAD and seek their views.
01/02/1995	DTI's Line Supervisor B passes the correspondence that DTI have had with Equitable about the Society's critical illness policy to an adviser in DTI's legal department (Legal Adviser A). The Line Supervisor asks for his views.
02/02/1995	Legal Adviser A advises Line Supervisor B that in his view the policy is Class IV not Class I or III.

07/02/1995 [entry 1] GAD write to DTI with some comments on Equitable's letter of 25/01/1995. GAD begin by saying that: *'to understand the guidance notes, it is useful to remember the effect of an implicit item, and why it might reasonably be allowed. The purpose is to allow an office to hold less assets against the required minimum margin than would otherwise be required, on the grounds that over the life of the policies, based upon past experience, a surplus will be generated'.*

GAD advise:

> *Changes of valuation basis can have various causes, but there are two main points to consider. A release of surplus from a weakening of the valuation basis is non-recurring, and indeed may even be at the expense of future surplus. It is therefore an exceptional item of surplus, and should properly be disregarded in the calculation.*
>
> *A valuation strain arising from a basis strengthening could also be regarded as an exceptional item of deficit arising, but this is inappropriate if the reserve strengthening were required to meet the regulations, in particular to establish a prudent basis. This would tend to indicate that previous surpluses were overstated, for whatever reason. In general, therefore, the cost of reserve strengthening should not be excluded from the calculation.*

GAD continue:

> *These comments relate more relevantly to significant changes of basis, such as Equitable made in 1990 ... Most companies do make smaller changes from time to time, and these often are cancelling in effect from year to year. This will be less common under the 1994 regulations but will still occur. It seems unreasonable to exclude a surplus that arises from the release of a reserve the cost of setting up of which was included in a previous year. It is appropriate for reserve weakenings and strengthenings which relate to a similar item, such as the interest rate basis, should be allowed to be offset, so that the weakening need not be disregarded to the extent that the cost of strengthening the same assumption is included in a different year in the comparison ...*
>
> *It would not, of course, generally be appropriate in the context of the Insurance Companies Regulations 1994 to allow a strengthening of mortality basis and a weakening of interest basis to be offset in this way.*

07/02/1995 [entry 2]	DTI write to Equitable in reply to their letter of 09/12/1994 about their critical illness policies. DTI explain: *'Our view is that the principal objective of these policies is the provision of* [permanent health insurance] *benefits and that they should therefore be classified as Class IV. The ultimate decision on this type of issue would of course lie with the courts'.*
09/02/1995	The German regulatory authority reply to DTI's letter of 13/01/1995. The regulatory authority say that the background to the issue is the treatment of mathematical reserves and reserves for the return of contributions with regard to trade tax. The regulatory authority explain that they had presented the facts to the relevant ministry but its reply could be influenced by any legal repercussions which might occur if Equitable were to appoint a trustee on a voluntary basis, as

they understand that a trustee could not be nominated under English law. The regulatory authority ask DTI for their interpretation of the applicable law.

Having sought legal advice, DTI's Head of Life Insurance responds on 27 March 1995. His short letter says '[DTI] *are not aware of any reason in English law why a UK life insurance company should not appoint a trustee in Germany, if both parties are willing'.*

(Note: I have found no evidence that DTI informed Equitable of this response.)

16/02/1995	Equitable's Chief Executive writes to DTI's Head of Life Insurance to set out some concerns that the Society has about another taxation issue concerning the rules for business written in Europe. He begins his letter: *'Following our luncheon earlier this week with your colleagues at which we discussed the role of the DTI as our "supporting agency", I have already found a problem I hope you can help us with'.* The Chief Executive explains: *... the simple changes required to the taxation rules for life offices have been so complicated by regulations that the legislation will not have the effect needed by the industry to take advantage of the current opportunities in Europe. The proposed regulations are so severe that we may well need to close our branches in Germany, Guernsey and the Republic of Ireland.* Equitable's Chief Executive says that he has written to the Financial Secretary to the Treasury to request a change to the applicable regulations, but asks the Head of Life Insurance to use his influence to *'ensure that something happens'.*
28/02/1995	Equitable write to DTI in response to their letter of 07/02/1995 about the Society's critical illness policies. The Society continues to dispute that these policies should be viewed as Class IV. Equitable point out that they write the same business in the UK and *'you have not yet challenged us on that'.* Against this, Line Supervisor B has written *'but we are now!'* on this letter.
02/03/1995	DTI's Line Supervisor B writes to Line Manager B enclosing a copy of GAD's note of 07/02/1995. The Line Supervisor says: *'I keep looking at this and putting it back in my tray! It all looks* [very] *involved!'.* She asks if she should send the note itself to Equitable or request GAD's Scrutinising Actuary D to draft a reply. She adds as a postscript: '[A GAD actuary] *was saying to me yesterday that the calculation of the implicit item was essentially flawed, and he didn't fuss too much about* [very] *technical details. But perhaps that's just* [him]*!'.* On the same day, the Line Supervisor seeks views from DTI's Legal Adviser A and GAD's Scrutinising Actuary D on Equitable's letter of 28/02/1995.
03/03/1995	DTI's Line Manager B says in response to the Line Supervisor's note of 02/03/1995: *'Hmm! Tends to make the eyelids droop!'.* The Line Manager suggests that she should ask GAD to draft a reply.
07/03/1995 [entry 1]	DTI's Line Supervisor B writes to GAD in response to their note of 07/02/1995. The Line Supervisor says: *I am having problems with how to put your comments into a letter! Equitable's arguments are all very theoretical as they don't even use their implicit item!* *I would be most grateful if on this occasion you could prepare a draft reply to* [Equitable's Appointed Actuary] *which I can "top and tail".*
07/03/1995 [entry 2]	DTI's Head of Life Insurance writes to Equitable's Chief Executive in response to his letter of 16/02/1995. The Head of Life Insurance explains that he has spoken to the Inland Revenue and the Association of British Insurers. He suggests that there is little scope to effect the changes in

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the taxation rules Equitable are seeking but that the Association of British Insurers are exploring options and that Equitable should notify the Association of British Insurers of their concerns.

07/03/1995 [entry 3]	DTI's Legal Adviser A comments on Equitable's letter of 28/02/1995 about their critical illness policy. Legal Adviser A takes the view that it is Class IV.
08/03/1995	GAD write to DTI in relation to two issues. First, GAD confirm their view that Equitable's critical illness policy should be classified as Class IV. Secondly, in relation to the calculation of future profits implicit items GAD provide a draft reply to Equitable's letter of 25/01/1995, reflecting the points in GAD's note of 07/02/1995.
15/03/1995	Equitable write to the President of the Board of Trade to highlight the taxation issue referred to in Equitable's letter of 16/02/1995.
20/03/1995	The German regulatory authority write to DTI about the sale by Equitable, in Germany, *'of single premium annuity insurance policies with immediate effect, where the annuities payable monthly are guaranteed for life at a level which precludes participation in surpluses'.* The regulatory authority point out that the yields required to meet the policies are unrealistic in Germany: *From my position I cannot assess to what extent the provisions on the interest rate of reserves applicable in the United Kingdom have been observed. It does however appear possible that the undertaking has not complied with the provisions of Article 19 in conjunction with Article 18(1)(c) of the Third Life Insurance Directive. The German press quotes the undertaking's marketing manager ... as saying ... that no distinction is made between British and German people, or between men and women. The application of such a policy to annuities would in Germany be contrary to the actuarial principles which apply.* *In connection specifically with the requirement on German life insurance undertakings to observe the new mortality ratios in annuity insurance and partially to reduce their guarantees in future policies, there is also naturally a competition policy aspect to this case and it has attracted considerable attention in the press. There is room for doubt, particularly in so far as Equitable Life's product is to a considerable extent sold to women, as to whether the premiums received will suffice to meet the commitments entered into.*
21/03/1995 [entry 1]	A DTI official advises Line Manager B that he and DTI's Director of Insurance, along with GAD's Directing Actuary A, are shortly visiting the German regulatory authority and could discuss the letter of 20/03/1995 at their meeting. The note is copied to Directing Actuary A. In an undated note, GAD's Scrutinising Actuary D informs the Directing Actuary that Equitable price German annuities on an a(90) select mortality table but do distinguish between men and women, although GAD are currently researching the position further. He points out that *'as* [Equitable] *only have one in force policy, they aren't too bothered about the reserve! Nonetheless, it seems under full control'.*
21/03/1995 [entry 2]	DTI's '*Sponsorship Section*' visit Equitable's offices. DTI's conclusion from the visit is that Equitable have great confidence in themselves as market leaders, based not just on up-to-date IT systems but also refined business processes and a programme of culture change amongst staff. In a note made on 5 April 1995, Line Manager B remarks that *'it would have been* [very] *nice to have known about this visit in advance'.*

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23/03/1995 DTI write to Equitable in reply to their letter of 25/01/1995. The letter largely repeats GAD's note of 07/02/1995.

DTI's reply crosses with a chasing letter of the same date from Equitable's Appointed Actuary. In relation to the Society's solvency position presented in Form 9, the Appointed Actuary says:

> *As at 31 December 1994 the excess of available assets over the required minimum margin will be of the order of £400m which will present a marginally stronger position than at the end of 1991. I am, however, considering the possibility of making use of the Section 68 order for a future profits implicit item which was enclosed with your letter of 29 December 1994. Our accounts for 1994 will be published in the new format under the Insurance Accounts Directive. Given such a significant change, and in particular the new asset of "deferred acquisition costs" it seemed an appropriate time to make full use of the margins available to us in the DTI returns. Hence both sets of documents may be described as "true and fair"!*

The Appointed Actuary informs DTI that: *'In 1994, the Society's valuation bases were changed with the result that overall there was a release of reserves. The Society's current approach to the treatment of profits and losses arising from valuation basis changes will for the five years 1990 to 1994 be the more conservative of the two possible approaches, as was the case for five year periods ending prior to 1993'.*

The Appointed Actuary repeats his request for advice on the treatment of profits or losses arising from such changes to the valuation basis.

DTI later note on Equitable's letter that they had provided the advice requested.

27/03/1995 [entry 1] Equitable write to DTI in reply to their letter of 23/03/1995. Equitable say that this has provided the information DTI were seeking on the treatment of profits or losses arising from valuation basis changes. Equitable explain that: *'By far the major part of changes in reserves due to valuation basis changes over the last five years has been due to changes in valuation interest rates reflecting the movements in asset yields'.* They acknowledge that a few valuation bases have been strengthened, the cost of which should have been excluded from their calculations submitted in previous years. Equitable continue:

> *Those costs were, however, relatively small and I can confirm that they had no material effect on the applications for a future profits implicit item submitted by the Society in previous years.*
>
> *When the Society submits its application for a Section 68 Order in respect of a future profits implicit item based on the average profits for the years 1990 to 1994, the effects of the strengthening of reserves other than those due to changes in interest bases will be excluded from the calculation of those average profits.*

27/03/1995 [entry 2] DTI's Line Supervisor B seeks advice from Line Manager B about how to respond to Equitable's letter of 28/02/1995 about the critical illness policy.

In an undated note, Line Manager B says to Line Supervisor B that he deduces from the note that no one at DTI agrees with Equitable that the business should be classified as Class III. The Manager informs her that he has asked Legal Adviser A about the solvency implications of classifying the business as Class IV. He also says that they could discuss the issue with GAD's Scrutinising Actuary D when he is at DTI to discuss problems at another company.

28/03/1995 Equitable write to DTI enclosing a 12 page *'State of Play Report at 31 March 1995'* on their internal control systems, sent in response to DTI's 'Dear Director' letter of 01/12/1994. The Society's report sets out Equitable's systems of internal control and considers the extent to which they comply with the guidelines contained in Prudential Guidance Note 1994/6. The report concludes that Equitable's systems are adequate to ensure the safekeeping of the assets held on behalf of policyholders and that, where areas of weakness are identified, Equitable take corrective action.

30/03/1995 DTI inform the German regulatory authority that they have received notice from Equitable of changes to the requisite details of their German branch, and have no objections to these.

31/03/1995 Equitable write to GAD following a press report, from which it appears that GAD have decided to take no action following their survey of bonus distribution practice (see 09/07/1993). Equitable welcome the press report, if it is accurate, but state that it was *'discourteous'* for the results of the survey to be disseminated in this way.

03/04/1995 [entry 1] GAD write to Equitable in response to their letter of 31/03/1995. GAD say that they explained to the journalist in question that:

> *... the grounds for intervention available to the Secretary of State are prescribed in the ICA 1982, as amended, and if higher bonuses are awarded than have been earned, this is principally a matter for commercial judgement provided the reasonable expectations of the other policyholders are not affected.*

GAD deny that they are disseminating the results of the survey through the press and add:

> *In fact, during the conversation I told* [the journalist] *that it was decided not to publish the results of the survey due to the difficulty of not laying ourselves open to the charge that one could identify particular companies' practices.*

03/04/1995 [entry 2] The Financial Secretary to the Treasury writes to Equitable in response to their letter of 16/02/1995 in relation to overseas life insurance business and the tax treatment of policyholders.

06/04/1995 [entry 1] Equitable write to GAD to thank them for the clarification and to accept that they misinterpreted the situation. Equitable suggest that there is still merit in GAD reporting the progress of such exercises direct to the participants. The letter is copied to DTI.

06/04/1995 [entry 2] DTI's Line Supervisor B prepares a note for Line Manager B, setting out the case for recommending Equitable's Chief Executive and Appointed Actuary for an honour. The Line Supervisor gives brief details of his career with Equitable and some background to Equitable's activities. Under *'Grounds for Recommendation',* the Line Supervisor writes:

> *The Society has a good reputation. No known pension sales malpractice or LAUTRO compliance problems. Financial Strength rating by Standard + Poor's 5/12/94 of Double A rating.*
>
> *GAD comment on 1993 returns – expenses of Society remain low, with comfortably the best ratios in the industry. Cover for solvency margin is substantial.*

(Note: during the relevant period, it was common practice for public bodies – especially those like DTI which had a 'sponsorship' role for an industrial sector or sectors in addition to their other functions – to consider whether to put individuals forward for recognition through the honours system.)

11/04/1995 DTI's Head of Life Insurance writes to the Director of Insurance to recommend Equitable's Chief Executive and Appointed Actuary for an honour in the 1996 New Year list. The Head of Life Insurance explains:

... the Equitable's achievements and reputation are undeniable; and there is a case for recognising through the honours system the Managing Director of a company which has so conspicuously got it right, both in terms of commercial results and in terms of avoiding the poor reputation which the sector as a whole suffers from.

The Head of Life Insurance suggests the following citation:

[The individual] *has been Managing Director and Appointed Actuary of the Equitable Life since July 1991, after service with the company in various capacities since 1953.*

The Equitable Life has a well deserved reputation as a life office which has not only achieved outstanding results (regularly topping tables for high investment returns and low charges); but has also managed to avoid the poor image which currently afflicts the life industry generally, as a result of poor selling methods and breaches of regulatory rules. In particular, the Equitable Life does not pay commission to intermediaries (the main cause of inappropriate sales within the industry); the proportion of policies surrendered early is one of the lowest in the industry; and the payments for early surrender are among the highest.

The Equitable Life is also an industry leader in the application of Information Technology to improving services to clients; and is the chosen partner for [a leading retailer's] *new venture to distribute life insurance through its stores.*

As Managing Director, and very much the driving force behind the Equitable Life, [the individual] *can claim the main credit for these achievements. In addition, he is that rare specimen – an actuary who can communicate effectively in plain English.*

The Head of Life Insurance copies his suggested citation to GAD's Directing Actuary A for comment.

13/04/1995 DTI write to Equitable seeking a reply to DTI's letter of 25/10/1994 on potential liability for compensation payments for pension transfers and opt-outs.

19/04/1995 [entry 1] DTI's Line Supervisor B passes a copy of the letter of 20/03/1995 from the German regulatory authority to Line Manager B and to GAD's Chief Actuary C. The Line Supervisor asks: *'Should we be taking this up with Equitable Life?'.*

19/04/1995 [entry 2] DTI write to Equitable to reiterate their view that the critical illness policy is Class IV rather than Class III.

19/04/1995 [entry 3] Equitable write to DTI to respond to their letter of 13/04/1995. Equitable apologise for not replying to the earlier letter of 25/10/1994. They say:

It is simply not possible to quantify, even crudely, the potential liability for compensation payments, given the uncertainty of the rules. My stance on that has not changed although we believe that our exposure is likely to be relatively small.

We are therefore making no explicit provision against this contingency in the accounts although I have "over estimated" the technical liabilities by £50m as a very full implicit provision. Our auditors have given a "true and fair" certificate on our accounts in the new Insurance Accounts Directive in the full knowledge of our approach.

21/04/1995 GAD write to DTI in reply to their request for advice on the letter from the German regulatory authority. GAD suggest seeking Equitable's comments on what has been said, as it appears Equitable are adopting an aggressive marketing stance, contrary to what they said at the company visit. (Note: DTI's note of the visit – see 09/12/1994 – made no reference to

Equitable's marketing stance.) GAD end their letter: *'No doubt* [Equitable's Chief Executive] *will provide you with a satisfactory explanation which you could consider passing on to the German supervisor, if that is felt to be appropriate'.*

Line Supervisor B passes the note to her Line Manager who replies: *'Don't do it! Let's wait to see* [a DTI official's] *report of the Berlin meeting'.*

24/04/1995 [entry 1] DTI's Line Supervisor B notes that the following is added to the submission in support of a recommendation that Equitable's Chief Executive should receive an honour:

> *1993 returns – Funds under Management of £13 billions*
>
> *" " – New premium income was £920 millions*
>
> *Standard & Poor press release of 5/12/1994 rated Equitable's financial strength as "AA" (Excellent).*

24/04/1995 [entry 2] Equitable telephone DTI. According to Line Supervisor B's note of the call, Equitable's Appointed Actuary says that he accepts the points made in DTI's letter of 19/04/1995 regarding the critical illness policy. The Appointed Actuary asks if DTI would be inclined to accept that the product was Class III if there were a death benefit. The Line Supervisor says that this would be unlikely. The Society's Appointed Actuary '*admits that he had been trying to avoid putting it in Class IV for tax reasons'* and asks if Equitable could keep the existing business in Class III for the 1994 returns, as it was *'de minimis'* (i.e. of minor importance). The Line Supervisor agrees to this.

26/04/1995 Equitable write to DTI enclosing details of some changes they intend to make to the premium bases for Irish and German temporary assurances and annuities. Equitable explain that the new premium bases are being introduced to bring them into line with the bases already used, or those about to be used, in the United Kingdom. DTI copy the letter to GAD and ask if GAD have any comments.

28/04/1995 GAD's Scrutiny Strategy Working Party (a group, established in June 1994, made up of GAD actuaries and DTI supervisors and including Chief Actuary C and Line Manager A) report to Directing Actuary A and DTI's Head of Life Insurance on their work on the production of comparative information on the life insurance industry. The Working Party say that they have considered two possible approaches: to include comparative information within each company's detailed scrutiny report or to produce an annual report on the life insurance industry. The latter approach is recommended and the Working Party attach a suggested format for such a report.

Under *'Objectives'*, the Working Party report:

> *The longer-term objectives identified in our December 1994 report, relating to comparative information, were to provide DTI with:*
>
> *a) an understanding of how a company is performing in relation to its peers, and any problems this may cause if current trends in performance indicators continue*
>
> *b) the basis of understanding the problems facing the various sectors of the industry*
>
> *c) industry-wide analyses of certain key aspects of performance*

It was recognised that an annual report could be designed to meet these basic objectives but that it need not be restricted to these. In particular, such a report provided an opportunity to give a far wider perspective on the industry as a whole, something for which DTI had been looking for some time.

Following initial discussions with DTI, it became clear that the aim should be to provide a report that could be used for reference purposes by senior DTI management, and which would build into a useful series of documents over a number of years. In addition, the report was also seen as potentially useful to the GAD actuaries. They could cite the report when completing detailed scrutiny reports, to enable them to make more informed comments on a given company's relative performance.

The following items are listed as being useful potential contents:

- *an executive summary of the key points emerging from the report, generally at industry level but also commenting on individual companies or sectors, if required*
- *a background section, focussing on significant developments in the industry during the year*
- *analyses of new business, expenses and persistency*
- *analyses of free assets, maturity payouts and bonuses*
- *analyses of free assets and valuation bases*
- *remarks on compliance, press comment, etc.*
- *changes in composition of the industry, including new authorisations, take-overs, closures, mix of UK/overseas business, etc.*
- *views, opinions and predictions for the future.*

The Working Party report that some initial work has already been undertaken to produce a dummy report for the 1993 returns and that this would be progressed over the following three months. They say that feedback on the dummy report is to be given in August 1995, ahead of the commencement of work on the report on the 1994 returns.

The Working Party also hold a meeting on this day, at which there is a general discussion on the period with which companies are permitted to file their DTI returns. The minutes record: *'It was generally agreed that a reduction in this time would greatly improve the effectiveness of the detailed scrutiny process. However, it was recognised that this was not achievable without a change in legislation, and was, therefore, an impractical requirement, at least for the time being'.*

08/05/1995	The German regulatory authority write to DTI, enclosing a copy of a letter from Equitable about the mortality table and interest rates used for their German annuity plan (see 20/03/1995). Equitable have explained that they base the plan on the mortality table used in England and had no reason to assume that it could not be used for their German business. The regulatory authority ask DTI for a copy of the table. They comment that, in their view and in accordance with the Third Life Directive, Equitable should use a mortality table that takes into account the mortality of the annuitant in the country where they are selling the product.
16/05/1995	DTI write to Equitable to check that the 'state of play' report sent on 28/03/1995 also covers University Life.
19/05/1995 [entry 1]	Equitable confirm to DTI that, subject to certain specified provisos, the report does cover University Life.

19/05/1995 [entry 2]	Equitable's Chief Executive writes to DTI's Head of Life Insurance raising again Equitable's concerns about the taxation rules applying to overseas business. The Chief Executive encloses a copy of correspondence with a Minister and says Equitable have made no real progress. The Chief Executive asks the Head of Life Insurance to exert any influence he can. The Head of Life Insurance later notes on the letter that he does not see what more he can do at this stage.
19/05/1995 [entry 3]	GAD write to DTI to comment on Equitable's letter of 26/04/1995 in relation to the proposed bases for Irish and German business. GAD say that they are: *... concerned at the proposed reserving basis for mortality. I am particularly concerned at the term assurances, where a table of adjustments to the base table is provided. We would only consider this appropriate for the UK if current experience were produced to support the basis, and are more concerned for Eire. I note that* [Equitable's Appointed Actuary] *says the table of future improvements will not be used, but there is still the table headed "Age adjustments for* [Equitable] *experience". In addition the AIDS adjustment is unusual.* GAD recommend that these points are pursued with Equitable. GAD also note that they have no reason to challenge Equitable's view that they should use a UK mortality table for their business in Germany.
01/06/1995	DTI seek comments from GAD on the letter from the German regulatory authority of 08/05/1995.
05/06/1995	GAD write to DTI to acknowledge that Equitable have accepted the view that their critical illness policy is Class IV. But GAD question the comment made by Line Supervisor B (see 24/04/1995 [**entry 2**]) that the addition of a death benefit would not make the policy Class III. Line Supervisor B passes the note to Line Manager B and says she is loath to bring this up again, as Equitable have agreed to re-classify the policy as Class IV. The Manager's advice is: *'Let sleeping dogs lie!'*.
08/06/1995 [entry 1]	DTI write to Equitable in response to their letter of 26/04/1995. DTI ask Equitable to provide details of the experience they rely on when setting the mortality basis of the valuation reserves, and the grounds on which they have made specific age adjustments for the Republic of Ireland.
08/06/1995 [entry 2]	GAD provide DTI with comments on the German regulator's letter, requested on 01/06/1995. GAD advise that: *... it is our view that the mortality table for the premium basis is not covered by the 3rd Life Directive, and indeed is not subject to supervision of itself. We broadly concur with the BAV statement if applied to reserving bases; we would expect a UK Appointed Actuary to have regard to the local experience though we take the view that, where the amounts involved are not significant, the use of a UK table can be acceptable on de minimis grounds.*
16/06/1995	Equitable write to DTI in reply to their letter of 08/06/1995. The Society explains that it is relying on the UK experience, but that it will keep the matter under review as the business develops. Line Supervisor B passes a copy of the letter to GAD and seeks their comments.
28/06/1995	Equitable's Appointed Actuary writes to DTI, saying:

The Society has included a future profits implicit item of £249,985,000 in Form 9 of its annual returns to the DTI for the 1994 financial year. I am applying on behalf of the Society, therefore, for a further order under Section 68 of The Insurance Companies Act 1982 to allow that future profits implicit item to be counted towards the Society's required solvency margin on 31 December 1994.

Against this Line Supervisor B has written: *'I think he must mean 31/12/95?'.*

The Appointed Actuary says that the Society has used the future profits implicit item *'for the purpose of achieving equality between the total net value of policyholders' assets included in Form 9 (i.e. lines 21 + 31 – 24) and the corresponding total net asset value shown in the Society's Companies Act accounts'.*

The Appointed Actuary provides calculations in support of Equitable's application. These calculations include, for the estimated annual profits, that:

Year ending	*(A) Total surplus*	*(B) Exceptional items*	*(C) Surplus arising from solvency margin*	*(A)-(B)-(C) Ordinary surplus*
	£m	*£m*	*£m*	*£m*
31.12.90	*422.5*	*557.0*	*26.6*	*(161.1)*
31.12.91	*596.5*	*(13.2)*	*59.5*	*550.2*
31.12.92	*330.5*	*(46.0)*	*46.4*	*330.1*
31.12.93	*480.9*	*(1015.2)*	*178.5*	*1317.6*
31.12.94	*520.0*	*1245.9*	*19.3*	*(745.2)*
				1291.6

Average annual profit = 1291.6/5 = £258.3m

Note: *In 1990 and 1994 surplus was increased as a result of changes in valuation interest bases. In 1991, 1992 and 1993, surplus was decreased as a result of changes in valuation interest bases. Those changes in surplus are included as exceptional items in column (B) above.*

The calculations state that the average period to run for the Society's in-force contracts is nine years. The Appointed Actuary explains:

The periods to run have been reduced to take account of premature withdrawals based on the Society's recent experience of such withdrawals. In respect of retirement annuity and personal pension contracts for which a range of retirement ages is available, it has been assumed that retirement benefits are taken at the lowest possible age, or immediately if that age has already been attained.

The calculations suggest that the maximum future profits permissible is 50% of £258.3m multiplied by nine years – that being £1,162.4m.

Submission of the 1994 regulatory returns

30/06/1995 **Equitable submit their 1994 regulatory returns to DTI.** Whilst in the same format as in previous years, the returns are now required to be made with regard to the new valuation regulations as contained within ICR 1994. Accompanying the returns are copies of the Society's annual report and financial highlights and its statutory accounts, prepared in accordance with the Companies Act 1985 and both dated 22 March 1995.

Equitable also send DTI a declaration under section 94A of ICA 1982 and pay Insurance Fees of £20,250 in respect of their 1994 returns.

These documents include the following information about Equitable's business and about their financial position as at 31 December 1994.

Companies Act annual report and financial highlights
In their *President's Statement,* Equitable explain that 1994 had demonstrated the benefit of the with-profits system in smoothing out fluctuations in investment returns. Equitable say that they had been able to maintain the rates of reversionary bonus even though they had suffered negative investment returns. They also comment that possible pensions mis-selling costs are unlikely to be material.

In their *Management Report,* Equitable explain that with-profits policyholders have recently received notices of their bonuses and statements together with a letter explaining the approach to bonus allocation in 1994. They note that, in common with other such funds, Equitable's investment return for the year was negative and that it was in such conditions that the benefits of the with-profits system, with its ability to smooth short term peaks and troughs of investment performance, became apparent. They explain that the Directors had decided to allocate an overall rate of return of 10% for recurrent single premium with-profits pensions business. Equitable say their reversionary bonuses had mirrored gilt yields for many years and fallen in recent years as gilt yields declined. Equitable had maintained the reversionary bonus for 1993 as it was consistent with yields at the end of 1994.

Companies Act statutory accounts
Equitable's statutory accounts include a *Directors' Report for 1994.* The report includes an example of how bonuses are allocated to policies, which is as follows:

> *... the rate of declared bonus for personal pension plans for 1994 was £4% (1993 – £4%) which, with the rate of roll-up already guaranteed by the policy, gave an overall allocation of benefits in guaranteed form of just over 7½%.*
>
> *The total return allocated to this type of policy was 10% which was the rate which had applied for determining actual pay-outs during the course of 1994. The amount in excess of 7½% was in the form of final bonus which is a non-guaranteed addition and may be varied at any time before the policy benefits become contractually payable.*

The returns
Equitable's returns are again submitted in two parts covering Schedules 1, 3 and 6 and Schedule 4 to the ICAS Regulations 1983.

GAD's copy of the 1994 returns includes various annotations which were made by Scrutinising Actuary D during the scrutiny programme. For ease of reference, mention of these annotations is made here. However, I am satisfied that the annotations were made on or before 25/07/1995, at the time GAD prepared their A2 Initial Scrutiny check.

Schedule 1 (Balance sheet and profit and loss account)
As in previous years, Schedule 1 of Equitable's returns consists of Forms 9, 10, 13, 14 and 16. Form 9 summarises the Society's financial position at 31 December 1994 as follows:

Long term business admissible assets	*£13,551,281,000*
Total mathematical reserves (after distribution of surplus)	*£12,377,514,000*
Other insurance and non-insurance liabilities	*£256,265,000*
Available assets for long term business required minimum margin	*£917,502,000*
Future profits	*£249,985,000*
Total of available assets and implicit items	*£1,167,487,000*
Required minimum margin for long term business	*£494,616,000*
Explicit required minimum margin	*£82,436,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£835,066,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	*£672,871,000*

GAD annotate the form with the figure, on the appendix valuation basis, for *'Total mathematical reserves (after distribution of surplus)'*, being £12,077,193,000.

Equitable use for the first time a future profits implicit item of £250m.

Schedule 3 (Long term business: revenue account and additional information)
As in previous years, Schedule 3 consists of Forms 40 to 51, which have been supplemented by various notes providing further information about/explanation for the figures provided.

Form 45 shows that 47% of Equitable's non-linked assets are invested in equities, 8% in land and 40% in fixed and variable interest securities (compared with 43%, 7% and 43% respectively in 1993). A note to the Form explains that one of the yields shown in the Form (that for variable interest securities shown in line 5) would be higher if calculated in accordance with Regulation 69(6) of ICR 1994. GAD note that the yield would be 4.24% under the new regulations (rather than the figure of 2.76% stated in the Form). They also add the total yield shown on line 12 from the previous returns.

As in previous years, Equitable disclose in Form 46 that the gross redemption yields on fixed interest securities issued or guaranteed by any government or public authority are, for certain durations, higher than for those not issued or guaranteed by any government or public authority. GAD circle the gross redemption yields stated for fixed interest securities not issued or guaranteed by any government or public authority with redemption periods of between one to five and five to ten years. They also circle the figure supplied for the total yield for this group of assets and question whether it is *'low?'*.

In the notes to this part of the returns, Equitable disclose that no provision has been made for the contingent liability to tax on unrealised capital gains for non-linked business, which they have estimated as £21.9m.

Equitable disclose that they have been granted a section 68 Order permitting them to take into account a future profits implicit item with a value not exceeding £500m. The Society state that it has included an item of £249,985,000.

Equitable state that they have been granted a section 68 Order which permits them to include in aggregate form details of their *'Personalised Funds'* in Forms 49, 50, 51 and 57, instead of the separate details for each Personalised Fund required by the ICAS Regulations 1983.

Schedule 6 (Certificates by directors, actuary and auditors)
Three Equitable Directors provide the certification required by Regulation 26(a) of the ICAS Regulations 1983. Equitable's Appointed Actuary provides the certification required by Regulation 26(b) of the ICAS Regulations 1983. As required by Regulation 27 of the ICAS Regulations 1983, Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

Schedule 4 (Abstract of valuation report prepared by the Appointed Actuary)
Under the new valuation regulations, the calculation of the mathematical reserves must comply with Regulations 64 to 75. It is no longer possible to hold reserves calculated under a basis that does not comply with these regulations even where, in aggregate, the reserves are higher than if calculated in accordance with the regulations. As in previous years, Equitable present two valuations of their long term liabilities (their main and appendix valuations). The results of the main valuation are carried forward, unadjusted, from Form 58 to Form 14 and on to Form 9.

Schedule 4 – main valuation (text)
Schedule 4 of Equitable's returns answers the questions set out in paragraphs 1 to 19 of Schedule 4 to the ICAS Regulations 1983 and includes Forms 55 to 58 and Form 60. Equitable state that this valuation conforms to Regulation 64 of ICR 1994.

In response to paragraph 3 of Schedule 4, Equitable provide 20 pages of information about their non-linked contracts. Most of the information about the contracts remains unchanged from previous years. The increase in information from the previous returns is largely due to new German policies. GAD tick the descriptions provided, or otherwise note where there has been an addition or change in the information provided from the previous year.

As in previous years, Equitable provide a description of their principal guarantees of terms. GAD tick or mark as being new each of the descriptions provided.

In response to paragraph 4, Equitable provide 47 pages of information about their linked contracts. Most of the information about the contracts remains unchanged from the previous year. GAD tick the descriptions provided or otherwise note where there has been an addition or change in the information provided from the previous year.

In paragraph 5, on the general principles and methods adopted in the valuation, Equitable disclose that personal pension business has been valued on the basis that benefits are taken at age 55. This is the first time during the period under investigation that the retirement age assumption for personal pension business is disclosed in the main valuation.

Equitable disclose, in paragraph 5(1)(a), that they have tested the ability of the Society to hold reserves which satisfy Regulations 64 to 74 of ICR 1994 in the three scenarios of changed investment conditions described in DAA6. Equitable state:

> *In these conditions the Society would be able to set up reserves which satisfy* [Regulations 64 to 74 of ICR 1994] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued.*

GAD tick this paragraph.

(Note: the entry at line 51 of Form 14 was the excess of the value of admissible assets representing the long term fund over the amount of those funds and represented the difference between the market value and book value of those funds.)

As in previous years, Equitable state that, in determining the provision needed for resilience reserves and tax on unrealised gains, they have taken account of the fact that the long term fund has been valued at book value.

In paragraph 5(1)(e), Equitable disclose that a reserve for the prospective liability to tax on unrealised capital gains (losses) is held in respect of policies where benefits are linked to the Society's internal funds. They also disclose that the contingent liability for tax on unrealised capital gains in respect of non-linked business is estimated not to exceed £22m. The returns state that Equitable consider that there are sufficient margins in the valuation basis to cover the discounted value of this amount and, accordingly, they again hold no specific reserve. GAD note on the returns the figure for the previous year.

As in previous years, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity. GAD tick this paragraph.

As in previous years, in paragraph 5(1)(g) Equitable state:

> *The premium rate guarantees and options under the Society's policies are described in paragraph 3. Where the right to effect further policies without medical evidence of health is carried a reserve equal to one year's extra premium deemed or actually charged was set up. It was considered unnecessary in current conditions to make explicit provision for the other guarantees and options described in paragraph 3.*

GAD tick this paragraph.

As in previous years, in paragraph 6(1) Equitable disclose that, for certain non-profit deferred annuities, the valuation rates of interest used are those assumed in the premium basis. Equitable, again, do not elsewhere in the returns disclose the rates used in the premium basis.

Unlike previous years, in response to paragraph 7(b) of Schedule 4 to the ICAS Regulations 1983 (which asks in respect of non-linked contracts for a description of *'the method by which provision is made for expenses after premiums have ceased or where no future premiums are payable or where the method of valuation does not take credit for future premiums as an asset')*, Equitable explain the method by which they had made provision in the main valuation for future expenses on their recurrent single premium business:

> *For recurrent single premium business the valuation rates of interest shown in Form 55* [the valuation summary of non-linked contracts] *are net of a ½% interest rate reduction as a provision for future expenses.*

GAD mark this statement as *'New'*.

As in previous years, at paragraph 7(d) Equitable state:

> *A further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994. The resultant aggregate liability is less than the aggregate liability on the methods and bases described in this report. The report on the net premium valuation is given in an appendix following Form 60 of this report.*

GAD tick this paragraph.

As in previous years, in paragraph 11 Equitable disclose: *'The Society has no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund'.*

As in previous years, in paragraph 12 Equitable state: *'The Society has no shareholders and the principles upon which the distribution of profits among the policyholders is made are determined by the Directors in accordance with the Society's Articles of Association'.*

In paragraph 13, Equitable disclose that they had set the reversionary bonus for the main policy classes at 4.0%. As in previous years, Equitable disclose that they offered loans under a *'loanback'* arrangement to some retirement annuity and individual pension policyholders. GAD note that the wording of this paragraph has been revised.

In paragraph 16, Equitable set out their system for allocating final bonus. GAD tick various parts of this description, note the rates of bonus applying in the previous year, and mark where the wording is revised or new.

The returns again contain, at paragraph 16 (vi), the statement:

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

(Note: as for the 1993 returns (see 27/06/1994), in GAD's copy of the 1994 returns this paragraph has been sidelined in pencil. This marking is consistent with that made by Scrutinising Actuary E in the 1995 returns, during the scrutiny of the 1995 returns. (See 28/06/1996.))

<u>Schedule 4 – main valuation (forms)</u>
In Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts, along with information on number of contracts in force, the benefits guaranteed and the rates of interest and mortality assumptions used in valuing them.

In Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity and the rates of interest and mortality assumptions used in valuing them. Equitable again disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 58, Equitable set out the valuation result and the composition and distribution of fund surplus.

<u>Schedule 4 – appendix valuation (text)</u>
Equitable explain that the appendix valuation:

> *... was undertaken for the purposes of demonstrating that in aggregate the mathematical reserves determined by the valuation undertaken using the gross premium method, the results of which are reported on the preceding pages, are not less than an amount calculated in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994.*

Equitable's appendix valuation provides the information required by paragraphs 1, 5, 6, 7, 9, 17 and 18 of Schedule 4 to the ICAS Regulations 1983. They say that the information required for the other paragraphs (apart from paragraph 19 – being a statement of the required minimum margin in the form set out in Form 60 of Schedule 4 which, having had *'regard to the purpose of the valuation',* has not been provided) is identical to that given in the main valuation.

As in previous years, in response to paragraph 5(1)(a), Equitable state: *'In these conditions the Society would be able to set up reserves which satisfy* [Regulations 64 to 74 of ICR 1994] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued'.*

(Note: on GAD's copy of the returns, the words *'at line 51 of Form 14'* have been underlined in pencil (rather than the red ink used by Scrutinising Actuary D during his scrutiny of these returns). This marking is consistent with that made in the 1995 returns by Scrutinising Actuary E during his scrutiny of those returns. (See 28/06/1996.))

As in the main valuation, in paragraph 5(1)(e) Equitable state that no reserve is made for any prospective liability for tax on unrealised capital gains in respect of non-linked business. GAD sideline this statement.

As in the main valuation, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity.

As in previous years, in paragraph 5(1)(g) Equitable disclose the ages that retirement benefits could be taken on their recurrent single premium with-profits pension business. Equitable state that, for the purposes of the statutory minimum valuation, they now assume a retirement age for personal pension policies of 55 (increased from the previously assumed retirement age of 50).

As in the previous years, in paragraph 7(b) Equitable explain the method by which they have made provision in the appendix valuation for future expenses on their recurrent single premium business.

Schedule 4 – appendix valuation (forms)
In the appendix version of Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts on the appendix valuation basis. GAD note changes from the previous year's returns to some of the interest rates and mortality tables used.

In the appendix version of Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts on the appendix valuation basis.

05/07/1995 DTI ask GAD for their views on Equitable's section 68 Order application. DTI query if Equitable mean to use the Order, if granted, in their 1995 returns rather than their 1994 returns.

12/07/1995 A GAD actuary and member of their Scrutiny Strategy Working Party provides some analysis to another GAD actuary on the emerging draft *'Free assets & valuation bases'* section of their 1993 dummy report on the life insurance industry. (Note: the copy of the note that I have seen does not include all of the attachments referred to within the document.) The analysis held on file with this document includes data on the average gross valuation interest rates used by companies in their 1992 and 1993 returns. GAD's data shows:

1992		*1993*	
Lowest valuation interest rate	*3.74%*	*Lowest valuation interest rate*	*3.44%*
Highest valuation interest rate (excluding Equitable)	*6.87%*	*Highest valuation interest rate (excluding Equitable)*	*5.51%*
Equitable	*9.52%*	*Equitable*	*7.20%*

In commenting on GAD's work to attempt to evaluate the relative strength of companies' valuation bases (which is not attached to the document; however, see 30/08/1995), the GAD actuary says:

> *The "strength ratio" figures appear remarkably sensible. Equitable is silly because it uses a bonus reserve valuation method, I think.*

(Note: in relation to the GAD's comment that *'Equitable is silly'*, the bodies under investigation have told me that: *'This refers to the fact that the result of the calculation was odd for Equitable, as its "strength ratio" was not comparable to those for other companies* *because the valuation interest rates used in its calculation were those used in the bonus reserve valuation (the main valuation). These interest rates were significantly higher (and the "strength ratio" therefore correspondingly lower) than those for other companies, which used a net premium valuation, as reflected in the table shown in this entry. This was naturally the case, because the bonus reserve valuation allowed explicitly for future reversionary bonus whereas the net premium valuations used by other companies made implicit allowance for future reversionary bonus, in part through the use of a significantly lower valuation interest rate'.)*

17/07/1995 GAD provide DTI with comments on Equitable's section 68 Order request. GAD suggest that Equitable probably did mean to refer to using the Order in their 1994 returns, as the guidance note on implicit items requires a company using one to submit an application with the returns, covering at least the amount in the returns. GAD tell DTI that they assume, however, that this is also an application for the 1995 returns. GAD say:

> *This is a similar request to previously, in that not all the allowable amount is claimed. It is worth noting that Equitable are now, in part, using the order.*

GAD continue:

> *There does seem to be some confusion still regarding the exceptional items. The surplus or deficit arising from changes in the interest rates in the valuation basis appears to have been excluded from the calculation, but the covering letter refers to previous correspondence and states they are included. The conclusion of our (protracted) correspondence with* [Equitable's Appointed Actuary] *earlier this year* [see exchanges on the issue between 25/01/1995 and 27/03/1995] *was as described in his letter, and not as in the calculations. The result however does not impact the £500m requested implicit item, and this can properly be granted.*

GAD also comment that DTI need not take any action in response to the information Equitable supplied (see 16/06/1995) regarding Irish and German term assurances. However, that information *'is on record if there is any challenge from our friends in Germany'.*

24/07/1995 **GAD complete the A1 Initial Scrutiny check on the Society's 1994 regulatory returns.** The design of the form has changed and there is no longer an entry showing cover for the required minimum margin. GAD identify no concerns.

25/07/1995 **GAD complete the A2 Initial Scrutiny check on the Society's 1994 regulatory returns.** GAD note that the priority rating is 3, unchanged from the previous year. They note that the mortality rates look reasonable *'but thin'* and that Equitable have not set up any identifiable provision to meet personal pension transfer problems. Under '*Aspects which look worrying'*, GAD write *'Mismatching?'.* GAD also note:

> *Derivatives – investigate*
>
> *Ethical fund general investments*
>
> [paragraph] *4(2)(c)* [of Schedule 4 to the returns] *omitted*
>
> [capital gains tax] – *"sufficient margins"*
>
> *Check into mis-selling.*

GAD identify no items to notify to DTI, to be taken up immediately with Equitable. Accompanying the Initial Scrutiny check is a Form B – Initial Scrutiny Form, which includes certain key figures disclosed in the 1991 to 1994 returns.

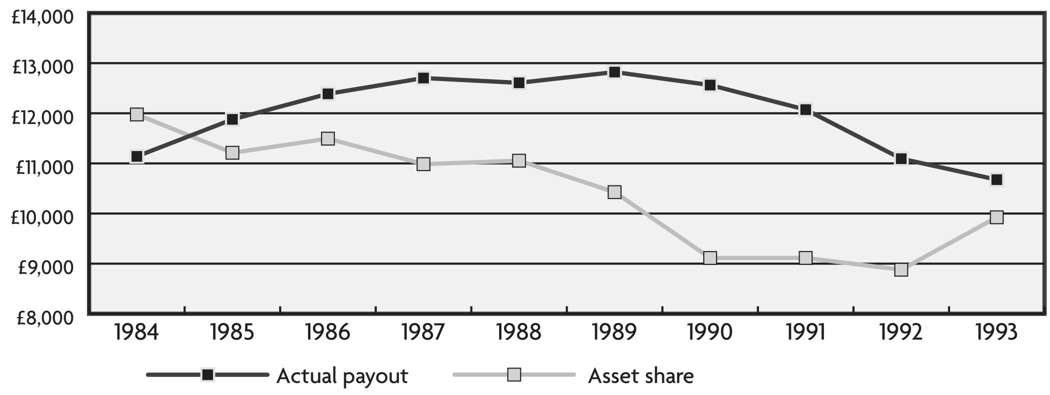
(Note: the Initial Scrutiny check was dated 25 July 1996, but this seems to have been a mistake.)

31/07/1995	DTI send GAD a copy of a draft letter to the German regulatory authority in response to their letter of 08/05/1995. The draft is based on the comments provided by GAD on 08/06/1995. DTI ask for any further comments. The final version, which was sent the same day, says: *Our view is that the mortality table for the premium basis is not explicitly covered by the Third Life Directive. Nor is it subject to supervision except insofar as it influences the adequacy of reserving bases which are indeed covered by Article 18(1)(c) of the Directive. We would expect a UK Appointed Actuary to have regard to the local experience – though as discussed between* [Directing Actuary A] *of the Government Actuary's Department and* [an official of the German regulatory authority] *(following your letter to us of 20 March 1995) we take the view that, where the amounts involved are not significant, the use of a UK mortality table would be acceptable. Where the volume is significant, (and unless the company's own experience in Germany justified an alternative assumption) we would expect the company to use a local table, or a suitably adjusted UK table that gave similar results.*
01/08/1995 [entry 1]	GAD's Directing Actuary A writes to Equitable's Appointed Actuary, inviting him to a reception *'for friends and colleagues whom I have had the pleasure of knowing over my actuarial career'* on the occasion of his retirement. (Note: I have been told that an invitation was also sent to approximately 200 other people in the actuarial profession and the insurance industry.)
01/08/1995 [entry 2]	DTI write to Equitable enclosing a section 68 Order, permitting them to include a future profits implicit item in their 1995 returns with a value not exceeding £500m. DTI point out that, before including any implicit items in the forthcoming returns, Equitable are required to update the calculations to ensure that the amount adopted is still justified.
02/08/1995	Line Supervisor B adds a note to DTI's copy of the letter of 01/08/1995 to record a telephone call from Equitable: *They weren't actually asking for a S.68 Order – just updating 94 calculations!* *But they will want an Order for £500m. He'll drop me a line confirming this ...*
03/08/1995	Equitable write and confirm to DTI that the information provided in the Society's letter of 28/06/1995 had been *'to demonstrate that the amount of £500m in the Section 68 order dated 22 December 1994 did not exceed that resulting from the revised calculations at 31 December 1994'*. The Society confirms that it is Equitable's intention to include a future profits implicit item in Form 9 of their returns for 31 December 1995, and that they would have applied for the Order on the basis of the calculations enclosed with the letter of 28/06/1995. Equitable explain that, in future when submitting their returns and updated calculations for one year, they would seek a section 68 Order for the subsequent year. Line Supervisor B notes on the letter: *'No action – but confirms my query re their reference to end '94 returns'*.
04/08/1995	Equitable's Appointed Actuary writes to GAD's Directing Actuary A to decline his invitation, as he would be away. The Appointed Actuary expresses the hope *'that we can get together for lunch some time'*.
30/08/1995	GAD's Scrutiny Strategy Working Party meet to discuss, amongst other matters, their 1993 dummy annual report on the life insurance industry. The attendees include Chief Actuary C and

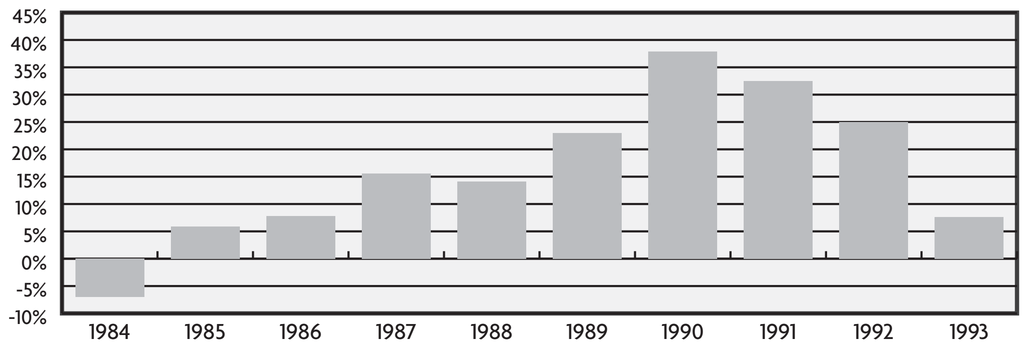
DTI's Line Manager A. Some of the completed draft sections of the report are circulated before the meeting.

For the section of the annual report on *'Maturity Payouts'*, GAD provide a description of the work undertaken so far, rather than the proposed draft text of this section. GAD explain that they have attempted to collate information on maturity payouts and to establish theoretical asset shares so that a comparison between the two can be made. GAD set out the '*heroic*' assumptions which they have used in conducting this analysis, for possible discussion by the Working Party. The results of this preliminary work are presented as follows:

Comparison of actual average maturity payout and theoretical asset share for the years 1984-93 for a £50 per month 10 year endowment policy

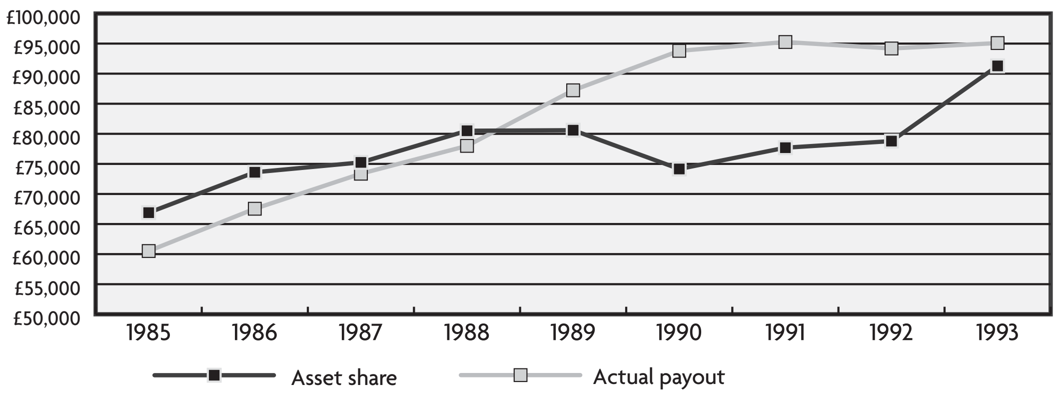


% departure of actual average maturity payout from theoretical asset share for the years 1984-93 for a £50 per month 10 year endowment policy

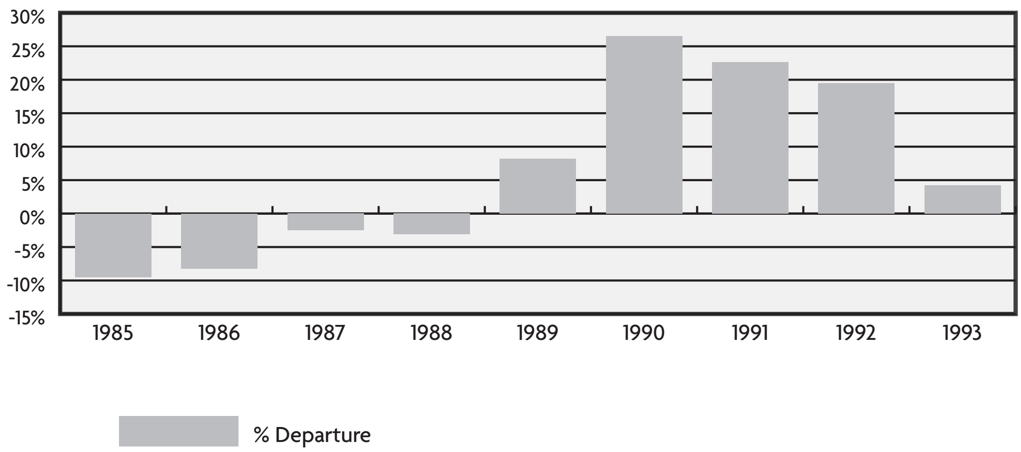


1995

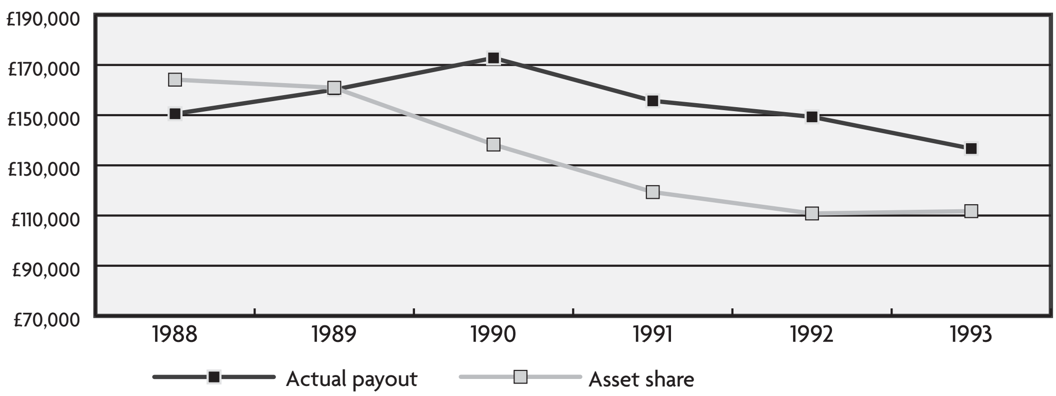
Comparison of actual average maturity payout and theoretical asset share for the years 1985-93 for a £50 per month 25 year endowment policy



% departure of actual average maturity payout from theoretical asset share for the years 1985-93 for a £50 per month 25 year endowment policy

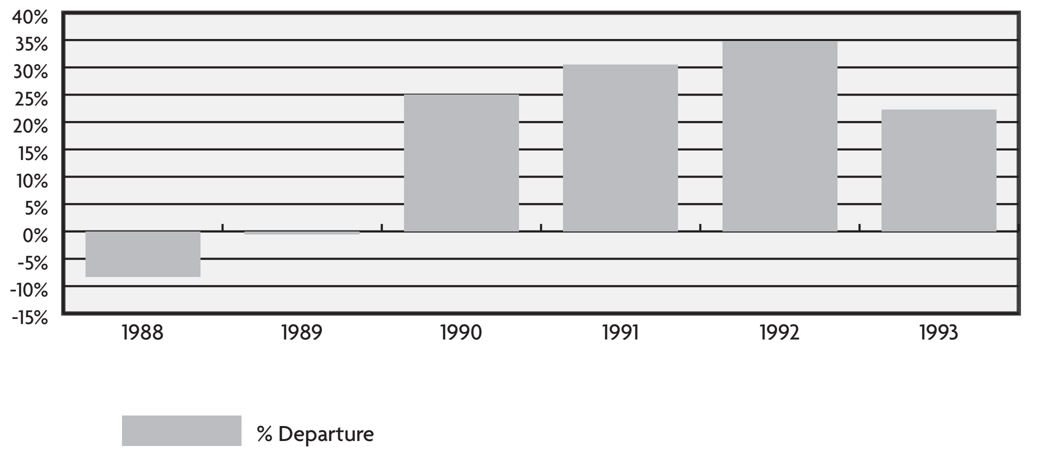


Comparison of actual average maturity payout and theoretical asset share for the years 1988-93 for a £200 per month 15 year pension policy



1995

% departure of actual average maturity payout from theoretical asset share for the years 1988-93 for a £200 per month 15 year pension policy



In the section on *'Free assets & valuation bases'*, GAD say: *'A broad-brush attempt has been made to assess the relative strengths of the valuation bases adopted by the major with profit offices'*. GAD explain the method they have used to do this as being:

> *First, the yield on the total non-linked assets shown in Form 45 has been adjusted upwards by stripping out the lowest yielding assets until such time as sufficient assets remain to exactly match the total non-linked liabilities, net of reinsurance, from Form 55.*
>
> *Second, an average valuation rate of interest in respect of the non-linked liabilities has been calculated. This is based on a weighted average of the actual rates used for the various classes of business, the weights being the corresponding net of reinsurance valuation reserves. Taxable business has been grossed up. For simplicity, a tax rate of 25% has been used throughout.*
>
> *Finally, the adjusted asset yield, reduced by the 7½% margin in the valuation of liability regulations applicable in 1993, is divided by the average valuation interest rate, and the result expressed as a percentage.*

The resulting percentages, which might be called "basis indices", provide a crude measure of the strength of the valuation basis used. The higher the basis index, the stronger (i.e. more cautious, less worrying) the valuation interest basis relative to the minimum prescribed by the regulations. The basis index figures for 1993 are shown in [an appendix], *and the companies with the highest and lowest figures are shown in* [the table below].

The dummy report then includes the following table:

Basis indices giving a crude measure of the strength of valuation bases used in 1993

Strongest:	*Sector*	*Ratio (%)*	*Weakest:*	*Sector*	*Ratio (%)*
[a company]	[...]	*162.3%*	[a company]	[...]	*107.9%*
[a company]	[...]	*154.1%*	[a company]	[...]	*105.2%*
[a company]	[...]	*153.0%*	[a company]	[...]	*104.0%*
[a company]	[...]	*148.5%*	[a company]	[...]	*103.9%*
[a company]	[...]	*143.7%*	[a company]	[...]	*103.6%*
[a company]	[...]	*139.9%*	[a company]	[...]	*96.3%*
[a company]	[...]	*139.1%*	[a company]	[...]	*94.8%*
[a company]	[...]	*136.7%*	[a company]	[...]	*91.7%*
[a company]	[...]	*135.5%*	[a company]	[...]	*90.7%*
[a company]	[...]	*131.3%*	Equitable	[mutual]	*66.8%*

I have seen from GAD's supporting documents that they had also calculated that the strength of Equitable's valuation basis for 1992 was 66.1% and for 1989 it was 69.4%. (However, see also the note at the end of this entry.)

GAD's report continues:

Within the limit of approximations inherent in the above method, a 100% figure indicates that the basis just complies with the regulations. Any company below 100% would normally have been closely monitored in the course of its detailed scrutiny, usually by examination of a "matching rectangle" to allow for hypothecation of different types of asset to different classes of business.

The highly simplified nature of the above approach requires these figures to be treated with caution. For example, the figure of 66.8% for Equitable Life results from their philosophy of effectively reserving for all future terminal bonus at currently declared rates. This should be regarded as indicative of strength rather than weakness, although the company is still out of line with the rest of the market.

The report says that GAD have repeated this analysis for the previous year to provide an indication of whether companies have strengthened or weakened their valuation bases. The report states that Equitable have strengthened their valuation basis by 1% between 1992 and 1993. For the period from 1989 to 1993, the report says that Equitable's valuation basis has been weakened by 4%.

At the meeting of the Working Party, GAD's Chief Actuary C asks DTI's Line Manager A to provide any further feedback on the report that he receives from DTI.

(Note: in relation to GAD's measurement the strength of Equitable's valuation bases, the bodies under investigation have told me that:

The dummy 1993 report was an internal GAD pilot and was not provided to the prudential regulator. This included an incorrect explanation for Equitable's low "basis index" of 66.8% that this "results from their philosophy of effectively reserving for all future terminal bonus at currently declared rates". The correct explanation is in fact that ... the valuation interest rates used in the calculation of Equitable's basis index were those *used in its bonus reserve valuation (the main valuation), which were significantly higher than those used by other companies, which used a net premium valuation.*

The comment should have referred not to Equitable reserving for future terminal bonus – which, in line with other companies, it did not do – but rather to the valuation on which the figure for Equitable was based making explicit provision for future reversionary bonus, unlike the valuations used by other companies. However, the essential point made – that the figure for Equitable was not comparable to those of other companies – was correct.

The error was corrected for the 1994 report, the first provided to the prudential regulator. This used the valuation interest rates used in Equitable's net premium valuation (the appendix valuation) to determine its "basis index", resulting in the marked increase in this index to 96.3% for 1994 recorded in the entry for 03/11/95. Had this approach also been used for the 1993 calculation, the corresponding index for 1993 would have been 99.6% (and 100.9% if allowance was additionally made for the resilience reserve required in the appendix valuation in that year).

No weight should be placed on the 66.8% basis index figure for 1993. It was not comparable to those of other companies, a point recognised by GAD at the time and stated in the 1993 dummy report. When it was adjusted to a basis comparable to other companies, it was close to 100% and did not give rise to any concern.

It would have been quite inappropriate for GAD to be influenced by the unadjusted index for 1993 when conducting its detailed scrutiny of the 1994 returns. This was because the 1993 index compared the weighted average valuation interest rate and the adjusted yield on the assets matching the reserves in the main valuation. That comparison was of no significance for the main valuation. This is because the main valuation was not required to comply with regulation 59 of the Insurance Companies Regulations 1994. It was required to comply only with the aggregate reserves test in regulation 54 of those Regulations.

The bodies under investigation have also told me it should be noted that: *'the charts selected for this entry all show maturity payouts for regular premium contracts only. By contrast, the bulk of Equitable's business was recurrent single premium. These charts therefore have very little significance for Equitable. This comment also applies to the corresponding charts provided in the reports prepared by GAD for subsequent years'.)*

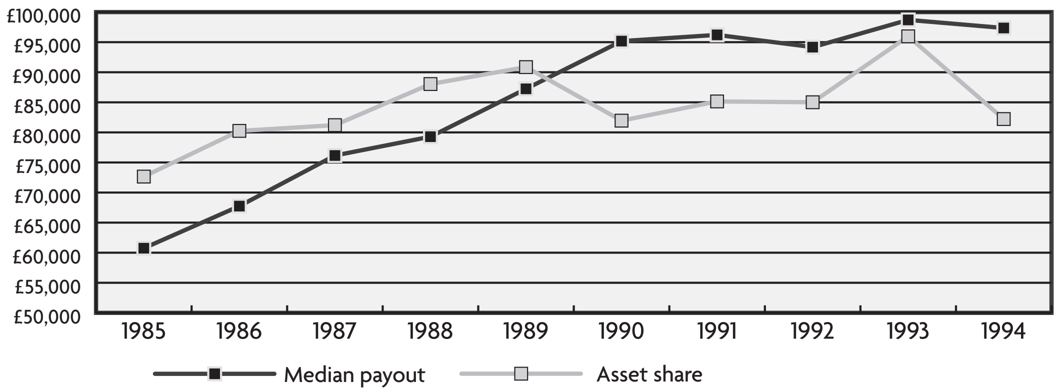
07/09/1995	Equitable apply to DTI for a section 68 Order exempting them from producing a Schedule 5 quinquennial statement of business within their 1995 returns. Equitable point out that it is intended to abolish this requirement from 1 January 1996, and that, in the meantime, companies had been invited by DTI to seek such an Order, if they wished.
25/09/1995	DTI send Equitable the requested section 68 Order.
28/09/1995	Equitable send DTI statistics on the business they have transacted in the Republic of Ireland and Germany (as required by the ICR 1994).
30/10/1995	GAD's Scrutiny Strategy Working Party meet to discuss progress on the production of their 1994 annual report on the life insurance industry. (Note: Scrutinising Actuary D is now a member of the Working Party.) GAD's note of the discussion records that Line Manager A asks for approximately 15 copies of the report for DTI. It is noted that GAD would need about 10 copies and it is agreed that 30 copies should be printed, *'which would give a few spares'*. It is agreed that copies of the report are to be prepared and distributed on 03/11/1995.

03/11/1995 According to the minutes of a meeting of GAD's Scrutiny Strategy Working Party held on 23/02/1996, GAD provide to DTI copies of their 1994 annual report on the life insurance industry *'as planned'*.

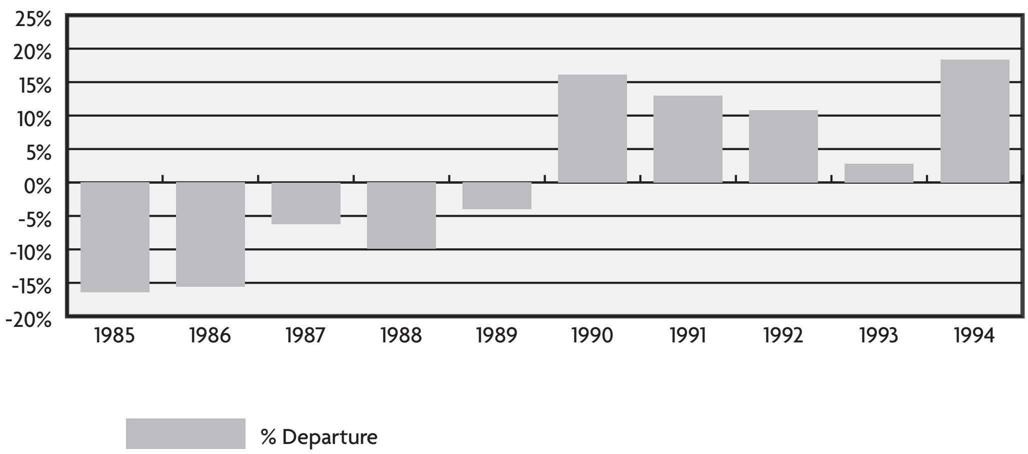
(Note: the bodies under investigation have been unable to provide me with a copy of this report. However, I have seen GAD's detailed analysis which underpinned this report, along with certain tables and charts which appear to have been prepared for use in the main body of the report.)

As in the 1993 dummy report (see 30/08/1995), GAD undertake a comparison of maturity payouts against their own estimate of theoretical asset shares. GAD produce the following charts:

Comparison of actual median maturity payout and theoretical asset share for the years 1985-94 for a £50 per month conventional with-profits 25 year endowment policy (£)

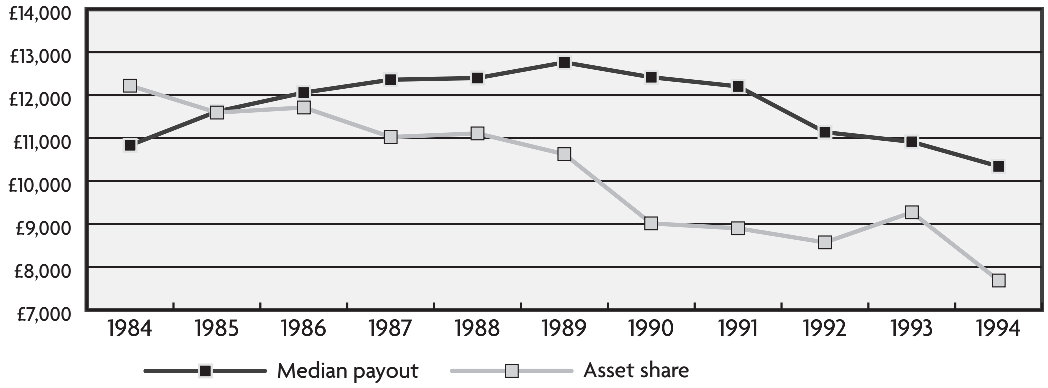


% departure of actual median maturity payout from theoretical asset share for the years 1985-94 for a £50 per month conventional with-profits 25 year endowment policy

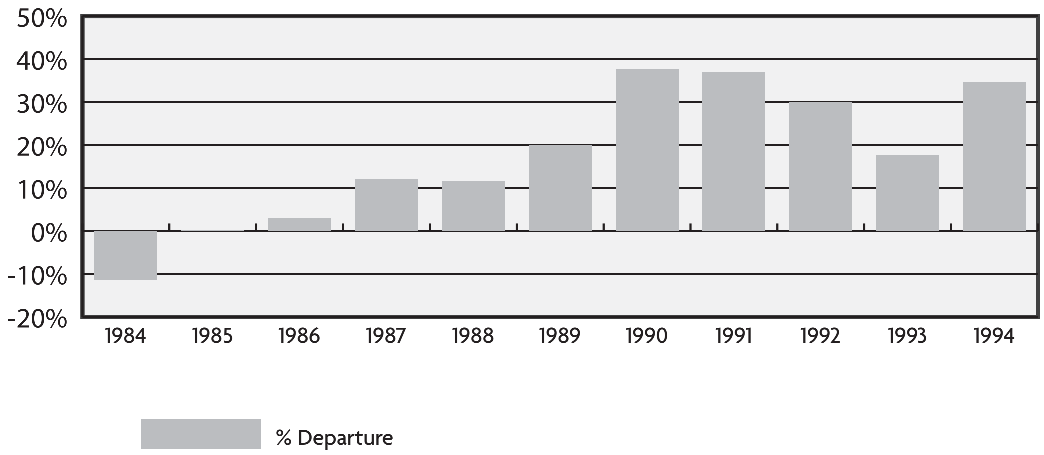


The supporting data shows that GAD calculate that, for endowment policies (based on contributions of £50 per month for 25 years), the with-profits industry median payout is £97,142. GAD calculate this to be 118% of the theoretical asset share. For Equitable, GAD calculate that they are paying £87,887. GAD show this to be 107% of the theoretical asset share.

Comparison of actual median maturity payout and theoretical asset share for the years 1984-94 for a £50 per month conventional with-profits 10 year endowment policy (£)

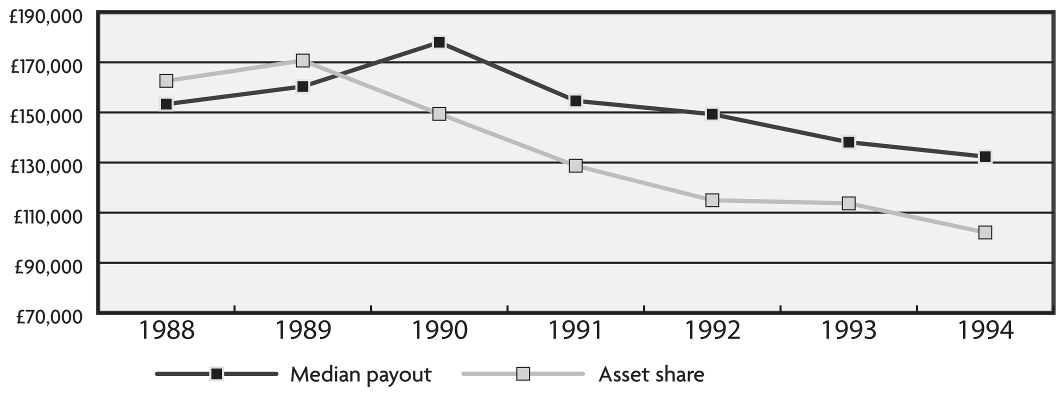


% departure from actual median maturity payout from theoretical asset share for the years 1984-94 for a £50 per month conventional with-profits 10 year endowment policy

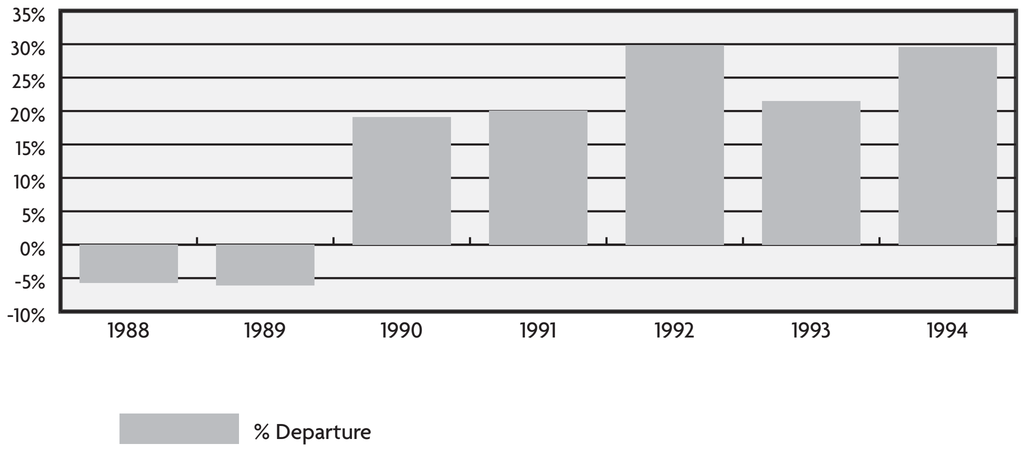


The supporting data shows that, for endowment policies (based on contributions of £50 per month for ten years), GAD calculate that the with-profits industry is paying a median maturity value of £10,322. GAD show this to be 134% of the theoretical asset share. For Equitable, GAD calculate that they are paying £10,575. GAD show this to be 138% of the theoretical asset share.

Comparison of actual median maturity payout and theoretical asset share for the years 1988-94 for a £200 per month conventional with-profits 15 year pension policy (£)



% departure of actual median maturity payout from theoretical asset share for the years 1988-94 for a £200 per month conventional with-profits 15 year pension policy



The supporting data shows that, for pension policies (based on contributions of £200 per month for 15 years), GAD calculate that the with-profits industry is paying a median maturity value of £133,605. GAD show this to be 131% of the theoretical asset share. For Equitable, GAD calculate that they are paying £145,338. GAD show this to be 142% of the theoretical asset share.

GAD carry out a similar analysis of the strength of companies' valuation bases as that used in the 1993 dummy report (see 30/08/1995). However, for these returns GAD assess the strength of Equitable's appendix (i.e. net premium) valuation, rather than the Society's main (i.e. gross premium) valuation which was not comparable to the valuation method used by most other life insurance companies. Their analysis again shows that Equitable have the weakest valuation basis with a figure of 96.3% (a figure of 100% being one that GAD had previously described as indicating that the valuation interest rates used only just complied with the regulations). I have seen from GAD's supporting documents that they had also calculated the strength of Equitable's net premium valuation basis for 1993, and that it was 102.1%.

(Note: the bodies under investigation have told me that it should be noted that: *'the charts selected for this entry all show maturity payouts for regular premium contracts only. By contrast, the bulk of Equitable's business was recurrent single premium. These charts therefore have very little significance for Equitable. This comment also applies to the corresponding charts provided in the reports prepared by GAD for* [other] *years'.)*

06/11/1995	DTI's Line Supervisor B receives a note of a telephone call from an Equitable policyholder asking what DTI were doing about Equitable's poor financial position, as reported recently in a newspaper. The official who dealt with the call explains that he *'took the usual line that we do not reveal any regulatory action we take or may consider taking'*.
08/11/1995	Line Supervisor B obtains a copy of the article in question. The article suggests that Equitable were being secretive about their financial strength and were refusing to reveal the amount of cash they held in reserve. The Line Supervisor passes the article to Line Manager B, commenting: *I know* [Equitable] *has a different way of calculating their reserves than most* [companies] *– but surely their financial strength <u>can</u> be ascertained from the DTI returns – albeit ... not necessarily from Form 9. Otherwise how* [would Standard & Poor's] *be able to give them such a good rating?*
09/11/1995	DTI send GAD a copy of the article. DTI seek advice, saying: *I know* [Equitable] *has a different way of calculating their reserves than most companies, and there has been press criticism of their apparent low free asset ratio in the past. But surely there is a way for an advisor or commentator to see that they are financially strong? (Presumably Standard & Poor's know what to look for – or they wouldn't have given them a good rating.) Can one point to anything particular in the DTI returns, apart from Form 9?* There is no evidence of a reply from GAD. Line Supervisor B passes Line Manager B a newspaper article about problems with the selling of managed annuities. The Line Manager comments: *'Interesting, but if it comes to the crunch I think it is for the PIA rather than us'*. The Line Supervisor passes to Line Manager B a copy of an article, which had appeared in a financial journal on 21/09/1995, criticising Equitable's practice of imposing high penalties on policyholders seeking to transfer their pension funds to another provider. Line Supervisor B comments: *'I meant to show you this earlier.* [Equitable] *is suffering from a poor press recently!'*. The Line Manager comments in return: *'There seems to be a prima facie case that these penalties run counter to PRE.* [Please] *ask for GAD's comments. Is this a standard industry practice?'*. The Line Supervisor passes the papers to GAD seeking their comments. It appears that GAD advise DTI to check the position directly with Equitable.
06/12/1995	DTI write to Equitable to seek their comments on the article in the financial journal about transfer penalties. DTI say the article *'refers to an* [independent financial adviser's] *client who was over 60 with a pension fund of £470,000. When he wanted to take out* [a pension in a small self-administered scheme], *the article says that the Equitable Life imposed a 15% penalty'*. DTI ask Equitable to confirm whether this is factually correct.
08/12/1995	GAD write to Equitable to suggest that the 1994 returns show that Equitable make *'significant use of derivatives on a regular basis'*. GAD explain that it will help them in their examination of the returns to understand better the investment guidelines and controls that Equitable apply. GAD ask a series of detailed questions about Equitable's approach.

14/12/1995 [entry 1] Equitable write to DTI in response to their letter of 06/12/1995 about the article in the financial journal. Equitable say:

> *The article to which you refer was unfortunately a biased piece of journalism. You will be aware that the Society's pension plans guarantee full value on retirement or earlier death. There are no guarantees on surrender or transfer for deferred benefits. What we do pay is a value based on the underlying assets – the adjustment made is expressed as a deduction from the full retirement fund value on the day of transfer. In that respect, the adjustment is a financial adjustment and is certainly not a penalty.*

Equitable enclose a copy of their leaflet *'The Society's Approach to Transfers and Switches from With-Profits Personal (and Other) Pension Contracts'.* The leaflet says:

> *The Society has not guaranteed the amount of a surrender (or transfer) value since 1762. Our approach today to surrender of with-profits policies is still to offer no guaranteed values.*
>
> *What we do offer, however, is a clear and unequivocal statement of the procedure for calculating the transfer and to apply it systematically and fairly across the board. The general approach is to take the benefits currently attaching to the policy as the starting point for the calculation.*
>
> *For with-profits it is the full value of the fund value attaching or, when markets are running behind the rate of build up of the with-profits fund, the Society's estimate of the market value of the assets supporting the fund value.*

In explaining the background to with-profits business, in contrast to unit-linked policyholders who take their own investment risk, the leaflet says:

> *For with-profits business, the policyholder joins in a common managed fund whose returns are averaged. Each policyholder benefits at the same rate as other policyholders in the class. On occasions the averaged return allotted falls behind the return actually earned in the period, while at other times it exceeds the return earned, depending upon market conditions. On contractual termination of the policy, the full averaged return allocated is paid out regardless of the market value.*

The leaflet continues:

> *In other words, with-profits policyholders share the risk between them. Whilst it would be desirable to pay out full value on non-contractual termination there are financial conditions when to do so would be to favour the outgoing policyholder at the expense of those remaining in the fund. That would be quite inequitable – hence the use of the MVA.*

The leaflet states:

> *The Society's with-profits pension policies guarantee that the full policy value is available on retirement at any age or prior to death.*

And explains:

> *We are able to offer those guarantees because we can model the expected number of policies coming into payment and so estimate the cost implications. In this way, by sharing the investment risks amongst the pool of with-profits policyholders, the guarantees implicit in the system can be honoured.*

The leaflet then says:

> *We are unable to offer such a guarantee of the value available if a client selects against the other with-profits members by choosing to discontinue the policy and to transfer from the with-profits fund because no reasonable allowance can be made for such self-selection in the estimates. Such guarantees would open up the possibility for clients to time the withdrawal of funds to maximise the benefits of smoothing, thereby gaining at the expense of the remaining policyholders. For example, it would be possible to withdraw when the returns allocated are greater than those actually earned. The inevitable result would ultimately be a reduction in policy values for those clients who, as the majority, continue their policies until retirement or maturity. That would clearly be unfair.*

Equitable set out in their leaflet a comparison of the annual returns on the with-profits fund against the smoothed returns allotted.

Under the heading *'Current basis',* Equitable say that, as at September 1995, their financial adjustment is calculated as follows:

> *Up until 31 December 1993, the accumulated returns allocated were broadly in balance with the accumulated return earned over various periods of time. During 1994, the Society earned about -4% on its assets but allocated 10% for the year. In other words, earnings for 1994 ran 14% behind allocations. To date, in 1995, 11% has been earned and policies have accumulated at about 7%, hence earnings have run 4% ahead of allocations. The basis currently used is therefore to deduct 10% of the 31 December 1994 value from the current claim value to reflect the shortfall of earnings in 1994 compensated in part by excess earnings in 1995 to date. This adjustment is therefore intended to bring the value on surrender or transfer broadly in line with the market value of the underlying assets.*

Equitable's leaflet concludes:

> *The approach demonstrates the Society's stated practice of giving policyholders fair returns based on their participation in the with-profits fund. It is worth remembering that the following basic features of our contract remain true:*
>
> - *full value on death for our main pension contracts;*
> - *full value on retirement at any age;*
> - *full value for existing funds which remain with the Society should premiums have to stop for any reason.*

14/12/1995 [entry 2] Equitable write to GAD in response to their letter of 08/12/1995. Equitable confess:

> *... to some surprise at having received it. As shown in our 1994 Returns our maximum exposure to derivatives at 31 December 1994 was £15.8m and had not been materially different during the year. That is only around 0.1% of our assets. I would hardly have called that "significant".*

Equitable enclose a copy of their *'State of Play Report at 31 March 1995'* which they had submitted to DTI on 28/03/1995. Equitable say this should answer GAD's questions.

18/12/1995 DTI pass a copy of Equitable's letter of 14/12/1995 on transfers to GAD and ask if they have any comments. DTI record that answer as being *'No!'* (however, see 24/01/1996).

1996

23/01/1996[entry 1] **GAD provide DTI with their detailed scrutiny report on the Society's 1994 regulatory returns.** (A copy of this scrutiny report is reproduced in full within Part 4 of this report.) The report uses the detailed format adopted for the 1993 returns (see 15/11/1994 [**entry 1**]) and comprises 13 sections as follows:

(1) Summary
Under *'Key features'*, GAD state that Equitable are the seventh largest company, measured in terms of long term business. GAD explain that Equitable are classified as priority 3, unchanged from the previous year. They note that: *'Rather unusually, especially since the recent disappearance of* [another mutual company], *the company publishes a gross premium bonus reserve valuation, and a net premium comparison'*. GAD also note that Equitable have used a *'small'* future profits implicit item for the first time; that their pensions business *'is somewhat unusually structured in that it is almost all on a recurrent single premium basis';* and that *'reserving bases are weak, by design, to maximise the free asset ratio. Nonetheless, this has fallen in 1994'*.

Under *'Action points'*, GAD note that they had derived much useful information the previous year from Equitable's With-Profits Guide. However, as GAD only have the May 1994 edition, they have requested a later version. (Note: GAD had previously asked Equitable to send this document routinely, and Equitable had agreed to do so: see 28/03 and 07/04/1994). GAD state that they *'have also raised a number of areas of greater or lesser concern, pre-eminent amongst which are mortality bases for annuitants and interest rates used in the valuation'*.

(2) Background
GAD repeat information included in the Background section of their report on the 1993 returns, namely that Equitable are the oldest mutual life assurance society in the world, that they never pay commission to third parties, and that they have a:

> *... somewhat unusual approach to bonuses, unit linked products (which often have discretionary surrender values) and valuation using a gross premium bonus reserve method. The DTI returns also show the results of applying a net premium basis with assumptions close to the minimum permitted by the regulations.*

GAD note that, as well as using a future profits implicit item for the first time in 1994 to the value of £250m, Equitable have obtained a section 68 Order in the sum of £500m for use in the 1995 returns.

GAD explain that Equitable have been active overseas in recent years (in Guernsey, the Republic of Ireland and Germany) and that these branches are producing ever increasing amounts of new business. GAD state:

> *The impression we have been given is that the Equitable regard this as an exercise in extending the numbers of people who can benefit from the Society as an institution. It is almost like missionary work, rather than a purely commercial move in the interests of UK policyholders, for example. The mutual concept is extended to all policyholders, and indeed is even part of Equitable's dealing with UK non profit policyholders.*

GAD also note that they and DTI visited Equitable in December 1994 (see 09/12/1994 [**entry 2**]) and that: *'The Appointed Actuary and Managing Director posts are both held by* [the same person], *who is due to retire within a few years (though it is dangerous to speculate exactly when!)'*.

(3) New business
GAD provide details of the new products Equitable have developed and produce two tables setting out the regular and single premiums which Equitable have received for the various classes of policies sold from 1990 to 1994. GAD produce a third table, showing the year on year increase in new business over the same period.

In a commentary on the figures, GAD state that *'new business results for Equitable are once again strong'* and '[there] *will have been a material strain in 1994 associated with the new business, especially in a year of declining market values of assets'*. GAD explain that the sales figures are *'somewhat strange, however, in that a great volume of pension business is regarded as recurrent single premium. This is reported in the year of issue as regular premium, in accordance with the guidance notes, but it does not appear in form 43* [of the returns] *as regular premium'*.

GAD add:

> *The annual report on the industry showed Equitable as one of the success stories of 1994. It was ranked only 27th for new life business, but was 1st in pensions and 3rd in the combined table. In terms of growth, it ranked 8th, and was the top mutual office. It held the same place over the period 1989 to 1994 ...*

(4) Changes in business in force
GAD produce a table showing the recent history of regular premiums. They comment that there has been a continued rise in regular premiums, which is helpful in keeping the expense ratio low. GAD note that this is *'clearly a virtuous circle'*.

Under *'Claims experience'*, GAD produce a table showing the recent history of mortality rates. They comment:

> *It is not possible from the DTI return to form any view on the mortality experience of annuitants. This was the subject of correspondence with the company in recent times, partly prompted by an enquiry from the BAV on the business being written in Germany. We are returning to this issue again in the light of recently published data.*

Under *'Persistency experience'*, GAD produce tables showing lapse rates and surrender and paid up conversion rates.

(5) Expenses
GAD produce a table showing the history of expenses from 1990 to 1994. GAD comment that Equitable again compare very well with the industry as a whole and that their expense ratios have now reached *'astonishingly low levels'*. GAD explain:

> *Equitable is well known as a non-commission paying office, and prides itself in its low expense ratio. It is a very positive marketing message, and a key attraction of the Society with its customers. It helps explain the positive sales figures in a poor time for most of its competitors, and* [is] *part of a virtuous circle.*

(6) Non-linked assets
GAD produce tables showing Equitable's mix of assets at the year end, their recent history of allocation of new money (based on Equitable's own figures), their recent history of yields, and the assets attributable to with-profits business (Note: this was said to be taken from Equitable's *'latest available'* With-Profits Guide, although the later guide, dated July 1995, was available at that time). They comment again that the most noteworthy feature of the latter is the shift towards a higher fixed interest component. They calculate from information contained in the returns that the rate of return from investment for 1994 was -5.0%. Against this, GAD note Equitable's own figure for the return on the with-profits fund of -4.2%.

(7) Unit-linked funds
GAD provide brief details of this class of business.

(8) Valuation and solvency
Under *'Strengths and/or weaknesses'*, GAD first provide an overview:

> *It is known from the company visit at the end of 1994 that Equitable's Actuary has decided that the interests of the Society are best served by using a weak valuation basis to show as strong a free asset position as is possible. This means that the valuation basis is selected at the limits of the regulations. This requires us to exercise particular vigilance in ensuring that users of the returns are not misled. Additionally, the Equitable has a full distribution policy. Although one should not, perhaps, be critical of this per se, it does mean that the Society is more vulnerable than many to adverse conditions. The low free asset ratio means that there is comparatively little to spare if the reserves do prove inadequate.*
>
> *There are, however, a number of hidden strengths in the valuation. Principal amongst these is the treatment of recurrent single premium pensions business. This is assumed to pay no more premiums, and this is an extremely strong basis, though arguably only in line with the best practice. If the business were treated as regular premium, margins in future premiums and charges on the funds built up might allow some lower reserves. It is likely that some credit is being taken implicitly for this in the expense reserves ...*

GAD go on to discuss four particular areas:

Mortality — GAD explain that they are satisfied with the bases used for Assurances, Annuities — pension, and German business. For Annuities — general, GAD explain that Equitable use a mortality table *'well in excess of recent industry experience, and although the Appointed Actuary claimed to be able to justify this last year, we are pressing him quite vigorously on this point this year'*.

Valuation rates of interest — GAD produce tables showing the interest rates used for major classes and compare those with assets and yields. The scrutiny report is as follows:

> *The following table summarises the interest rates used, in general terms, for major classes (with liabilities in excess of £50m).*

Classes	*Net Interest Rate*	*Gross Interest Rate**	*Approximate Liability (£m)*
UK with profit assurances	*3.25%*	*4.06%*	*270*
UK unitised with profit assurances	*4.25%*	*5.31%*	*633*
UK with profit general annuities in payment	*5.75%*	*5.75%*	*155*
UK non profit general annuities in payment	*8.50%*	*8.50%*	*90*
UK pensions with profit – regular premium	*5.00%*	*5.00%*	*208*
UK pensions unitised with profit style	*5.75%*	*5.75%*	*7,499*
UK pensions non profit – main classes	*8.50%*	*8.50%*	*1,481*

** grossed up at 20% tax for with profit assurances and 25% for non profit assurances.*

Comparing this table with the assets and yields as below, gives rise to some doubts as to the sufficiency of higher yielding assets, particularly [once] *a yield differential for risk is included.*

Category of Assets	*Value of Admissible Assets (£m)*	*Yield*
Land	*1,014*	*6.82%*
Gilts etc	*3,380*	*8.92%*
Other fixed interest	*1,313*	*7.51%*
Indexed Gilts	*300*	*4.24%*
Other variable interest	*12*	*5.34%*
Equities	*5,834*	*3.34%*
Debts secured on land	*16*	*7.70%*
Other	*253*	*4.78%*

It is far from clear how this asset yield pattern will allow such a high rate of interest for the with profits business, if the non profit business takes the highest yielding assets to support its valuation rate. We are therefore seeking a thorough matching rectangle in the format under the proposed new Accounts and Statements regulations.

Expenses – GAD state that these are well controlled and falling and that *'There is little reason to question the low expense allowances in the valuation, therefore. A substantial hidden margin in respect of the pensions recurrent single premium business covers any apparent shortfall'.*

Resilience and special reserves – GAD explain:

The Equitable takes advantage of its use of a bonus reserve gross premium valuation to hide its resilience reserve. The difference between the net premium valuation and the gross premium valuation results is its resilience reserve (or at least a substantial part of that difference). They do not disclose how much. This will be asked for yet again. Other reserves seem to be on a reasonable basis.

Under *'Changes since previous year'*, GAD note that Equitable made small amendments to the reserves held for future bonuses under the net premium basis and that interest rate bases were revised to absorb some of the effect of rising interest rates and falling asset values. They note: *'Pension annuitant mortality was strengthened from a very weak basis to an acceptable one. The old basis would not, given recent publications, have continued to be defensible'.*

Under *'Summary of results for main classes'*, GAD provide three tables showing liabilities for linked and non-linked business and a valuation summary. The latter covers the years 1992, 1993 and 1994 and includes figures from both the main and appendix valuations. For 1994, this information is presented as follows:

	1994 BRV £m	*1994 NPV £m*
Non-linked liability	*10,932.1*	*10,651.2*
Linked liability	*1,095.7*	*1,095.8*
Bonus Reserves	*349.6*	*330.2*
Total [mathematical] *reserves*	*12,377.5*	*12,077.2*
Additional Reserves	*0*	*????‡*
Other liabilities	*256.3*	*256.3*
Total liability	*12,633.8*	*????‡*
Long term assets	*13,551.3*	*13,551.3*
Shareholders' assets	*0*	*0*
Available assets	*917.5*	*????‡*
Implicit items	*250.0*	*250.0*
Total amount available	*1,167.5*	*????‡*
Required Minimum Margin	*494.6*	*????‡*
Cover	*2.36x*	*????‡*
Free asset ratio	*3.1%*	*????‡*

> *‡ The amount of resilience reserve is not known for 1994. It is possibly sufficient to make the difference between the* [bonus reserve valuation] *and* [net premium valuation] *zero, but we have no way of telling until the answer to our enquiry is received.*

GAD's table shows that, under the bonus reserve valuation, Equitable's free asset ratio had fallen from 9.4% in 1993 to 3.1% in 1994.

Under *'Cover for the solvency margin'*, GAD comment:

> *It is not possible at present to calculate the net premium basis cover for the required minimum margin, but the gross premium cover is stated as higher. The cover with the implicit item included amounts to 2.36x, and if the implicit item had not been included it would have been 1.85x. The market reaction to the free assets falling to the level shown in our table (3.12%) as opposed to the free asset ratio often used including the implicit item (4.97%) might have been similar to that when* [another mutual life company] *revealed a low figure. Note that the section 68 order actually allowed an item up to £500m.*
>
> *The cover may not be huge, but it is adequate, provided the Appointed Actuary can satisfactorily defend his basis from the questions we have raised.*

(Note: the returns stated that the mathematical reserves established using the gross premium valuation method as presented in the main body of Schedule 4 of the returns were at least as high as would be required when using an appropriate valuation method. The returns did not state that the cover for the required minimum margin under the gross premium valuation was higher.)

(9) Financial results
This section is made up of the following table:

Surplus emerging

Gross Premium Basis	*1990*	*1991*	*1992*	*1993*	*1994*
Surplus emerging (£000s)	*422,489*	*596,501*	*330,523*	*480,935*	*519,981*

(10) Bonuses

Under *'Cost of bonuses declared'*, GAD include the following table:

Cost in £000s (on Gross Premium Valuation)	*1990*	*1991*	*1992*	*1993*	*1994*
Reversionary Bonus	*268,534*	*304,459*	*298,582*	*317,509*	*349,647*
Terminal and other bonuses in anticipation of a surplus	*154,725*	*151,565*	*167,898*	*165,053*	*173,541*
Total Distributed	*425,249*	*458,015*	*468,472*	*484,555*	*525,182*

GAD repeat the description of Equitable's final bonus system used in their report on the 1993 returns (see 15/11/1994 [**entry 1**]). GAD also repeat Equitable's own description of their final bonus system and again provide three tables of statistics showing changes in reversionary and final bonus rates. GAD reproduce Equitable's table of the actual investment returns on gross market value and the rate allocated in fixing bonuses, updated to include 1994:

	1990	*1991*	*1992*	*1993*	*1994*
Actual	*–8.3%*	*13.5%*	*17.1%*	*28.8%*	*–4.2%†*
Allocated	*12%*	*12%*	*10%**	*13%*	*10%†*

' 12% on new benefits secured during the year*
† figures from annual report, not With-Profits Guide'

GAD repeat their comments on Equitable's distribution policy made in their report on the 1993 returns (see 15/11/1994 [**entry 1**]), stating again that the reductions in reversionary bonus rates over recent years have influenced policyholders' reasonable expectations downwards in line with yields.

(11) Reinsurance
GAD state that Equitable make little use of reassurance.

(12) Compliance
GAD state:

> *Although the Equitable take a highly esoteric line on a number of issues, and are inclined to argue their case rather longer than most, they have a culture which would not permit the continuation of a compliance breach.*
>
> *There are some small omissions from Schedule 4 relating to a new fund and question 4(2)(c)* [of Schedule 4 of the returns]. *These are not all mentioned in our letter, and we do not feel they are of sufficient significance for DTI action, especially as elsewhere the actuary does provide the information on derivatives (under 4(2)(a)).*

They are reporting business believed by us and DTI to be class IV as class III, but have undertaken to revise this in future. This will have trivially understated the required minimum margin.

Under *'PIA and other compliance problems'* GAD note that: *'Although they have had a few issues, we understand, they are not significant'*.

(13) Miscellaneous
On mis-selling of pensions, GAD comment:

It looks from the outside as if it is almost impossible for Equitable to conceive that any of their salesmen could have mis-sold anything – or at least they could not publicly acknowledge it! There is no explicit provision, but we understand from Equitable's reply to [DTI's] *letter* [see 19/04/1995] *that £50m has been set aside by an "over-estimation" of the liabilities, and this has been accepted under the "true and fair view" accounts sign-off, despite the lack of any sophisticated supporting calculations.*

GAD also explain that they have asked Equitable about the Society's use of derivatives (see 08/12/1995) as this was quite high. (Note: but see Equitable's reply of 14/12/1995.)

Finally, GAD comment that Equitable were probably the first insurance company to publish their accounts in the new statutory form. GAD note:

Deferred acquisition costs of £219.1m are shown in the accounts. These are not, of course, admissible in the DTI return. It is a matter of debate how meaningful these deferred acquisition costs are in any life assurer, and here less than 60% of acquisition costs are deferred. The total figure represents almost 19% of the "Fund for Future Appropriations" in Equitable Life.

GAD's scrutiny report runs to 20 pages. DTI's Line Supervisor B copies the report to the Head of Life Insurance and to Line Manager B.

23/01/1996 [entry 2] GAD write to Equitable with questions from their scrutiny of the 1994 returns. GAD:

(1) ask for a copy of the current With-Profits Guide and request that Equitable send a further copy whenever the document is updated;

(2) challenge the mortality tables used by Equitable which GAD consider to be over-optimistic. GAD also ask Equitable to *'indicate how you feel the future improvement in annuitant mortality is catered for in this choice of basis, and what margins you believe are included for adverse deviations'*;

(3) seek additional information, in the form of a matching rectangle, to support the rates of interest used in the alternative net premium valuation contained in the appendix to Schedule 4 of the returns (and enclose a copy of a draft form for the presentation of the results);

(4) ask, in relation to the net premium valuation, *'what would be the increased reserves on that basis if explicit provision were made for the resilience test referred to* [in the returns]'; and

(5) say that they were *'unable to find a description of the Ethical Fund in accordance with the regulations'*.

24/01/1996 GAD write to DTI with comments on the papers relating to Equitable's application of a market value adjustment to policy transfers (see 18/12/1995). GAD point out that Equitable apply a market value adjustment for transfers, but unlike some other companies do not do this for retirements, even when they are not on the originally selected date. GAD note:

This is more generous therefore, but it does mean that transfers, which do suffer an MVA if one is generally applicable, look less generous than retirements. The justification for this is that retirement is not normally selected just for market conditions, but transfer can be.

If you try to justify Equitable's stance from rights of transferring policyholders against those of retiring policyholders, it looks unfair and even unreasonably protectionist. However, it would be impossible to allow unfettered unadjusted transfer, and therefore the only way to avoid this comparison being less than happy would be to level down — that is to remove the freedom from MVA (from future policies) on retirements other than on a fixed date. That would diminish the rights of the majority, and is not, I feel, a line which DTI would wish to take.

DTI note on this that there is no need to write again to Equitable.

21/02/1996 [entry 1] Equitable write to GAD in reply to their letter of 23/01/1996 about the 1994 returns. Equitable:

(1) enclose a copy of their current With-Profits Guide (dated July 1995) and state that GAD will be sent future updates;

(2) provide information about the mortality basis used in the valuation, and explain that Equitable would be strengthening the basis for the 1995 returns;

(3) comment that, were they to follow literally the instructions on the form for presenting information on rates of interest in the net premium valuation, Equitable would have to complete around 30 forms in all. Equitable state that they have put their internal records into the format of the draft forms *'which involves net and gross business on the same basis (apart from tax) being treated together and some minor classes being amalgamated with larger classes on similar ... valuation bases. That results in 10 different forms ...'*, which they enclose;

(4) explain that, had they published the net premium valuation, Equitable would have needed to show an explicit resilience reserve of £171m in the 1994 returns; and

(5) explain that their ethical funds are invested in the Equitable Ethical Unit Trust, which is described in the returns.

An unsigned analysis carried out by GAD of Equitable's letter includes on (2): *'OK for now, general comments only to* [Equitable's Appointed Actuary]'. On (3):

Supplied approximately in the requested format except that, surprise surprise, the resilience reserve is omitted.

OK apart from the missing resilience line. It is probably pushing it a bit to complain and I intend to turn a blind eye.

On (4), that the resilience reserve required is £171m, the comment is: *'OK'*. On (5), the note reads: *'I did not know there was such a unit trust – hence the confusion. Now OK'*.

21/02/1996 [entry 2] DTI's Line Manager B returns his copy of GAD's scrutiny report on the 1994 returns to the Line Supervisor. On this, the Line Manager notes:

I propose to invite myself to see Equitable to discuss

1) Plans for Permanent [Insurance] *+ development of overseas business*

2) Asset/liability management.

23/02/1996 GAD hold a meeting of their Scrutiny Strategy Working Party. DTI's Line Manager A attends and provides feedback from DTI on GAD's 1994 annual report on the life insurance industry. GAD's

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minutes record: '[Line Manager A] *said that he had found the report extremely useful, both in relation to specific companies and for wider purposes, such as briefing officials and answering parliamentary questions. However, he was not convinced that his colleagues at DTI used the report to anything like the same extent. The GAD actuaries used the report in writing detailed scrutiny reports, but* [Chief Actuary C] *said that he wished they would use it more'*.

05/03/1996 GAD write to Equitable with comments on their letter of 21/02/1996. GAD note that Equitable intend to strengthen the mortality basis for 1995 and offer some advice about what mortality tables to use. GAD add: *'Annuity mortality bases are a matter that GAD keeps under constant review for all offices with a material portfolio, and we shall undoubtedly return to this issue in future years'*. GAD raise no objections to Equitable's amalgamation of information on rates of interest *'provided that the valuation rate of interest given is the highest for liabilities grouped together'*. GAD acknowledge Equitable's information on the resilience reserve and add:

> *We do need to know this figure every year, but I appreciate that you do not wish to publish it at present. It would assist me if you could write to me with this figure at about the time you submit the return, as this may avoid correspondence later in the year.*

GAD send DTI an update on their scrutiny report for the 1994 returns. GAD revise the valuation table to take account of Equitable's figure for the resilience reserve under a net premium valuation, as follows:

	1994 NPV £m
Non-linked liability	*10,651.2*
Linked liability	*1,095.8*
Bonus Reserves	*330.2*
Total [mathematical] *reserves*	*12,077.2*
Additional Reserves	*171.0*
Other liabilities	*256.3*
Total liability	*12,504.5*
Long term assets	*13,551.3*
Shareholders' assets	*0*
Available assets	*1,046.8*
Implicit items	*250.0*
Total amount available	*1,296.8*
Required Minimum Margin	*490†*
Cover	*2.65x*
Free asset ratio	*4.1%*

† Estimated figure.

GAD conclude:

> *We are now satisfied with the valuation basis. The net premium cover for the required minimum margin is greater than that for the published basis, and a priority of 4 could have been justified.*
>
> *The scrutiny is now complete.*

15/03/1996 The Securities and Futures Authority ask DTI about a proposal that Equitable become the controller of a stock broking business.

25/03/1996	Equitable write to GAD, in response to their letter of 05/03/1996. Equitable suggest that GAD's comments on mortality tables appear to imply that: *... GAD decides what is a professionally satisfactory choice of basis and then sees how close offices come to that. That carries the unfortunate impression that the GAD feel the only people capable of exercising true professional judgment are themselves.* Equitable conclude: *I would much prefer to see the GAD/DTI taking a far tougher line on whom they allow to become appointed actuaries rather than adopting an increasingly interventionist approach to overcome the deficiencies of some appointees.* GAD copy the letter to DTI's Line Supervisor B who notes, against the concluding comment: *'Nice one!'*.
01/04/1996	DTI ask Equitable for brief details of the rationale for the proposal that they become the controller of a stock broking business (see 15/03/1996).
03/04/1996	GAD reply to Equitable's letter of 25/03/1996. GAD point out that DTI rely heavily on GAD when satisfying themselves that regulations are being complied with and that GAD's independent review underpins rather than undermines the Appointed Actuary system. GAD reassure Equitable that: *'We do not seek to substitute our judgement for that of the Appointed Actuary, but rather, as you suggest, to seek confirmation that relevant factors have been taken into account and that the conclusions are reasonable'*. GAD continue that this *'requires us to decide whether the basis is within the range actuaries generally would consider to be acceptable, and not to set our own basis. However, we have to start from somewhere, and in particular we do use guideline mortality tables to determine whether to make further enquiries'*. GAD add: *As you say, it would be unfortunate if GAD were giving the impression of some form of monopoly over professional judgement. We do, however, sometimes express a view to Appointed Actuaries when we feel this might assist their consideration of an issue. My observation was merely intended, in the context of your previous letter, to point out a possible advantage of moving to the latest tables, which you indicated you were considering, and no more than that. I am sorry if you felt any criticism of your professional judgement was implied, and assure you that none was intended.* GAD say: *I feel you may have misunderstood the reference I made to a "material portfolio". This was not a reference to, say, market share, but to the size of the portfolio in relation to free assets, for example. I was referring to those companies where an improvement in mortality of annuitants might cause a financial strain material for either solvency margins or policyholders' bonuses ...* GAD continue: *This might particularly be the case where the actuary has elected to use a basis that is near to the minimum. Thus "material" should be read perhaps more in the sense used by the accountancy profession. You will appreciate that the mortality experience of your annuity portfolio could be material, because significant improvements above those implicit in the table you use might produce a large financial effect.* GAD also comment on Equitable's request that GAD should take a tougher line on whom they allow to become Appointed Actuaries:

> *... the "gatekeeper" to the role is really the profession, through the system of practising certificates. If there is to be a tightening then it would be for the profession to give effect to it. Neither DTI nor GAD has any powers in this respect.*

GAD copy the letter to DTI. Line Supervisor B notes that it is a good letter and that the statement that DTI rely heavily on GAD for advice is *'true!'*.

10/04/1996	DTI's Head of Life Insurance writes to Equitable's Chief Executive (and to Chief Executives of all other life companies) to ask for a revised estimate of their liability for pension mis-selling and comment on the financial implications for the Society.
15/04/1996	Equitable's Appointed Actuary writes to GAD in reply to their letter of 03/04/1996. The Appointed Actuary says that: *'In general I was reassured by your comments'*. The Appointed Actuary explains that he shares GAD's concerns about the need to manage the risk of future improvements in mortality on an annuity portfolio and adds: *That was one of the reasons why we introduced our with profits annuity some years ago. Any unexpected improvement for that class could, of course, be reflected in the bonus rate granted. You may be interested to know that around two thirds of our current immediate annuity new business is with profits.* Equitable's Appointed Actuary also expresses surprise at GAD's comment that neither they nor DTI have any powers to secure better quality Appointed Actuaries. He says: *Although I accept that the Act does not require approval of Appointed Actuary appointments, there would appear to be an avenue of influence under the "sound and prudent management" criteria. That is via the requirement that any office "is directed and managed by a sufficient number of persons who are fit and proper persons to hold the positions which they hold".* Against this, Scrutinising Actuary D writes: *'This wouldn't pass review'*.
19/04/1996	Equitable provide DTI with the details requested on 01/04/1996 in relation to the Society taking a controlling interest in a stock broking business.
02/05/1996	DTI write to the Securities and Futures Authority, in response to their letter of 15/03/1996, to say that, as the prudential regulators for Equitable, DTI have no concerns about the proposal.
06/05/1996	Equitable's Appointed Actuary telephones DTI to advise them that, by the end of the year, sale of all permanent health insurance business would be transferred to the Permanent Insurance Company (Permanent Insurance) (in which Equitable hold a majority shareholding) *'via S.49'*. The officer who took the call (identity unknown) records: *'I mentioned about EC policies + contacting supervisors re S.49 transfers.* [The Appointed Actuary] *didn't think there were any but was grateful for this* [information]'.
20/05/1996	DTI send the British Consul General in Munich information about the Society ahead of a speech that he was to give at an Equitable dinner. Under *'Key Features'*, DTI say that Equitable are the seventh largest company in terms of long term business assets, that expenses remain amongst the lowest in the industry and that '[the] *Appointed Actuary and Managing Director posts are both held by* [the same person]'.
28/05/1996	Permanent Insurance write to DTI to explain that they intend to begin issuing policies in the Republic of Ireland and that the policies will be sold using Equitable's sales force.

31/05/1996	Equitable ask DTI to provide a letter stating that they have no objection to the Society registering a representative office in the United Arab Emirates.

05/06/1996 DTI's Sponsorship Secondee Unit send Equitable notes of a meeting that had been held on 2 May 1996 to discuss insurance industry competitiveness. Under the heading *'Working with Government & Regulators'*, Equitable's Appointed Actuary is quoted as saying:

> *DTI valuation regulations have now gone too far ...*
>
> *Regulation has not caused Equitable to change its approach, but it has put up its costs.*
>
> *Believes that, despite regulations, very little advice is actually given.*

14/06/1996 Equitable write to DTI in reply to their letter of 10/04/1996 about liability for pension mis-selling. Equitable say that their comments remain as in their letter of 19/04/1995, but also explain that they aim to complete a review of all transfers and opt-outs by 1 July 1997. Equitable would thus have a much clearer idea of their potential liability by the end of 1996, but still believe their exposure is likely to be relatively small.

18/06/1996 DTI's Director of Insurance writes to Equitable's Chief Executive and Appointed Actuary to congratulate him on his appointment as a Commander of the British Empire in the Birthday Honours. The Director of Insurance says:

> *I am sure your many friends and admirers in the industry and elsewhere — among who I would count myself — will regard this as a well deserved recognition of a lifetime's service to England's oldest life insurer, and to the high standards for which you have been rightly renowned for so many years. The Equitable's achievements in recent years show that high ethical and customer standards can be fully compatible with the more conventional measures of commercial success.*

26/06/1996 Equitable apply to DTI for a section 68 Order for a future profits implicit item of £600m, for possible use in their 1996 returns. Equitable provide financial calculations in support of the application suggesting that they could seek an Order up to the value of £2,212.6m.

> *Equitable say that they have 'included in its 1995 annual returns a future profits implicit item of £263,731,000 for the purpose of achieving equality between the total net value of policyholders' assets included in Form 9 (i.e. lines 21 + 31 – 24) and the corresponding total net asset value shown in the Society's Companies Act accounts'.*

These calculations include, for the estimated annual profits, that:

Year ending	*(A) Total surplus*	*(B) Exceptional items*	*(C) Surplus arising from solvency margin*	*(A)-(B)-(C) Ordinary surplus*
	£m	*£m*	*£m*	*£m*
31.12.91	*596.5*	*(13.2)*	*59.5*	*550.2*
31.12.92	*330.5*	*(46.0)*	*46.4*	*330.1*
31.12.93	*480.9*	*(1015.2)*	*178.5*	*1317.6*
31.12.94	*520.0*	*1245.9*	*19.3*	*(745.2)*
31.12.95	*662.8*	*(462.3)*	*119.5*	*1005.6*
				2458.3

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Average annual profit = 2458.3/5 = £491.7m

Note: *In 1994 surplus was increased as a result of changes in valuation interest bases. In 1991, 1992, 1993 and 1995, surplus was decreased as a result of changes in valuation interest bases. Those changes in surplus are included as exceptional items in column (B) above.*

The calculations state that the average period to run for the Society's in-force contracts is nine years. Equitable explain:

The periods to run have been reduced to take account of premature withdrawals based on the Society's recent experience of such withdrawals. In respect of retirement annuity and personal pension contracts for which a range of retirement ages is available, it has been assumed that retirement benefits are taken at the lowest possible retirement age, or immediately if that age has already been attained.

The calculations suggest that the maximum future profits permissible is 50% of £491.7m multiplied by nine years – that being £2,212.6m.

Submission of the 1995 regulatory returns

28/06/1996 **Equitable submit their 1995 regulatory returns to DTI**. Accompanying those returns are copies of the Society's annual report and financial highlights and its statutory accounts, prepared under the Companies Act 1985 and dated 27 March 1995.

These documents include the following information about Equitable's business and their financial position as at 31 December 1995.

GAD's copy of the 1995 regulatory returns and Companies Act reports and accounts include various annotations. I am satisfied that those annotations were made by Scrutinising Actuary E during the scrutiny programme, on or around 18/07/1996, when Scrutinising Actuary E completed the A2 Initial Scrutiny check. However, for ease of reference, mention of these annotations is made here.

Companies Act annual report and financial highlights
Equitable provide information on their Directors. GAD note that there are five executive directors and eight non-executive directors.

In their *President's Statement to Members*, Equitable explain *'While we have been at the forefront of those raising bonus levels when investment returns increase, we have not been afraid in the past to reduce bonus levels to reflect reduced investment returns where this was appropriate'* and that they had been able to maintain bonus rates (both reversionary and terminal) at the 1994 levels, as there had been no justification on investment grounds to reduce them. Equitable argue that *'This is in contrast to some of our competitors, who have decreased bonus rates this year having deferred the decision from an earlier year'*.

GAD mark some of the statements made in the President's Statement, including that:

- they had secured a record level of new business;
- their expense ratio had fallen from 5.5% to 4.8%;
- Equitable are *'satisfied that we can safely and securely continue to develop our business and maintain the interests of our policyholders without the need for any injection of shareholder capital'*;
- they have continued to develop the business outside the United Kingdom; and
- on bonus policy that, *'There should be no deliberate holding back of profits from one generation to the next'*.

In their *Management Report*: *an appraisal of the Society today*, Equitable provide a statement of the principles on which they operate. Under *'Investment Performance'*, Equitable say:

> *A full distribution policy does not lead to investment considerations different from those applying to life assurance companies generally. The asset mix from time to time reflects relative price movements and preferences on investment grounds over the years rather than blind adherence to any particular "culture". Over many years there have not been any particular technical restrictions placed on the investment team.*

GAD sideline the following table which appears in this section under the heading *'The factors contributing to the cost-effective internally financed growth'*:

Acquisition Expense Ratio 1994

Lowest – The Equitable Life	*18.08%*
Nearest competitor	*45.52%*
Average	*101.90%*

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GAD also highlight that the fund charge for internal-linked funds had been reduced to 0.5%.

In their *Management Report, features of 1995*, Equitable provide information on: *'New Business and Sales'; 'Investment'; 'Bonus Declaration'; 'Customer Service'; 'Systems and Consultancy'; 'Staff';* and *'Looking Ahead'*.

GAD note that the Society has operations in Germany and the Republic of Ireland and an international branch based in Guernsey.

Under the *'Bonus declaration'* section, Equitable note that with-profits policyholders had recently received notices of their bonus statements, together with a letter explaining Equitable's approach to bonuses for 1995. Equitable note that in 1995, when investment returns on their with-profits assets had been 16.6%, the Directors had decided to allocate an overall rate of return of 10% for recurrent single premium business, the same as in 1994 when the investment returns on the with-profits funds had been –4.2%. Equitable say that this demonstrated how the with-profits system smoothed out the relative peak of performance in 1995, as well as the troughs in earlier years.

Companies Act statutory accounts
In their *Directors' Report for 1995*, Equitable provide an example of how bonuses are allocated to policies. The example (using a personal pension plan policy) includes mention of the 3½% *'roll-up rate'* guaranteed by the policy.

GAD make various annotations against the figures provided in the Profit and Loss Accounts and the Balance Sheets.

The returns
Equitable's returns are again submitted in two parts covering Schedules 1, 3 and 6 and Schedule 4 to the ICAS Regulations 1983.

Schedule 1 (Balance sheet and profit and loss account)
As in previous years, Schedule 1 of Equitable's returns consists of Forms 9, 10, 13, 14 and 16. Form 9 summarises the Society's financial position at 31 December 1995 as follows:

Long term business admissible assets	*£16,502,548,000*
Total mathematical reserves (after distribution of surplus)	*£14,915,189,000*
Other insurance and non-insurance liabilities	*£153,979,000*
Available assets for long term business required minimum margin	*£1,433,380,000*
Future profits	*£263,731,000*
Total of available assets and implicit items	*£1,697,111,000*
Required minimum margin for long term business	*£586,275,000*
Explicit required minimum margin	*£97,713,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£1,335,667,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	*£1,110,836,000*

GAD tick some of the figures provided and note the cover for the required minimum margin with and without implicit items (being x2.89 and x2.44), along with the equivalent figures for the previous year (being x2.36 and x1.85).

Equitable use a future profits implicit item in their 1995 returns of £263.4m.

In Form 13, GAD circle the figure disclosed for investments in dependent non-insurance companies and query what companies these are.

Form 13A (Analysis of derivative contracts) includes a note which reads: *'Included in column one are convertible securities of £185,274,823, warrants of £22,345,129 and partly paid securities of £4,963,931'*. GAD circle these figures and question whether they should be shown on this Form. However, GAD also write: *'Seems acceptable, following Prudential Note 1995/2'*.

In Form 14 (Long term business liabilities and margins), GAD circle the previous year's figure for liabilities due to *'Other creditors'*.

Schedule 3 (Long term business: revenue account and additional information)
As in previous years, Schedule 3 consists of Forms 40 to 51, which have been supplemented by various notes providing further information about/explanation for the figures provided.

In the version of Form 40 (Revenue account) relating to *'Ordinary Long Term (Life, General Annuity and Permanent Health Fund)'*, GAD circle the figures provided for the value of non-linked assets brought into account. Next to this GAD write: *'as necessary!'*.

In the annex to Form 40, Equitable disclose the principles and methods applied. Under *'Increase/Decrease in the value of assets brought into account'*, Equitable disclose:

> *The increase/decrease in the value of linked assets brought into account has been allocated directly to the relevant part of the fund. In respect of other assets the allocation is such as to give in each case, a "fund carried forward" of at least the amount of the mathematical reserves (including those arising from a distribution of surplus at the end of the financial year) in respect of the business attributable to the part of the fund in question.*

GAD underline the second sentence and write: '*ie. allocation from investment reserves as necessary!'*.

In Form 41, Equitable provide information on premiums and expenses. GAD annotate the forms with corresponding figures from the previous year's returns. They also add some corresponding figures taken from Form 44.

In Form 43, Equitable provide a summary of the changes in ordinary long term business. The instructions to this Form say that figures for annual premiums shall not include any recurrent single premiums. GAD underline the words *'any recurrent single premiums'*.

In Form 44, Equitable provide an analysis of their new ordinary long term business. GAD make various annotations on the Forms, checking the figures provided. In relation to UK non-linked with-profits pension business and Equitable's regular premium contracts, GAD calculate the total amount of business to be just over £307m. Against this they note: *'But FORM 43 excludes recurrent* [single premiums] *+ shows only 1,398k!'*.

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Form 45 shows that 50% of Equitable's admissible non-linked assets are invested in equities, 7% in land and 38% in fixed and variable interest securities (compared with 47%, 8% and 40% respectively in 1994). The Form also shows the expected yield on those assets. GAD tick some of the figures and add the total yield percentage shown on line 12 from the previous year (being 5.51%).

As in previous years, Equitable disclose in Form 46 that the gross redemption yields on fixed interest securities issued or guaranteed by any government or public authority are, for certain durations, higher than for those not issued or guaranteed by any government or public authority. GAD tick the Form.

In the notes to this part of the returns, Equitable disclose that no provision has been made for the contingent liability to tax on unrealised capital gains on non-linked business, which they have estimated as £37.4m. GAD underline that no provision has been made and sideline the paragraph.

Equitable disclose that they have been granted a section 68 Order permitting them to take into account a future profits implicit item with a value not exceeding £500m. The Society states that it has included an item of £263,731,000 for the purpose of *'achieving equality between the total net value of policyholders' assets included in Form 9 ... and ... total net asset value shown in the Society's Companies Act accounts'.* GAD underline the quoted part of this sentence.

Equitable state that they have been granted a section 68 Order which permits them to include in aggregate form details of their *'Personalised Funds'* in Forms 49, 50, 51 and 57, instead of the separate details for each Personalised Fund required by the ICAS Regulations 1983.

Equitable state that they have been granted a section 68 Order permitting them not to submit a statement of their long term business as at 31 December 1995 (i.e. a Schedule 5 of the returns).

<u>Schedule 6 (Certificates by directors, actuary and auditors)</u>
Three Equitable Directors provide the certification required by Regulation 26(a) of the ICAS Regulations 1983. Equitable's Appointed Actuary provides the certification required by Regulation 26(b) of the ICAS Regulations 1983. As required by Regulation 27 of the ICAS Regulations 1983, Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

<u>Schedule 4 (Abstract of valuation report prepared by the Appointed Actuary)</u>
As in previous years, Equitable present two valuations of their long term liabilities (their main and appendix valuations). The results of the main valuation are carried forward, unadjusted, from Form 58 to Form 14 and on to Form 9.

<u>Schedule 4 – main valuation (text)</u>
Schedule 4 of Equitable's returns provides the information required by paragraphs 1 to 19 of Schedule 4 to the ICAS Regulations 1983 and includes Forms 55 to 58 and Form 60. Equitable state that this valuation conforms to Regulation 64 of ICR 1994.

In response to paragraph 3, Equitable provide 23 pages of information about their non-linked contracts. Most of the information about the contracts remains unchanged from previous years. GAD make various annotations to this section of the returns.

As in previous years, Equitable disclose that certain deferred annuity policies carry guaranteed terms under which future premiums could be paid. In paragraph 3(xiv) Equitable also, again, disclose that they applied a guaranteed annuity rate to the accumulated cash fund generated by certain types of with-profits policies, stating that the guarantees applied to policies issued prior to 1 July 1988. GAD tick the paragraph and underline *'prior to 1 July 1988'.*

As in previous years, Equitable provide a description of their principal guarantees of terms. GAD tick each description.

In response to paragraph 4, Equitable provide 48 pages of information about their linked contracts. GAD tick some of the descriptions provided or otherwise note where there has been an addition or change from the previous year.

As in the previous year, on the general principles and methods adopted in the valuation set out in paragraph 5(1), Equitable disclose that personal pension business has been valued on the basis that benefits are taken at age 55. GAD tick this paragraph.

As in previous years, in paragraph 5(1)(a) Equitable disclose that they have tested the need for resilience reserves against the three scenarios contained in DAA6. They state the changed conditions examined were: *'an immediate 20% fall in property values combined with (1) a 20% reduction in fixed interest yields and a 10% fall in equity values; (2) a 10% reduction in fixed interest yields and a 25% fall in equity values; (3) a rise in fixed interest yields of 3% and a 25% fall in equity values'*.

GAD underline *'immediate 20% fall in property values'* and write against it *'not needed in all scenarios!'*.

As in previous years, Equitable disclose that they have tested the ability of the Society to hold reserves which satisfy Regulations 64 to 74 of ICR 1994 in the three scenarios of changed investment conditions described in DAA6. Equitable state:

> *In these conditions the Society would be able to set up reserves which satisfy* [Regulations 64 to 74 of ICR 1994] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued.*

GAD tick this paragraph.

(Note: the entry at line 51 of Form 14 was the excess of the value of admissible assets representing the long term fund over the amount of those funds and represented the difference between the market value and book value of those funds.)

As in previous years, Equitable state that, in determining the provision needed for resilience reserves and tax on unrealised gains, they have taken account of the fact that the long term fund has been valued at book value.

As in previous years, in paragraph 5(1)(d) Equitable set out the rates of future bonus valued for each class of business. GAD add corresponding figures from the previous year and write: *'<u>Mainly unchanged</u> (at levels <u>much lower</u> than 1993)'*.

In paragraph 5(1)(e), Equitable disclose that a reserve for the prospective liability to tax on unrealised capital gains (losses) is held in respect of policies where benefits are linked to the Society's internal funds. They also disclose that the contingent liability for tax on unrealised capital gains in respect of other business is estimated not to exceed £37m. GAD underline this figure and add next to it the previous year's figure of £21.9m.

As in previous years, Equitable continue: *'It is considered that there were sufficient margins in the valuation basis to cover the discounted value of the liability. Accordingly, no other additional reserve was made for any prospective liability for tax on unrealised capital gains'*. GAD sideline these two sentences and note them with a question mark.

As in previous years, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity. GAD tick this paragraph.

As in previous years, in paragraph 5(1)(g) Equitable state that they do not consider it necessary to hold an explicit provision for the guarantees and options described in paragraph 3, except where the right to effect further policies without medical evidence of health is carried. GAD tick this paragraph.

As in previous years, in paragraph 6(1) Equitable disclose that, for certain non-profit deferred annuities, the valuation rates of interest used are those assumed in the premium basis. Equitable, again, do not elsewhere in the returns disclose the rates used in the premium basis.

As in the previous year, in response to paragraph 7(b) of Schedule 4 to the ICAS Regulations 1983, in respect of their life assurance, general annuity and pension business, Equitable state:

> *For recurrent single premium business the valuation rates of interest shown in form 55* [the valuation summary of non-linked contracts] *are net of a ½% interest rate reduction as a provision for future expenses.*

As in previous years, at paragraph 7(d) Equitable state:

> *A further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994. The resultant aggregate liability is less than the aggregate liability on the methods and bases described in this report. The report on the net premium valuation is given in an appendix following Form 60 of this report.*

GAD sideline this paragraph.

As in previous years, in paragraph 11 Equitable disclose: *'The Society has no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund'.*

As in previous years, in paragraph 12 Equitable state: *'The Society has no shareholders and the principles upon which the distribution of profits among the policyholders is made are determined by the Directors in accordance with the Society's Articles of Association'.*

In paragraph 13, Equitable disclose that they had set the reversionary bonus for the main policy classes at 4.0% (unchanged from the previous year). GAD tick or mark as new the information in this section. As in previous years, Equitable disclose that they offered loans under a *'loanback'* arrangement to some retirement annuity and individual pension policyholders. GAD sideline this paragraph.

In paragraph 16, Equitable set out their system for allocating final bonus. GAD make various annotations to this section. The returns, again, contain the statement at paragraph 16(vi):

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

GAD sideline this paragraph.

Schedule 4 – main valuation (forms)
In Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts along with information on the number of contracts in force, the benefits guaranteed and the rates of interest and mortality assumptions used in valuing them. GAD note some of the changes from the previous year to the rates of interest and mortality tables used.

In Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity and the rates of interest and mortality assumptions used in valuing them. Equitable again disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 58, Equitable set out the valuation result and the composition and distribution of fund surplus.

Schedule 4 – appendix valuation (text)

Equitable explain that the appendix valuation:

> *... was undertaken for the purposes of demonstrating that in aggregate the mathematical reserves determined by the valuation undertaken using the gross premium method, the results of which are reported on the preceding pages, are not less than an amount calculated in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994.*

Equitable's appendix valuation provides the information required by paragraphs 1, 5 to 7, 9, 17 and 18. Equitable say that the information required for the other paragraphs (apart from paragraph 19 – being a statement of the required minimum margin in the form set out in Form 60 of Schedule 4 which, having had *'regard to the purpose of the valuation',* has not been provided) is identical to that given in the main valuation.

As in previous years, in response to paragraph 5(1)(a), Equitable state: *'In these conditions the Society would be able to set up reserves which satisfy* [Regulations 64 to 74 of ICR 1994] *without needing to have recourse to the assets whose current value is shown at line 51 of Form 14* [in Schedule 1] *of these Returns. No provision was made for any mismatching between the nature (including currency) and term of the assets held and the liabilities valued'.*

GAD underline the words *'at line 51 of Form 14 of these Returns'* and write: *'i.e. margin between* [bonus reserve valuation] *liability +* [net premium valuation] *liability covers mis-match reserve'.*

As in the main valuation, in paragraph 5(1)(e) Equitable state that no reserve is made for any prospective liability for tax on unrealised capital gains in respect of non-linked business. GAD sideline this statement.

As in previous years, in paragraph 5(1)(f) Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity. GAD tick this paragraph.

As in previous years, in paragraph 5(1)(g) Equitable disclose the ages that retirement benefits could be taken on their recurrent single premium with-profits pension business. Equitable state that they assumed a retirement age for personal pension policies of 55. GAD underline the number.

As in the previous years, in paragraph 7(b) Equitable explain the method by which they had made provision for future expenses on their recurrent single premium business.

<u>Schedule 4 – appendix valuation (forms)</u>
In the appendix version of Form 55, Equitable set out the mathematical reserves held for the various types of non-linked contracts on the appendix valuation basis. GAD note changes from the previous year's returns to some of the interest rates and mortality tables used.

In the appendix version of Form 56, Equitable set out the mathematical reserves held for the various types of linked contracts on the appendix valuation basis.

02/07/1996 DTI's Line Supervisor B asks Legal Adviser A for advice on the proposed sale of critical illness policies through Permanent Insurance. She queries in particular if the use of Equitable's staff to sell Permanent's products might breach section 16 of ICA 1982.

03/07/1996 DTI provide Equitable with a certificate confirming that the company meet the statutory solvency requirements to trade in Dubai.

04/07/1996 DTI'S Legal Adviser A advises the Line Supervisor that, provided Equitable sell Permanent's products with their own products, section 16 would not be breached.

08/07/1996	**GAD complete the A1 Initial Scrutiny check on the Society's 1995 regulatory returns**. GAD identify no concerns.
10/07/1996	DTI's Line Manager B asks Legal Adviser A for advice on whether the use of Equitable's staff to sell Permanent's products would breach section 16 of ICA 1982.
18/07/1996	**GAD complete the A2 Initial Scrutiny check on the Society's 1995 regulatory returns**. GAD reduce Equitable's priority rating from 3 to 4. GAD identify a number of matters: • the AIDS reserve is contained within the reserve for future bonus in the main valuation; • unit costs have not been updated from the previous year (except for annuities); • it remains the case that not all reassurance is with UK authorised companies; and • the company has not set up any identifiable provision to meet exposure to personal pension transfer problems. Against this is a note *'April 1995 letter indicated that technical liabilities "overstated" by £50m'*. GAD also note: *S68 Order permitted implicit future profits item of up to £500m. £263,731K used — cover for* [required minimum margin] *of 2.89* [Company] *provides* [management] *services to University Life ... + Permanent* [Insurance]. [Paragraph] *4(2)(c)* [of Schedule 4 of the returns] *still omitted ... - (covered in 4(2)(a))* *Reduced management charges for Funds!* *Unchanged expense allowance for linked contracts, but <u>raised</u> allowances for annuities.* *New reinsurance treaty with connected* [company] *for Major Medical Cash Plans. – No current reassurance seems to be in place.* GAD identify no worrying aspects and no items to notify to DTI, to be taken up immediately with Equitable. Accompanying the scrutiny check is a Form B Initial Scrutiny Form, which includes certain key figures disclosed in the 1992 to 1995 returns. GAD tick some of the figures provided.
22/07/1996	DTI's Legal Adviser A provides advice to the Line Manager in response to his note of 10/07/1996 on whether Permanent Insurance's plans to sell policies in the Republic of Ireland using Equitable's staff would breach section 16 of ICA 1982. He advises that he does not believe that it could be said that the sale of policies was for the purposes of, or in connection with, Equitable's insurance business. Therefore, Section 16 of ICA 1982 would apply.
23/07/1996	Equitable's Appointed Actuary writes to GAD's Scrutinising Actuary D (who about this time becomes a Chief Actuary (Chief Actuary D) and retains responsibility for Equitable), enclosing the latest version of the With-Profits Guide (dated July 1996). The Appointed Actuary adds: *I should also like to take this opportunity to thank you for your kind letter about the award I received in the Queen's Birthday Honours. It was a surprise as well as an honour, as you can imagine.* *As you indicate, I hope the award will be interpreted as a recognition of the standing and regard in which the Equitable is held. Many have contributed to that and to the work we have all been doing to benefit the industry's clients. The award should, in that way, be shared by all involved.*

26/07/1996	DTI send GAD a copy of Equitable's application for a section 68 Order of 26/06/1996. On GAD's copy of the letter, a new Scrutinising Actuary (Scrutinising Actuary E) has annotated the following statement with a question mark: *In 1994 surplus was increased as a result of changes in valuation interest bases. In 1991, 1992, 1993 and 1995, surplus was decreased as a result of changes in valuation interest bases. Those changes in surplus are included as exceptional items in* [the calculation of average annual profit]
30/07/1996 [entry 1]	GAD write to Equitable's Appointed Actuary, to thank him for his letter of 23/07/1996 and to inform him that Scrutinising Actuary E would now have day to day responsibility for Equitable.
30/07/1996 [entry 2]	Equitable give formal notice to DTI that they intend to sell permanent health insurance policies (wholly reassured through Permanent Insurance) in the Republic of Ireland. Equitable supply details of the proposed changes to the requisite European Community and United Kingdom details.
05/08/1996	DTI send GAD a copy of Equitable's letter of 30/07/1996 and ask for their comments on the changes of requisite details. DTI explain that there had been previous correspondence on this issue (see 02/07/1996, 04/07/1996, 10/07/1996 and 22/07/1996) and that Legal Adviser A *'did have doubts about the border line between the two companies being "blurred" for regulatory purposes'*. Line Supervisor B also sends a copy of Equitable's letter to the Legal Adviser *'in case he has any further comments about the "blurring" of regulatory boundaries between companies!'*.
09/08/1996	Equitable inform DTI that they intend to establish two branches in Malta and require two solvency certificates for the years 1994 and 1995 for submission to the Maltese authorities.
13/08/1996	DTI provide Equitable with a certificate covering both years.
21/08/1996	GAD advise DTI that Equitable's application for a section 68 Order for a future profits implicit item (see 26/06/1996) is *'well within the maximum figure calculated and can be properly granted'*. GAD also say that they could see no problem with the proposed changes to the requisite details for Equitable's Republic of Ireland business. GAD suggest that the possible problem about the blurring of regulatory boundaries does not really exist, as an amendment to the requisite details *'indicates that the contract sold will be "similar in nature" to the UK version written by Permanent Insurance, of which details were provided, but we infer that it will actually be an Equitable contract — albeit wholly reassured with Permanent Insurance'*.
23/08/1996	GAD write to DTI about the detailed scrutiny programme for the 1995 returns. GAD say that they have completed the initial scrutinies for all life insurance companies and have prioritised the order of the detailed scrutinies, for agreement by DTI. The attached list gives the target date for the detailed scrutiny of Equitable's returns as December 1996. GAD also say: *I am also enclosing a copy of the criteria we are currently applying in determining priorities. These are as agreed with* [Line Manager A] *at the Scrutiny Strategy Working Party, and you will note that we have replaced the old "priority 5" category with two new categories.* *"Priority 5" now conveys the meaning that the company is not such that GAD considers a scrutiny desirable, bearing in mind our limited resources, but that we will reconsider the position later in the year, when we have a greater feel for the time and resources available. "Priority 6" will be reserved for those companies to be omitted from the 1995 programme when this review takes place.*

25/08/1996	DTI's Legal Adviser A replies to the Line Supervisor's minute of 05/08/1996. The Adviser says: *'These companies are making my head spin! It appears from the literature that they are not, as they have said, selling Equitable products which are reassured through Permanent. They are selling Permanent products so it looks as if Permanent will require branch authorisation for Ireland. Are we not back to square one?'.*
28/08/1996	In response to GAD's proposed programme for the detailed scrutiny of all life companies' 1995 returns, DTI's Line Manager B suggests that the target date for completion of Equitable's detailed scrutiny is advanced from December to October (with a corresponding demotion of one of two suggested companies that come under the responsibilities of Scrutinising Actuary E). (Note: in his witness statement to Penrose, Scrutinising Actuary D/Chief Actuary D said that the scrutiny report was completed early because of an impending visit to Equitable as part of DTI's rolling programme of visits. A meeting between DTI, GAD and Equitable took place on 08/11/1996.)
11/09/1996	DTI send Equitable the section 68 Order for a future profits implicit item of £600m, for use in their 1996 returns. DTI remind Equitable that, in accordance with the Guidance Notes which were issued in 1984, before including the item in the forthcoming returns the company must update the calculations to demonstrate that they still support the amount used.
15/10/1996	DTI write to Equitable to arrange the next visit to Equitable as part of DTI's and GAD's three year rolling programme. (DTI and GAD last visited Equitable, under this programme, on 09/12/1994.) DTI set out the main subject areas they would like to discuss: (1) The business plans for the next five years, with particular reference to solvency and any requirements which there might be for additional resources. DTI ask for a copy of Equitable's most recent business plan. (2) Equitable's purchase of Permanent Insurance. (3) Equitable's experience of doing business in Europe. (4) Equitable's *'managed annuity'* product. (5) Use of genetic information in the underwriting of long term business products. (6) Equitable's potential liability for compensation relating to personal pension transfers, opt-outs and non-joiners. DTI also seek a guided tour of the *'paperless office'* which Equitable have established. DTI propose that *'the visit should take the form of a series of meetings with appropriate members of your team to discuss these areas, and would hope to cover them all adequately in a single day'*. DTI explain that it is not essential for Equitable to send any documentation in advance, other than the business plan referred to above, but that they would be pleased to receive any internal papers which might facilitate the discussions, such as structure charts and corporate plans. The visit is arranged for 08/11/1996.
29/10/1996	Every Appointed Actuary is sent by the Government Actuary a copy of DAA8 on his recommended AIDS reserving policy. The guidance includes clarification of the changed investment condition scenarios that are expected to be tested in the resilience test.

01/11/1996 [entry 1] **GAD provide DTI with their scrutiny report on the Society's 1995 regulatory returns.** (A copy of this scrutiny report is reproduced in full within Part 4 of this report.) The report uses the detailed format adopted for the 1993 and 1994 returns (see 15/11/1994 [**entry 1**] and 23/01/1996 [**entry 1**]) and comprises 12 sections as follows:

(1) Summary
Under *'Key features'*, GAD state that Equitable are the seventh largest company, measured in terms of long term business. GAD explain that Equitable are classified as priority 4 (reduced from priority 3 the previous year). They note that:

> *Unusually, the company publishes a gross premium bonus reserve valuation — and a net premium comparison. For the second year, Equitable has used an implicit profits item in Form 9, amounting to about £264m.*

GAD note that, in a year when the industry struggled, Equitable achieved record sales and that their main line of business is pensions *'somewhat unusually structured, with almost all on a recurrent single premium basis'*. They note that expenses *'remain the lowest in the industry, and the ratios continue to fall'*. GAD also note that:

> *Reserving bases are fairly weak, by design, to maximise the disclosed free asset ratio, while permitting fair bonus distributions to the current generation of policyholders. The* [required minimum margin] *was shown as comfortably covered by a factor of 2.89 at the end of 1995 (cf 2.36 at end 1994) — the factor would be 2.44 without crediting the implicit future profits item.*

Under *'Action points'*, GAD state that they have raised no points directly with Equitable, but that, at the planned visit (see 08/11/1996 [**entry 2**]), it would be interesting to discuss:

> *1. Details of the continued fall in its actual overhead expense levels, and its potential ability to continue on this creditable path.*
>
> *2. How the company views the sustainability of its present contract structures — largely based on accumulating funds to which regular bonuses are added. What scenario tests has it performed in relation to possible falls in asset values, and how would it react to sustained unfavourable market movements?*
>
> *3. The increased investment in non-insurance companies — £75.4m in shares and £18.7m in debt (previously, £49.3m and £2.8m respectively).*

(2) Background
GAD repeat information included in the Background section of their reports on the 1993 and 1994 returns, namely that Equitable are the oldest mutual life assurance society in the world, that they never pay commission to third parties, that they demonstrate *'a determination to provide fair bonuses to policyholders, with no deliberate holding back of profits from one generation to another'*, and that they use a bonus reserve valuation method. GAD note that, as well as using a future profits implicit item for the first time in 1994, Equitable obtained an Order in the sum of £500m for 31 December 1995 and have used £264m. GAD explain that Equitable have been active overseas in recent years (in Guernsey, Republic of Ireland and Germany) and that these branches are producing ever increasing amounts of new business. GAD state, as in their report on the 1994 returns:

> *Equitable regard this as an exercise in extending the numbers of people who can benefit from the Society as an institution. It is almost like missionary work, rather than a purely commercial move in the interests of UK policyholders. The mutual concept is extended to all policyholders, and is even part of Equitable's dealing with UK non profit policyholders.*

GAD also note that they and DTI visited Equitable in December 1994, that a further visit is planned for 08/11/1996, and that: *'The Appointed Actuary and Managing Director posts are both held by* [the same person], *but the Board is chaired by a non-executive ... and the total Board of 13 includes 8 non-executives'.*

(3) New business
GAD provide details of the new products Equitable have developed and produce two tables setting out regular and single premiums Equitable have received for the various classes of policies sold from 1991 to 1995. The tables show that regular premium business has increased by 10.5% and single premium business by 30.4% since the previous year. GAD produce a third table, showing the year on year increase in new business over the same period. GAD provide no commentary on the figures.

(4) Changes in business in force
GAD produce tables showing:

- *Recent history of regular premiums*
- *Claims experience*
- *Persistency experience*
- *Recent history of combined surrender, lapse & paid-up conversion rates.*

GAD identify no concerns.

(5) Expenses
GAD produce a table showing the history of expenses from 1991 to 1995. They comment that Equitable's expense ratios keep improving and have again reached *'astonishingly low levels'*. GAD note, as in the scrutiny report for the 1994 returns, that Equitable are a non-commission paying office and pride themselves on their low expense ratio. They state that the revealed total of *'other management expenses'* has continued its *'amazing fall'*. GAD suggest: *'It would be interesting to determine at the next visit exactly how this has been achieved'*.

(6) Non-linked assets
GAD produce a table showing Equitable's *'Recent history of asset mix'*. They state:

> *Increased investment in non-insurance companies has been noted — £75.4m shares and £18.7m in debt at the end of 1995 (previously, £49.3m and £2.8m respectively), and it would be interesting to receive details of these holdings.*

GAD produce a table showing Equitable's *'Change in portfolio over the last year'*. They identify no concerns.

GAD produce a table showing Equitable's *'Investment performance'*. This states a return on investments in 1995 of 16.5%. GAD comment:

> *1. The Equitable's own figure for its with profits fund was a rise of 16.6%.*
>
> *2. The overall result is close to expectations, based on known market movements and after allowing for investment expenses having absorbed about ½%.*
>
> *3. A slightly higher figure might have been hoped for in relation to a with profits fund, but it may be that the expanded overseas equity portfolios (referred to in the 1996 With-Profits Guide) were biased towards far eastern markets that performed poorly in 1995.*

(7) Unit-linked funds
GAD provide details of this class of business.

(8) Valuation and solvency

Under *'Strengths and/or weaknesses'*, GAD first provide an overview, which is similar to that provided in their report on the 1994 returns:

> *The company produces its published Return on the basis of a gross premium valuation, with some allowance for future bonuses, but the results of a net premium valuation are also shown in the Returns. It is known from the company visit at the end of 1994 that Equitable's Actuary has decided that the interests of the Society are best served by using a weak valuation basis to show as strong a free asset position as is possible. This means that interest bases are selected near the limits of the regulations. Detailed matching rectangle data was sought in relation to the 1994 Returns and was found acceptable.*
>
> *Additionally, the Equitable tries to provide a fair bonus allocation to each generation of policyholders — without holding back an excessive estate. The result is that lower free asset margins are revealed than might have been expected for such a well thought of institution. It may be noted that the Society has, for the last two years, found it desirable to utilise a future profits implicit item to improve the disclosed free assets position — although at nowhere near the maximum that could be justified under the guidelines.*
>
> *There is one obvious hidden strength in the valuation — the treatment of recurrent single premium pensions business, under which it is assumed that no more premiums will be received. Although arguably only in line with the best practice, this is an extremely strong basis. If the business were treated as regular premium, margins in future premiums and charges on the funds built up might allow lower reserves. It is likely that some credit is being taken implicitly for this in the expense reserves ...*

GAD go on to discuss four particular areas:

Mortality — GAD explain that they are satisfied with the bases used for Assurances and German business. For Annuities — general, they explain that Equitable use:

> *... the a(90) table with a two year down rating. This follows discussions last year with the Appointed Actuary about the inadequacy of a one year down rating, which he claimed to be able to justify last year. It would seem desirable to keep pressing him quite vigorously on this point — as longevity improves.*

For Annuities — pension, GAD explain that Equitable's table is out of date. However, *'this is close to the effect of using the more recent table with a fair adjustment for improving mortality, and we are not currently minded to press the Actuary regarding use of this table'*.

Interest rates — GAD produce tables showing the interest rates used for major classes and compare these with assets and yields. They comment that the assumptions made are acceptable.

Expenses — GAD state that these are well controlled and continue to fall. They repeat that: *'There is little reason to question the low expense allowances in the valuation. Increased provision has been made this year for the cost of paying annuities. A substantial hidden margin in respect of the pensions recurrent single premium business could cover any apparent shortfall elsewhere'*.

Resilience and special reserves — GAD explain:

> *The Actuary indicates that the resilience reserve required in relation to his net premium valuation would be covered by the difference between the bonus reserve gross premium valuation liability and the net premium valuation liability.*
>
> *This difference is revealed as £436m, and we have no reason to doubt its adequacy — although managing the distribution of bonuses and consequent growth in guaranteed liabilities in respect of the very substantial (over £8.6bn) portfolio of unitised with profit type business is a potential problem to be monitored.*

(The actual resilience reserve that would have been required at the end of 1994 was disclosed in correspondence with the Actuary as £171m.)

Other reserves seem to be on a reasonable basis, although the failure to set up a specific reserve in relation to the contingent liability for tax on capital gains of £37.4m is dubious — relying on other margins in the valuation basis.

Under *'Changes since previous year'*, GAD note that Equitable had revised their interest rate bases to reflect falling interest rates and rising asset values and that they had strengthened annuitant mortality and expense reserves following correspondence on the 1994 returns.

Under *'Summary of results for main classes'* GAD produce three tables, showing liabilities for non-linked and linked business and a valuation summary.

Under the table for non-linked business, GAD explain that they presume that, in the bonus reserve valuation, any additional reserve required for AIDS is covered by the bonus margin. They note that most of the margin between the total bonus reserve and net premium valuations would be needed to cover resilience.

Under the table for linked business, GAD note that the appendix valuation included an additional AIDS reserve of just £11,000.

The valuation summary shows, under the main valuation, that Equitable's cover for the required minimum margin is 2.89, compared with 2.36 in 1994. As in the scrutiny report on the 1993 returns (see 15/11/1994 [**entry 1**]), there is no estimated figure for the appendix valuation. The table shows Equitable's free asset ratio has risen to 5.13%, from 3.12% in 1994.

Under *'Cover for the solvency margin'*, GAD comment:

It should be appreciated that this bonus reserve valuation includes only an allowance for modest levels of future bonuses, with the result that the disclosed liability is actually very similar to that that would be derived from an acceptable net premium valuation with due allowance for resilience reserves.

Thus, the picture shown above may reasonably be compared directly with other offices who prepare Returns on standard net premium valuation bases. Without the implicit future profits item, cover for the [required minimum margin] *would be by a factor of 2.44. This is satisfactory.*

(9) Financial results
GAD provide the following table:

(£000s)	*1991*	*1992*	*1993*	*1994*	*1995*
Surplus emerging (Form 58)	*596,501*	*330,523*	*480,935*	*519,981*	*662,848*

(10) Bonuses
Under *'Cost of bonuses declared'*, GAD include the following table:

£000s	*1991*	*1992*	*1993*	*1994*	*1995*
Reversionary Bonus	*304,459*	*298,582*	*317,509*	*349,647*	*417,361*
Terminal and other bonuses in anticipation of a surplus	*151,565*	*167,898*	*165,053*	*173,541*	*245,487*
Total Distributed	*456,024*	*466,480*	*482,562*	*523,188*	*662,848*

GAD provide a description of Equitable's final bonus system similar to that used in their reports on the 1993 and 1994 returns. GAD reiterate Equitable's own description of their final bonus system. GAD produce three tables of statistics showing changes in reversionary and final bonus rates and reproduce Equitable's table of earned investment returns on gross market value and the rate allocated in fixing bonuses, updated to include 1995:

	1990	*1991*	*1992*	*1993*	*1994*	*1995*
Earned	*–8.3%*	*13.5%*	*17.1%*	*28.8%*	*–4.2%*	*16.6%*
Allocated	*12%*	*12%*	*10%**	*13%*	*10%*	*10%*

' 12% was applied to new benefits secured during the year'*

Under *'Distribution policy',* GAD state:

> *The society follows a policy aimed at providing each generation of policyholders with a return that reflects earnings on assets during his or her membership of the fund, whilst avoiding short term fluctuations. Thus, total bonuses are intended to reflect a smoothed total earned rate. Part is allocated in the form of non-cancellable reversionary bonuses and the rest is in the form of final bonus.*

GAD make no reference to the effect of Equitable's bonus policy on policyholders' reasonable expectations.

(11) Reinsurance
GAD state that Equitable make little use of reinsurance.

(12) Compliance
Under *'DTI compliance problems'*, GAD state:

> *The Equitable is a highly ethical institution and likes to think of itself as being beyond reproach, although it has recently given ground in relation to mortality assumptions in relation to annuity liabilities.*
>
> *I am unconvinced of the value of its gross premium bonus reserve valuation, and would be happier to see a clearer exposition of its ability to react to possible falls in the value of assets — bearing in mind its exceptionally large exposure to unitised with profit type liabilities. It would be helpful to learn what scenario testing it undertakes.*
>
> *No serious reporting omissions are noted, although the Actuary continues to rely on the comments made about derivatives under 4(2)(a) rather than include a specific response to 4(2)(c). (Usage of real derivatives is minimal, with the majority of entries in Form 13A relating to quasi-derivatives, i.e. convertible bonds, warrants and partly paid shares.)*

Under *'PIA and other compliance problems'*, GAD state:

> *Although the Equitable might be expected to be beyond reproach, we understand that an over-estimation of pension liabilities of £50m has been incorporated into its reserves as a provision against possible costs arising from pensions mis-selling.*
>
> *No other problems are known.*

GAD's scrutiny report runs to 16 pages. Line Supervisor B copies the report to the Head of Life Insurance and to Line Manager B.

01/11/1996 [entry 2] Every insurance company is sent by DTI's Director of Insurance a letter requesting state of play information on money laundering, close matching of linked benefits, counterparty exposure on derivatives and controls on investments of linked funds.

05/11/1996	DTI write to Equitable to set out three matters to discuss under 'Any Other Business' at the visit now planned for 08/11/1996: *1. Details of the continued fall in the company's actual overhead expense levels, and its potential ability to continue on this creditable path.* *2. How the company views the sustainability of its present contract structures — largely based on accumulating funds to which regular bonuses are added. What scenario tests has it performed in relation to possible falls in asset values, and how would it react to sustained unfavourable market movements?* *3. The increased investment in non-insurance companies — £75.4m in shares and £18.7m in debt (previously, £49.3m and £2.8m respectively).*
08/11/1996 [entry 1]	DTI prepare a brief manuscript note for the meeting on 08/11/1996, summarising some of the correspondence since April 1995. DTI refer to a number of matters, including the discussions over Equitable's critical illness policy, their activities in non-UK markets (Malta, Republic of Ireland, United Arab Emirates), particular investment activities and *'June 1996 CBE for* [Equitable's Chief Executive and Appointed Actuary]*!!'*.
08/11/1996 [entry 2]	DTI (Line Manager B and Line Supervisor B) and GAD (Chief Actuary D and Scrutinising Actuary E) meet Equitable's Appointed Actuary/Chief Executive, Company Secretary and another employee. DTI prepare a note of the meeting, which is amended by GAD. Although DTI had suggested a series of meetings (see 15/10/1996), only one meeting takes place. DTI and GAD record discussion under six main areas: <u>Reports to Equitable's Board</u> Equitable's Appointed Actuary explains the cycle of reports presented on a monthly and quarterly basis and provides figures on Equitable's premium growth, expenses, turnover, profits of administration and marketing departments and expense ratios (the latter presently running at 4.8%, compared with 7.5% in early 1995). These show also that, over the past year, there had been 25% more new business on annual premiums and 30% more on single premiums. DTI and GAD note that recurrent single premiums are classed as annual. In response to a question from Scrutinising Actuary E, the Appointed Actuary agrees that Equitable's falling expenses are partly the result of high software expenditure several years ago. The note records: *'There was some discussion on the "financial condition" report. On the concept of dynamic solvency testing,* [Equitable's Appointed Actuary] *said that you needed dynamic management – there was a need to manage the business actively'*. <u>Bonuses</u> Scrutinising Actuary E asks if the company built up a terminal bonus reserve. In reply '[the Appointed Actuary] *said not — terminal bonuses were "instantaneous"! Declared rates were always broadly linked to the gilt rate for guaranteed benefits. Final bonuses were paid out of what was left. He noted that a "lively" life company would have smaller free assets than a moribund one!'*. The Scrutinising Actuary comments that he was not clear what Equitable's bonus declarations said. In relation to accumulated with-profits business, the Appointed Actuary explains *'that all bonus statements showed a build-up of guaranteed benefits — then also showed the non-guaranteed benefits. In the DTI returns, the terminal non-guaranteed bonus was not shown as a liability — not in the reserves'*. DTI and GAD record Equitable's Appointed Actuary as noting that:

1996

... every actuary valued as weakly as possible, to make the business look stronger. [Scrutinising Actuary E] *suggested that gross premium reserving was not really any stronger than a standard net premium valuation method.* [The Appointed Actuary] *agreed — but said the Board was used to this method and happy with it. At the AGM, someone had asked about the "orphan estate", and was told that it was all paid out!* [The Appointed Actuary] *explained that they never guaranteed a surrender value on any business.* [Scrutinising Actuary E] *noted that they had to be very careful with their bonus statements — to ensure that customers were not misled about the benefits.*

Future plans/Permanent Insurance
Equitable's Appointed Actuary sets out the Society's plans to grow its health and sickness products. He explains that business in the Republic of Ireland is buoyant. DTI's Line Manager B notes:

... that the Department's lawyers were not happy about [Equitable's] *sales force selling another company's products — section 16 implications. He was relaxed about this issue.* [The Appointed Actuary] *said he hadn't thought about section 16 ...* [Line Manager B] *said that it would be no problem if* [Equitable] *owned the whole of Permanent* [Insurance].

The Appointed Actuary explains that the Society's German branch was losing about £2m per annum at present and that Equitable would be deciding whether or not to pull out in the next few weeks. He explains that Equitable were thinking of doing business in Italy, Austria and Malta. Line Manager B suggests Gibraltar.

Equitable's 1995 returns
GAD's Chief Actuary D queries Equitable's investments in a non-insurance subsidiary. The Appointed Actuary explains that the companies involved are not subsidiaries in a real sense, as Equitable have majority holdings in them for investment purposes. These are carefully controlled through the investment committee.

The Appointed Actuary explains that the Society *'had sold all its software to its consulting company and had lent the company £10m to pay for the software! They had also lent £6m to the unit trust subsidiary. He promised to provide more detail'*.

Equitable's Appointed Actuary explains that the Society had put £50m in technical reserves for personal pensions mis-selling. The Appointed Actuary says that he thinks that:

... about £10-15m would be needed. This didn't include staff costs. All policyholders had been written to. 35,000 cases to review, of which 10,000 were priority. 6,000 cases had been done. Very little evidence of real mis-selling. Some policyholders were "mis-remembering" details! About £449K had been paid on 28 cases so far. Where possible, [the Society] *was enhancing benefits. 50 staff were progressing cases — at a cost of about £1.5m. In August, the PIA enforcement team came — 4 people for a week.* [The Appointed Actuary] *thought they had misunderstood the issues, and had sent them away! It was hoped that all cases would be settled by Autumn 97.*

Selling
The Appointed Actuary explains that Equitable would begin telephone sales.

Business plans
The Appointed Actuary explains that Equitable have no new business targets or plans to increase their sales force.

Under Any other business, the Appointed Actuary explains that Equitable might apply for a section 68 Order for a subordinated loan. He also explains, as regards his retirement, that he would stay *'until all the changes had been consolidated'*.

A copy of the note is passed to Chief Actuary C. He underlines the Appointed Actuary's statements that a lively life company would have smaller assets than a moribund one, and that every actuary valued as weakly as possible. He also underlines Scrutinising Actuary E's comment that Equitable had to be very careful not to mislead customers with their bonus statements.

27/11/1996	Equitable write to DTI seeking their views on a subordinated loan. The Society says it could raise finance from the market but was interested in the possibility of raising finance by the sale of bonds to Equitable's own policyholders. Equitable say that this would be cheaper and would provide benefits to policyholders. Equitable ask DTI to indicate if, in principle, they would agree to the necessary application for a section 68 Order.
December 1996	At around this time, GAD prepare an update to their 1994 annual report on the life insurance industry using information disclosed in companies' 1995 returns. (Note: GAD did not produce a full report for this year due to *'particular resource constraints within GAD during 1996'*. The bodies under investigation have been unable to provide me with a copy of this update. However, as for the 1994 report (see 03/11/1995), I have seen GAD's detailed analysis of the parts of the report which were updated.) GAD update their comparison of maturity payouts against their own estimates of the theoretical asset shares. For endowment policies (based on contributions of £50 per month for 25 years), GAD calculate that the with-profits industry median payout is £97,496. GAD calculate this to be 113% of the theoretical asset share. For Equitable, GAD calculate that they are paying £86,739. GAD show this to be 101% of the theoretical asset share. For endowment policies (based on contributions of £50 per month for ten years), GAD calculate that the with-profits industry is paying a median maturity value of £10,004. GAD show this to be 125% of the theoretical asset share. For Equitable, GAD calculate that they are paying £10,221. GAD show this to be 127% of the theoretical asset share. For pension policies (based on contributions of £200 per month for 15 years), GAD calculate that the with-profits industry is paying a median maturity value of £126,199. GAD show this to be 132% of the theoretical asset share. For Equitable, GAD calculate that they are paying £131,239. GAD show this to be 137% of the theoretical asset share. GAD update their analysis of the strength of companies' valuation bases. GAD use the same method as that used in the 1993 dummy report (see 30/08/1995). Their analysis again shows that Equitable's net premium valuation basis is the weakest across the industry, with a figure of 89.9% (a figure of 100% being one that GAD had previously described as indicating that the valuation interest rates used only just complied with the regulations). I have seen that GAD looked back and assessed the strength of Equitable's net premium valuation basis for 1990. GAD's analysis produces a figure of 93.2% for that year.
05/12/1996	Equitable apply to DTI for a section 68 Order to allow Equitable to include details of their *'Personalised Funds'* in aggregate form. This is a replacement for the Order issued on 14/10/1986. The need for a new Order arises because the Insurance Companies (Accounts and Statements) Regulations 1996 (the ICAS Regulations 1996) were due to come into force (see 23/12/1996). (Note: Equitable's *'Personalised Funds'* were self-invested pension funds. As at 31 December 1995, there were 33 funds, totalling £7.7m.)
06/12/1996	DTI send GAD a copy of Equitable's letter of 27/11/1996 and ask whether they have any comments on the proposed subordinated loan.

16/12/1996	Equitable write to DTI, to respond to the letter from DTI of 01/11/1996 seeking state of play information about a number of issues, including money laundering, the matching of linked benefits, exposure to derivatives and controls of investments of linked funds.
17/12/1996	DTI seek advice from GAD on Equitable's application to renew the section 68 Order issued in 1986.
23/12/1996	The ICAS Regulations 1996 come into force.

1997

08/01/1997	GAD confirm to DTI that a section 68 Order to allow Equitable to include details of their 'Personalised Funds' in aggregate form (05/12/1996) is *'still required — but now only for 3 Forms as suggested by* [Equitable's Appointed Actuary]' and that it '[seems] *OK to issue* [the Order] *in this case'*.
31/01/1997	DTI send Equitable the section 68 Order applied for on 05/12/1996 and revoke the section 68 Order issued on 14/10/1986.
14/02/1997	GAD advise DTI on Equitable's letter of 27/11/1996 about a subordinated loan. GAD question if the bonds Equitable have in mind fall within the concept of members accounts envisaged by the Third Life Directive. GAD warn that DTI and Equitable would *'find themselves in difficulty over a very short term if the concept were ever to fail'*. GAD say that they would be troubled if such a pool of bonds were treated as perpetual. GAD also advise that: *... we would always feel uncomfortable that the Society could "market" such a product, even if the risks were clearly explained, and then treat the proceeds as free capital and not be obliged to hold full reserves within the long term fund to cover the repayment liability.* GAD conclude: *Despite our general misgivings as expressed ... above, we believe that it might be possible within the terms of the* [Third Life] *Directive for Equitable to issue a tranche of "term subordinated loans" to its members — but the DTI would need to be satisfied that early redemptions were strictly limited or that bonds surrendered would be taken up under an agreement with an underwriting bank or that some similar arrangement was in place to ensure that solvency cover could not suddenly evaporate. Such term debt could, of course, only count for up to 25% of the Required Margin of Solvency.* *You should of course ascertain the views of your legal advisers on this proposition.*
14/03/1997	Equitable fax DTI about a subordinated loan. Equitable explain that they plan to raise £150m in Dollars, £100m in Deutschmarks and £50m in Yen *'essentially for investment purposes, not to finance developments'*. Equitable say that the process is about to start with a planned completion date of mid-May. It would therefore be helpful to know fairly early on if the DTI would find difficulty with such an approach. Equitable also ask *'whether the practice followed by preceding borrowers of setting up a subsidiary for the purposes of raising the loan was a DTI requirement. Since we already have power to borrow we hope to avoid that complication'*. Against this, Line Supervisor B notes: *'I'm sure this isn't a requirement'*.
19/03/1997	DTI seek advice from GAD on Equitable's fax of 14/03/1997.
24/03/1997	GAD advise DTI as follows: *With reference to the letter from* [Equitable's Appointed Actuary] *of 14 March ... and the question raised regarding the need to establish a subsidiary company for the purposes of issuing subordinated debt, it is my understanding that this arose from a DTI view that it would not be possible to satisfactorily issue such debt from within the Long Term Fund.*

GAD continue:

If an insurance company issued subordinated debt through a Long Term Fund, the view is that it is not possible to achieve a proper degree of subordination to protect the interests of the Long Term policyholders. Issuance by a subsidiary company seems to have been the most satisfactory way of overcoming the problem of achieving acceptable subordination.

01/04/1997 DTI's Validation and Compliance Unit write to DTI supervisors to point out that they are obliged to provide certain statistical reports, derived from companies' European Statistical returns. DTI's records show that Equitable's statistical return for 1995 has not been received.

08/04/1997 Equitable's Appointed Actuary asks DTI for advice as to how recurrent single premiums should be analysed between 'annual' and 'single' premiums for the purposes of the statutory returns. The Appointed Actuary explains:

As I think you will know, we capture policyholders' intentions regarding premium maintenance at the new business stage and that analysis is used, in part, as the basis for remunerating our field force. Our published new business figures reflect that same analysis.

It is, therefore, straightforward for us to prepare Form 47 using that same analysis. That will give a helpful consistency with the analysis shown in our statutory accounts.

We are, however, finding it extremely difficult to arrive at a meaningful "in-force" annual premium on recurrent single premium business for the purpose of Form 46. There are really two main difficulties:

(i) Our internal definition of "annual" and "single" is based on an expression of client intention and is held on an entirely separate system, which is primarily used for field force remuneration, from our main data system. That system has a variety of internal rules, including grouping of similar contracts (e.g. retirement annuities and personal pensions) and limitations on what can be treated as "annual", which would make translation of that information back to interpret the premium records on the main data system from which the in-force data needs to be drawn extremely complex.

(ii) Even if the problems in (i) could be overcome the data would be subject to significant distortion because our internal rules operate on a policy year rather than calendar year basis. Thus a policyholder paying (in our terms) a level premium each year but varying the timing within the policy year could create a sequence of "ons" and "offs" in the DTI data.

Equitable's Appointed Actuary continues:

We have investigated this matter in depth but can see no practical solution. If, therefore, we are to adopt a realistic presentation in Form 47, which I think we would all agree to be highly desirable, we shall need to request a modification of Instruction 3 to Form 46.

I should, therefore, like to request that a section 68 order be granted allowing us not to include recurrent single premiums within the "annual premium" figures in Form 46 of the Returns.

14/04/1997	DTI's Line Supervisor B passes to an official copies of Equitable's fax of 14/03/1997 and GAD's advice of 24/03/1997. The Line Supervisor says that she can find no reference to a requirement to set up a subsidiary in the relevant guidance note (Prudential Guidance Note 1994/1 *'Hybrid Capital: Admissibility for Solvency'* (PGN 1994/1)). The Line Supervisor asks if it is *'possible to achieve a proper degree of subordination when a company issues subordinated debt through the Long Term Fund'*.
16/04/1997	Equitable telephone DTI to ask about the procedures for seeking section 68 Orders, in the context of their pursuit of a subordinated loan. Equitable also query whether it is necessary for any loan to be issued by a subsidiary. DTI suggest that any such loan might have to be issued through a subsidiary due to section 16 of ICA 1982, but that *'there might be other reasons'*. DTI say that they would want to take advice on the issue and they ask Equitable in the meantime to submit an application for a section 68 Order, including any relevant background information.
18/04/1997 [entry 1]	DTI telephone Equitable in response to their call of 16/04/1995. DTI draw the Society's attention to GAD's and DTI's views regarding the 'proper degree of subordination' and to PGN 1994/1. Equitable respond that they have incorporated the requirements of PGN 1994/1, but would check this with their solicitors.
18/04/1997 [entry 2]	Equitable's solicitors send DTI draft term sheets for the proposed subordinated loan. The solicitors also send DTI a copy of Equitable's *'Memorandum and Articles of Association'*.
22/04/1997	DTI write to GAD about Equitable's proposed subordinated loan. DTI say that their own advice, in the light of PGN 1994/1, is that there should be proper subordination and that for a mutual this was best achieved through a subsidiary company. However, Equitable's view is that they already comply with the terms of PGN 1994/1 as regards subordination. DTI ask GAD for their comments.
24/04/1997 [entry 1]	Line Supervisor B asks a DTI legal adviser for comments on Equitable's proposed subordinated loan. The Line Supervisor explains that *'GAD's response is that they don't know how the principle of subordination is supposed to work. As far as he's concerned, there are no assets held outside the long term fund of the company'*. The Line Supervisor asks for advice on whether or not a mutual should set up such a loan through a subsidiary.
24/04/1997 [entry 2]	Equitable provide GAD with specimen forms showing how they propose to treat recurrent single premiums in the returns (see 08/04/1997).
25/04/1997	A DTI legal adviser provides comments on Equitable's proposed subordinated loan. The legal adviser points out that PGN 1994/1 makes clear that responsibility for achieving effective subordination rests with the company and their legal advisers. He advises that the paperwork Equitable have provided shows that they have had regard to PGN 1994/1 and that they *'have indeed achieved the necessary degree of subordination'*. He advises DTI to draw Equitable's attention to one part of PGN 1994/1 (on ensuring that the documentation secures that the note holders' (i.e. bondholders') claims on the assets of the company were subordinated to the liabilities assessed in respect of all long term business policies) and suggests that they have explicit regard to this in their documentation. He adds that, in principle, it does not seem necessary to issue the loan through a subsidiary company; this is not required in PGN 1994/1. He notes GAD's concern that there are no assets held outside the long term fund. If that were the case:

... we should put that point to the company and see what response it elicits. If in that context we are able to say that the usual practice is for the issue to be by a subsidiary company and to identify adequate reasons for that (I am bound to say that from the papers which I have seen no clear rationale for that proposition emerges) I see no harm in doing so.

29/04/1997 [entry 1] GAD write to DTI about Equitable's proposed subordinated loan, having seen the legal advice received (see 25/04/1997). GAD express their uncertainty about how the proposals would operate, *'bearing in mind the requirement that the loan (capital and interest) should not constitute a liability attributable to the long term fund'*. GAD query how Equitable would make interest payments and eventual capital repayment if they hold no assets outside the long term fund. GAD advise that others have used a subsidiary to achieve the necessary subordination. GAD suggest DTI raise these points with Equitable. GAD conclude:

It should be appreciated by the DTI that the potential sums involved in these proposed issues are substantial ... ie a possible total of £325m, and this amount of gearing could cause problems to the Society unless the terms are reasonable and proper subordination to policyholder rights is achieved.

29/04/1997 [entry 2] Line Supervisor B asks an official to chase Equitable for their 1995 European Statistical returns which were due by 30 September 1996 (see 01/04/1997).

30/04/1997 [entry 1] DTI ask Equitable for their 1995 European Statistical returns.

30/04/1997 [entry 2] GAD inform Equitable that they agree to the requested section 68 Order allowing Equitable to treat recurrent single premiums in Form 46 of the returns in the way they propose (see 08/04/1997). GAD say:

... I understand that [Chief Actuary D] *has agreed that we would recommend to the DTI that they should accept your request for a Section 68 Order in this regard – <u>on a temporary basis</u>. (The volume of pensions business sold by the Society subject to variable premiums is so large that it would be unreasonable to allow it a permanent exemption from disclosure in Form 46* [of the returns, on summary of changes in ordinary long term business].

An exemption from the inclusion of recurrent single premium pensions business in Form 46 for the 1996, 1997 and 1998 Returns has been suggested – with the expectation that the Society will be able to provide meaningful data in Form 46 from 1999.

GAD copy their letter to DTI. In an accompanying note, GAD inform DTI that:

... on the telephone [Equitable] *have agreed that it should be possible to have in place appropriate record systems by the end of 1998 — to generate an acceptable presentation for the Returns at the end of 1999.*

We therefore recommend that you grant a Section 68 Order ... for three years only.

(Note: GAD's compliance issues on the scrutiny report had included the failure by Equitable to produce meaningful in-force premium figures for renewable single premium business. Against this, Line Supervisor B had written *'wouldn't call this a compliance <u>problem</u>'* – see 16/12/1997.)

30/04/1997 [entry 3] DTI's Line Supervisor B writes to a new Line Manager with responsibility for Equitable (Line Manager C), relaying GAD's continuing concerns that Equitable's proposed subordinated loan should be issued through a subsidiary. The Line Supervisor asks if it would help to have a meeting with Equitable. The Manager's advice is that, as she is not available for a meeting, Line Supervisor B should write instead.

30/04/1997 [entry 4]	Equitable inform DTI that Equitable's Chief Executive and Appointed Actuary is to retire on 31/07/1997. Equitable notify DTI who is to succeed him as Chief Executive (but not as Appointed Actuary). Equitable undertake to advise later who the Society's new Appointed Actuary would be.
30/04/1997 [entry 5]	Equitable write to DTI. Equitable refer to the auditing profession's concern about their ability to audit statements in the directors' certificate on money laundering and the operation of the internal linked fund. Equitable say that they understand that DTI are issuing section 68 Orders taking these matters outside the scope of the audit opinion. Equitable ask for such an Order in respect of Equitable. Equitable also set out some revised wording for their subordinated loan documentation, taking account of the fact that it is not being issued through a subsidiary. DTI's Line Supervisor B notes that the revised wording makes no reference to assets held outside the long term fund, and asks for GAD's comments. GAD's Scrutinising Actuary E notes on the letter: *'I still do not see how these issues can be made to satisfy* [paragraph 25 of PGN 1994/1 (on the requirement of documentation to satisfy that a loan should not constitute a liability attributable to the long term fund and the rights of the note holder are to be met from assets held outside the long term fund)]'.
30/04/1997 [entry 6]	Equitable ask DTI for guidance on how to present immediate annuities in the returns.
01/05/1997 [entry 1]	Equitable send DTI copies of their 1995 European Statistical returns. Equitable explain that these had been sent on 6 August 1996 and enclose a copy of their letter from that date.
01/05/1997 [entry 2]	DTI reply to Equitable's solicitors' letter of 18/04/1997 about the subordinated loan. DTI refer to the statement in PGN 1994/1 that responsibility for achieving effective subordination rests with Equitable and their advisers. They query how Equitable would make interest payments and eventual capital repayment if they held no assets outside the long term fund. DTI state that the taxation clause in the summary of terms and conditions does not appear to comply with PGN 1994/1.
06/05/1997	Equitable's solicitors provide DTI with comments on their letter of 01/05/1997. The solicitors explain that, in their view, the revised wording in Equitable's letter of 30/04/1997 provides the necessary degree of subordination. The solicitors suggest that the taxation clause is of academic interest only, but that in any event it satisfies PGN 1994/1.
08/05/1997	DTI remind Equitable that any announcement about the new Chief Executive would need to be given with the proviso that the appointment is subject to approval by the Secretary of State.
09/05/1997	A DTI official writes to Line Manager C and another official about subordinated loans issued by mutuals. The official notes that a subordinated loan taken out by a mutual was likely to constitute a liability on the long term fund. However, DTI had already issued section 68 concessions to mutuals *'despite the apparent lacking of the safeguard that would be in place in a proprietary company'*. The official suggests that DTI: *... should not change what has become our policy, namely that we are prepared to consider offering section 68 concessions to enable mutuals to count subordinated loan capital toward their* [required minimum margin], *subject to considering each individual proposal and satisfying ourselves that the proposal is reasonable, particularly in relation to there being adequate subordination ...* The official also suggests that DTI should not insist on the issue being effected through a subsidiary.

The official says that, if DTI were to adopt this approach, it would be necessary for him to amend PGN 1994/1 to reflect this.

12/05/1997 [entry 1] GAD write to DTI about Equitable's proposed subordinated loan. GAD note the inability of a mutual to satisfy PGN 1994/1 but add:

> *Since other mutual offices have already by-passed* [PGN 1994/1] *successfully (even though the advance from a subsidiary must still have actually become a liability of the Long-Term Fund), and it seems to be accepted in principle that mutual offices should be able to benefit from the issuance of Hybrid Capital, it would seem that the DTI needs to review the application to mutual offices of* [PGN 1994/1]. *We would, however, emphasise the desirability of retaining this Paragraph to apply to proprietary offices.)*

GAD explain that they have discussed this problem with a DTI official who is expecting a meeting to clarify DTI's approach. GAD also raise concerns about the proposed taxation clause on the grounds that it *'introduces the possibility of generating interest strains that are greater than it may be reasonable to accept as falling within the permitted guidelines'*. GAD add:

> *... to the best of my knowledge, this is the first UK insurance company to consider raising capital in this way. It is therefore a new problem, and we would wish to be assured that such a clause did not introduce an unacceptable level of volatility to the obligation undertaken by the company. If the DTI were to be convinced that these clauses are indeed "of academic interest only" as suggested by* [Equitable's solicitors] *then it might decide not to make the existence of such a clause a reason for refusing to grant a Section 68 Order.*

12/05/1997 [entry 2] GAD telephone Equitable to advise them on how to present immediate annuities in the returns.

12/05/1997 [entry 3] DTI's Company Law Directorate write to DTI's Inspector of Companies, with a copy to Line Supervisor B. DTI set out the procedure that they follow when companies repeatedly breach Part VI of the Companies Act 1985 (which deals with disclosure of interest in shares), including sending progressively stronger letters, warning that the Department might take action for non-compliance. DTI explain that a first letter is usually sufficient to prevent further breaches. However:

> *... there are some investors who have become multiple offenders and we have now reached a position with the Equitable Life Assurance Society where it has committed its fourth offence within a period of twelve months, and, indeed, its third offence since the beginning of the year. The Equitable Life Assurance Society does not seem to take its responsibilities under part VI sufficiently serious enough.*

DTI seek views, especially from Line Supervisor B, as to what further action should be taken.

16/05/1997 DTI's Line Manager C writes to a DTI official in response to his note about subordinated loans (see 09/05/1997). The Line Manager agrees *'that we should not change our policy on mutuals' access to* [subordinated loan capital]. *I also share your view that there would appear to be no clear reason why we should insist on this taking place through a subsidiary'*.

On the same day, Line Manager C writes to Equitable's solicitors. The Line Manager explains that, while the revised wording in Equitable's letter of 30/04/1997 is more appropriate, it still did not address the issue of how the rights of a note holder could be met from assets outside the long term fund. The Line Manager also repeats concerns about the taxation clause, in the light of the comments by GAD on 12/05/1997.

27/05/1997	Equitable remind DTI that they were awaiting two section 68 Orders. (see the applications made on 08/04 and 30/04/87 [**entry 5**]).
28/05/1997	Equitable's solicitors write to DTI in response to their letter of 16/05/1997. The Society's solicitors explain: *I do not think it is helpful, in the descriptive wording which is to be included in the term sheet, to specify that the rights of the Noteholders will be met from assets outside the long term fund. As I have said, that will be the effect of the actual subordination wording contained in the bond, but to insert that wording as part of the description in the term sheet would, in my view, arguably be misleading because it may give rise to the notion that there are indeed assets held outside the long term fund of the Society which are available to meet the rights of the Noteholders. In the case of a mutual there are of course unlikely to be any such funds.* The solicitors also explain that they do not consider that there is any foreseeable exposure for Equitable from the taxation clause.
29/05/1997 [entry 1]	DTI ask GAD for their comments on the letter received from Equitable's solicitors the previous day.
29/05/1997 [entry 2]	Every Appointed Actuary is sent by the Government Actuary a copy of DAA9 on reserving for guarantees provided under the pensions mis-selling review.
01/06/1997	GAD advise DTI on the letter of 28/05/1997 from Equitable's solicitors. They note that the solicitors still believe the proposal satisfies PGN 1994/1, even though they acknowledged that there were unlikely to be any assets of a mutual company outside the long term fund. GAD say: *... it is only honest that all parties should acknowledge that the Long Term Fund is involved — and the DTI has already accepted the reality of the situation. We think that the adoption of clever legal wording to try to avoid the issue should be discouraged.* GAD set out the advice that they have given in respect of another mutual pursuing a subordinated loan as to how to show the loan in their returns. GAD also explain that they have reviewed the information Equitable's solicitors have provided on the taxation clause. GAD suggest that there are now only concerns in relation to the Deutschmarks issue. GAD also suggest that DTI seek guidance from other sources as to whether there would be any major additional liability falling on Equitable, while noting that Chief Actuary D *'remains somewhat uncomfortable about this proposed issue'*.
03/06/1997	DTI's Head of Life Insurance provides briefing to a Minister for a visit to Equitable. The Head of Life Insurance writes: *The Equitable Life is one of the leading UK life insurance companies, with particular strength in pensions business. Generally speaking, it has a well deserved reputation for giving good returns to policyholders, and has so far escaped the worst of the criticism aimed at the life insurance sector in recent years. However, its heavy involvement in pensions business means that it is not immune from the problems of the* [Securities and Investments Board]*/PIA Pensions Review.* DTI's Head of Life Insurance expresses no concerns in relation to matters relevant to the prudential regulation of the Society.

05/06/1997	DTI's Head of Legal Services writes to DTI's Company Law Directorate in response to their note of 12/05/1997. She advises them to send Equitable a further warning letter or to consider starting a criminal investigation. She copies her note to Line Supervisor B who notes: '[An official] *suggested that the Grade 7 ... should get in touch with* [Equitable's] *Compliance Officer + find out if they have proper systems in place. Threaten to visit* [company]. [The official] *likened it to a driving offence!*'.
06/06/1997	DTI advise Equitable that the Secretary of State had no objection to the appointment of their new Managing Director. DTI send Equitable the section 68 Order requested on 30/04/1997, exempting Equitable's auditors from auditing statements in the directors' certificate on money laundering and the operation of the internal linked fund.
10/06/1997	DTI ask GAD for their comments on a draft they have prepared in relation to Equitable's application for a section 68 Order to permit them not to include the recurrent single premiums within the 'annual premium' figures in the returns. GAD suggest some small amendments to the wording of the Order.
13/06/1997	DTI's Line Supervisor B writes to DTI's Company Law Directorate in response to their note of 12/05/1997. She says '*we do not think that the matter warrants action under the Insurance Companies Act Schedule 2A under the criteria of "sound and prudent management"*'. The Line Supervisor suggests that the matter is pursued through the Companies Act legislation. The Line Supervisor goes on to suggest '*that the issue is taken up by your head of section who could contact the company's Compliance Officer ... and find out if they have proper systems in place to comply with the notifications procedure. (We know that Equitable Life have very sophisticated computer systems – we have had a tour of their "paperless office" – which should easily be able to cope with this)*'. DTI's Line Supervisor B sends Equitable the section 68 Order allowing Equitable not to include the recurrent single premiums within the '*annual premium*' figures in Form 46 of the 1996, 1997 and 1998 returns. The Order requires the Society to include a note in its returns saying: *The Secretary of State has issued an Order dated 13 June 1997 under section 68 of the Act to the effect that figures in Form 46 exclude recurrent single premiums from the annual premium figures as the Company cannot at present calculate a meaningful figure.*
16/06/1997	DTI write to Equitable's solicitors, acknowledging that servicing the subordinated loan would necessarily require drawing on the long term fund. DTI discourage Equitable from adopting complex legal wording to avoid the issue. DTI reiterate their concerns about the taxation clause insofar as it affects the Deutschmark issue.
24/06/1997	DTI's Company Law Directorate write to Equitable regarding Equitable's breach of Part VI of the Companies Act 1985. DTI state that: *... having considered the circumstances explained in your letter* [of 28 April 1997] *and having noted your investigation of the matter, has decided not to take any further action on this occasion.* *However, the Department is not prepared to tolerate a further breach of the provisions of Part VI by The Equitable Life Assurance Society. Accordingly, in the event of any future contravention, I will have no other option but to refer the matter to the Department's Investigations and Enforcement Directorate in order that consideration be given to the taking of prosecution action ...*

25/06/1997	Equitable confirm that the contents of DTI's letter of 24/06/1997 have been noted and attach details of the procedures currently in place to identify disclosure situations.
27/06/1997	DTI copy Equitable's letter of 25/06/1997 to DTI's Head of Legal Services.

Submission of the 1996 regulatory returns

30/06/1997 [entry 1] **Equitable submit their 1996 regulatory returns to DTI**. Accompanying these returns are copies of the Society's annual report and financial highlights and its statutory accounts, prepared in accordance with the Companies Act 1985 and both dated 26 March 1997.

These documents include the following information about Equitable's business and their financial position as at 31 December 1996.

GAD's copy of the 1996 regulatory returns and Companies Act reports and accounts includes various annotations. I am satisfied that those annotations were made by Scrutinising Actuary E during the scrutiny programme on or around 07/08/1997, when the Scrutinising Actuary completed the A2 Initial Scrutiny check. However, for ease of reference, mention of these annotations is made here.

<u>Companies Act annual report and financial highlights</u>
In their *'President's Statement to members'*, Equitable make particular mention of three achievements in 1996, being:

- a record level of new United Kingdom annual premium income of £400m.
- total new premium income had exceeded £2bn for the first time (including single premiums of £1.59bn).
- a fall in the expense ratio to 4.3%.

GAD note these facts.

The President explains that the Society's approach to bonus distributions was an important aspect of their status as a mutual organisation. He says it had always sought to ensure that each generation of with-profits policyholders received the returns they deserved on their investments with the company. (GAD underline this point.) The distributions had been *'full and fair'*. The President explains that Equitable had not built up surplus assets in order to boost their *'free assets'* and so their free asset ratio was *'inevitably, and rightly, lower'* than some of their competitors. (GAD underline this point.) He argues that their low free asset ratio was a reflection of their full distribution policy and not an indication of financial weakness. Equitable's President demonstrates that their assessment of the financial strength of the Society is supported by an expert third party and reports that the *'AA (Excellent)'* rating awarded by the international rating agency Standard & Poor's in 1993 had been confirmed in each subsequent year. The President states that he *'would like again to put on record your Board's continued strong commitment to maintaining The Equitable as a mutual society'*.

In their *'Management Report: An appraisal of the Society today'*, Equitable explain that, because the Society was self-financing without any shareholder capital, it looked to their members to provide development capital which it expected to repay through its bonus policy. Equitable explain that the prime need for capital was to finance the up-front costs of new business and the occasional major investment in new systems. They explain how existing members provided a loan to cover the acquisition costs of new members and that this was repaid from charges over the lifetime of those policies. Equitable also state that a full distribution policy did not lead to investment considerations that were any different from those applying to life offices generally. They go on to say: *'Over many years there have not been any particular technical restrictions placed on the investment team'*. GAD underline this sentence.

In their *'Management Report: Features of 1996'*, Equitable set out their investment aim, *'to provide good returns for our policyholders by prudent investment of their funds'*, and discuss the issue of investment risk. They explain:

By implication, with-profits policyholders have indicated a desire for some guarantees and for some protection to their policy values from the short-term volatility of investment markets. The investment risk is controlled by holding a range of assets in several different categories and the guarantees are provided with the help of a suitable proportion being held in U.K. government securities. The assessment of future risk is, however, difficult and it is not possible to define precisely in advance what level of overall risk is implied by a particular investment strategy. Nor can risk be considered solely in absolute terms, since we are in competition with other providers and the "success" of the Society's investment returns will be largely measured by the results delivered to policyholders compared with those provided by our competitors. Nevertheless, techniques are available which enable a reasonable assessment to be made both of absolute and relative risk, and these are utilised in the management of the Society's portfolio in pursuit of its investment objectives.

The report goes on to explain that the Society had earned 10.7% on its with-profits assets at market value in 1996, with the result that the average annual return over the last 4 years had been 13% – around 1% per annum higher than would have been obtained on 15-year gilts. The Directors had decided to allocate an overall rate of return of 10% to recurrent single premium pensions business. Equitable say that for many years reversionary bonuses had followed the trend in gilt yields and that the declared rates in 1993 were consistent with the then current gilt yields. As yields had subsequently remained broadly at that level, Equitable had maintained reversionary bonuses at the same level, in 1994, 1995 and 1996.

GAD note the return earned on the Society's with-profits assets and the rate of return allocated for 1996. GAD also note that Equitable had decided to use an interim rate of return for 1997 of 9%. Next to this GAD write: *'too high? Unless supported by capital appreciation'*.

Companies Act statutory accounts
The Directors' Report for 1996 includes explanation of the financial results of the Society along with the valuation and bonus declaration made. GAD make various annotations against the Notes on the Accounts.

The returns
The new accounts and statements regulations, ICAS Regulations 1996, came into force during the year. These had altered the format of the information given in the returns and introduced some further disclosure requirements in respect of both the forms and the abstract to the actuary's valuation report. Some forms were also transferred from Schedule 3 to Schedule 4.

Equitable's returns are submitted in one part covering Schedules 1, 3, 4 and 6 to these regulations.

Schedule 1 (Balance sheet and profit and loss account)
Schedule 1 of Equitable's returns consists of Forms 9, 10, 13, 14 and 17. Form 9 summarises the Society's financial position at 31 December 1996 as follows:

Long term business admissible assets	*£19,131,286,000*
Total mathematical reserves (after distribution of surplus)	*£17,572,128,000*
Other insurance and non-insurance liabilities	*£138,980,000*
Available assets for long term business required minimum margin	*£1,420,178,000*
Future profits	*£312,794,000*
Total of available assets and implicit items	*£1,732,972,000*
Required minimum margin for long term business	*£685,282,000*
Explicit required minimum margin	*£114,214,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£1,305,964,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	*£1,047,690,000*

GAD tick some of the figures and circle the future profits figure.

In Form 13, Equitable set out their admissible assets. GAD make various notes on the forms.

In Form 14, Equitable set out their long term business liabilities and margins. GAD note that the excess of the value of admissible assets representing the long term business funds over the amounts of those funds, shown on line 51, is *'DOWN!'* from the previous year. The figure for 31 December 1996 is £1,420m and the figure for 31 December 1995 is £1,433m.

Schedule 3 (Long term business: revenue account and additional information)
Schedule 3 of Equitable's returns consists of Forms 40 to 45.

In Form 40, Equitable set out information for the *'Long term business: Revenue account'*. GAD tick some of the figures provided.

In Form 41, Equitable set out information for the *'Long term business: Analysis of premiums and expenses'*. GAD note on this Form the previous year's figures for *'Management expenses in connection with acquisition of business'* (which had increased from £82,376,000 to £88,457,000) and *'Management expenses in connection with maintenance of business'* (which had decreased by £14,000 to £30,208,000).

Schedule 4 (Abstract of valuation report prepared by the Appointed Actuary)
As in previous years, Equitable present two valuations of their long term liabilities (their main and appendix valuations). The results of the main valuation are carried forward, unadjusted, from Form 58 to Form 14 and on to Form 9.

Schedule 4 of Equitable's returns provides the information required by paragraphs 1 to 23 of Schedule 4 to ICAS Regulations 1996 and includes Forms 46 to 49, 51 to 58, 60 and 61.

Schedule 4 – main valuation (text)
Equitable state that this valuation is made in conformity with Regulation 64 of ICR 1994.

In response to paragraph 4 of Schedule 4, Equitable provide ten pages of information about their non-linked contracts.

Equitable begin by describing their accumulating with-profits contracts and disclose, in paragraph 4(1)(a)(i), the following as being applicable to all such contracts:

> *The Society reserves the right to pay less than the full identifiable current benefit attributable to a policy where the contract is terminated by the policyholder at a time other than one at which the policy benefits can be contractually withdrawn. It is the Society's current practice only to make an adjustment to the full identifiable current benefit in circumstances where the policyholder is exercising a financial option against the Society, for example by requesting a transfer to another provider, and the full policy value exceeds the underlying share of assets. The current method of adjustment is to pay only a proportion of the full final bonus in such circumstances but there is no guarantee that the amount of the adjustment cannot exceed the full amount of final bonus.*

GAD underline *'to pay less than the full identifiable current benefit attributable to a policy'* and have written next to this: *'Define "full identifiable current benefit"'*.

GAD also underline *'the full policy value exceeds the underlying share of assets'* and *'there is no guarantee that the amount of the adjustment cannot exceed the full amount of final bonus'*. They sideline this part of the paragraph and write *'Is this reasonable?'*.

Equitable go on to disclose in paragraph 4(1)(a)(ii) that, for all accumulating with-profits contracts:

> *The valuation method is a prospective valuation of the benefits contractually payable and the resultant mathematical reserves may well be less than the full current benefit. That result is not, however, a consequence of taking explicit account of the position described ... above in the valuation method.*

GAD underline *'the resultant mathematical reserves may well be less than the full current benefit'* and against this have written:

> *I presume that "full current benefit" includes the non-guaranteed bonus.*

and

> *In the resilience scenario, it would be hoped that the liability would be no less than the guaranteed benefits!*

Equitable explain that they have four main categories of accumulating with-profits contracts. These categories are listed as: *'Life savings plans'*; *'Life protection plans'*; *'Pension contracts – old series'*; and *'Pension contracts – new series'*.

For their Life Savings Plans, Equitable disclose that the full fund is guaranteed to be available on surrender at certain dates, typically the *'5th and subsequent policy anniversaries'*. GAD underline the quoted words, and on the next page of the returns, query whether a full or partial guarantee of fund applies to Equitable's with-profits bonds.

For *'Pension contracts – old series'*, Equitable disclose that virtually all contracts include a 3.5% guaranteed rate of accumulation (i.e. the guaranteed investment returns). GAD underline this figure. The returns disclose that the full accumulated fund is guaranteed to be available on retirement at ages permitted by the relevant legislation, *'e.g. between ages 60 and 75 in the case of retirement annuity contracts'*. GAD underline *'between ages 60 and 75'* and write *'a wide spread!'*. Equitable also state: *'Some older contracts contain minimum guaranteed rates for annuity purchase at retirement'*.

For *'Pension contracts – new series'*, Equitable say that the contracts are identical to *'old series'* contracts, except *'There are no guaranteed investment returns or bonus rates other than a return of the investment contents paid'*.

GAD note that Equitable offer Major Medical Cash Plans. Next to the description, GAD write *'how do these operate? (an additional benefit funded by cancellation of units) – see* [page] *5 of 1995* [Schedule] *4'*.

In response to paragraph 5 of Schedule 4, Equitable provide 63 pages of information about their linked contracts. GAD note the business series that are open to new business and mark as new the contracts introduced in 1996.

The description of the general principles and methods adopted in the valuation is now provided in paragraph 6 of Schedule 4 of the returns. The information supplied by Equitable includes that, for accumulating with-profits deferred annuities:

> *The liability was calculated by discounting the cash fund purchased to date plus declared and attaching bonus cash fund with an allowance for future bonus.*

GAD underline this sentence. The information disclosed in the returns continues:

> *For with profits retirement annuity and personal pensions benefits ... the benefits have been valued on the basis that the benefits will be taken at age 60 or, if that age has been attained, at the valuation date.*

GAD sideline this and the preceding sentence and write next to it: *'i.e. can be less than current face value of benefits'*.

Equitable then disclose that, for with-profits Managed Pension Policies, the *'current full value of the guaranteed fund and attaching declared bonus was reserved'*. GAD underline the quoted words and place three ticks next to the paragraph.

In paragraph 6(1)(b), Equitable disclose:

> *The valuation method makes specific allowance for rates of future reversionary bonus additions, the levels of which are consistent with the valuation interest rates employed having regard to the Society's established practices for the determination of declared bonus rates. The balance of the total policy proceeds, consistent with policyholders' reasonable expectations, will be met by final bonus additions at the time of claim. Such additions are not explicitly reserved for in advance but are implicitly covered by the excess of admissible assets over mathematical reserves.*

GAD sideline the last sentence and underline the words *'implicitly covered by the excess of admissible assets over mathematical reserves'*.

In paragraph 6(1)(e), Equitable set out the rates of future bonus valued for each class of business. GAD add corresponding figures from the previous year or otherwise note where figures are unchanged or new. Equitable then state:

> *The reserves for future bonus under personal pensions contracts are such that, after allowing for any costs associated with the review of past sales of pensions transfers and opt-outs, future bonuses at the above rates could be supported if the valuation assumptions were met.*

GAD underline the words *'after allowing for any costs associated with the review of past sales of pensions transfers and opt-outs'*.

In paragraph 6(1)(f), Equitable state that a reserve for the prospective liability for tax on unrealised capital gains (losses) is held in respect of policies where benefits are linked to the Society's internal funds. They disclose that the contingent liability for tax on unrealised capital gains in respect of other business is estimated not to exceed £47.7m. Equitable state that they hold no reserve for this, as they consider there were sufficient margins in the valuation basis to cover the discounted value of this liability. GAD underline this figure and add next to it the previous year's figure of £37.4m. GAD sideline the sentence which says that no reserve was made. GAD have also written:

> *This is not really acceptable is it?*

In paragraph 6(1)(g), relating to investment performance guarantees, Equitable state that, in current conditions, they do not consider it necessary to hold a specific reserve for the guarantee they offer on a unit-linked annuity. GAD underline the words *'in current conditions'*.

In paragraph 6(1)(h), relating to the reserves for all other guarantees not covered by paragraph 6(1)(g), Equitable state:

> *The premium rate guarantees and options under the Society's policies are described in paragraph 4. Where the right to effect further policies without medical evidence of health is carried a reserve equal to one year's extra premium deemed or actually charged was set up. It was considered unnecessary in current conditions to make explicit provision for the other guarantees and options described in paragraph 4.*

That is, Equitable state that they do not consider it necessary to hold an explicit reserve for, amongst others, annuity guarantees.

In paragraph 6(1)(i), Equitable disclose that, for certain non-profit deferred annuities, the valuation rates of interest used were those used in the premium bases. Equitable, again, do not elsewhere disclose the rates used in the premium bases.

In paragraph 6(2), Equitable state that, in determining the provision needed for resilience reserves and tax on unrealised gains, they have taken account of the fact that the long term fund has been valued at book value.

In paragraph 7(4), Equitable state that the mortality tables for annuity contracts shown in Forms 51 and 54 have sufficient implicit allowance for future reductions in rates of mortality. Against this, GAD have written *'Check'*.

In paragraph 7(5), Equitable explain that they consider the reserves for future bonus within the valuation to be fully able to withstand any future strains which would arise if there were significant changes in mortality or morbidity experience. They say that, accordingly, the Society does not consider it necessary to establish any additional reserves in this respect.

The information required to be provided in relation to resilience testing and establishment of resilience reserves is changed from previous years. In paragraph 7(6), Equitable set out the resilience scenarios tested (i.e. the scenarios described in DAA6). In paragraph 7(8), Equitable state that no resilience reserve has been provided for. GAD underline this. The Society goes on to disclose, in paragraph 7(8)(a), the changes made to valuation assumptions and methods in the resilience scenarios:

> *It was assumed that the valuation has been undertaken using the net premium method as described in the appendix following Form 61 of this report with the following changes:*
>
> > *(i) the interest rates are as stated in Form 57;*
> >
> > *(ii) for all accumulating with profits business, an annual loading of 0.2‰ increasing by 4% per annum compound of the basic benefit was reserved which is considered to be a prudent allowance for ongoing expenses: for accumulating with profits pensions business, ½% per annum of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses.*
> >
> > *(iii) the mortality table used for accumulating with-profits pensions business was adjusted to AM80 ult – 5 years.*

GAD underline the words *'using the net premium method'* and *'AM80 ult – 5 years'*.

In paragraph 7(8)(b), Equitable explain how they had hypothecated assets to liabilities for the resilience test. In paragraph 7(8)(c), they state that, from the application of the most onerous resilience scenario, liabilities changed by £3,278m and assets allocated to match those liabilities changed by £3,273m. GAD question which of the scenarios tested was the most onerous for Equitable.

In paragraph 8(b), Equitable state that *'For accumulating with profit* [pension] *business the valuation rates of interest shown in Form 52 are net of a ½% interest rate reduction as a reserve for future expenses'*. GAD underline this sentence and note that the rate is unchanged from the previous year.

In paragraph 8(d), Equitable state:

> *A further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994. The resultant aggregate liability is less than the aggregate liability on the methods and bases described in this report. The report on the net premium valuation is given in an appendix following Form 61 of this report.*

GAD sideline this paragraph.

In paragraph 13, Equitable disclose: *'The Society has no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund'*.

As now required by paragraph 14 of Schedule 4 to ICAS Regulation 1996, Equitable set out a statement of their aims with regard to bonus distribution and of how they maintain equity between different generations of policyholders. They refer to the Directors' absolute discretion as to timing and nature of bonus distributions, given to them by the Society's Articles of Association.

In response to paragraphs 14(1)(d), (e) and (f), Equitable's returns disclose:

> *Any literature, including documents the Society is or has been required to issue by any regulatory body authorised under the Financial Services Act 1986, advertisements or other communications with policyholders, dealing with the distribution of bonuses, have stated that the principles underlying the Society's approach are as follows:–*
>
> - *that bonuses are primarily influenced by the investment earnings on the invested premiums and that, in particular, future bonus rates will be mainly determined by future investment conditions*
> - *that all with profits policyholders participate in common funds of assets (one for each currency of the policy) and that bonus systems aim to pass the earnings on those assets on to policies of different types and terms in a consistent and fair manner*
> - *that with profits policyholders stand in the position of proprietors and share in any profits or losses which arise from the transacting of non-participating business*
> - *that the bonus systems aim to pass on to each generation of policyholders the value of the assets which their policies have built up; in particular, that there should be no deliberate holding back of returns to build up an "estate" of assets which belongs to no-one*
> - *that changes in bonus rates should reflect the underlying trend of investment returns rather than mirroring short-term fluctuations; that is, changes in rates should be gradual whenever circumstances permit.*

In response to paragraph 14(2), Equitable's returns disclose that:

> *The Society's aims in relation to the distribution of profits amongst policyholders flow from the principles described above. In particular:*
>
> *(a) Policies reaching their contractual termination date should receive, subject to smoothing, the full value of the assets secured by their invested premiums. On early surrender the aim is also generally to pay out a "full value" amount except where the policyholder is exercising a financial option against the office. In such circumstances the aim is to ensure that the continuing policyholders are not disadvantaged and that is achieved by paying a surrender value which approximates to the unsmoothed value of the assets attributable to the surrendering policy where that is below the "full value" amount.*
>
> *(b) Policies of all types and terms should be treated in a consistent fair manner.*
>
> *(c) Fluctuations in investment returns should be smoothed over reasonable periods, unless conditions are so exceptional that such an approach would be seriously inequitable, so that bonus rates can progress in an orderly manner.*

The returns continue by stating that the principal method by which these aims are achieved is by comparing the current and projected value of assets with total policy values.

In paragraph 15, Equitable disclose that they had set the reversionary bonus for the main policy classes at 4.0%. GAD note that most of the reversionary bonus rates are unchanged from the previous year.

As in previous years, Equitable disclose that they offered loans under a '*loanback*' arrangement to some retirement annuity, individual and group pension policyholders. GAD note that this description is unchanged from the previous year.

In paragraph 16, Equitable set out final bonus rates. GAD note the comparable rates from the previous year or where the description provided is unchanged or new.

The returns, again, contain the statement, at paragraph 16(viii):

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

In paragraph 21, Equitable explain that they risk-adjusted the yields on assets other than land and equity shares by restricting them to 10%, which is that available on the highest yielding risk-free security they hold. Equitable also explain that, where it was considered appropriate, they risk-adjusted yields on land and equity shares.

<u>Schedule 4 – main valuation (forms)</u>
In Form 46, Equitable provide information on changes in their ordinary long term business. GAD circle the figures provided for annual premiums on United Kingdom non-linked pensions business and have written: *'These omit all renewable premiums!'*.

In Form 47, Equitable provide an analysis of their new ordinary long term business. GAD make various annotations to these forms, checking the figures provided.

In Form 48, Equitable provide figures for their expected income from admissible assets not held to match liabilities in respect of linked benefits. This form shows that 52% of Equitable's non-linked assets are invested in equities, 6% in land and buildings and 38% in fixed and variable interest securities (compared with 50%, 7% and 38% respectively in 1995).

Next to the yield percentage figures on the form GAD have written *'? Expected'* and annotate the form with the following figures:

Type of asset		*Yield %*	*GAD's figure*
Land and buildings		*7.30*	*7.0*
Fixed interest securities	*Approved securities*	*7.67*	*7.4*
	Other	*7.32*	*7.9*
Variable yield securities	*Approved securities*	*3.79*	*3.6*
(excluding items shown at line 16)	*Other*	*5.25*	*5.5*
Equity shares and holdings in collective interest schemes		*3.17*	*3.5*
Loans secured by mortgages		*7.33*	*8.0*
All other assets	*Producing income*	*4.65*	*5.5*
	Not producing income		
Total		*5.08*	

GAD circle the figure for other fixed interest securities of 7.32% and have written *'Query – see Line 24* [of Form 49]'.

In Form 49, Equitable provide an analysis of their fixed interest and variable yield securities. Equitable disclose that the gross redemption yields on fixed interest securities issued or guaranteed by any government or public authority are, for certain durations, higher than for those not issued or guaranteed by any government or public authority. GAD circle the gross redemption yield figure of 5.25% provided for other fixed interest securities with redemption periods of between 10 and 15 years and note that this is very low.

In Form 51, Equitable set out the mathematical reserves held for various types of non-linked contracts (excluding accumulating with-profits), along with information on the number of contracts in force, the benefits valued and rates of interest and mortality assumptions used in valuing them.

In Form 52, Equitable set out the mathematical reserves held for accumulating with-profits contracts, along with information on the number of contracts in force, the benefits guaranteed and the rates of interest and mortality assumptions used in valuing them. Columns 11 and 12 of the Forms detail the current benefit value and discounted value of the Society's liabilities. GAD note that the difference between these figures (which is almost entirely accounted for by the valuation of Equitable's UK pensions business) is £638m.

In Form 53, Equitable set out the mathematical reserves held for the various types of property-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death and the rates of interest and mortality assumptions used in valuing them. Equitable also disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 54, Equitable set out the mathematical reserves held for the various types of index-linked contracts along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity, and the rates of interest and mortality assumptions used in valuing them.

The new Regulations require that matching rectangles (i.e. the notional allocation of assets to each category of non-linked liabilities to show the valuation rates of interest that are supportable) are provided in Form 57. Equitable provide 34 Form 57s, each Form covering a different interest rate and class of business. GAD annotate the first Form (which gives the total values of assets notionally allocated) with corresponding asset figures taken from Form 48. The total value of assets notionally allocated is given as £15,679,987,000. On the Form, GAD have written (the figures being in units of £000s):

[Non-linked] *Liability*	*15,151,688*
Bonus	*503,622*
	15,655,310
+ [Statutory reserves] *on Linked*	*21,380*
	15,676,690
+ [Statutory reserves] *on Index Linked*	*3,248*
	15,679,988

GAD have also written *'N.B. No Resilience Reserve'*.

In Form 58, Equitable set out the valuation result and the composition and distribution of fund surplus.

Schedule 4 – appendix valuation (text)
Equitable explain that the appendix valuation:

> *... was undertaken for the purposes of demonstrating that in aggregate the mathematical reserves determined by the valuation undertaken using the gross premium method, the results of which are reported on the preceding pages, are not less than an amount calculated in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994.*

Equitable's appendix valuation provides the information required by paragraphs 1, 6 to 8, 10, 11, 20 and 22. The Society states that the information required by the other paragraphs of the ICAS Regulations 1996 is the same as that provided in the main valuation (apart from paragraph 23 – being a statement of the required minimum margin in the form set out in Form 60 of Schedule 4 which, having had *'regard to the purpose of the valuation'*, has not been provided).

In their description of the general principles and methods adopted in the valuation (paragraph 6), for accumulating with-profits deferred annuities Equitable disclose that the liability was calculated *'by discounting the cash fund purchased to date plus declared and attaching bonus cash fund'*. GAD have underlined the words quoted. Equitable then disclose that they have valued benefits assuming retirement ages of 60 for both retirement annuity business and personal pension business.

For with-profits bonds, Equitable disclose that *'The liability was calculated by discounting the guaranteed fund and attaching bonuses'*. GAD underline the words quoted.

In paragraph 6(1)(b), Equitable state that the valuation rates of interest were chosen with due regard to policyholders' reasonable expectations and their established practices for determining reversionary bonuses. As in the main valuation, Equitable also disclose that:

> *The balance of the total policy proceeds, consistent with policyholders' reasonable expectations, will be met by final bonus additions at the time of claim. Such additions are not explicitly reserved for in advance but are implicitly covered by the excess of admissible assets over mathematical reserves.*

GAD underline the words *'are implicitly covered by the excess of admissible assets over mathematical reserves'* and next to it write *'How well?'*.

As in the main valuation, in paragraph 6(1)(f) Equitable disclose that a reserve is held for the prospective liability for tax on unrealised capital gains in respect of policies where benefits are linked to the Society's internal funds. They also disclose that the contingent liability for tax on unrealised capital gains in respect of non-linked business is estimated not to exceed £47.7m. Equitable state that they hold no reserve for this, as they consider there are sufficient margins in the valuation basis to cover the discounted value of this liability. GAD also underline the figure provided in this appendix valuation, note the previous year's figure of £37.4m and write *'Not really acceptable?'*.

As in the main valuation, and as in previous years, Equitable state that, in current conditions, they do not consider it necessary to hold a reserve for the guarantee they offer on a unit-linked annuity. Next to this, GAD write *'Investigate further?'*.

In paragraph 6(1)(h), Equitable state:

> *The premium rate guarantees and options under the Society's policies are described in paragraph 4.*
>
> *Where the right to effect further policies without medical evidence of health is carried a reserve equal to one year's extra premium deemed or actually charged was set up.*
>
> *It was considered unnecessary in current conditions to make explicit provision for the other guarantees and options described in paragraph 4.*

That is, Equitable state that they do not consider it necessary to hold an explicit reserve for, amongst others, annuity guarantees.

In response to paragraph 7(8) of Schedule 4, Equitable disclose that their valuation includes a resilience reserve of £501m. GAD circle and underline this figure and write: *'Is this a grossed up figure – considering the assets allocated to it. Check* [Form] *57!'*.

The Society goes on to disclose, in paragraph 7(8)(a), the changes made to valuation assumptions and methods in the resilience scenarios, including that:

> *... for all accumulating with profits business, an annual loading of 0.2‰ increasing by 4% per annum compound of the basic benefit was reserved which is considered to be a prudent allowance for ongoing expenses: for accumulating with profits pensions business, ½% per annum of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses.*

As in the main valuation, Equitable disclose in paragraph 7(8)(c) the changes to their liabilities and assets resulting from the application of the most onerous resilience scenarios. GAD query which of the scenarios produces this result and write *'presume (c)?'*.

As in the main valuation, in paragraph 21 Equitable explain that they risk-adjusted the yields on assets other than land and equity shares by restricting them to 10%, which is that available on the highest yielding risk-free security held by Equitable. Against this figure, GAD write *'High?'*.

Schedule 4 – appendix valuation (forms)
In appendix Form 51, Equitable set out the mathematical reserves held on the appendix valuation basis for various types of non-linked contracts (excluding accumulating with-profits), along with information on the number of contracts in force, the benefits valued, and the rates of interest and mortality assumptions used in valuing them. GAD note changes from the previous year's returns to some of the interest rates used.

In appendix Form 52, Equitable set out the mathematical reserves held on the appendix valuation basis for accumulating with-profits contracts, along with information on the number of contracts in force, the benefits guaranteed, and the rates of interest and mortality assumptions used in valuing them. GAD make various annotations on these forms, including:

- for some life assurance and general annuity business, GAD note that Equitable have used a valuation interest rate of 2.5% in the appendix valuation compared to *'Nil used in* [the gross premium bonus reserve] *valuation'*. GAD note that there is a *'£54m discount'* on the current benefit value of liabilities. GAD also note that the corresponding figure used in the previous year was 4.0%.
- for some pensions business, GAD note that Equitable have used a valuation interest rate of 5.0% in the appendix valuation compared to *'4.75%* [discount] *used in* [the gross premium bonus reserve valuation]'. Below the figures provided for the rates of interest used, GAD write *'High?'*. GAD note on the form the discounted value of liabilities is *'-£1,246m below face value!'*.
- for Equitable's German life assurance and general annuity business, GAD circle the rates of interest disclosed and write *'High?'*. They also note that the difference between the current benefit value of liabilities and the discounted value is *'£2.07m'*.
- for Equitable's Guernsey life assurance and general annuity business, GAD circle the rates of interest disclosed and write *'High?'*. They also note that the difference between the current benefit value of liabilities and the discounted value is *'£1.7m'*.
- for Equitable's Guernsey pensions business, GAD circle the rates of interest disclosed and they note that the difference between the current benefit value of liabilities and the discounted value is *'£4.2m'*.
- for Equitable's Republic of Ireland life assurance and general annuity business, GAD note that the difference between the current benefit value of liabilities and the discounted value is *'£1.5m'*.
- for Equitable's Republic of Ireland pensions business, GAD circle the rates of interest disclosed and they note that the difference between the current benefit value of liabilities and the discounted value is *'£9.7m'*.
- for the total of the Society's accumulating with-profits business, GAD note that the difference between the current benefit value of liabilities and the discounted value is *'£1,320m'*.

In appendix Form 53, Equitable set out the mathematical reserves held on the appendix valuation basis for the various types of property-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death, and the rates of interest and mortality assumptions used in valuing them. They also disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In appendix Form 54, Equitable set out the mathematical reserves held on the appendix valuation basis for the various types of index-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity, and the rates of interest and mortality assumptions used in valuing them.

In appendix Form 57, Equitable provide matching rectangles on the appendix valuation basis covering the different classes of their business. As with the main valuation, GAD annotate the first Form (which gives the total values of assets notionally allocated) with corresponding asset value figures taken from Form 48. Equitable state that the total value of assets notionally allocated is £15,174,191,000. On the Form, GAD have written the following (the figures being in units of £000s):

[Non-linked] *Liability*	*14,675,207*
Bonus [Reserve]	*474,207*
	15,149,414
+ *Sterling* [reserves] *on Linked*	*21,380*
	15,170,894
+ *Sterling* [reserves] *on Index Linked*	*3,298*
	15,174,192
+ [Resilience] *Reserve*	*+501,000?*

Notes to the returns
In the notes to the returns, disclosed at the end of Schedule 4, Equitable disclose that they have been granted a section 68 Order which permits them to include in aggregate form details of their *'Personalised Funds'* in Forms 43, 45 and 55.

Equitable also disclose that they have been granted a section 68 Order permitting them to take into account a future profits implicit item with a value not exceeding £600m. The Society states it has included an item of £312,794,000 for the purpose of *'achieving equality between the total net value of policyholders' assets included in Form 9 ... and ... total net asset value shown in the Society's Companies Act accounts'*. As for the previous returns, GAD underline the quoted part of this sentence.

Equitable state that no provision has been made for the contingent liability for tax on unrealised capital gains for non-linked business, which they have estimated as £47.7m. GAD sideline this paragraph and underline the figure of £47.7m.

The notes to the returns also disclose that Equitable had been issued a section 68 Order *'to the effect that figures in Form 46 exclude recurrent single premiums from the annual premium figures as the Company cannot at present calculate a meaningful figure'*. GAD sideline this note.

Schedule 6 (Certificates by directors, actuary and auditors)
Three Equitable Directors provide the certification required by Regulation 28(a) of ICAS Regulations 1996. Equitable's Appointed Actuary provides the certification required by Regulation 28(b) of ICAS Regulations 1996. Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

30/06/1997 [entry 2] Equitable apply to DTI for a section 68 Order for a future profits implicit item of £700m, for possible use in their 1997 returns. Equitable provide financial calculations in support of the application, suggesting that they could seek an Order up to the value of £2,252.4m. Equitable explain that they have included a future profits implicit item of £312.8m in their 1996 returns.

These calculations include, for the estimated annual profits, that:

Year ending	*(A) Total surplus*	*(B) Exceptional items*	*(C) Surplus arising from solvency margin*	*(A)-(B)-(C) Ordinary surplus*
	£m	*£m*	*£m*	*£m*
31.12.92	*330.5*	*(46.0)*	*46.4*	*330.1*
31.12.93	*480.9*	*(1015.2)*	*178.5*	*1317.6*
31.12.94	*520.0*	*1245.9*	*19.3*	*(745.2)*
31.12.95	*662.8*	*(462.3)*	*119.5*	*1005.6*
31.12.96	*802.5*	*(256.1)*	*151.2*	*907.4*
				2815.5

Average annual profit = 2815.5/5 = £563.1m

Note: In 1994 surplus was increased as a result of changes in valuation interest bases. In 1992, 1993, 1995 and 1996, surplus was decreased as a result of changes in valuation interest bases. Those changes in surplus are included as exceptional items in column (B) above.

The calculations state that the average period to run for the Society's in-force contracts is now eight years. Equitable explain:

The periods to run have been reduced to take account of premature withdrawals based on the Society's recent experience of such withdrawals. In respect of retirement annuity and personal pension contracts for which a range of retirement ages is available, it has been assumed that retirement benefits are taken at the lowest possible retirement age, or immediately if that age has already been attained.

The calculations suggest that the maximum future profits permissible are 50% of £563.1m multiplied by eight years – that being £2,252.4m.

03/07/1997 Equitable's solicitors explain to DTI that Equitable now propose a subordinated loan of £350m of Sterling Perpetual Notes and that: *'In line with market practice, the issuer will be a wholly owned subsidiary of the Society and the issue will be guaranteed by the Society'*. (This replaces the previous proposal to raise a smaller amount in Dollars, Deutschmarks and Yen — see 14/03/1997.) The solicitors enclose the proposed terms, and comment that they are very similar to recent issues by other companies, including mutual companies. The solicitors ask that DTI give their application for the necessary section 68 Order priority treatment, as the timing of the issue is very tight.

04/07/1997 DTI ask GAD for comments on the letter from Equitable's solicitors of 03/07/1997. DTI note that *'Equitable has changed tack on the subordinated loan issue!'*.

07/07/1997 GAD tell DTI that they would not wish to make definitive comment until GAD have seen the draft offer document, but they are *'happy to confirm that the terms of the proposed issue appear to be acceptable and in line with precedent'*. GAD raise one further query about the taxation clause. Against this, Line Supervisor B notes that she has checked the point with Equitable's solicitors who have said that there is not a problem.

10/07/1997 Equitable's solicitors send DTI a copy of the draft offer document. The Society's solicitors copy this to GAD.

11/07/1997 [entry 1]	Equitable's solicitors send DTI a copy of a Trust Deed used by another mutual life company and explain that they propose to conform with this in all material respects. Equitable copy this to GAD.
11/07/1997 [entry 2]	GAD send DTI some suggested text for inclusion in the loan agreement. This reads: *Liabilities due to policyholders must be calculated so as to fully meet their reasonable expectations, as determined by the appointed actuary to the company, with the appointed actuary also treating the Loan for this purpose as if it did not exist as a liability of the long term fund at that time.* GAD say that this wording '*... would be very suitable for us. It also helps to reinstate the concept of Para 25 of Prudential Note 1994/1 in the circumstance of a winding up*'.
14/07/1997	DTI fax Equitable's solicitors the proposed text.
15/07/1997	Equitable's solicitors point out to DTI that the insurance company winding up rules applied and so they did not agree with the suggested amendment. DTI seek advice from GAD and comment: *... do you think they have a point? The (Winding-Up) Rules 1985 refer to policyholders expectations — but presumably the suggested inserted paragraph defines the Appointed Actuary's responsibilities re PRE prior to the Court making a direction?.*
16/07/1997 [entry 1]	DTI note that GAD's Chief Actuary D accepts Equitable's solicitors' point. DTI also note: '*This is a Perpetual loan — only applies on winding up — there are PRE rules for this*'.
16/07/1997 [entry 2]	Equitable's solicitors send DTI three further documents relating to Equitable's proposed subordinated loan. Equitable's solicitors ask for DTI's indication that they would approve the necessary section 68 Order by the following day.
17/07/1997	DTI copy GAD one of the documents (the draft loan agreement) and seek their comments. Equitable's solicitors fax DTI information on the interest rate applicable to the proposed bonds. DTI ask GAD for their comments on this also.
18/07/1997 [entry 1]	DTI tell Equitable's solicitors that they agreed in principle to the issue of the necessary section 68 Order, but warn that, if there were any changes to the offer, the Order could not be issued until they had reviewed those.
18/07/1997 [entry 2]	**GAD complete the A1 Initial Scrutiny check on the Society's 1996 regulatory returns**. GAD note that, in accordance with the section 68 Order issued on 06/06/1997, there were no statements in the auditor's report relating to money laundering.
22/07/1997	Equitable's solicitors send DTI amended subordinated loan documents. The Society's solicitors explain that the changes had been made solely to allow Equitable to sell bonds in the United States. They also inform DTI that the interest rate for the loan had been set at 8%.
25/07/1997	GAD comment to DTI: '*To the best of our understanding, we are prepared to accept that the revisions made to the Offering Circular do not have any impact on subordination to interests of policyholders*'. GAD conclude: *In our opinion therefore, these revisions should not change the provisional agreement of the DTI to provide a Section 68 Order allowing the Society to leave this loan out of account as a liability on its return, subject to the normal limits.*

29/07/1997	DTI's Line Supervisor B asks the Head of Life Insurance if, following GAD's comments, he agreed that she should confirm to Equitable's solicitors that DTI still agreed in principle to the issue of the section 68 Order. The Head of Life Insurance gives his agreement and the Line Supervisor advises Equitable's solicitors accordingly.
31/07/1997	An Equitable actuary writes to GAD with a query about future profits implicit items. He refers to the correspondence with DTI in 1995 (see exchanges on the issue between 25/01/1995 and 27/03/1995 [**entry 1**]). The actuary seeks GAD's further views on the inclusion, in their profit calculations, of increases or decreases in reserves due to changes in interest rate bases. The actuary explains that he is writing at the request of Equitable's Appointed Actuary, but also that he would be taking on that role from 01/08/1997.
01/08/1997	Equitable appoint a new Managing Director and a new Appointed Actuary.
06/08/1997	Equitable's solicitors send DTI the finalised documents relating to the subordinated loan.
07/08/1997	**GAD complete the A2 Initial Scrutiny check on the Society's 1996 regulatory returns.** The form for the A2 check is now more detailed, reflecting the amendments to the returns following the introduction of the ICAS Regulations 1996 and includes the following: <u>Strength of valuation basis</u> In response to the question: *'Are the interest rates in* [Form] *57 (including those in line 39) supported by the risk adjusted yields on the matching assets – for with-profits business?'*. GAD circle *'Yes'* and against this write: *'But?* [accumulating with-profits] *Line 39'*. In response to the question: *'Do the with-profits rates in line 29 and 39 appear to make provision for PRE?'*, GAD circle both *'Yes'* and *'No'*. GAD note that they *'might query'* Equitable's mortality rates for annuities, and note that Equitable have *'surprisingly raised their unit growth assumption'*. They confirm that Equitable have applied the resilience test in accordance with the Government Actuary's latest guidance. GAD judge the overall interest basis as *'adequate'* to *'weak'* and the valuation basis as *'adequate'* to *'weak'*. <u>Solvency position</u> In response to the question: *'Taking into account the individual characteristics of the company, is the absolute level of cover for the* [required minimum margin] *shown in* [Form] *9 best described as very healthy (A), healthy (B), adequate (C), of concern (D) or negative/such as to require immediate action by DTI (E)?'*. GAD circle *'C'*. Against this they write: *'As a major* [with-profits] *office is unlikely to be insolvent — but may be building higher expectations than can be met'*. GAD describe the trend in the level of cover over recent years as *'Flat'*. <u>Suitability of assets</u> GAD answer *'Yes'* to the question: *'Does the hypothecation of assets to liabilities in* [Form] *57 look reasonable?'*. <u>Operating results</u> GAD answer that the absolute level of surplus/deficit and its trend over recent years do not give current cause for concern. They record that the absolute level of sales and its trend over recent years do not give current cause for concern. Next to their answer, GAD write: '[Very] *high!'*.

PRE issues
GAD record that it is not clear whether the answer given by Equitable in paragraph 4(1)(a)(ii) of Schedule 4 of the returns is satisfactory. (In the paragraph referred to, Equitable had written: *'The valuation method is a prospective valuation of the benefits contractually payable and the resultant mathematical reserves may well be less than the full current benefit'*. In the margin of the returns, next to this statement, the scrutinising actuary wrote in pencil: *'I presume that "full current benefit" includes the non-guaranteed bonus'*; and *'In the resilience scenario, it would be hoped that the liability would be no less than the guaranteed benefits!'*.)

Current issues
GAD note that it is not clear if Equitable have set up any identifiable pensions mis-selling reserve, but that GAD understand that Equitable hold £50m in technical reserves. GAD note that Equitable have completed the new style returns *'adequately'* and against this have written: *'Review Forms 57'*.

Aspects that look worrying
GAD note *'Substantial unitised* [with-profits] *– high declared bonuses but reduced reserves could rely too much on application of MVA. [*[Company] *would be in more comfortable position if held back more as terminal bonus.]'*.

Other notes
GAD identify the following:

(1) Review Pension/Annuity mortality assumptions.

(2) Consider raised level for assumed unit growth.

(3) Review [unitised with-profits] *reserves in resilience scenario.*

[(4) [outstanding] *review of Implicit Profit item calculation.]*

The last point is noted on the form as *'Dealt with'*.

GAD identify no items to notify to DTI, to be taken up immediately with Equitable. They raise Equitable's priority rating from 4 to 3. Accompanying the scrutiny check is a Form B Initial Scrutiny Form, which includes certain key figures disclosed in the 1993 to 1996 returns. GAD circle the figure of 8.5% for the growth assumption used for unit-linked business.

08/08/1997 GAD's Scrutinising Actuary E prepares a note for the Government Actuary about Equitable, ahead of the Government Actuary's meeting with the Society's new Appointed Actuary. The note says:

> *As a mutual* [Equitable] *makes a strong play of not building an excessive estate — and this leads to it declaring high "non-guaranteed" final bonuses on its substantial accumulating with profit contracts ... There may be some doubts about the practical ability of the Society to apply an MVA in all the circumstances covered by the resilience test (as assumed in the valuation) – but they insist that their bonus declarations give them the necessary flexibility.*

Chief Actuary D adds:

> [The individual] *has been heir-apparent to the* [Appointed Actuary] *post for some time. He seems very competent, & having served on a working party he chaired I think he will cope well, & be a bit less "prickly" than* [the previous Appointed Actuary]*!*

11/08/1997 Equitable write to DTI to confirm the appointment of the new Appointed Actuary of Equitable and of University Life with effect from 01/08/1997.

13/08/1997	Equitable's solicitors seek an update from DTI on the section 68 Order for the subordinated loan.
14/08/1997	The Government Actuary writes to Equitable's Appointed Actuary to welcome him to his new role and to suggest an introductory meeting. The Government Actuary encloses copies of GAD's Dear Appointed Actuary letters.
19/08/1997	DTI's Line Supervisor B passes the letter from Equitable's solicitors, dated 06/08/1997, to Line Manager C, and notes on it that the '[section] *68 order* [is] *ready for you to sign ...*'.
20/08/1997	DTI send Equitable's solicitors the section 68 Order, dated 19/08/1997, for the subordinated loan.
22/08/1997	GAD's Scrutinising Actuary E writes to Equitable's Appointed Actuary in response to his letter of 31/07/1997. The Scrutinising Actuary says:

> *It seems to me that the calculation of a maximum allowable Future Profits Implicit Item is not an exact science, particularly for a with-profit office that carries a large and variable margin in Line 51 of Form 14.*
>
> *For a company that has sold a large amount of participating business, it seems obvious that potential insolvency is unlikely – unless such a company were to grant bonuses in relation to capital gains on assets that were later found to evaporate. However, I would obviously feel uncomfortable if it seemed that a major part of future surplus might be needed to maintain solvency – rather than be available to pay bonuses in line with the reasonable expectations of policyholders.*
>
> *I suspect that part of the margin carried in Line 51 of Form 14 by such a with-profit office may be being retained to cover accumulating but unreserved-for terminal bonus payments, and it seems to me that the best way to interpret the guidance on Future Profits Implicit Items is to accept the judgement of the Appointed Actuary as to the amount of surplus that is distributable each year. Thus, the Form 58, Line 35 figure is the basic amount on which I focus for this purpose.*
>
> *Clearly, "exceptional items" that affect the disclosed figure must be adjusted for, but <u>these do not include</u> changes in the amount of liabilities due to modifications made in valuation interest rates that reflect similar changes in asset yields — that result in an offsetting variation in asset values. It appears that the "exceptional items" shown in Column B in the Table provided in Section 1 of the Appendix to* [Equitable's] *letter of 30 June relate solely to valuation interest rate changes. These items should only be considered to be "exceptional" to the extent that such interest rate changes were not matched by variations in yields on your asset portfolio arising from market movements – although it must be recognised that a switch in asset allocation strategy that modified the portfolio yield would require special consideration.*

Scrutinising Actuary E goes on to say:

> *Although I have in some cases been concerned about the "double counting" of income arising from assets representing the explicit components of the solvency margin, I am not sure in the case of Equitable that such income is necessarily taken credit for in the surplus shown in Form 58 – however.*

The Scrutinising Actuary asks Equitable to review their submission in the light of his comments. He concludes: '*I have no doubt that, however we look at the figures, we will have no difficulty in agreeing to the previously requested figure of £700m*'.

GAD's file contains a page of calculations prepared by Scrutinising Actuary E in respect of the future profits implicit item. These are set out as follows:

£000s	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
[Long Term] *Fund*	*6,992,749*	*8,562,056*	*11,450,888*	*12,377,514*	*14,915,189*	*17,572,128*
[Form] *14* [line] *52*	*347,441*	*838,513*	*1,713,333*	*917,502*	*1,433,380*	*1,420,178*
[Form] *14* [line] *12*	*140,790*	*4,833*	*3,207*	–	–	–
[Appreciation] *Credited* [Form] *40* [line] *3*	*399,000*	*140,000*	*1,180,000*	*(583,513)*	*798,125*	*669,016*
[Form] *14* [line] *51* (*A*)		*491,072*	*874,820*	*(795,831)*	*515,878*	*(13,202)*
[Form] *58 Surplus* (*B*)		*330,523*	*480,935*	*519,981*	*662,848*	*802,539*
Exceptional?		*(46,000)*	*(1,015,200)*	*1,245,900*	*(462,300)*	*(256,100)*
<u>Consider</u> Real Surplus Emerging? (*A*) + (*B*)		*821,595*	*1,355,755*	*-275,850*	*1,178,726*	*789,337*
Total	*3,869,563*					
Surplus on Solvency Margin	*514,900*					
	3,354,663 ÷ 5		*= £670,933,000*		*cf £563.1m claimed*	

However, some of this surplus is clearly being retained to cover terminal bonus liabilities that are not fully reserved for.

[Sum of] *(B) above*	*£2,796.7m ÷ 5*	*= <u>£559.3m</u>*	*x 4 = £2,237.2*
[Sum of] *Surplus on Solvency Margin*	*514.9m*		
	£2,281.8m ÷ 5	*= <u>£456.4m</u>*	*x 4 = £1,825.6*
			<u>cf £700m claimed</u>

01/09/1997 Equitable inform GAD that they are happy to go along with the approach suggested in the letter of 22/08/1997 and have sent DTI revised calculations to support their request for a future profits implicit item for 1997. Equitable's calculations suggest that the maximum future profits implicit item that could be allowable is £2,222m.

02/09/1997 GAD tell DTI that Equitable's Appointed Actuary has taken full account of the comments made in their letter of 22/08/1997 and that they are *'comfortable with the figures shown and that it is totally reasonable to grant a Section 68 Order'*. This will allow a future profits implicit item of £700m to be counted towards Equitable's required solvency margin in their 1997 returns.

03/09/1997 DTI's Line Supervisor B asks an official to issue the section 68 Order.

25/09/1997 The DTI official advises Line Supervisor B that he is unable to issue the section 68 Order because of a problem with the IT system.

26/09/1997	The Government Actuary meets Equitable's Appointed Actuary (at GAD's offices). His note of the meeting sets out Equitable's arrangements for actuarial work. The Government Actuary concludes: *Overall, this is a company with a strong actuarial tradition, where the appointed actuary has a strong position in relation to all aspects of the business. Expense levels remain one of the lowest in the industry and new business is still quite buoyant, although now heavily pensions orientated, with quite a lot of AVC business, for example from the NHS and Civil Service pension schemes, for which the Equitable is a preferred FSAVC provider.*
30/09/1997	Every insurance company is sent by DTI's Head of Life Insurance a letter asking them to provide details of their provision for potential liabilities for mis-sold personal pensions.
14/10/1997	DTI send Equitable the section 68 Order for a future profits implicit item of £700m, to be counted in their 1997 returns. DTI point out that, before including any implicit items in the forthcoming returns, Equitable are required to update the calculations to ensure that the amount adopted is still justified.
24/10/1997	Equitable reply to the letter from DTI of 30/09/1997 seeking details of their provision for potential liabilities for mis-sold personal pensions. Equitable explain that, as at 30 September 1997, they had 36,013 potential cases (compared with 34,999 as at 31 December 1996), with an estimated compensation liability of £85m (compared with £50m as at 31 December 1996). Equitable explain that one reason for the increased estimates is that: *... the 31 December 1996 figures treated a block of business, which had been classified as "execution only" under LAUTRO guidelines, as outside the scope of the review. Following subsequent discussions with the PIA those cases have been brought back into the review and subjected to loss assessment.* Equitable note that the cost would be met from the long term fund and therefore, in practice, by the generality of policyholders. Equitable say that, by 30 September 1997, they had made offers of compensation of £11m. They explain that, as their review progresses, Equitable should have a much greater degree of confidence in the provision to be established at 31 December 1997 than was the case at 31 December 1996 and that '[accordingly], *we are likely to show the provision more explicitly on our 1997 published statements*'. Comments on the letter suggest that, in comparison with other offices, some of Equitable's estimates of the proportion of cases assumed to require compensation are low, other estimates of the assumed average amount of compensation on some individual cases are high. A further comment is that Equitable's figures generally appear *'very "rounded"'*.
17/11/1997	The National Health Service write to DTI to say that they are reviewing their AVC arrangements and are considering appointing Equitable as the AVC provider for all their pension schemes. They ask DTI if there have been any points of contention within the last three years, or whether there are any material factors the Secretary of State should be aware of before a decision is made.
25/11/1997	DTI's Line Supervisor B seeks the views of the Head of Life Insurance and Line Manager C on the letter of 17/11/1997 from the NHS. She says: *'To my knowledge there are no outstanding supervisory "points of contention" with Equitable Life (and would we say anything if there were?)'*. The Line Supervisor notes some recent issues that have arisen, including:

Personal pensions mis-selling – Equitable appears to be getting on well with this – as at 30/9/97 compensation offers of £11m had been made. Total provision at 30/9/97 is £85m, including non-priority cases.

New Chief Executive from 1/7/97 and separate Appointed Actuary. Previously [Chief Executive] *was also the* [Appointed Actuary].

Issue of £350m subordinated loan capital August 1997.

Future profits implicit item agreed for 1997 returns of £700m.

Line Supervisor B notes that, at 31 December 1996, Equitable's cover for the required minimum margin was 2.53. Against this, an official notes that, without the future profits implicit item, it would be 2.07.

The Line Manager advises the Line Supervisor to reply to the NHS, confirming Equitable's solvency position and indicating that DTI are not aware of any matters that should be brought to the Secretary of State's attention.

26/11/1997

DTI's Line Supervisor B informs the NHS that, on the basis of Equitable's 1996 returns, and in the absence of interim information, she would say that the company was financially sound. The Line Supervisor adds that there are *'no outstanding issues of a material nature pertaining to DTI's regulation of the Equitable Life Assurance Society'*. Line Supervisor B bases the wording in her letter on one sent in respect of another company. She informs Line Manager C that, in that letter, DTI had referred to strong solvency cover of more than 600%. She explains that she has omitted this from the letter about Equitable as *'their solvency cover* [without] *the implicit item is 207%, which isn't that hot'*.

December 1997

GAD send DTI their annual report on the life insurance industry for the year ending 31 December 1996.

The purpose of the report is described as follows:

The idea of an annual report on the life assurance industry emerged from the work undertaken by the joint GAD and DTI Scrutiny Strategy Working Party. It was seen as a means of providing comparative information to enable more informed comments on relative performance to be made in the detailed scrutiny report written annually on each individual company. However, it was recognised that even more importantly, an annual report also provided the opportunity to give a far wider perspective on the industry as a whole, and act as a useful reference source.

The primary purpose of the report is, therefore, to act as an internal reference document for DTI and GAD senior management, providing a commentary on significant developments within the industry during the year, and an indication of likely future developments. It is also designed to provide detailed comparative information between companies to allow potentially weak companies to be identified. Finally, where relevant, any significant variations between different sectors of the industry can be identified.

The disclaimer says that: *'The views expressed in this report are not those of any individual, but neither do they represent "official" GAD or DTI thinking. They are meant to contribute to thinking on the past and present developments of the industry'*.

On *'New Business'*, the report notes that Equitable are top of the table for pensions sales with a new business index of £512m (£226m more than the second placed company) and are also top for total new business, with an index of £581.2m (the second placed company having a new business index of £573.4m). The report says: *'Equitable are in a dominant position in the pensions market, as they are known for low charges and generally attract high premiums per* *case'*. On distribution channels, GAD explain that the profile for mutual companies is similar to that of the industry, with 50% of sales made through independent financial advisers and approximately 40% through direct sales.

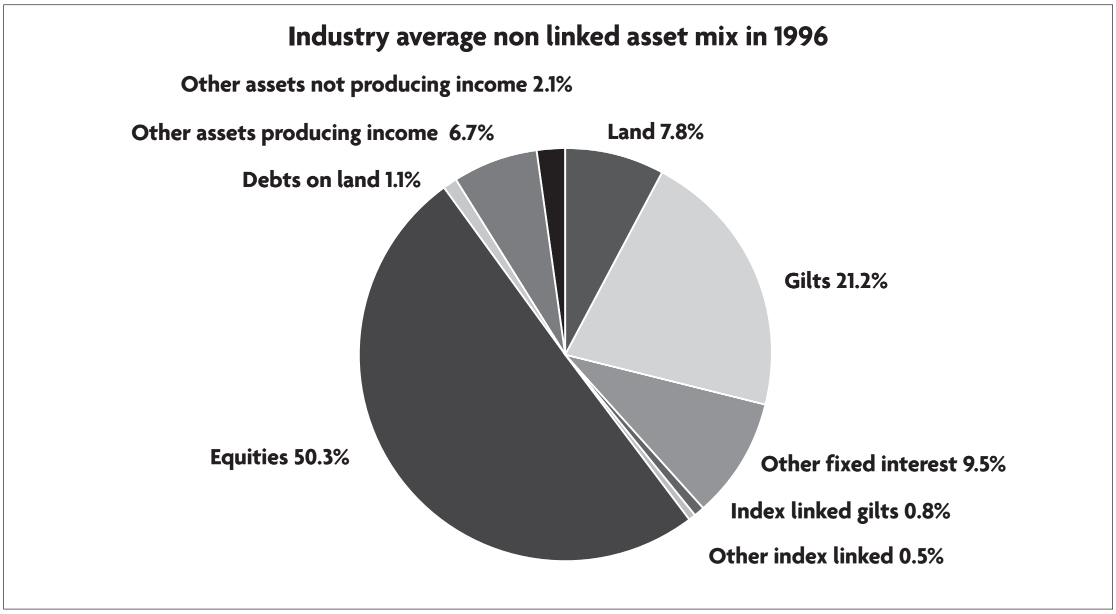
The report discusses mortality trends and the work of the Continuous Mortality Investigation Bureau (an independent industry body which monitors mortality experience). On mortality experience for people who have taken out life insurance, GAD say the main features demonstrated are:

> *A rapid improvement in overall mortality ...*

On mortality experience for pensioners and annuitants, GAD say:

> *The main point here is to note that the rate of improvement in mortality has been much faster than expected.*

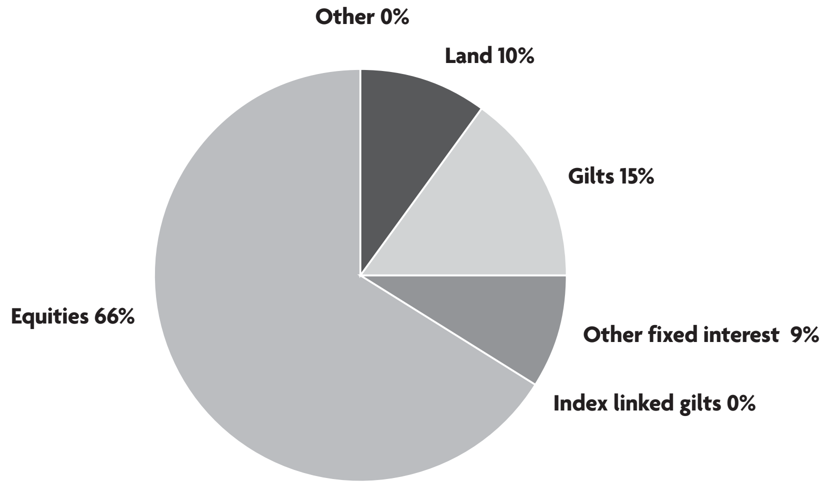
On *'Assets'*, GAD provide a breakdown of the average non-linked asset mix, presented as follows:



1997

GAD also produce an estimation of the breakdown of the portfolios that are held by companies to support their with-profit liabilities (including the free estate). They explain: *'This estimate has been based on the assumptions that fixed interest assets are held to match fixed liabilities and that most miscellaneous assets are held against other miscellaneous liabilities, while real assets are mainly allocated to match with-profit liabilities'*. The report includes the following chart:

Average mix of assets backing with profit liabilities of major with profit offices in 1996



GAD say:

> *It is concluded that with-profit liabilities at the end of 1996 were matched by about 75.6% of real assets (10.2% property and 65.4% equities) and by over 24% held in fixed interest securities (14.9% gilts and 9.2% other fixed interest holdings).*
>
> *This represents a marked reduction of 5.5% in the real asset proportion over the last year. Bearing in mind known market movements, this change would seem to result from deliberate cautious policy changes – and may reflect real tightness in the financial position of certain offices.*

On investment performance, GAD say that the average estimated investment return on non-linked assets is 10.4%. The report includes a table setting out the estimated returns achieved by individual companies, which for Equitable shows an estimated return of 10.34%.

GAD's report includes a chapter on maturity payouts. In the summary, and under the heading *'Impressions'*, GAD say:

> *While maturity payouts on shorter term policies have fallen sharply over the nineties, and fell generally between 1995 and 1996, the longer term policies have seen a comparatively level performance over the 1990s. However our projections of underlying asset shares, although a very crude indicator of the future, implies further sharp drops are likely. The sharp movements in the early 1990s on 10 year policies were in many ways a reflection of the upswing from the late 1980s (as companies recognised underpayment to policyholders fuelled by favourable investment markets) having to be hastily reversed as lower inflationary expectations brought lower expectations of investment return. At the same time reversionary bonus rates (as opposed to terminal rates) were also under downward pressure for the longer term policies, driven by the same fears of lower*

investment earnings. The process caused some angst over the speed with which companies could drop reversionary bonus, though the process has been eased by unexpectedly favourable equity markets in the most recent years. Overlaid on this have of course been differing competitive pressures on short term savings vehicles (such as a ten year endowment) and longer term mortgage repayment vehicles (such as a 25 year endowment). Criticism has been made by some of the mutuals over what they perceive as a belated move to more generous payouts from the proprietary companies, which has increased the competitive squeeze on the mutuals.

Companies generally have paid well over simple asset shares (defined below) in recent years, either by their particular experience but more likely by miscellaneous surplus and their estates, with such generosity encouraged by competitive pressures and dividend demands in the proprietary companies. The steady switch from conventional with profit business to unitised with profit options within a unit linked policy may well reduce the competitive pressures on what will become, in time at least, closed conventional series.

GAD provide the following *'Warnings'* about the information presented in this chapter:

This section of the report looks purely at [ordinary business] *conventional with profit policies. Comparisons of Industrial Branch maturity payouts are unfortunately not published in any of the trade magazines, which hinders any useful review.* [Ordinary business] *unitised with profit business, though very significant, is comparatively young and gives little maturity pay out information with only a handful of companies now capable of showing ten year (pension) results. This class is therefore considered in Section 9 on bonus rates.*

The companies considered are the 28 conventional with profit companies that have appeared in the most recent magazine surveys. These are practically all within the "top 66" group that underlies the bulk of this annual report but conversely there are a number (around 10) of "top 66" companies that have not bothered to appear (or avoided appearing) in the magazine surveys. It is these 28 companies that are used for median and leaders and laggards tables in this section.

By concentrating on the major companies who bother to enter surveys one does still capture the bulk of the business in existence, but the considerable number of companies no longer contributing to the surveys must reduce the benefit of our review. (This is indeed a complaint made by the magazines themselves). As noted those not disclosing results are not just the second rank companies outside the top 66 companies but large groups such as [three named companies] *and others. While occasional lapses are not suspicious one presumes studied non appearance is because these are often poorly performing offices. (The same effect can potentially be true of the more minor series of policies in the better offices). Such an effect, the self selecting exclusion of poorly performing offices from surveys, means magazine trends of average pay outs must be treated with caution as the later years have higher proportions of those offices who did well. The tables below provide historical data solely for the offices reviewed in 1996, i.e. offices that appeared in the latest surveys, and thus avoid the problem of distorted trends. However the picture is slanted to a band of more successful offices, as some self selection is present by weaker offices being excluded throughout.*

On *'Assets Shares'*, GAD's report explains:

The retrospective roll up of premiums, known as asset shares, is becoming a reasonably common device by which companies gauge the balance of bonus distributions between differing terms of policies. (It is only in some companies that such simple asset shares are looked upon as the sum total of policyholders' PRE). A graph of asset shares representing the roll up of premiums for the same period as the maturing policies year by year shows *a similar picture to a managed fund unit linked policy, i.e. a volatile picture driven by each year's investment returns. However, the gap between asset shares and the typical smoothed maturity payout can give an indication of the level of miscellaneous surplus and earnings on the estate that companies are distributing to their policyholders. We have therefore created a series of simple asset shares representing the roll up of premiums after the average expense levels identified in section 5, and using investment returns as shown by broadly based indices as the typical with profit asset mix analysed in section 7. The calculations are necessarily crude but do accord with other more theoretical work in actuarial papers of asset shares before the addition of miscellaneous surplus. The main caveats are*

- *using the average industry acquisition expense for policies of different term overcharges the shorter terms and undercharges the longer terms.*
- *the asset mix treats all equity investment as in the UK, with none overseas*
- *the average asset mix could theoretically be a mixture of more conservative mixes for policies close to maturity and more speculative mixes for earlier policies.*

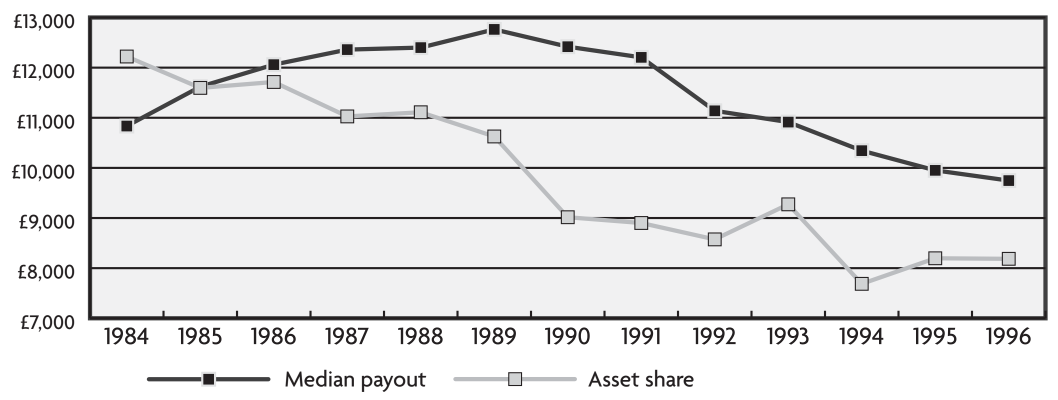
GAD set out maturity payouts for 10 and 25 year endowments and 15 year pensions using data from market surveys published in Money Management. They describe the trends in payout levels and particular aspects of certain companies. GAD then set out their *'Asset Share Comparison'*.

Under the heading *'Theoretical asset share to actual payouts'*, GAD say:

> *On a more speculative basis we can consider the median pay out of the top companies to our calculated progression of simple asset shares, which have no additional miscellaneous surplus added and represent merely a roll up of the contractual premiums less expenses. This comparison is made for a 10 year endowment, a 25 year endowment and a 15 year pension respectively in* [the figures below].

GAD present the following figures:

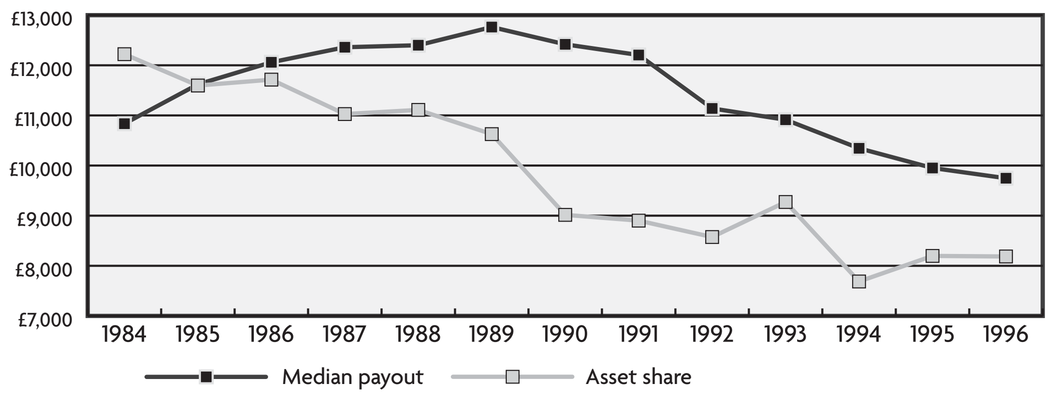
Comparison of actual median maturity payout and theoretical asset share for the years 1984-96 for a £50 per month conventional with-profits 10 year endowment policy (£)



An appendix to the report states that, for 10 year endowment policies, the average maturity payout as a percentage of asset share is 117%. For Equitable, the percentage is 121%.

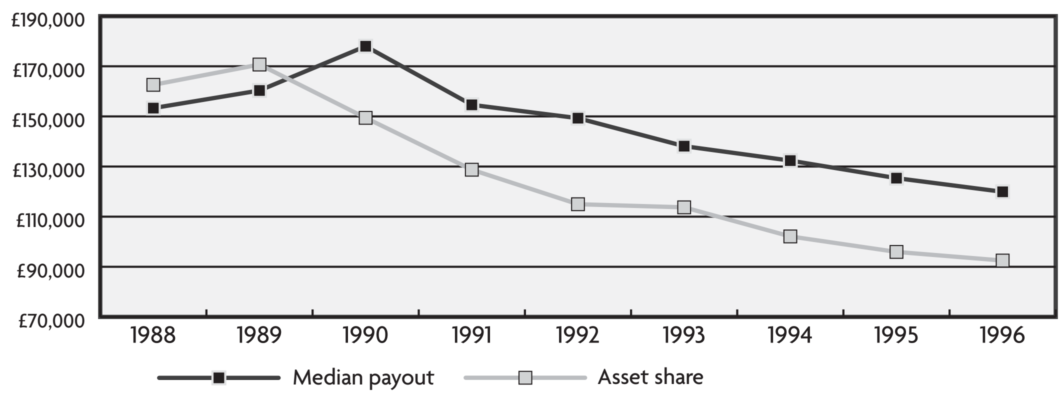
1997

Comparison of actual median maturity payout and theoretical asset share for the years 1985-96 for a £50 per month conventional with-profits 25 year endowment policy (£)



An appendix to the report states that, for 25 year endowment policies, the average maturity payout as a percentage of asset share is 106%. For Equitable, the percentage is 96%.

Comparison of actual median maturity payout and theoretical asset share for the years 1988-96 for a £200 per month conventional with-profits 15 year pension policy (£)



1997

An appendix to the report states that, for 15 year pension policies, the average maturity payout as a percentage of asset share is 127%. For Equitable, the percentage is 130%.

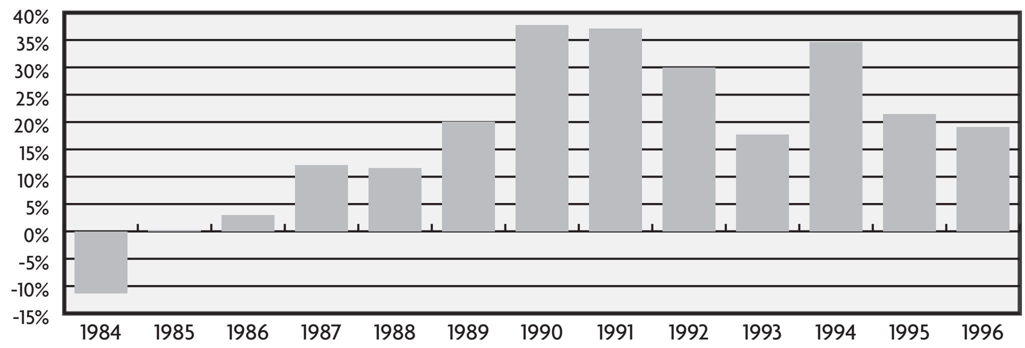
GAD say:

> *Bearing in mind the caveats of sub section 1 and problems arising where terminal bonus declarations are infrequent, there is as expected a noticeable smoothing of maturity payouts. The general effect is of payouts roughly tracking asset shares but at a considerable excess over asset shares in the 1990s. There is a range of possibilities at work here, including the introduction of more accurate methods of setting terminal bonus, competitive pressures in a harsher market and dividend demands in the proprietary companies.*

> *The real interest is whether this apparent situation will continue, as companies recognise the amount of miscellaneous surplus and estate they can distribute; or whether, as at least some companies currently arguing over the attribution of their estates contend, payouts are bound to fall closer to asset shares.* [A named company] *has separately complained bitterly in public about over paying companies setting unrealistic long term hopes. All of this goes to the heart of PRE arguments and the division of prior surplus not yet distributed.*
>
> *It is worth noting that if one pushes these simple asset shares on into the years after 1996 then relatively continuous falls in the underlying asset share is revealed year on year, an effect particularly sharp on the longer terms such as the 25 year term. The revealed excesses of current payouts to these crude asset shares described below, and the terminal bonus cover reviewed in section 9 both mean such a future needs a lot of care in management, and may foretell a future reduction in the perhaps over comfortable terminal bonus cushions that were common for offices at the beginning of the 1990s.*

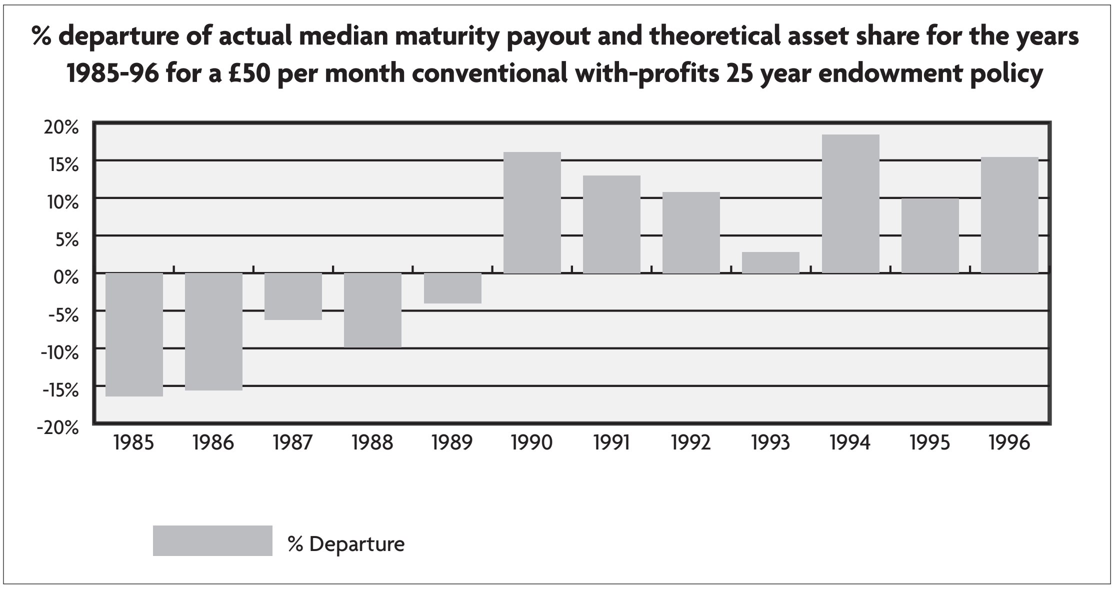
Under the heading *'Excess of actual payouts over asset share'*, GAD present the following chart:

% departure of actual median maturity payout and theoretical asset share for the years 1984-96 for a £50 per month conventional with-profits 10 year endowment policy



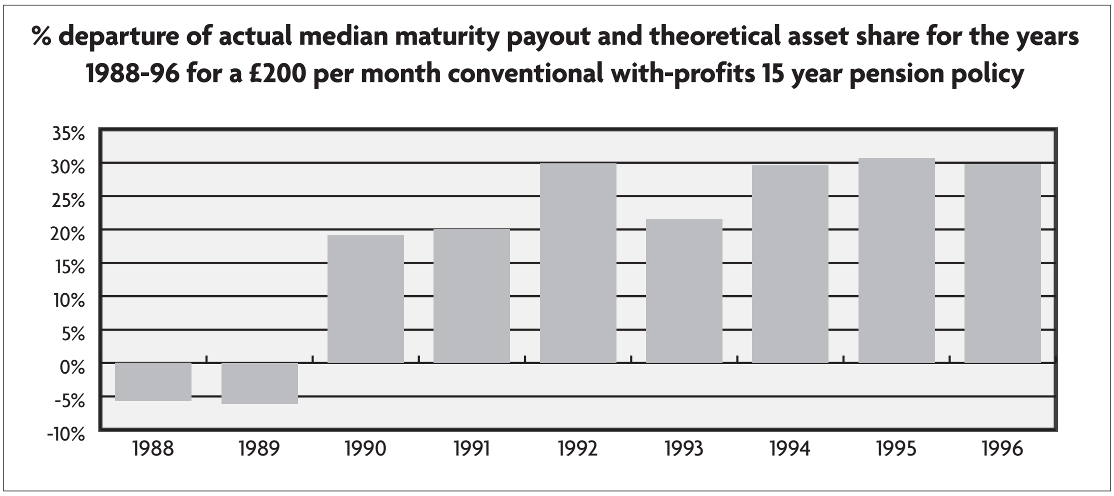
GAD explain: '*With the 10 year contract the excess payment has been present for far longer, though as noted the simple asset shares above are not helped by heavy acquisition costs included in the calculation. None of the top 66 pay under the 1996 base asset share amount of £8,186. With such excesses it is probably no coincidence that the 10 year contract was previously particularly singled out as needing correction by companies in public statements*'.

For 25 year endowment policies, GAD present the following chart:



GAD explain: '*The excess has arisen in the 1990s and implies quite severe earlier under payment to policyholders in the 1980s. If one trusts the crude calculation basis of these simple asset shares, then there has been a significant change in the approach of companies in the last 10 years, possibly for the reasons above with perhaps a more accurate analysis of what is due to policyholders uppermost. By 1996, with a simple asset share of £87,279, the top 66 companies paying below our asset share are* [four named companies], *Equitable and* [another company]. *One reasonably common thread between these companies might be a lack of profitable non profit business to boost payouts and relatively modest estates with a similar effect*'.

For 15 year pension policies, GAD present the following chart:



GAD explain: '*The more restricted survey results means the plot of the excess can only be carried back to 1988. The picture does however closely follow that of the ten year endowment. Even with the greater spread of results noted in sub section 2 above for this contract, only* [a named company] *pays under our simple asset share of £92,486 for 1996*'.

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In the chapter on *'Free Assets'*, GAD report:

> *In past years' annual reports, a broad-brush attempt was made to assess the relative strengths of the valuation bases adopted by the major with-profit offices by comparing the yield on total non-linked assets, adjusting this by stripping out the lowest yielding assets until exactly sufficient assets remain to match the total net non-linked liabilities, and comparing the resulting yield with an average valuation rate of interest used in respect of this business calculated as a weighted average of the actual rates used, the weights being the corresponding net of reinsurance reserves.*
>
> *This analysis has not been repeated this year, partly because the calculation of the average valuation rate of interest is a very labour intensive exercise, but mainly because there is serious doubt that the level of approximation inherent in the above approach is too great to produce meaningful results. In these circumstances, it seemed that a major manual data extraction exercise from the returns was not the best use of available resources.*

GAD continue:

> *It is hoped that for the 1997 report, a more sophisticated approach might be used based on the information now given in Form 57 of the returns under the new regulations, once a whole year's experience has been gained in using and summarising the information provided. For this year, however, we have restricted the report to providing just the ratios themselves, with appropriate comments on the relative strength of the valuation basis where this is known from first hand knowledge of the company concerned.*
>
> *The strength of the valuation basis is, of course, analysed in considerable detail in individual companies' detailed scrutiny reports. The reader is therefore advised when extracting individual figures from this report to also look at the detailed scrutiny report to put the figure into context.*

GAD say that four companies have used implicit items in their 1996 returns, one of which is Equitable. They say that this is unchanged since 1994. GAD say that the free asset ratio for Equitable excluding the implicit item is 3.8%. Under the heading *'Winners and losers'*, GAD provide a table of companies with the highest and lowest free asset ratios. Equitable are listed as being the sixth lowest, with a ratio of 5.5%. (Using free asset ratios that exclude implicit items moves Equitable to joint fourth lowest in the table.) GAD report that:

> *Both Equitable Life and* [the company with the fourth lowest free asset ratio] *use the gross premium (bonus reserve) method of valuation, so that the free asset ratios quoted for these companies are not strictly comparable to the others. This method of valuation produces larger reserves because explicit allowance is made for future expenses and bonuses, thereby reducing the free asset ratio. If these ratios were recalculated using the net premium method used by all the other companies, their relative position would improve to some extent.*

On the *'Overall picture'*, GAD provide a chart of the percentage change in free asset ratios from 1995 to 1996 and explain:

> *The most notable feature ... is the lack of significant change in free asset ratios compared with 1995. This is in fact not surprising given the economic conditions prevailing during 1996. These were such as to give a typical with-profit office, with a standard spread of investments, a rise in asset values of around 4.75% and a total gross return of around 10.75%. Although this may seem quite a good return, most companies actually require a return of at least this level to sustain their position. Overall, therefore, it was to be expected that free asset ratios would be little changed during the year. Individual companies' ratios will have changed largely as a result of factors specific to them.*

GAD comment on the changes in the free asset ratios of certain companies. They say that Equitable's free asset ratio had fallen over the year, *'but this is as much to do with the company's policy of not maintaining a large amount of free assets as anything else'*.

(Note: the bodies under investigation have told me that it should be noted that: *'the charts selected for this entry all show maturity payouts for regular premium contracts only. By contrast, the bulk of Equitable's business was recurrent single premium. These charts therefore have very little significance for Equitable. This comment also applies to the corresponding charts provided in the reports prepared by GAD for* [other] *years'.)*

09/12/1997 DTI, having received advice from GAD, inform a correspondent from Germany that '[being] *a member* [of Equitable] *does not involve any obligations other than the obligation to pay the premium'*.

(Note: this statement was to be the subject of criticism in the Penrose Report (Chapter 16, paragraph 215).)

16/12/1997 **GAD provide DTI with their Scrutiny Report on the Society's 1996 regulatory returns**. (A copy of this scrutiny report is reproduced in full within Part 4 of this report.) The report uses a detailed format similar to that adopted for the 1993, 1994 and 1995 returns (see 15/11/1994 [**entry 1**], 23/01/1996 [**entry 1**] and 01/11/1996 [**entry 1**]). It comprises 15 sections as follows:

(1) Executive summary
GAD say that Equitable are highly regarded, the oldest mutual life assurance society in the world and pay no commission to intermediaries. They achieve outstanding new business growth, based largely on their reputation for low expenses. GAD note:

> *About 65% of its liabilities relate to unitised with-profits business, for which it endeavours to show competitive annual accumulations of benefits reflecting the total investment returns achieved, but, because guaranteed bonuses include credit for a measure of asset appreciation, future bonus declarations of the Society would seem to be vulnerable to any sustained stock market downturn. It has a modest free estate.*
>
> *Some questions have been raised about the strength of the reserves established.*

(2) Key features
GAD set out some key statistics and observations, including:

- the cover for Equitable's required minimum margin is 2.53;
- their priority rating is 3;
- new business has more than doubled over the last five years;
- expense ratios are the lowest in the business and persistency experience is good;
- Equitable have achieved a '*mediocre*' investment return of 10.3% in 1996; and
- *'The gross premium bonus reserve valuation published does not appear to be any stronger than its permissible net premium valuation'*.

(3) Action points
GAD explain that they have asked the Appointed Actuary:

> *... about the provisions made: (1) for resilience, (2) for possible* [capital gains tax]*, and (3) for pensions mis-selling in the net premium valuation.*
>
> *He has also been asked to supply data comparing total accumulated assets shares for contracts in force with the total assets available.*

(4) Background
GAD reiterate information included in the Background section of their reports on the 1993, 1994 and 1995 returns, namely that Equitable are the oldest mutual life assurance society in the world and that they never pay commission to third parties. GAD explain that: *'This background is typified by a determination to provide fair bonuses to policyholders, with no deliberate holding back of profits from one generation to another, by unit linked products which often have discretionary surrender values, and by using a gross premium bonus reserve valuation method'*. GAD also say that:

> *The DTI returns also show the results of applying a net premium basis with assumptions close to the minimum permitted by regulations.*

GAD note that Equitable obtained a section 68 Order for a future profits implicit item of £600m for the 1996 returns and have used £312.8m. They also note that, in 1995, Equitable purchased a controlling interest in Permanent Insurance and bought out the minority shareholders in June 1997.

GAD explain that Equitable have increased their overseas activity in recent years (in Guernsey, Republic of Ireland and Germany) and that this was producing increasing amounts of new business. GAD state, as in their reports on the 1994 and 1995 returns, that Equitable regard this as *'missionary work'*.

GAD note that the last visit to Equitable was made in November 1996 (see 08/11/1996 [**entry 2**]), and that in 1997 Equitable took out a £350m subordinated loan.

(5) New business
GAD set out the new products Equitable have developed and the sources of their business. GAD produce tables showing the recent history of new regular premiums and new single premiums and a new business index. GAD comment that Equitable continue to produce exceptionally strong new business figures and that a very large proportion of the business *'is of the "accumulating with-profit" type, which is newly identified in the 1996 Returns'*.

GAD note that, as Equitable are not able to produce meaningful in-force premium figures for renewable single premium business, with the agreement of DTI the annual premiums recorded in Form 46 of the returns ignore this business.

(6) Changes in business in force
GAD provide a table showing *'Recent history of regular premiums received'*. They note:

> *While the revised Regulations were intended to help give appropriate recognition to renewable single premium business and classify it as regular premium business, the flexible nature of Equitable's products has made it difficult for them to quote a basic regular premium payment. As a somewhat perverse result, for 1996 the Returns of Equitable actually show lower regular pension premiums and higher single premiums.*

GAD produce tables showing: *'Claims experience'*; *'Persistency experience'*; and, *'Recent history of combined surrender, lapse & paid-up conversion rates'*.

GAD note that, although pensions is the major class of Equitable's business, persistency data was not available, due to the flexible nature of the contracts written.

(7) Expenses
GAD produce a table showing the history of expenses from 1992 to 1996. They comment that Equitable's expense ratios keep improving and have again reached *'astonishingly low levels'*. GAD note that Equitable claim to have invested £50m in redeveloping all operating systems over recent years, but that no exceptional costs were observed in 1996.

(8) Non-linked assets
GAD produce tables showing Equitable's: *'Recent history of asset mix'*; *'Recent history of asset mix attributable to UK with-profits business'*; *'Movement in asset values during the year'*; and, *'Investment performance'*.

The latter shows a return of 10.3%. GAD comment:

> *This return is slightly disappointing for the portfolio held, but includes a write-down in the value of investments in dependants. However, the return claimed in the Society's accounts for assets matching with-profit liabilities of 10.7% is competitive.*

(9) Assets held to match linked liabilities
GAD provide details of internal linked funds, other assets matching property-linked liabilities, mismatching to property-linked liabilities, assets matching index-linked liabilities and PRE. On the latter, GAD comment:

> *Where a fund invests in an Equitable Unit Trust, the annual management charge is reduced by ½%, and charges are also adjusted where a fund invests in units of another fund to ensure that only one levy is made.*

GAD observe no particular problems.

(10) Valuation basis
GAD explain that Equitable:

> *... produces its published Return on the basis of a gross premium valuation for non linked business, with some allowance for future bonuses, but the results of a net premium valuation are also shown in the Returns – with a negligible liability difference.*
>
> *The Equitable tries to provide a fair bonus allocation to each generation of policyholders – without holding back an excessive estate. The result is that lower free asset margins exist than might have been expected for such a well thought of institution. It may be noted that the Society has, for the last three years, found it desirable to utilise a future profits implicit item to improve the disclosed free assets position – although at nowhere near the maximum that could be justified under the guidelines.*
>
> *There is one hidden strength in the valuation – the treatment of recurrent single premium pensions business, under which it is assumed that no more premiums will be received. Although in line with the best practice, this is a strong basis – particularly for property linked contracts. If such business were treated as regular premium, margins in future premiums and charges on the funds built up might allow somewhat lower reserves.*

GAD note, as in previous years, that a hidden strength in the valuation is the treatment of recurrent single premium pensions business, under which it is assumed that no more premiums will be received. GAD go on to discuss six particular areas:

Interest – GAD provide a table showing the valuation interest rates used for major classes. They state that *'Forms 57 show that matching assets are available'*.

Mortality – GAD explain that the bases used are reasonably conservative and that '[the] *Appointed Actuary insists in his report that these tables contain sufficient allowance for future reductions in rates of mortality'*.

Expenses – GAD state that the total provisions were more than adequate and that the Actuary's contention that no additional provisions are needed to cover the continued sale of new business or to cover closure seemed acceptable.

Resilience and special reserves – GAD explain:

> *A resilience reserve requirement is reported of £501m, but this has not been allowed for in Line 29 of Form 57 and bearing in mind that this must be largely covered by equity assets, it is thought that a grossed up figure of £668m should have been provided for.*
>
> *This is being queried.*

Other factors – GAD explain that the parameters used for establishing sterling reserves for unit-linked products seem rather weak. *'However, potential expense strains are not thought to be great for this company and the standard annual expense inflation rate assumption they use is only 4%, so no question has been raised on this occasion'.*

GAD add:

> *The failure to set up a specific reserve in relation to the contingent liability of £47.7m for tax on capital gains on non-linked assets is dubious – relying on other margins in the valuation basis. This is being queried.*
>
> *A pensions mis-selling reserve of £50m was included within the future bonus provision in the bonus reserve valuation, but it is not clear that any such provision was established in the net premium valuation. This is also being queried. [Recent correspondence suggests that the required provision had risen to £85m by 30 September 1997.]*

Overall strength — GAD state:

> *The Society informs its holders of accumulating with profit contracts of the amount of their accumulating final bonus (although clearly stating that it is not guaranteed), but only holds reserves for a discounted sum compared with the current guaranteed value.*
>
> *It is stated in the return that final bonus additions (the accumulated amount of which are not revealed) are implicitly covered by the amount of excess admissible assets over the mathematical reserves – shown in the 1996 Return as being about £1.4bn (including the* [required minimum margin]*). However, since the reserves already value current guaranteed benefit values at a combined discount of some £1.3bn, it seems likely that the total current "asset shares" (including final bonuses indicated to members) exceed total current admissible assets. The Actuary is being asked to clarify his view of the situation!*
>
> (11) Financial results

GAD provide an overview:

> *The Bonus Reserve Gross Premium valuation shows available assets covering the* [required minimum margin] *by a factor of 2.53, and the net premium valuation would show a similar picture.*
>
> *Without the implicit future profits item of about £312.8m, cover for the* [required minimum margin] *would be reduced to a factor of 2.07. Further, we are not clear that provisions made against the market value of assets for resilience and prospective capital gains tax are as strong as they should be.*
>
> *Because of the large proportion of business written on a participating basis and the high level of annual emerging surplus, there are not considered to be any actual potential solvency problems for the Society, but it does seem that, in the event of a marked fall in asset values, the Society might find itself in a position where it had to cut back severely the level of payout to members.*
>
> *It would seem desirable for the Society to hold back more of its emerging surplus by declaring lower guaranteed bonuses – although it could still attempt to pay out generous final bonuses to members (preferably without raising expectations too much in advance with its declarations of "non-guaranteed final bonuses").*

Against this last point, DTI's Line Supervisor B notes *'Policyholders must find this confusing!'*.

Under *'Summary of results for main classes'*, GAD produce three tables showing liabilities for non-linked and linked business and a valuation summary. The valuation summary shows, under the main valuation, that Equitable's cover for the required minimum margin is 2.53 (compared with 2.89 in 1995). There is no figure for cover under the appendix valuation. The table shows that Equitable's free asset ratio has fallen to 3.84% (from 5.13% in 1995). GAD comment:

> *The Net Premium Valuation generated a lower non-linked liability of £14,675,209,000 and a lower reserve for declared bonuses of £474,207,000 but was shown to require a resilience reserve of £501m.*
>
> *Thus, the total Long Term liabilities for ... the* [net premium valuation] *would be £17,705,214,000, ie most of the apparent margin between the* [bonus reserve valuation] *and* [net premium valuation] *policy liabilities is needed to cover resilience, and the* [bonus reserve valuation] *does not produce any material extra margins.*

GAD produce a further table showing composition and distribution of surplus. They make no comments on this.

(12) <u>Bonuses</u>
GAD produce tables showing the cost of bonuses declared and the recent history of key bonus rates. They repeat the description of Equitable's bonus system and quote from Equitable's own description. Against this, Line Supervisor B writes: *'Perhaps this confuses* [policyholders]*?'*.

GAD reproduce Equitable's table of earned investment returns on gross market value and the rate allocated in fixing bonuses, updated to include 1996:

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*
Earned	*-8.3%*	*13.5%*	*17.1%*	*28.8%*	*-4.2%*	*16.6%*	*10.7%*
Allocated	*12%*	*12%*	*10%**	*13%*	*10%*	*10%*	*10%*

' 12% was applied to new benefits secured during the year'*

Under *'PRE'*, GAD state that Equitable:

> *... tries very hard to achieve an equitable distribution to each generation of its policyholders, whilst avoiding short term fluctuations in benefits – with the result that it has not accumulated any material unallocated estate compared with accumulated asset shares (if any – see Section 10.7).*
>
> *However, it reserves the right to penalise early surrenders, even in relation to guaranteed bonuses added under unitised contracts, and it might be desirable for this possibility to receive greater prominence in the literature distributed. Further, with such a large proportion of unitised business and with the level of guaranteed bonuses declared taking account of some asset appreciation, it would seem to be desirable that policyholders were given some greater warning about the possible implications for future bonuses of a substantial market setback.*

Against this, Line Supervisor B notes:

> *Take up with company? I discussed this briefly with* [Scrutinising Actuary E] *– concern is that* [the company] *has no estate – no cushion. Should not perhaps be giving bonuses to new* [policyholders]. *But the markets are up at present.*

(13) <u>Reinsurance</u>
GAD state that Equitable make little use of reinsurance.

(14) Compliance
Under *'DTI compliance problems'*, GAD state:

> *The Society is not able to produce meaningful in-force premium figures for renewable single premium business, and a Section 68 Order has been given on a temporary basis (up to the end of 1998)* [see 30/04/1997] *allowing the Society to exclude recurrent single premiums from the annual premiums recorded* [in the returns].

Against this, Line Supervisor B has written *'I wouldn't call this a compliance problem'*.

Under *'PIA and other compliance problems'*, GAD state:

> *A pensions mis-selling reserve of £50m was included within the future bonus provision in the bonus reserve valuation, although it is not clear that any such provision was established in the net premium valuation and this is being queried.*
>
> *Recent correspondence suggests the required provision had risen to £85m by 30.9.1997.*

(15) Professional requirements
GAD certify that their report conforms with the requirements of the Institute and Faculty of Actuaries as set out in their Memorandum of Professional Conduct and Advice on Professional Conduct and has been prepared in accordance with the Service Level Agreement approved in March 1995.

GAD's scrutiny report runs to 19 pages. Line Supervisor B copies the report to Line Manager C and to the Head of Life Insurance.

GAD write to Equitable to pursue five issues arising from their scrutiny of the 1996 returns.

(1) GAD point out that Equitable do not state what test they have applied in assessing the required resilience reserve. GAD query if the figure indicated in the report on the net premium valuation (£501m) should be grossed up.

(2) GAD state that they are not convinced that it is acceptable for Equitable to assert that other margins are available to cover the discounted value of the prospective liability for tax on unrealised gains. GAD invite Equitable to comment on this point and to advise what other margins are considered to be available.

(3) GAD note the provision for £50m for pensions mis-selling in the bonus reserve valuation and ask where the corresponding provision is in the net premium valuation.

(4) GAD say:

> *It is stated in the return that final bonus additions are implicitly covered by the amount of excess admissible assets held over the mathematical reserves – shown in the 1996 Return as being about £1.4bn. (including the* [required minimum margin]*). However, since your reserves already value current guaranteed benefit values at a combined discount of some £1.3bn, it seems likely that the total current "asset shares" (including the final bonuses indicated to members) exceed total current admissible assets. Is this a correct deduction? Please provide a figure for the accumulated asset shares for all in-force accumulating with-profit contracts at end 1996.*

(5) GAD ask Equitable to explain if:

> *... the policy reserves for any accumulating with profits policies were lower than the basic surrender values available at the valuation date (ie excluding any amounts in respect of final bonus from these values)? If so how much was the total of such differences?*

1998

05/01/1998	Responsibility for prudential regulation passes from DTI to HMT.

13/01/1998 Equitable write to GAD in reply to the five points in their letter of 16/12/1997:

(1) Equitable state which of the resilience scenarios tested was the most onerous and used for the resilience reserve. They undertake to specify this in future. They confirm that the figure used is the grossed up amount.

(2) Equitable reiterate that there are substantial margins in the expense reserves and point to the parts of their returns which show these. They say:

> *The prospective liability to tax on unrealised gains will essentially relate to earnings to be distributed as final bonus on* [basic life and general annuity] *business. As such the potential tax liability might reasonably be argued to be a charge on the Investment Reserve and, accordingly, not need to be provided for within the mathematical reserves in any event.*

Equitable ask for GAD's comments on this view.

(3) Equitable state that the provision of £50m was similarly held within the mathematical reserve for personal pension business.

(4) Equitable explain that they do not understand GAD's question. Equitable say:

> *A comparison of the totals of columns 11 and 12 on form 52 shows that the discounted value of accumulating with profits benefits is £638m less than the full "face value", not £1.3bn less as you state. I am also not clear as to the meaning you attach to the highlighted words "current guaranteed". The face value of benefits is the current value of guaranteed benefits <u>if</u> a contractual event (eg death) occurred at the valuation date. In most cases there is no contractual right to receive the current accumulated benefit at the valuation date.*

Against this paragraph, GAD note that current benefits are discounted by £638m *'for* [gross premium valuation], *but £1,320m in* [net premium valuation]'.

Equitable acknowledge, however, that GAD are:

> *... correct in deducing that at 31.12.96 the total face value of policies including accrued final bonus was in excess of the value of the assets attributable to with profits business. Those assets will include items like the accumulated new business strains and so are higher than a pure share of the Form 9 admissible assets.*

Equitable continue:

> *Regarding your final sentence, I am not clear whether you are asking about unsmoothed or smoothed asset shares. Because of the flexibility of our contracts we do not calculate unsmoothed asset shares for every policy. However, given the way we operate the business the totality of unsmoothed asset shares will be close to the value of the assets attributable to with profits business. If, however, you are asking about smoothed asset shares, then our bonus systems mean that the policy value, including final bonus, is effectively a smoothed asset share. Thus the total of such asset shares will be the total face value of policies including accrued final bonus, as discussed above.*

Equitable then state that the total figure for accumulating with-profits contracts at 31 December 1996 was £14.7bn.

(5) Equitable explain that their accumulating with-profits policies do not include guaranteed surrender values as such, but that:

> *... there are ranges of dates between which benefits may be taken at full value (eg on retirement). The valuation method takes account of such options which explains why the discounted value of benefits is 95% of the face value, when the typical outstanding period to selected pension date would lead one to expect a much more substantial degree of discounting.*

They add:

> *You may be interested to know that, in the light of the reduction in yields in 1997 and the loss of tax credits on UK dividends, I expect that the reserves at 31 December 1997 for accumulating with profits business will, including resilience reserves, need to be greater than the face value of benefits.*

GAD sideline this paragraph.

16/01/1998 GAD write to Equitable in reply to the five points in their letter of 13/01/1998:

(1) GAD thank Equitable for confirming that the resilience reserve required of £501m is the grossed up value. GAD say:

> *It would be easier to follow what has been done if Forms 57 of your Returns included the resilience reserve as a liability in Line 29 – presumably giving a total initial liability of £15,675,191,000 and a corresponding value for initial matching assets.*

GAD point out that Equitable's figure in the body of their returns for the fall in value of assets and liabilities does not correspond with the figure in the net premium valuation.

(2) GAD state:

> *We accept that there are margins that will emerge from expense reserves in future years, but are still not convinced that it is appropriate to use these to cover the discounted value of the prospective liability for tax on unrealised gains on assets shown at market value in Form 9.*

GAD continue:

> *With regard to your more general point, in the Statement of Solvency as set out in Form 9 total liabilities are set against the total market value of admissible assets. This automatically includes any amount that is considered to be an "investment reserve", irrespective of the use to which it might be put. We believe that liabilities must also allow for any tax payable on chargeable gains, though it is naturally possible to reduce this tax liability in resilience scenarios.*

GAD ask Equitable to reconsider this matter for their next returns.

(3) GAD note that the pensions mis-selling provision of £50m was included within the mathematical reserves for personal pensions business in the net premium valuation. They state: *'We consider that the existence of such reserves should be disclosed in the valuation report, and it would clearly be helpful if it were also disclosed where such reserve is held. Please review for the next Return'.*

(4) GAD explain that the figure for the discounting of reserves of £1.3bn is taken from the figures supplied in the net premium valuation. GAD say that this *'is the valuation basis that we consider to be most informative. [Indeed, I am unclear as to why the Society persists with providing the gross premium bonus reserve alternative.]'*

GAD continue:

> *It is my understanding that bonus notices from Equitable relating to accumulating with-profits business include details of accumulated non-guaranteed final bonuses. I do not think that it is possible to derive from your Returns the amount to which such final bonus expectations have accumulated at the valuation date, and my emphasis on the level of accumulated "current guaranteed" benefits was merely intended to highlight this missing information. I naturally accept your point that even the amount of the current face value of guaranteed benefits is not immediately payable at the valuation date.*
>
> *I am grateful for the clear answers given in your second and third paragraphs, confirming my deductions about the overall financial position of the Society. The total figure for the face value of all accumulating with-profit policies including accrued final bonus of £14.7bn is £3.8bn above the net premium reserve carried for this business, and this margin clearly well exceeds the amount of available free assets shown in Form 9. I am happy to confirm that this does not necessarily cause me any concern, but the lack of any unutilised free estate does bring to prominence the importance of not building up policyholder expectations too far – with the implication that it might then be considered necessary to hold reserves for anticipated final bonus additions. I am sure that you are acutely aware of this.*

Line Supervisor B underlines and sidelines the comment about the lack of an unutilised free estate and policyholders' expectations. On her copy of GAD's scrutiny report on the 1996 returns, the Line Supervisor records concern that Equitable have no estate and queries if they should be giving bonuses to new policyholders (see 16/12/1997). She further records that the above is GAD's response.

(5) GAD state that they assume Equitable's answer relates to the reserves held in the bonus reserve valuation, whereas their question related to the net premium valuation. GAD repeat their request that Equitable confirm:

> *... that available surrender values at the valuation date under accumulating with profit policies, excluding any amount which may be attributed to final bonuses, did not exceed the discounted reserves held in the net premium valuation.*

GAD send copies of Equitable's letter of 13/01/1998 and this reply to HMT. GAD explain that they will provide their final thoughts on the scrutiny after they have considered Equitable's next reply.

04/02/1998 Equitable write to GAD in reply to the five points in their letter of 16/01/1998:

(1) Equitable give an explanation for the discrepancy in the figures. They query if GAD's suggestions for completing the returns are consistent with the ICAS Regulations 1996.

(2) Equitable note GAD's comments and undertake to consider the matter for the 1997 returns.

(3) Equitable explain that their approach in the 1996 returns reflected the difficulty of quantifying the amount of the possible liability. Equitable say they now have more data and that they *'will be showing an explicit reserve in the 1997 returns'*.

(4) Equitable explain that:

> *The bonus reserve valuation published is the one the Appointed Actuary considers appropriate to the requirements of regulation 64(1). The fact that it is based on a bonus reserve method is partly due to historical precedent (it was the method developed by William Morgan to carry out the first ever actuarial valuation of a life office) but, more importantly, because successive actuaries have felt it better suited to the nature of our*

business. The net premium valuation is published purely to demonstrate compliance with regulation 67(4).

Equitable suggest that the figures given by GAD in their letter of 16/01/1998:

> *... somewhat misrepresent the position because you are comparing the excess of total policy values (including final bonus) over the net premium reserves with the Form 9 "free assets" which are based on the bonus reserve valuation. Also, as noted in my previous letter the admissible assets are, in commercial terms, a conservative view of the assets properly attributed to the with profits policyholders.*

Equitable explain that they *'take great care on our bonus statements to emphasise that the final bonus element of the current policy value is not guaranteed in any way' and that 'In the years we have been using this form of presentation we have, as you say, been acutely aware of the need not to build-up inappropriate expectations'. Equitable continue and say that they 'do, however, feel very strongly that giving full policy values (as well as the current value of guaranteed benefits) is very useful for policyholders in planning their affairs'.*

Equitable suggest that some declared bonuses are being kept imprudently high by some offices, particularly on with-profits bonds *'partly due to a failure of* [those] *offices to communicate the developing terminal bonus position adequately to their clients'*. They continue by saying that '[an] *annual presentation of the overall position, such as that used by the Society, avoids such pressures and allows a more disciplined approach to reversionary bonuses. I think it would do a grave dis-service both to policyholder communications and the sound management of offices if quoting current policy values including terminal/final bonuses effectively became outlawed for the reasons implied by your penultimate sentence'.*

(5) Equitable state:

> *I apologise for misunderstanding your question but the approach described in ... my response applied equally to the net premium valuation. (The degree of discounting is slightly higher due to the higher interest rates.)*

05/02/1998 HMT's Line Supervisor B tells the Head of Life Insurance that an ex-National Lottery regulator who had been subject to press criticism had been linked in a newspaper article to Equitable. She had checked and found that he had been appointed a director in 1995. The Line Supervisor explains that she is checking further to see if there are any 'fit and proper' implications. The Head of Life Insurance replies that *'It may be that his failings as regulator don't make him unfit to be one of many directors – but the case needs to be reviewed, and it may be that Equitable themselves will want him to go'.*

10/02/1998 GAD's insurance sections hold a regular monthly meeting. Amongst other matters, they discuss annuity guarantees. GAD's minute records the following:

> [A Directing Actuary] *explained that this subject had become relevant due to the current low interest rate environment for both short and long term stocks, and with the additional factor that mortality rates were lower than when guarantees were given.*
>
> [A GAD Scrutinising Actuary and member of the Annuity Guarantees Working Party] *outlined the response by the Institute Working Party on this matter, although the* [Working Party] *had not met since the Brighton conference in November 1997. The three aims of the working party were to:*
>
> *a) Identify what the risk was.*
>
> *b) Find methodologies for reserving for that risk.*
>
> *c) Survey the industry to determine what actuaries were thinking on their reserving basis.*

The findings demonstrated that a problem existed, with roughly 50% of companies recognising they had a problem and of those, a further 50% reserving properly, leaving 75% of companies not reserving adequately.

It was agreed that a GAD circular letter should be sent to companies to provide information on this subject, with the [Working Party] *questionnaire being used as a template.*

23/02/1998	Equitable inform HMT that they have received no reply to their letter of 01/09/1997 about their application for a section 68 Order for a future profits implicit item of £700m, for use in their 1997 returns.
24/02/1998	HMT send Equitable a copy of their letter of 14/10/1997 enclosing the requested section 68 Order.

27/02/1998 GAD write to Equitable in reply to the five points in their letter of 04/02/1998:

(1) GAD state:

We and, I confidently believe, most actuaries have accepted that long term liabilities to be incorporated into Forms 57 include any required resilience reserve – and such reserve is normally included with other liabilities that do not require a discount rate to be applied.

(2) & (3) GAD note Equitable's comments.

(4) GAD say that they:

... note your reasons for sustaining the bonus reserve valuation for conventional with-profit business, but I would point out that the overall result compared with the net premium valuation (that we monitor) would now appear to be little different. I calculate that, including the required resilience reserve, the liability that would have been shown in Line 23 of Form 9 using your alternative net premium valuation as at 31.12.1996 was £17,567,234k, i.e. less than £5m lower than the reserves produced using the bonus reserve valuation figures.

GAD reassure Equitable that no consideration was being given to outlawing the type of bonus notice they currently issue, but that it would be a matter for concern if any holders of accumulating with-profits contracts were ever to feel that they had been misled. GAD add:

It is clearly in the best interests of the whole industry for all participants to be wary of either granting over-generous guaranteed bonuses or of building up any false expectations in relation to final bonuses. The manner in which Equitable operates as a mutual – giving the best possible returns to each generation of policyholders, with the consequent lack of any substantial unutilised free estate, does mean that you do not have much of a cushion to enable you to protect holders of such contracts from the natural effects of future falls in the market value of assets. We remain confident that your company is fully aware of this.

(5) GAD note Equitable's comments, but add:

I am not clear that you have directly answered my question "can you confirm that available surrender values at the valuation date under your accumulating with-profit policies, excluding any amount which may be attributed to final bonuses, did not exceed the discounted reserves held in the net premium valuation?"

GAD copy this letter to HMT. GAD say that there are no compliance points in relation to the 1996 returns for HMT to follow up, although Equitable have agreed to some presentational changes for the 1997 returns (see 04/02/1998, point 3). GAD continue:

I also confirm that, even though our correspondence is not yet concluded about their accumulating with-profit business, we are basically satisfied with the prudence of their reserving bases as adopted for the 1996 returns.

The position revealed is very tight, since Equitable operates on the basis that, as a mutual, it should endeavour to give full value to each generation of policyholders. It therefore does not accumulate any meaningful free estate. Hence our desire to ensure that it does not build up any false expectations for its policyholders, because it would be hard for it to establish reserves for any greater liabilities than those it currently recognises.

GAD conclude that HMT may now regard the scrutiny of the 1996 returns as complete.

12/03/1998

Equitable write to GAD in reply to their letter of 27/02/1998. In response to the outstanding points from the correspondence:

(1) Equitable explain that they are happy to adopt whatever approach GAD require, but observe that there seems to be *'some general confusion'* on the point, with one other company interpreting the requirement in the same way as the Society. They suggest that HMT clarify the guidance notes on this point at the next update.

(4) Equitable note GAD's comments with interest. Equitable add:

The relationship between the bonus reserve valuation result and the net premium result is not surprising where the view taken about the appropriate level of the bonus reserve valuation is similar to the regulatory requirements (including resilience testing).

The point may become clearer in the 1997 returns. As mentioned previously, I shall be showing essentially "full value" bonus reserve liabilities (ie no discounting of the accumulating with profits "current benefits") since I consider that to be appropriate to current conditions. The net premium reserves will be lower. Conditions at 31 December 1997 were, however, such that an explicit resilience reserve will be needed in addition to the bonus reserve liabilities in order to satisfy the GAD guidelines. The net premium valuation will naturally require a larger resilience reserve, the difference between the two resilience reserves being equal to the difference between the two sets of mathematical reserves.

(5) Equitable explain that they now understand GAD's question to relate to any surrender. Equitable say that they could not *'state categorically that the non-contractual surrenders we were actually paying on 31 December 1996 were, in all cases, lower than the mathematical reserves held'*. They add that they are not clear as to the relevance of the point as:

The surrender values being paid were only "available" because we were prepared to pay them on the low incidence of early non-contractual terminations being experienced. If we had been experiencing a significant volume of surrenders we should have exercised our right to reduce further the values paid – possibly to below the level of the mathematical reserves in all cases – in order to protect the fund.

21/04/1998

GAD write to Equitable's Appointed Actuary in reply to their letter of 12/03/1998. GAD state that the new guidance note would make the approach to showing the resilience reserve clear. GAD note Equitable's comments on questions 4 and 5 and add:

The whole area of the appropriate bonus methodology to be used for accumulating with-profits business, the expectations built up for policyholders and the establishment of proper reserves has become more difficult as a greater proportion of investment returns is being derived from asset appreciation — which could prove to be ephemeral.

GAD describe Equitable's Appointed Actuary as Actuary to a leading office in the field which has been writing this type of business for longer than anyone else. GAD invite him to visit to discuss these topics. The meeting is set for 28/05/1998. On HMT's copy of this letter, Line Supervisor B notes that GAD would let HMT know the outcome. The Line Supervisor notes further: *'28/5 — discuss how he runs his bonus policy'*.

08/05/1998 [entry 1]	In response to a letter from HMT's Head of Life Insurance, Equitable provide an update on their potential liability for pensions mis-selling. Equitable say that, in their 1997 returns, they expect to show a total provision of £75m, minus whatever actual redress is paid out in the first quarter of 1998.

08/05/1998 [entry 2] An HMT official writes to the Head of Life Insurance about the service level agreement in place between HMT and GAD. The official says:

> *This is the first time I have read this document and there are many parts of it that appear to me to be surprising and open to question. In places it reads much more like a set of rules designed to ensure that Insurance Directorate does not default on its obligations to GAD rather than the other way round. There is no provision for termination of the agreement, few standards are set out, and there is no time limit. In fact, if this agreement was submitted by a company requiring authorisation as a services agreement eg for third party administration, we would probably require it to be re-written!*
>
> *Given the sensitivities involved it may be difficult to do this but there is one part that is difficult to accept. This is A16. This allows GAD to write to the company without any reference to us unless they consider it appropriate for us to do so. In my view GAD should never write to a company without prior reference to us and express agreement on our part that they should do so; and they should copy such letters to us as soon as they have been sent.*
>
> *Basically I think this agreement is out of date and will be outmoded when we enter the FSA. There seems little to be gained by revising it at this stage. But what is the purpose of renewing it if it will be replaced by an FSA/GAD agreement. And is it really appropriate for us to renew it without reference to the FSA given that we are now getting into the mode of becoming more integrated with the FSA?*

28/05/1998 GAD (Scrutinising Actuary E and Chief Actuary D) meet Equitable's Appointed Actuary. GAD do not make a formal record of the meeting. However, the Scrutinising Actuary's notes of the meeting show that they discuss Equitable's bonus declaration strategy, individual savings accounts and Permanent Insurance. With respect to the first of these topics, Scrutinising Actuary E notes:

> *Non* [guaranteed] *element could be negative.*
>
> *Particular problems with Bonds rather than pensions* [business].
>
> *Has company done specific market research on policyholder understandings? Analysed telephone queries.*
>
> *Further discussion to take place on reserves. – Equitable.*
>
> [Regulation] *69, max interest rate. – Permanent* [Insurance]*?*
>
> *Discussed PRE surrender test.*

Equitable's Appointed Actuary prepares his own note of the meeting. He records:

The meeting was fairly unstructured and went through somewhat of a ragbag of not particularly well thought through concerns that [GAD] *have. However, their main points seem to be:*

(i) Declared bonus rates are still too high.

(ii) That offices have been incautious in distributing recent high capital returns and have not made sufficient allowance for the fact that such returns may reflect a "one off" adjustment to a lower yield basis or could be reversed to a significant degree by a change in sentiment.

(iii) That the way benefits have been presented to policyholders restricts the ability of offices to make significant changes to terminal bonuses without severely damaging policyholders' perceptions of them.

The Appointed Actuary notes that, although GAD had general concerns about the industry, GAD:

... appeared to have some specific concern that we were more exposed to the above risks than most other offices. That was partly due to our "full distribution" approach and also to some anecdotal evidence that policyholders believed their full fund value to be guaranteed.

The Appointed Actuary records that he strongly refuted the suggestion that Equitable were more exposed, citing Equitable's disciplined approach to declaring reduced bonuses; their realistic views on investment prospects *'that had led to a deliberately cautious approach to setting bonuses over the last couple of years'*; and the information provided to policyholders. He also notes that GAD:

... asked about the current relationship of total policy values to underlying assets and I said that I thought currently assets were around 105% of policy values.

He concludes:

It is difficult to judge exactly what [GAD] *were hoping to gain from the meeting but they stated at the end that they were considerably more reassured about our approach than they had been at the start.*

The Appointed Actuary notes that, at the end of the meeting, there was some general conversation about other issues, including the proposals from the Working Party on the statutory valuation basis and reserving for annuity guarantees.

08/06/1998 GAD write to Equitable following the meeting on 28/05/1998. GAD say:

I think that there is little more to be said or done at this stage in relation to the reserving bases that are appropriate for accumulating with-profits business, but it is clear that we are agreed that great restraint should be exercised in relation to the setting of guaranteed bonus levels at a time when a large part of investment returns is being derived from capital gains.

GAD note the openness of Equitable's current bonus structure and the clarity of the notes included in their bonus notices. GAD explain that they still remain wary that some of Equitable's policyholders may not appreciate that levels of non-guaranteed final bonus might actually be reduced from one declaration to the next. They note that the only research Equitable had done into policyholders' understanding of the notices was an analysis of telephone enquiries received, and question whether the analysis remained relevant.

GAD write to HMT enclosing a copy of their letter to Equitable. GAD confirm that their discussions:

... did not conclude that any particular strengthening of their reserves was needed in relation to accumulating with-profits business, although I remain somewhat concerned that not all holders of such contracts (with this and other offices) appreciate what could happen at future bonus declarations if we saw a sudden downturn in the market value of assets. The whole industry is relying on a soft landing, so that reductions can be achieved gradually and without trauma.

16/06/1998	Equitable inform HMT that they intend to do business in Greece. Equitable ask HMT to forward the required notice and certificate to the Greek authorities. HMT copy the letter to GAD for their comments.

18/06/1998 GAD inform HMT that they intend to conduct a survey of companies about annuity guarantees. GAD say:

> *You may like to see the attached questionnaire that we propose to send to life offices requesting further information about some of their pension contracts. We are aware from a recent similar survey by the actuarial profession that there is a potential issue for a number of companies which have provided guarantees of the basis on which they will convert lump sums under various pension contracts to an annuity income stream.*
>
> *Most of these guarantees were given on bases (for mortality and interest rates) which looked relatively conservative at the time they were given. However, with increasing life expectancies, and significant reductions in yields on gilts in recent years, a number of these offices may now be significantly exposed to additional liabilities in respect of these guarantees.*
>
> *Unfortunately, most of the company returns do not provide sufficient information at present about this particular exposure. Our questionnaire is therefore designed to elucidate further information on these guarantees from each office. This can then be analysed here so that we can identify those companies where further discussion may be needed as part of the ongoing supervisory process.*
>
> *I hope that there are no perceived difficulties over our collecting this general information. We shall certainly inform you of our findings, and of course highlight for you any companies where there may be a particularly significant problem.*

19/06/1998 [entry 1]	GAD advise HMT that it would be reasonable to provide the Greek authorities with the requested notice and certificate.
19/06/1998 [entry 2]	HMT give their agreement for GAD to conduct the survey. GAD send out the survey questionnaires on the following day (see below).

20/06/1998 Every insurance company is sent by a GAD Directing Actuary, who also has responsibility for Equitable, (Directing Actuary B) a letter, headed *'Reserving for Annuity Guarantees'*. The Directing Actuary says:

> *We are aware that a number of companies have included various forms of annuity guarantees on some of their pension products. Detailed information on the nature and extent of these guarantees is not though specified as having to be provided for all contracts in the returns.*

Directing Actuary B explains that, given trends in recent years in mortality and market interest rates, a number of the guarantees may be of increasing significance to the financial management of life insurers. Consequently, GAD are seeking further information about the nature of the annuity guarantees written, methods of reserving for them, and other related issues. The Directing Actuary encloses a questionnaire and asks for it to be completed and returned by 31/07/1998.

Submission of the 1997 regulatory returns

26/06/1998 [entry 1] **Equitable submit their 1997 regulatory returns to HMT**. Accompanying those returns are copies of the Society's annual report and financial highlights and its statutory annual report and accounts, prepared in accordance with the Companies Act 1985 and dated 25 March 1998.

These documents include the following information about Equitable's business and their financial position as at 31 December 1997.

<u>Companies Act annual report and financial highlights</u>
In their *President's Statement*, Equitable state that new premium income had exceeded £3bn for the first time and that their expense ratio had fallen for the ninth successive year to 4.1%. Equitable also state that *'in recent years we have been able to reduce the charges on many of our contracts, not just for new policies but also for existing contracts, and we were able to make further reductions during 1997'*. They also disclose that they had achieved a total return of 17.2% for their with-profits fund. The Board had decided to increase the total rate of return allocated to policies in the year but that reversionary bonus should reduce to reflect the lower returns which could be expected if inflation remained low. Equitable state that they operated a policy of full and fair distribution of profits and aimed to ensure that each generation of policyholders received a full and fair return on the amount they had invested, taking into consideration the investment and other experience over the duration of their contracts. As part of this policy, Equitable deliberately avoided the build-up of unnecessary free reserves that were sometimes termed an 'orphan estate'. Equitable disclose that they had raised £350m in subordinated loans during 1997 and commented that their ability to do so on favourable terms demonstrated the high regard in which they were held. The President reports that Standard & Poor's had reconfirmed their *'AA (Excellent)'* rating awarded to Equitable.

In their *Management Report*, Equitable say that one of their principles was to operate a policy of full distribution of profits and to avoid the unfairness created by the retention of profits earned by one generation of policyholders for the benefit of successors. Equitable say that they aimed at fair bonuses between all classes and durations of policy. Equitable explain that new systems of expense control had led to productivity gains for the benefit of policyholders. For 1994 to 1996, a rebate of charges had been made at the end of each calendar year where the aggregate contribution by the policyholder in the year exceeded £5,000. For 1997, the rebate was extended to all pension policyholders regardless of the amount contributed. Equitable state that, despite having a full distribution policy, investment strategy was *'driven by investment, rather than technical, considerations'*. They explain that the average annual return for the with-profits fund over the past four years had been 10.1% per annum which was around 1% per annum higher than would have been obtained on 15 year gilts (a proxy for risk free investments), while inflation had averaged 3.0% per annum.

On their bonus declaration, Equitable reiterate the aim of providing each generation of policyholders with full and fair returns on their investment. On the interim bonus for 1997, they say that:

> *In last year's report the general trend towards lower average returns, in a climate of relatively low inflation, was described. Taking account of that trend the rate of return to apply to claims in 1997 was set at 9% ...*

On the bonus declaration for 1997, Equitable explain:

> *Investment returns in 1997 were higher than expected at the start of the year and final bonus rates were increased for policies leaving the fund during the year. In the light of the actual earnings and taking account of the likely future position, the Directors decided to allocate a return of 13% p.a. to with-profits recurrent single premium pension*

contracts for 1997. That is the highest return allocated since 1993 and represents a very substantial real rate of growth for the year.

However, Equitable then go on to say:

The general trend towards lower returns remains unchanged. Indeed the growth in asset values and the reduction in yields over 1997 make lower returns in future more, not less, likely. For policies becoming claims in 1998 the Directors have, accordingly, decided to revert to the rate of return of 9% p.a. introduced at this time last year.

Equitable also explain that, in view of the likely future outlook, they had reduced the rate of declared reversionary bonus (i.e. guaranteed bonus) to 6.5% (down from 7.5%).

Companies Act statutory accounts
The Directors' Report for 1997 includes explanation of the financial results of the Society along with the valuation and bonus declaration made.

The returns
Equitable's returns are submitted in one part covering Schedules 1, 3, 4 and 6 to the ICAS Regulations 1996.

GAD's copy of the 1997 returns includes various annotations. I am satisfied that these were made by Scrutinising Actuary E during the scrutiny programme on or around 20/08/1998, when the Scrutinising Actuary prepared the A2 Initial Scrutiny check. However, for ease of reference, mention of these annotations is made here.

Schedule 1 (Balance sheet and profit and loss account)
Schedule 1 of Equitable's returns consists of Forms 9, 10, 13, 14, 15 and 17. Form 9 summarises the Society's financial position at 31 December 1997 as follows:

Long term business admissible assets	*£23,827,839,000*
Total mathematical reserves (after distribution of surplus)	*£21,900,091,000*
Other insurance and non-insurance liabilities	*£176,198,000*
Available assets for long term business required minimum margin	*£1,751,550,000*
Future profits	*£371,083,000*
Total of available assets and implicit items	*£2,122,633,000*
Required minimum margin for long term business	*£845,457,000*
Explicit required minimum margin	*£140,910,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£1,610,640,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	*£1,277,176,000*

GAD add the figure for total mathematical reserves after distribution of surplus under the appendix valuation of £21,857,343,000.

In Form 13, Equitable set out their admissible assets. GAD circle the lack of an entry for investments in other group participating interests and the figure for the previous year of £62m.

In Form 14, Equitable set out their long term business liabilities and margins. GAD circle the figure of £400m included as the *'Amount of any additional mathematical reserves included in line 51 which have been taken into account in the appointed actuary's certificate'*.

GAD also write on Form 14 that the *'£350,000,000 Sub Loan ignored as a liability!'*. At some point, this annotation has been partially erased.

Schedule 3 (Long term business: revenue account and additional information)
As in previous years, Schedule 3 consists of Forms 40 to 45.

In Form 40, Equitable provide a revenue account. GAD tick some of the figures provided.

In Form 41, Equitable provide an analysis of premiums and expenses. GAD annotate the form with some of the corresponding figures from the previous returns. GAD circle the figure for other management expenses of £7,279,000 (up from £2,514,000 the previous year).

Schedule 4 (Abstract of valuation report prepared by the Appointed Actuary)
As in previous years, Equitable present two valuations of their long term liabilities (their main and appendix valuations). The results of the main valuation are carried forward, unadjusted, from Form 58 to Form 14 and on to Form 9.

Schedule 4 of Equitable's returns provides the information required by paragraphs 1 to 23 of Schedule 4 to the ICAS Regulations 1996 and includes Forms 46 to 49, 51 to 58, 60 and 61.

Schedule 4 – main valuation (text)
Equitable state that this valuation is made in conformity with Regulation 64 of ICR 1994.

In response to paragraph 4, Equitable provide ten pages of information about their non-linked contracts. Most of the description provided is identical to that supplied in the previous returns.

GAD note the description for *'Pension contracts – old series'* that some older contracts contain annuity guarantees.

In response to paragraph 5, Equitable provide 66 pages of information about their linked contracts. GAD note where some of the information is unchanged or new.

In the description of the general principles and methods adopted in the valuation (which is largely unchanged from the previous returns), Equitable again state that, for accumulating with-profits deferred annuities:

> *The liability was calculated by discounting the cash fund purchased to date plus declared and attaching bonus cash fund with an allowance for future bonus.*

GAD again underline this and write *'can be less than current face value'*. The information provided in the returns continues:

> *For with profits retirement annuity and personal pensions benefits ... the benefits have been valued on the basis that the benefits will be taken at age 60 or, if that age has been attained, at the valuation date.*

In paragraph 6(1)(b), the returns again include the statement:

> *The valuation method makes specific allowance for rates of future reversionary bonus additions, the levels of which are consistent with the valuation interest rates employed having regard to the Society's established practices for the determination of declared bonus rates. The balance of the total policy proceeds, consistent with policyholders' reasonable expectations, will be met by final bonus additions at the time of claim. Such additions are not explicitly reserved for in advance but are implicitly covered by the excess of admissible assets over mathematical reserves.*

GAD again underline and sideline the final sentence.

In paragraph 6(1)(e), Equitable provide the values used for the rates of future bonus. GAD annotate the returns with figures from the previous year.

In paragraph 6(1)(f), Equitable disclose that they have explicitly made a provision of £75m for their prospective liability for tax on unrealised capital gains (in relation to business other than that linked to their internal funds), which they estimated as not exceeding £75.2m. GAD mark this paragraph with a large tick and write: *'NEW previously stated that other* [valuation] *margins were adequate to cover discounted liability'.*

In paragraph 6(1)(g), relating to investment performance guarantees, as in previous years Equitable state that they do not consider it necessary in current conditions to hold a specific reserve for the guarantee they offer on a unit-linked annuity.

As in previous years, in paragraph 6(1)(h) relating to the reserves for all other guarantees not covered by paragraph 6(1)(g), Equitable state:

> *The premium rate guarantees and options under the Society's policies are described in paragraph 4. Where the right to effect further policies without medical evidence of health is carried a reserve equal to one year's extra premium deemed or actually charged was set up. It was considered unnecessary in current conditions to make explicit provision for the other guarantees and options described in paragraph 4.*

That is, Equitable state that they do not consider it necessary to hold an explicit reserve for, amongst others, annuity guarantees. GAD underline the final sentence and they also note that the description is unchanged from the previous returns.

In paragraph 6(2) Equitable state that, in determining the provision needed for resilience reserves, they have taken account of the fact that the long term fund has been valued at book value.

Equitable disclose that, for certain non-profit deferred annuities, the valuation rates of interest used were those assumed in the premium basis. Equitable, again, do not elsewhere disclose the rates used in the premium basis.

As in their 1996 returns, Equitable explain in paragraph 7(5) that they consider the reserves for future bonus within the valuation to be fully able to withstand any future strains which would arise if there were significant changes in mortality or morbidity experience. Equitable say that, accordingly, the Society does not consider it necessary to establish any additional reserves in this respect.

In paragraph 7(6), Equitable disclose that they have tested the need for resilience reserves against the three scenarios contained in DAA6. They state that the most onerous scenario tested is scenario c (a rise in fixed interest yields of 3%, a 25% fall in equity values, a 20% fall in property values and a 25% increase in index-linked yields).

Equitable disclose that a resilience reserve of £325m was provided for. GAD note that this disclosure is *'NEW'* and that the figure for the previous year was nil.

In paragraph 7(8)(a), Equitable disclose the changes made to valuation assumptions and methods in the resilience scenarios. They explain that, in the resilience scenario, they had used the appendix (net premium) valuation method rather than the main (gross premium) valuation method but with some changes to the valuation described in the returns. As in their 1996 returns, Equitable disclose that the changes include, for all accumulating with-profits pension business:

> *... an annual loading of 0.5‰ increasing by 4% per annum compound of the basic benefit was reserved which is considered to be a prudent allowance for ongoing expenses: for accumulating with profits pensions business ½% per annum of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses.*

Equitable also disclose that, in the resilience scenario, they had reduced the reserve for their potential liability for tax on capital gains to £5m. GAD note that they had elsewhere in the returns made a provision of £75m for this liability.

In paragraph 8(b), Equitable state that *'For accumulating with profit business the valuation rates of interest shown in Form 52 are net of a 0.25% interest rate reduction as a reserve for future expenses'*. GAD note that the figure used in the previous valuation was 0.5%.

In paragraph 8(d), Equitable state:

> *A further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994. The resultant aggregate liability is less than the aggregate liability on the methods and bases described in this report. The report on the net premium valuation is given in an appendix following Form 61 of this report.*

GAD sideline this paragraph.

In paragraph 13, Equitable disclose: *'The Society has no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund'*.

In response to paragraph 14 of Schedule 4, Equitable set out a statement of their aims with regard to bonus distribution and of how they maintained equity between different generations of policyholders. The information provided is the same as for the previous year. They refer to the Directors' absolute discretion as to timing and nature of bonus distributions, given to them by the company's Articles of Association. Equitable highlight that bonuses were primarily influenced by earnings on premiums and that their policy of full distribution to each generation of with-profits policyholders meant that there was no deliberate holding back of returns in order to build up an *'estate'*.

In paragraph 15, Equitable disclose that they had set reversionary bonus for the main policy classes at 3.0%. As in previous years, Equitable disclose that they offered loans under a *'loanback'* arrangement to some retirement annuity, individual and group pension policyholders.

In paragraph 16, Equitable set out final bonus rates. The returns, again, contain the statement, at paragraph 16(viii):

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

In paragraph 21, Equitable explain that they risk-adjusted the yields on assets other than land and equity shares by restricting them to 8%, which is that available on the highest yielding risk-free security held by Equitable. GAD underline this figure, note that the corresponding figure for the previous year was 10% and they write *'still HIGH?'*. Equitable also explain that, where they considered this appropriate, they risk-adjusted yields on land and equity shares.

<u>Schedule 4 – main valuation (forms)</u>
In Form 46, Equitable provide information on changes in their ordinary long term business.

In Form 47, Equitable provide an analysis of their new ordinary long term business.

Form 48 shows that 53% of Equitable's non-linked assets are invested in equities, 6% in property and 35% in fixed and variable interest securities (compared with 52%, 6% and 38% respectively in 1996). GAD tick some of the figures provided.

In Form 49, Equitable disclose that the gross redemption yields on some fixed interest securities backed by a government guarantee are, for certain durations, higher than for those not backed by a government guarantee.

In Form 51, Equitable set out the mathematical reserves held for various types of non-linked contracts (excluding accumulating with-profit business) along with information on the number of contracts in force, the benefits valued and rates of interest and mortality assumptions used. GAD annotate the forms with corresponding rates of interest used in the previous returns.

In Form 52, Equitable set out the mathematical reserves held for accumulating with-profits contracts along with information on the number of contracts in force, the benefits guaranteed, and the rates of interest and mortality assumptions used in valuing them. The Scrutinising Actuary notes on the form some of the rates of interest used in the previous year. (Note: a GAD actuary has also identified – at an unknown time – those policies listed which include annuity guarantees.)

In Form 53, Equitable set out the mathematical reserves held for the various types of property-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death, and the rates of interest and mortality assumptions used in valuing them. They again disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 54, Equitable set out the mathematical reserves held for the various types of index-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity, and the rates of interest and mortality assumptions used in valuing them.

In Form 57, Equitable provide matching rectangles illustrating the notional allocation of assets to each category of liabilities, showing the valuation rates of interest supported and the ability of the matching assets to cover the reserves in the resilience scenarios.

In Form 58, Equitable set out the valuation result and the composition and distribution of fund surplus. GAD annotate the form with corresponding figures using the appendix valuation.

<u>Schedule 4 – appendix valuation (text)</u>
Equitable explain that the appendix valuation:

> *... was undertaken for the purposes of demonstrating that in aggregate the mathematical reserves determined by the valuation undertaken using the gross premium method, the results of which are reported on the preceding pages, are not less than an amount calculated in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994.*

Equitable's appendix valuation provides the information required by paragraphs 1, 6 to 8, 10, 11, 20 and 22. The Society states that the information required by the other paragraphs of Schedule 4 to the ICAS Regulations 1996 is the same as that provided in the main valuation (apart from paragraph 23 – being a statement of the required minimum margin in the form set out in Form 60 of Schedule 4 which, having had *'regard to the purpose of the valuation'*, has not been provided).

In paragraph 6, Equitable disclose that they have assumed a retirement age for personal pension policies of 60.

In paragraph 6(1)(b), Equitable again state that the valuation rates of interest have been chosen with due regard for policyholders' reasonable expectations and their established practices for determining reversionary bonuses.

As in the main valuation, in paragraph 6(1)(f) Equitable disclose that they have made explicit provision for their estimated contingent liability for tax on unrealised capital gains in respect of non-linked business of £75m. Against this, GAD place a tick and write *'GOOD'*.

As in the main valuation and previous years, Equitable state that they do not consider it necessary in current conditions to hold a specific reserve for the guarantee they offer on a unit-linked annuity.

As in the main valuation, Equitable state that they do not consider it necessary in current conditions to make provision for guarantees and options described in paragraph 4. That is, Equitable state that they do not consider it necessary to hold an explicit reserve for, amongst others, annuity guarantees. GAD note this statement.

In response to paragraph 7(8) of Schedule 4, Equitable disclose that a resilience reserve of £1,022m is required on the appendix valuation basis. GAD add the previous year's figure to the returns.

As in their main valuation and the previous returns, Equitable disclose in paragraph 7(8)(a) the changes made to valuation assumptions and methods in the resilience scenarios, including that:

> *... for all accumulating with profits business, an annual loading of 0.5‰ increasing by 4% per annum compound of the basic benefit was reserved which is considered to be a prudent allowance for ongoing expenses: for accumulating with-profits pension business, ½% per annum of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses.*

As in the main valuation, Equitable explain that they risk-adjusted the yields on assets other than land and equity shares by restricting them to 8%, which is that available on the highest yielding risk-free security held by Equitable. GAD also underline this figure, note that the corresponding figure for the previous year was 10% and write *'still HIGH?'*. Equitable also explain that, where they considered this appropriate, they risk-adjusted yields on land and equity shares.

Schedule 4 – appendix valuation (forms)
In the appendix version of Form 51, Equitable set out the mathematical reserves held on the appendix valuation basis for various types of non-linked contracts (not accumulating with profit), along with information on the number of contracts in force, the benefits valued and rates of interest and mortality assumptions used. GAD annotate the Forms with some of the rates of interest used in the previous returns.

In the appendix version of Form 52, Equitable set out the mathematical reserves held on the appendix valuation basis for accumulating with-profits contracts, along with information on the number of contracts in force, the benefits guaranteed and the rates of interest and mortality assumptions used in valuing them. GAD annotate the Forms with some of the rates of interest used in the previous returns. On the Form for United Kingdom pensions business, GAD write:

> *£811m below face value*
>
> *(*[previously] *£1,246m discount)*

GAD circle the figure provided of pension transfers and opt-out mis-selling provision of £75m.

On the Form for the total business, GAD write:

> *DISCOUNT £900m*
>
> *[*[previously] *£1,320m discount]*

In the appendix version of Form 53, Equitable set out the mathematical reserves held on the appendix valuation basis for the various types of property-linked contracts along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death, and the rates of interest and mortality assumptions used in valuing them. Equitable also disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In the appendix version of Form 54, Equitable set out the mathematical reserves held on the appendix valuation basis for the various types of index-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity, and the rates of interest and mortality assumptions used in valuing them.

As with the main valuation, Equitable provide appendix Forms 57, demonstrating the notional allocation of assets to liabilities on the appendix valuation basis. GAD annotate the total Forms with corresponding asset value figures taken from Form 48.

Equitable state that the total value of assets notionally allocated is £19,492,522,000. On the Form, GAD have written the following (the figures being in units of £000s):

	[Appendix valuation]	[Main valuation]
F51 Liabilities	*4,409,068*	*4,546,985*
F52 Liabilities	*13,484,257*	*14,011,088*
F53 Sterling Liabilities	*21,815*	*21,815*
F54 [Mortality and Expenses]	*4,537*	*4,537*
[Reversionary] *Bonuses*	*475,517*	*508,098*
	18,395,194	*19,092,523*
CGT Reserve	*75,000*	*75,000*
Resilience Reserve	*1,022,000*	*325,000*
	19,492,194	*19,492,523*

Notes to the returns
In the notes to the returns, included at the end of Schedule 4, Equitable disclose that they have been granted a section 68 Order to include in aggregate form details of their *'Personalised Funds'* in Forms 43, 45 and 55.

Equitable disclose that they have been granted a section 68 Order permitting them to take into account a future profits implicit item, with a value not exceeding £700m. The Society states that it has included an item of £371,083,000 for the purpose of *'achieving equality between the total net value of policyholders' assets included in Form 9 ... and ... total net asset value shown in the Society's Companies Act accounts'*.

Equitable disclose that they have been granted a section 68 Order enabling the Society to disregard amounts owing under the subordinated loan, up to an amount not exceeding 50% of the required solvency margin. GAD sideline this paragraph.

The notes to the returns also disclose that Equitable had been issued a section 68 Order *'to the effect that figures in Form 46 exclude recurrent single premiums from the annual premium figures as the Company cannot at present calculate a meaningful figure'*.

Schedule 6 (Certificates by directors, actuary and auditors)
Three Equitable Directors provide the certification required by Regulation 28(a) of the ICAS Regulations 1996.

Equitable's Appointed Actuary provides the certification required by Regulation 28(b) of the ICAS Regulations 1996. The Appointed Actuary certifies:

> *... that the mathematical reserves as shown in Form 14, together with an amount of £400 million (being a part of the excess of the value of admissible assets representing the long term business funds over the amount of those funds shown in Form 14) constitute proper provision at 31 December 1997 for the liabilities (other than liabilities which had fallen due before 31 December 1997) arising under or in connection with contracts for long term business including the increase in those liabilities arising from the distribution of surplus as a result of the investigation as at that date into the financial condition of the long term business.*

Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

26/06/1998 [entry 2] Equitable apply to HMT for a section 68 Order for a future profits implicit item of £850m, for possible use in their 1998 returns. Equitable provide financial calculations in support of the application, suggesting that they could seek an Order up to the value of £2,674m.

These calculations include, for the estimated annual profits, that:

Year ending	*(A) Total surplus*	*(B) Exceptional items*	*(C) Surplus arising from solvency margin*	*(A)-(B)-(C) Ordinary surplus*
	£m	*£m*	*£m*	*£m*
31.12.93	*480.9*	*0.0*	*0.0*	*480.9*
31.12.94	*520.0*	*0.0*	*19.3*	*500.7*
31.12.95	*662.8*	*0.0*	*0.0*	*662.8*
31.12.96	*802.5*	*0.0*	*0.0*	*802.5*
31.12.97	*895.6*	*0.0*	*0.0*	*895.6*
				3342.5

Average annual profit = 3342.5/5 = £668.5m

GAD tick the figures included in column (A) and the total ordinary surplus.

The calculations state that the average period to run for the Society's in-force contracts is again eight years. Equitable explain:

> *The periods to run have been reduced to take account of premature withdrawals based on the Society's recent experience of such withdrawals. In respect of retirement annuity and personal pension contracts for which a range of retirement ages is available, it has been assumed that retirement benefits are taken at the lowest possible age, or immediately if that age has already been attained.*

The calculations suggest that the maximum future profits permissible is 50% of £668.5m multiplied by eight years – that being £2,674m.

08/07/1998 HMT send the Greek authorities the necessary documents to allow Equitable to provide services in Greece. HMT inform Equitable that they have done so.

17/07/1998 **GAD complete the A1 Initial Scrutiny check on the Society's 1997 regulatory returns**. GAD identify no concerns.

The Society's response to GAD's *Reserving for Annuity Guarantees* survey

29/07/1998	**Equitable return their completed questionnaire on reserving for annuity guarantees**, in response to GAD's letter of 20/06/1998. In this, Equitable say that they have four products containing an annuity guarantee (a retirement annuity, an individual pension, a transfer plan and a group pension), all sold between 1956 and June 1988. Each is classified as: *'Recurrent single premium with profits'*. Equitable state that the mathematical reserves for these products, at the most recent valuation date (31 December 1997), total £6,539m but that this figure includes no reserves for the annuity guarantee. Against this an unidentified official writes: '?'. Equitable further state that *'No explicit provision is made for annuity guarantees'* and *'No explicit provision* [for annuity guarantees] *is made in setting the resilience reserve'*. Equitable confirm that they make no general allowance for the guarantees when establishing maturity values and take no significant account of the guarantees when determining investment policy and matching guidelines. In response to the question: *'On with profits contracts is your approach to setting terminal bonus rates for a cohort of policies influenced by whether or not an annuity guarantee is biting?'*, Equitable reply *'Yes'* and explain: *For any policy for which the annuity guarantee is biting, the amount of terminal bonus is reduced to pay for the cost of the guarantee. For all but a few small policies the "cost" of the annuity guarantee is covered by this adjustment.* GAD's Scrutinising Actuary E sidelines this statement. Equitable also confirm that policyholders are not advised of any available options to receive a guaranteed annuity when they reach retirement. Against this an unidentified official writes: '?'. Equitable further confirm that, if a policyholder selects an annuity different from the one on which a guarantee is offered, the amount of annuity is not determined on the same basis as would have applied. Equitable state that annuity guarantees raise no other issues for them as a company. They add as a final comment: *The cost of annuity guarantees has more than adequately been covered by the terminal bonus cushion to date for all but a few small policies, as described ... above. As the business to which annuity guarantees apply ages, the increasing terminal bonus cushion will make it increasingly unlikely that guarantees will actually bite.* Scrutinising Actuary E sidelines this response and writes: *'Is this acceptable?'*. GAD's Chief Actuary C (who has resumed responsibility for Equitable) annotates his copy of Equitable's completed questionnaire with a number of calculations.
30/07/1998	Equitable inform HMT that the Society would begin providing services in Greece on 3 August 1998.
11/08/1998	Equitable provide HMT with details of their review on pension mis-selling. Equitable explain that, in a small number of cases, they would be unable to complete the review in the time required. They accordingly intend to provide the policyholders with a guarantee that, once the review is completed, they would pay any appropriate compensation. Equitable enclose a copy of their letter to the PIA explaining their actions. Equitable state that their guarantee is not one that they need to reserve for. They add: *'As you will know from the reports already submitted by our Managing Director, I have established provisions within our mathematical reserves at*

31 December 1997 which make full allowance for the expected compensation payable on both priority and non-priority cases'.

13/08/1998 [entry 1] HMT pass GAD a copy of Equitable's letter of 11/08/1998 and ask for their comments.

13/08/1998 [entry 2] GAD's Chief Actuary D sends HMT a paper headed *'Guaranteed annuity options – matching and ancillary considerations'.*

The Chief Actuary explains that a guaranteed annuity rate effectively combines an annuitant mortality table and a rate of interest. But:

> *With the passage of time, the mortality table has become imprudent, in that it assumes too high a rate of mortality. This did not initially cause any problems, as the interest rate was modest, and the overall rate was below current rates. More recently, with significant falls in long gilt yields, this counter-balance has disappeared, or at least fallen to very modest levels.*
>
> *Companies now face a significant problem with regard to these options.*

The Chief Actuary suggests that insurance companies have in effect written derivatives for their policyholders' benefit and that one solution to the current problems is for companies to buy an equivalent option from the investment markets. This has a number of complications, but he states:

> *Whatever is the technical position, it must be remembered:*
>
> - *these GAOs exist in large numbers, and threaten solvency in many cases and policyholders' actual, if not necessarily reasonable, expectations in more*
> - *derivatives are a natural way to protect the interests of policyholders*
> - *there is a risk of these becoming the regulator's problem!*

Chief Actuary D discusses policyholders' reasonable expectations. He explains that there are two views in the industry:

> *Terminal bonus is determined as the amount necessary to raise policy proceeds to asset share (plus or minus a bit). If a GAO applies, then the policy proceeds can be measured as the cost of an annuity of that amount (on a realistic not a prudent basis). Therefore terminal bonus can be restricted to keep the cost of GAO down. This cannot justify a lower reserve, however, as the terminal bonus is not itself reserved for.*
>
> *Alternatively, the terminal bonus has been described, and therefore a policyholders' reasonable expectation created, based upon the open market option, and to the extent that a GAO applies to the full sum, the full pain must be borne.*
>
> *There is probably no solution to this issue on an industry basis, as it probably is a function of policy wordings, marketing material, with profits guides and similar items.*

Under *'Investment Policy'*, the Chief Actuary says:

> *The presence of guarantees of all kinds serves to restrict investment freedom. This is surely one of those things which fall within policyholders' reasonable expectations. Where there are GAOs on some policies and not on others, to what extent is it in accordance with PRE to:*
>
> - *buy derivatives, and charge the cost generally to the estate which may need to be built up again from current or future policyholders*

- *buy derivatives, but charge the cost to assets shares of the GAO policies*
- *buy derivatives, but charge the cost to asset shares of all policies*
- *invest more heavily in fixed interest securities, earmarked to those policies with GAOs, which therefore have probably lower asset share growth*
- *invest more heavily in fixed interest securities leaving the probably lower returns to impact asset share growth generally*
- *treat emerging losses as a charge to the estate, which may need to be built up again from current or future policyholders*
- *treat emerging losses as a hit on asset shares on GAO policies*
- *treat emerging losses as a hit on asset shares on all policies*
- *There is no easy answer, and again it may be necessary to look carefully at each case.*

The Chief Actuary also discusses the required minimum margin of solvency. He explains: *'The required minimum margin will rise naturally as reserves are held, but to the extent derivatives remove the need for mathematical reserves in a resilience test or mismatching test, there will be a reduced additional requirement'*. He suggests that any contract with a guaranteed annuity option requires a full 4% margin on all associated mathematical reserves.

Chief Actuary D concludes by suggesting that the matters discussed could be explained at a forthcoming conference on valuation developments and linked to a Dear Director or Dear Appointed Actuary letter.

14/08/1998

GAD inform HMT that Equitable are probably correct to say that the guarantee referred to in their letter of 11/08/1998 does not require reserving. GAD advise that, to be sure, HMT should ask Equitable for further supporting papers.

20/08/1998

GAD complete the A2 Initial Scrutiny check on the Society's 1997 regulatory returns.

The form for the A2 check follows the same, more detailed, format adopted for the 1996 returns and includes the following:

<u>Strength of valuation basis</u>
GAD note that the interest rates used are *'just about'* supported by the risk-adjusted yields on the matching assets. On Equitable's annuity mortality rates, GAD say that they *'thought about querying in 1996 Return, but did not'*. They note that other management expenses, at £7.3m, are material. GAD confirm that Equitable have applied the resilience test in accordance with the Government Actuary's latest guidance. They judge the overall interest basis as *'adequate'* and the valuation basis as *'adequate'* to *'weak'*. However, GAD state that *'Enormous Growing Liability for terminal bonus on* [unitised with-profits] *business is not reserved for, so that FORM 9 margin overstates strength!'*.

<u>Solvency position</u>
GAD note that the absolute cover for the required minimum margin is *'adequate'* and refer to their comments about Equitable's growing liability for terminal bonus and to the fact that Equitable had raised £350m from the subordinated loan.

<u>Operating results</u>
GAD circle both yes and no to whether Equitable's absolute level of sales or the trend over recent years give cause for concern and comment '<u>[very] *high*</u> *and negligible estate*'.

PRE issues
GAD do not answer the question as to whether the answer given by Equitable in paragraph 4(1)(a)(ii) of Schedule 4 of the returns is satisfactory.

Current issues
GAD note that Equitable have not set up any identifiable pensions mis-selling reserve and comment that *'In* [company] *response, £75m stated to be included (FORM 52)'*. GAD state that Equitable are known to have material exposure to annuity guarantees and note: *'Adjusts terminal bonuses – so no value to policyholders! No additional reserves considered necessary'*.

Aspects that look worrying
GAD query whether Equitable's position on annuity guarantees is satisfactory.

Other notes
GAD initially note that Equitable appear to have failed to disclose provision for pensions mis-selling as promised in their letter of 04/02/1998 – but then appear to be satisfied that provision has been made in the returns. GAD also identify the following:

> *(2) Review annuitant mortality assumptions*
>
> *(3) Issue of £350m Subordinated Loan appears to be sole reason for increase in available assets over year.*

GAD identify no items to notify to HMT, to be taken up immediately with Equitable. They lower Equitable's priority rating from 3 to 4.

Accompanying the Initial Scrutiny check is a Form B Initial Scrutiny Form, which includes certain key figures disclosed in the 1994 to 1997 returns.

(Note: there was no formal detailed scrutiny, given the events that unfold from July 1998 onwards, following the annuity guarantees survey, until comment on them is combined with the scrutiny of the 1998 returns: see 20/05/1999.)

27/08/1998 HMT's Line Supervisor B asks Equitable for further papers about their guarantee on mis-sold pensions. She also explains that day-to-day supervision of Equitable has passed to a new Line Supervisor (Line Supervisor C).

28/08/1998 A PIA official writes about emerging press interest in annuity guarantees. The official notes that the subject also raises solvency questions which HMT are looking at. The note is copied to the new Director of Insurance at HMT (who took up post the previous year), who later copies it to the Head of Life Insurance and to Line Manager C and to GAD.

01/09/1998 GAD write to HMT about monitoring *'the behaviour of companies towards policyholders who have ... a guarantee which is valuable at maturity'*. GAD set out the circumstances under which a company would be obliged to tell a policyholder about a guarantee and suggest that this would depend on whether, under the terms of the FS Act 1986, the company was offering advice or not. GAD explain that, if the company were offering advice, it would be obliged to offer best advice, and the PIA are the relevant authority to monitor that. GAD add that the powers under ICA 1982 are not applicable to advice *'unless the general obligations are relied upon'*.

GAD advise that HMT have a duty to ensure that policyholders' reasonable expectations are met. GAD say that HMT appear to have a number of options, but recommend the following *'best course of action'*:

- *circulate all companies referring to the issue of annuity options and guarantees and identifying the avoiding of these obligations as unacceptable behaviour;*
- *all companies should be asked to report on the procedures in place to ensure guaranteed rates are applied in maturity option quotations, and that the existence of options is made known (is this going a step too far?);*
- *any policyholder or* [independent financial adviser] *complaint should be the trigger for a visit to review the procedures;*
- *any subsequent failures should result in a Section 43A investigation, to include a sample review of files;*
- *identification of a substantial problem would necessitate action, including a review of cases and "fit and proper" action.*

GAD conclude:

> *A more proactive course, reviewing companies routinely, would seem to be too intensive in resources to be practical. It is also arguably a significant overreaction to few if any recorded incidents. It is open therefore to criticism as a misuse of powers.*

03/09/1998 HMT's Head of Life Insurance thanks GAD for their note of 01/09/1998. The Head of Life Insurance says: *'This is something which had begun to worry me, but I had not got beyond the unfocused feeling that we would need to do something. Your note helpfully clarifies the issues'*. He suggests a meeting of HMT and GAD officials to discuss these issues.

HMT's Head of Life Insurance writes to FSA's Managing Director of Financial Supervision (Managing Director A). He notes that there had been a good deal of recent press interest in guaranteed annuities. The Head of Life Insurance explains the action HMT and GAD had taken on annuity guarantees. He explains that: *'When it became clear that a number of companies had issued policies with these guarantees'* GAD, on their behalf, had written in June 1998 to all life companies seeking detailed information about their annuity guarantees and how they reserved for them. He says that the results were now being analysed by GAD and that they were *'also considering the implications for the fulfilment of policyholders' reasonable expectations'*. HMT copy the note to FSA's Director of Investment Business:

> *... since his division* [conduct of business] *will no doubt have an interest in some aspects of* [these] *issues (eg the extent to which companies are informing policyholders of the existence of a guarantee at the time when they come to make choices about annuities on retirement). This is an example of an issue on which we will need to work closely together to ensure a seamless regulatory approach.*

08/09/1998 [entry 1] Equitable provide HMT with the papers requested on 27/08/1998, about their guarantee on compensation for mis-sold pensions. The Society also points out that it has had no response to its application on 26/06/1998 for a section 68 Order for a future profits implicit item.

08/09/1998 [entry 2] Equitable send GAD a copy of their latest With-Profits Guide (dated August 1998), saying that they are doing this '[as] *usual, at around this time of year'*.

15/09/1998 GAD inform HMT that they are *'comfortable with the figures'* used in Equitable's application for a section 68 Order (see 26/06/1998 [**entry 2**]) and that it would be reasonable to grant the Order.

In the same note, GAD raise the issue of the reduction of terminal bonuses for policies which included annuity guarantees. GAD explain:

> *It should be recognised that guaranteed annuity rates based on a(55) ult and 7% interest rates (as offered by Equitable in a substantial number of cases) would, based on current life expectations, require the availability of investment yields in the regions of 9%. Such investment returns are not currently available, so that it would normally be presumed that the inclusion of such a minimum guaranteed annuity rate in a contract would give additional value.*
>
> *However, Equitable apparently considers it acceptable to reduce the terminal bonuses payable in such cases to nullify any additional value – and thus is suffering negligible strains and does not see any need to establish any special reserves.*

GAD say:

> *We suggest that it is desirable for HMT to explore this subject further. We suggest that you write to the Society indicating that you have noted the manner in which they are dealing with maturing pension contracts that contain guaranteed annuity rates, and request that they supply copies of relevant marketing literature or other evidence that gives support to their approach of reducing terminal bonuses in such cases — since you wish to be satisfied that the reasonable expectations of policyholders are being met.*

21/09/1998

HMT ask Equitable to *'supply copies of relevant marketing literature or other evidence that gives support to this approach of reducing terminal bonus in such cases* [where the annuity guarantee is biting] *as we will wish to be satisfied that policyholders' reasonable expectations are being met'*.

25/09/1998

HMT send Equitable the section 68 Order for a future profits implicit item of £850m, for use in their 1998 returns. HMT point out that, before including any implicit items in the forthcoming returns, Equitable are required to update the calculations to ensure that the amount adopted is still justified.

29/09/1998

Equitable write to HMT in reply to their letter of 21/09/1998. Equitable explain that a key underlying factor is that they guarantee *'full value'* benefits whenever retirement occurs within a wide permitted age range. Because of the wide ranging nature of the guarantee:

> *... it was always clear to us that the guarantee could become a valuable one in a period of sustained low interest rates. In a mutual with profits fund the key question is, of course, how the potential costs of guarantees should be reflected in bonus rates.*

Against this HMT's Line Supervisor C writes: *'Is it?'*.

Equitable set out a number of reasons why they did not think that it would be practical or fair to try to set bonus rates so that the same final bonus would be paid, irrespective of whether or not benefits were taken in cash (the open market option) or in guaranteed annuity form. Equitable explain that they had decided that the fairer course:

> *... was to introduce a system of different final bonus entitlements depending on whether the benefits were taken as an open market option cash fund or by utilising the guaranteed annuity option, so as to produce, as far as possible, benefits of equivalent value under the two approaches.*

Equitable add:

> *Until recently the likelihood of the guaranteed annuity option producing a higher level of income was small but recent declines in interest rates now make it more likely that the guaranteed annuity option will produce a higher level of income, if a client requires a form of annuity allowed for under the option. We have yet to decide whether to absorb the costs of that within the with profits fund generally or to introduce a small differential between the bonuses allotted to contracts carrying a guaranteed annuity option and those that do not. The Appointed Actuary will, of course, also be taking the position into account in setting his reserving basis at the end of the year.*

Against the penultimate sentence of this paragraph, Line Supervisor C writes: *'Is this what they said in the questionnaire*[?] *Seems different*'. On another copy of the letter, GAD's Chief Actuary C writes against the last sentence: *'Why did he not do this at the end of 1997?*'.

Equitable say that they have always described their approach to bonuses *'in the most general* terms in marketing literature'. They add:

> *... the comments we have made about bonuses have focused on principles such as fair treatment between different classes of business, that bonuses are primarily determined by the level of investment returns over a contract's lifetime, and that our aim is to pass on the smoothed earnings achieved on the contributions made during a policy's term.*

Equitable explain that they reinforce these messages when they write to policyholders explaining bonus decisions and that they *'make it very clear that final bonus is allotted only at the point of retirement, that the amount can vary and that any amount shown is not guaranteed'*. They add:

> *The approach of having a different final bonus entitlement where a guaranteed annuity option is exercised was first introduced at the end of 1993 and has been disclosed in the returns prepared for the DTI each year since then.*

Equitable continue:

> *In practice, the prevailing level of current annuity rates during 1994 and early 1995 meant that the final bonus entitlement was the same whether or not a guaranteed annuity option was taken. At the end of 1995, when conditions were such that the approach could give a different final bonus entitlement on some cases, a note was added to annual statements to indicate that that was the case. An example of the 1995 statement is also enclosed. The same approach was adopted for the 1996 statements and, with the exception of some policies for which the note was omitted in error, for the 1997 statements. Thus all clients with policies containing guaranteed annuity rates have had at least two annual statements explaining that a different final bonus entitlement could apply, as well as having had the more general material describing our bonus philosophy as set out in the preceding page of this letter.*

Equitable copy their letter to HMT, in view of the meeting arranged for 02/10/1998 (see below [entry 1]).

30/09/1998 HMT send Equitable an urgent fax requesting copies of policy documents containing guaranteed annuity rates.

01/10/1998 Equitable send HMT a copy of the retirement annuity policy document in use during the 1980s, prior to the withdrawal of guaranteed annuity contracts. Equitable state that they believe this to be representative of the *'significant number'* of different policy documents which include annuity guarantees. They point out that the description of the entitlement to bonuses in the policy is *'a very general one and cross-refers to the Society's rules and regulations*'. Equitable accordingly also enclose a copy of Article 65 of their Articles of Association. This states that the amount of any bonus which may be declared or paid and the amount to which any policyholder may become entitled *'shall be matters within the absolute discretion of the Directors, whose decision thereon shall be final and conclusive'*.

The explanatory note to the policy document states:

> *The principle benefit secured by the Policy is pension provision by application of the premiums to secure an annuity or further annuities which participate in the profits of the Society and which together form the basic pension on retirement. The annuity available may be increased if the annuity rates available when the pension payments begin exceed those guaranteed in the policy. The pension may begin at any time chosen between the ages of 60 and 70 with the option of extending the period to an age not later than age 75 and it is not necessary that the date chosen should coincide with the actual retirement date. The date must be notified to the Society in the month preceding the pension being required. In the event of death before the pension has commenced, the Society will pay the full value of the Fund built up under the Policy to the date of death.*

02/10/1998 [entry 1] HMT (Head of Life Insurance, a new Line Manager with responsibility for Equitable (Line Manager D) and Line Supervisor B) and GAD (Directing Actuary B and Chief Actuary C) meet Equitable's Chief Executive, Appointed Actuary and Investment Manager to discuss the Society's approach to deciding the benefits which policyholders with annuity guarantees would receive, and the solvency implications of reserving for those guarantees. HMT prepare a note of the meeting.

Equitable's Chief Executive reaffirms that the Society's approach to deciding policyholder benefits had been set out in recent correspondence with HMT and that he believed that its approach *'aimed to give all clients a fair return from the Equitable'*. He acknowledges that Equitable had received a bad press recently, but says that this was due to the media not having a full grasp of the facts. The Chief Executive says that he had received 25 letters of complaint and a few hundred enquiries about the issue. The note records: *'Ahead of the recent press coverage there had been no complaints from policyholders whose policies with GAO options had recently matured'*.

HMT's note says:

> *With respect to the specific charge of clawing back terminal bonuses to pay for GAOs the Equitable's response is that the company wants all policyholders in the mutual to be treated equally. On maturity policyholders receive either GAO benefits or cash of an equal benefit. In the current environment of plunging annuity rates it would be disproportionate to give, what are now, high annuity rates to one set of policyholders based on the same cash amount received by another set of policyholders without the GAO.*
>
> *There was, according to the company, considerable variation as to how the effected contracts were expressed at inception. Firstly for the earlier policies sold (pre 1980s) the concept of a terminal bonus did not exist, later when terminal bonuses were first introduced this bonus was a much smaller proportion of total benefits than what they would be for a policy sold today. Furthermore, the provision of a terminal bonus has always been at the discretion of the Directors and they have the powers within the Equitable's constitution to vary terminal bonuses for different cohorts of policyholders.*

GAD's Chief Actuary C says that *'when the GAO was offered to policyholders the literature could be interpreted to suggest that the policyholder was expecting to receive the higher of the two figures (unadjusted cash fund converted using current annuity rates or GAO)'*. In response, Equitable's Chief Executive claims that Equitable had not departed from any promises given, and that Counsel had recently advised that they were acting fully within their rights. The Chief Executive adds:

If the policy document states that a policyholder is entitled to additional benefits then the policyholder receives them. Currently a policyholder receives the greater of the guaranteed fund x guaranteed annuity rate or assets share x guaranteed annuity rate (the asset share being adjusted by the cost of providing the GAO). Subsequent to the submission of the GAD questionnaire annuity rates had fallen further in the market. This had meant that there were now policies where guaranteed fund x guaranteed annuity rate were biting, so these policyholders were getting a larger share of Equitable's assets than an equivalent policyholder with no GAO taking the cash benefit.

Only this year has guaranteed fund x guaranteed annuity rate bitten, they have not yet decided how to divide up funds with respect to this; [Chief Actuary C] *said it could be interpreted as an additional bonus.*

Equitable's Chief Executive explains that he would be concerned about policyholders' reasonable expectations if treating one set of policyholders more favourably affected the expectations of the remainder of Equitable's policyholders.

HMT's note records:

The company agreed that many of their policies allowed the payment of additional premiums, but this was not seen as a risk because of the treatment taken with respect to asset shares. However, switches of policies into the Equitable were currently a risk but the company was looking to impose endorsements on any switches in to stop these policyholders gaining disproportionate benefits.

Under the heading *'Solvency/Reserving'*, HMT's note records Equitable's Chief Executive as explaining that:

... no provision had been made for GAOs as at 31 December 1997 since it had only been recently that the guarantees were biting on the guaranteed fund. The Equitable does not as a matter of course reserve for GAOs that exist on policies; the recent practice has only been to reserve once the guarantees bite.

In response, GAD's view is that:

Whilst no reserve needs to be held on that part of the bonus that is discretionary (effectively the terminal bonus) ... guarantees should be provided for in the valuation basis (they should be reserved for whether or not they are biting).

Equitable's Appointed Actuary argues that *'two thirds of policyholders take the cash benefit, so it would not be appropriate to reserve fully for all the guarantees if only a small proportion of policyholders chose the guarantee'*. Chief Actuary C *makes the point that 'as the guarantees became more valuable it would seem logical to assume that a higher proportion of policyholders are going to take the GAO'.*

Equitable say that the need to reserve for the annuity guarantees *'could have severe consequences for the company and that they may have to switch from equities to gilts to maintain solvency'*. They continue: *'However in the current economic environment such a strategy would in itself harm the company as it would have to sell stocks which have fallen by c20% and buy gilts at inflated levels'*. Equitable's Investment Manager adds that: *'a flight to quality in current volatile markets was reducing gilt yields. Furthermore the abolition of* [advance corporation tax] *had exacerbated this. Further falls in the discount rate are going to hit Equitable and the life insurance industry heavily'*.

Equitable agree to provide a revised assessment of the reserves required for the annuity guarantees and to undertake a reassessment of their solvency. Options for identifying *'extra resources'* are discussed, including the possibility of reducing declared bonuses. HMT and GAD agree to consider the status of Equitable's future profits concession, following this assessment.

02/10/1998 [entry 2] HMT draw up initial working arrangements for the Insurance Directorate Supervisory Committee. The proposed terms of reference for the Committee are to:

- take decisions on the exercise of HMT's powers under the ICA 1982 and subordinate legislation (including decisions not to exercise powers in circumstances where they might be expected to be exercised);
- keep the use of all powers/discretion under review; and
- act as a forum for discussing/advising on casework raising novel or contentious issues, and supervisory policy generally.

09/10/1998 GAD write to HMT suggesting that there is a need to offer guidance to companies on policyholders' reasonable expectations in the context of annuity guarantees. GAD explain that, as a first step, they could say that policyholders with such guarantees could reasonably expect to pay some premium or charge towards the cost. GAD add:

> *The level of the charge deemed to be payable by participating policyholders for the annuity options and guarantees (applicable normally under the terms of the contract to at least the guaranteed initial benefit and attaching declared bonuses) would we understand generally be assessed by reference to their perceived value over the duration of the contract. The selected treatment by each office would though depend on the wording of their contracts and how these are presented to policyholders.*
>
> *This could therefore result in some reduction of the final bonus that would otherwise be payable if there were no such options or guarantees in the policy.*
>
> *As a consequence of the above, we would expect that for most companies the present guaranteed cash benefits (including declared bonuses) would be converted, as a contractual minimum, to annuity on the guaranteed terms. However, the appropriate final (or terminal) bonus may be somewhat lower than for contracts without such options or guarantees, and could be converted at current annuity rates.*

GAD also comment further on the points in Chief Actuary D's note of 01/09/1998. They cite six companies who seek to avoid letting policyholders know of the existence of annuity guarantees. GAD add:

> *Equitable Life also fall in this category, although we know that they do apply the guaranteed funds at the guaranteed rate where this would exceed the annuity derived from applying the "open market option" funds, including discretionary bonus, at current annuity rates.*

19/10/1998 HMT provide briefing for the Economic Secretary, who has expressed concern about Equitable and their exposure to annuity guarantees. HMT say that it was common practice in the 1970s and 1980s to include guaranteed annuity rates in pension contracts. HMT also say that:

> *The guarantee was set at a relatively low level and at the time the contracts were written the guarantee appeared unlikely to have any value. However, the recent dramatic falls in the yields on long term gilts on which annuity rates are based, along with increasing longevity of policyholders, means that the guaranteed rates are currently above, or comparable with, the annuity rates available in the market.*

Under the heading *'Equitable Life's position'*, HMT say:

> *Equitable Life is a very long-established mutual insurer with a high reputation for efficient and economical service, along with good investment returns to policyholders. It is one of the companies that has sold a large number of pension contracts which contain guaranteed annuity options which are set at a level above that currently available in the market.*

HMT continue:

> *Meeting the cost of the guarantees is putting a significant strain on the company's resources and, as a mutual, it does not have the option of obtaining a capital injection from shareholders to relieve this strain. We have discussed the situation with the company and it has been agreed that it will submit to HMT updated information regarding its liabilities for GAOs and its resulting financial position in order that we can monitor this and take any action that becomes necessary to protect policyholders' interests. It is feasible that the company could have to consider some form of demutualisation, for instance through merger with another company, depending on how serious the financial situation proves to be.*

HMT note that: *'Equitable Life has recently been heavily criticised in the press for the approach it is taking to fulfilling the guarantee contained in its pension contracts – adjusting the levels of terminal bonus paid to policyholders to take account of the cost of the guarantee'*. HMT report:

> *We have discussed the situation with the company, and our initial view, on the evidence we have seen to date, is that the company's approach appears to be consistent with the terms of the contracts sold, and that the company is endeavouring to fulfil the reasonable expectations of all its policyholders. In particular, the company is fully aware that any increase in the level of bonuses for policyholders with annuity guarantees would very likely lead to reduced bonuses for other policyholders. We are continuing to explore the position with the company.*

HMT say that they propose to provide guidance to the industry shortly *'to the effect that making some charge for the options is acceptable provided this does not conflict with the overriding requirement to meet policyholders reasonable expectations'*.

22/10/1998 HMT produce an update paper on the effect of current market conditions on UK life insurers. They refer to an undated paper submitted to a previous meeting of the Tripartite Standing Committee (a Committee of senior officials from HMT, FSA and the Bank of England). That paper says:

> *Most UK life insurers are reasonably well-placed to maintain an adequate financial position in current market conditions and allowing for further volatility in equity markets (although a fall on the scale of 1974 would create more serious problems).*
>
> *There are 8 fairly well-known offices that we are monitoring particularly carefully.*

One of the companies listed is Equitable. HMT go on to say: *'The two offices causing most concern at present are* [a named other insurance company] *and Equitable Life. These are likely to need some form of additional capital support if present conditions continue. We are in discussions with them about their view of their exposure, and options for remedial action'*.

In their analysis, HMT explain that there are a number of factors which help to protect life insurance companies against adverse investment conditions. These are listed:

> *(a) Our regulations require liabilities to be evaluated at relatively conservative long-term interest rates.*
>
> *(b) Allowance is also made in this evaluation for the effects of a 25% fall in equity values, and a 20% reduction in current gilt yields (the so-called "resilience test", the parameters for which are set from time to time in guidance from GAD).*
>
> *(c) For with-profit contracts, the bonuses (both declared bonus at year-end and final bonus payable on claims) may be reduced (though normally with some degree of smoothing).*
>
> *(d) Surrender values for most non-linked contracts are discretionary and could be reduced significantly, particularly in adverse investment conditions.*
>
> *(e) With unit-linked or index-linked contracts, all of the investment risk is normally borne by policyholders (or by investment banks in the case of some guaranteed bond products).*
>
> *(f) In extreme conditions, some modification of the solvency rules could be considered, though there are EU constraints to be observed.*

HMT note: *'As part of the regulatory framework there is an appointed actuary for each life insurer who is responsible for monitoring the ongoing financial condition of that company. The actuary is required to advise the board of directors on appropriate action to be taken if an unsatisfactory situation is developing, and if this is unsuccessful, the actuary is required to inform the regulators accordingly'*.

HMT recognise that:

> *Companies most at risk are likely to be those with a combination of:*
>
> *(i) Weak free asset ratios at end-97 (and few implicit margins),*
>
> *(ii) Significant exposure to annuity guarantees (which become more onerous with falling gilt yields),*
>
> *(iii) Pension mis-selling costs not yet fully recognised including the effect of any* [Investor Compensation Scheme] *levy, and*
>
> *(iv) Dependence on high investment returns to sustain bonus rates (some reduction in bonuses may now of course be expected but this is normally subject to smoothing).*

HMT say that the eight companies identified are those companies which HMT believe, based on current information, to be vulnerable on account of these factors. HMT conclude:

> *There are various strategies that can be followed by offices to improve their financial condition and to protect the interests of investors. These include:*
>
> *(a) Re-balancing the investments by switching from equities to gilts or corporate bonds with good credit ratings.*
>
> *(b) Reduction in overhead costs by trimming or even eliminating the sales distribution network.*
>
> *(c) Merger or take-over by other stronger company.*
>
> *(d) Reduction in bonus rates and in discretionary surrender values.*

An annex to the undated paper gives details for each office. On Equitable, HMT say that the Society:

> *... is a very long-established mutual insurer with a high reputation for efficient and economical service to policyholders, along with good investment returns for policyholders through discretionary bonus additions. In addition to a sizeable UK operation, they have also opened a branch in Germany a few years ago. They have always operated on the basis that "capital" should not be built up unnecessarily but should instead be returned to departing policyholders.*

HMT continue:

> *As a result, they are not well placed to weather difficult investment conditions. They are also impacted by a substantial exposure to annuity guarantees on a large number of their policies.*

HMT's update paper explains that recent improvements in equity markets and an increase in the yields on bonds are likely to result in *'fairly slight'* improvements to the financial positions of most companies. The update states that:

> [Another named insurance company] *and Equitable Life have each been asked to produce some more detailed figures to show their solvency position as at 30 September 1997. We expect these by the end of this month, and will study them with the help of GAD. We will then be able to consider with these companies what further action if needed.*

An annex to the update provides the following figures:

i.	*Equitable's free reserves as at 31 December 1997*	*1*	*£1,752m*
ii.	*Current additional cost of annuity guarantees*	*2*	*£1,000m to £2,500m*
iii.	*Possible further cost of pension mis-selling*	*3*	*£5m*
iv.	*Estimated current free reserves*	*4/5*	*£700m to –£750m*
v.	*Solvency margin requirement at 31 December 1997*	*6*	*£845m*

The notes to the figures are:

> *1) Free Reserves shown above exclude any item for future profits (which is allowable within limits as part of "own funds").*
>
> *2) Costs of Annuity Guarantees estimated by GAD from recent survey. (The range for Equitable reflects some present uncertainty about the nature of their guarantees).*
>
> *3) Additional possible cost for pension mis-selling is broad estimate based on industry averages (with no allowance for* [the Investor Compensation Scheme]*).*
>
> *4) No allowance has been made for margins in the liabilities that may be released.*
>
> *5) Effect of current investment conditions compared with 31/12/97 is assumed to be neutral or offset by margins as in Note 4 above.*
>
> *6) No allowance has been made for discretionary bonuses that may be payable at year end, or for profits earned during the year.*

26/10/1998	HMT's Line Manager D drafts a submission to the Economic Secretary to the Treasury, seeking approval for a letter to be sent to every insurance company giving guidance on methods which HMT consider are acceptable for meeting the costs of annuity guarantees. The Line Manager says that Equitable's approach of reducing terminal bonuses received by policyholders taking their annuity at the guaranteed rate specified in the policy *'is in line with this general guidance'*. She seeks confirmation from HMT lawyers that they are content with it. In a handwritten note, the head of the Treasury Advisory Division's insurance department (Legal Adviser B) records that she had discussed the matter with Line Manager D and had suggested some drafting amendments. (Note: I have been told that Legal Adviser B declined to provide advice on the guidance without full instructions containing representative samples and information about industry practice.)
27/10/1998	GAD produce a preliminary report on the results of the survey on reserving for annuity guarantees. GAD say that a number of companies hold substantial reserves for the guarantees. Equitable are one of two notable exceptions and they seem to be *'particularly vulnerable because the relevant business is approaching 30% of their total'*. GAD identify Equitable as one of 12 offices with potential solvency margin problems and one of 5 that could be *'technically insolvent'*. GAD state: *'We shall certainly need to raise the issue of annuity guarantees with each of these offices as part of the scrutiny process for their returns'*. GAD identify Equitable as one of seven companies that do not tell policyholders about the existence of a guaranteed option and one of eight that are considering whether they should reduce the final bonus payment to policyholders with guarantees to reflect part or all of the cost.
29/10/1998	HMT and GAD finalise the new Service Level Agreement.
30/10/1998	Equitable provide GAD with the information requested at the meeting on 02/10/1998. Equitable explain that, in the first nine months of 1998, only 3% of retirement annuities had been used to secure a conventional non-profit annuity. Equitable explain: *All retirement cases are checked to determine whether, if a conventional non-profit annuity is required, the guaranteed annuity rate will produce a higher level of income. Currently that is so in around 30% of cases and clients are advised accordingly, even if their intention is known to be to take some other form of annuity. Interestingly, to date no such clients have actually chosen to take advantage of the guaranteed annuity rate – all have preferred a more modern form of annuity.* Equitable estimate that, in a worst case scenario (i.e. where 100% of annuities which produce a higher income are taken in their guaranteed form), the cost to Equitable would be an additional £170m. But given their analysis of experience so far in 1998, they consider the more likely commercial cost would not exceed £50m. They explain that more generally they believe the figure of £7-10bn, quoted as the likely cost to the industry, to be totally unrealistic. Equitable say: *Such figures appear to have been computed as simply 20-30% (being the typical margin between guaranteed and current rates) of the liability figure of £35bn quoted in the working party's report. In practice, I believe that offices will generally fall into one of three main categories:* *(a) those that reduce the bonus rates for the class so that the open market option cash fund to which the guaranteed annuity rate is applied is lower than would otherwise be the case;* *(b) those that operate bonus systems similar to the Society;* *(c) those for whom the form of the guarantee is so restrictive that in practice only a small minority of clients will exercise it.*

Each of those approaches will significantly reduce the true cost, i.e. the value of additional benefits beyond those the policy would otherwise provide, which will fall to be met by shareholders or other policyholders.

Equitable set out some reserving issues, saying that:

... the additional reserve held in respect of guaranteed annuity rates should bear some relationship to a suitably prudent assessment of the commercial cost of those rates being exercised. To require a much higher level of reserving, e.g. one where the additional reserves were an order of magnitude greater than the expected commercial cost, would seem inappropriate for the following reasons:

i) The level of reserving will be interpreted by commentators as being broadly equivalent to the commercial cost. It would be particularly ironic for the Society if, having attracted criticism for an approach which minimises the impact on policyholders not having or not exercising guaranteed annuity options, those policyholders were then to read comments to the effect that annuity guarantees were going to "cost" the office, say, £500m.

ii) The purpose of reserving is to protect the interests of policyholders. It would be difficult to reconcile that purpose with an excessively prudent level of reserving in this area which, for example, pushed an office towards an extremely conservative investment strategy, thereby damaging the future prospects of those same policyholders. This point is particularly relevant in current financial conditions both because constraints on investment strategy would be more likely to arise than in other conditions, and because the current state of markets make it a particularly disadvantageous time at which to switch from equities into fixed interest securities.

Equitable conclude by saying that: *'A prudent approach to assessing the value of the option would be to assume that all eligible benefits would be taken in guaranteed annuity form where that would produce a higher income than the full open market option cash fund could secure on current rates. As indicated above, that would lead to a reserve of £170m in current conditions which would be at least 3-4 times the expected true commercial cost and, probably, a substantially higher multiple than that'.*

November 1998 GAD send HMT their annual report on the life insurance industry for the year ending 31 December 1997. The report follows a similar format to that used for the previous year. The report's purpose and disclaimers are unchanged. (See December 1997.)

The executive summary says, under the heading *'Provision for Annuity Guarantees'*, that:

The increasing longevity of annuitants, and the sharp fall in long term bond yields that has recently been experienced, has brought to light a new major problem for a number of offices in relation to guaranteed annuity rates that had been incorporated in pensions contracts - largely sold in the 1970s and 1980s. These guarantees are now proving to be very onerous, and large increases in provisions are needed.

Some general data is given in Appendix 4, showing total reserves held at the end of 1997 for annuity guarantees was nearly £3.8bn (when long gilts yielded about 6.4%). With yields now below 5%, this problem requires, and is being given, careful scrutiny on a case-by-case basis by HMT and GAD. A need for further increased provisions is likely to result.

On new business, the report notes that Equitable remain the largest writer of new pensions business (with a new business index of £613.7m). For total new business, Equitable move from first to second place (with a total new business index of £743.4m).

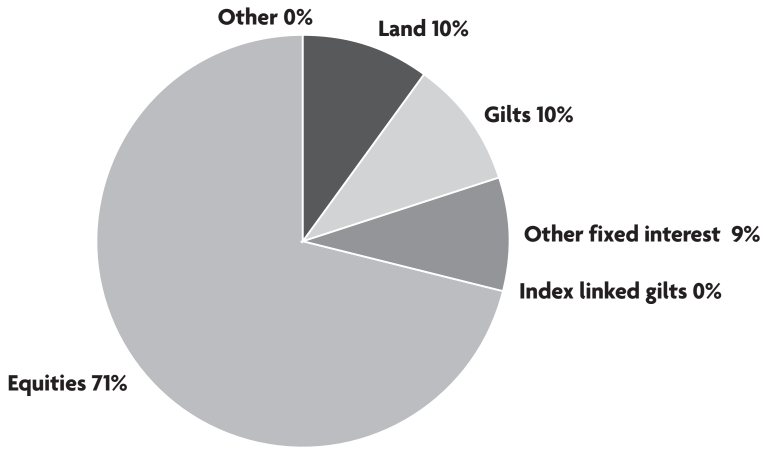
On mortality, the report repeats the material in the 1996 annual report, noting that the rate of improvement had been much faster than expected.

On *'Non-linked assets'*, GAD report:

> *Prospective long term yields have fallen substantially over the year, so that valuation interest rates should have been cut and liabilities substantially increased. Rises in terminal bonuses but falls in reversionary bonuses are a natural consequence of market movements. Strong asset performance should have been enough to sustain most Free Asset Ratios, but the recognition of lower prospective yields may be increasing valuation strains – especially in relation to guaranteed annuity rates.*

GAD again produce an estimation of the breakdown of the portfolios that are held by companies to support their with-profit liabilities (including the free estate). The report includes the following chart:

Average mix of assets backing with profit liabilities of major with profit offices in 1997



On investment performance, GAD say that the average estimated investment return on non-linked assets was 18.48%. The report includes a table setting out the estimated returns achieved by individual companies, which for Equitable shows an estimated return of 19.55%.

GAD again report their comparison of maturity payouts against their own calculations of the theoretical asset shares. In the background section to this part of the report, GAD note that Equitable have the largest in-force unitised with-profits pension liabilities. GAD explain:

> *For unitised with profit business (UWP), recent bonus additions have increasingly relied on capital gains rather than investment income, and this is beginning to cause reserving problems. UWP is a comparatively young product with, in theory, flexible bonuses. The product uses market value adjustments (MVAs) to protect companies against fluctuations in stock markets, except at defined moments or periods when no MVA is applicable – such as maturity. However, competition has meant a range of minimum bonus guarantees on earlier products, and annual bonus rates have been sustained at a level that is today high in comparison to the potentially reduced future investment returns. Terminal bonus cushions on UWP business have not therefore developed to any extent and the business would need considerable support in statutory reserving terms from the rest of the with profit fund, unless market value adjusters can be reflected in the valuation. Proposed*

amendments to HMT regulations tighten up standards in this area, with the effect of increasing reserves for certain offices.

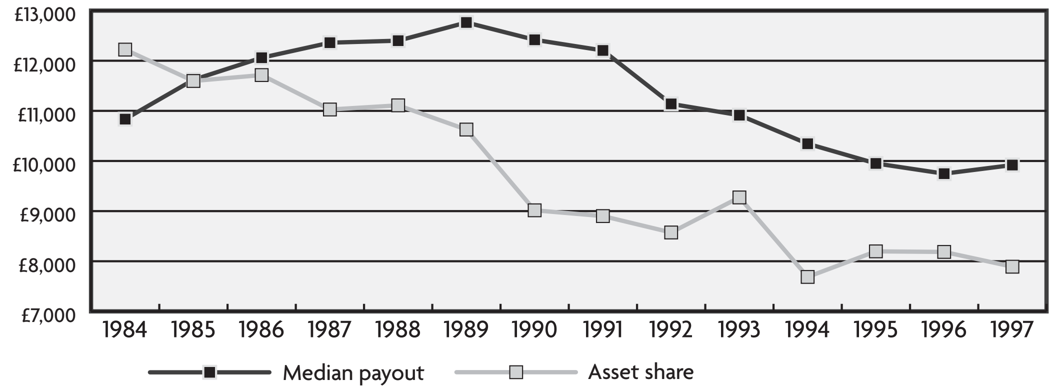
Thus, as offices project their future bonus policy, they may start to see greater problems in sustaining high, but volatile, equity investment in a total environment of more modest assumptions of future investment returns – unless they can rapidly reduce the expectations of policyholders in relation to guaranteed levels of benefits.

On '*Underlying trends, comparisons of Asset Shares*', GAD provide a similar explanation to that provided in the previous annual report, that being:

... a retrospective roll up of premiums, known as asset shares, is becoming a common device by which companies gauge the balance of bonus distributions between differing generations of policies. (In many companies such simple asset shares are looked upon as a floor to policyholders' PRE.) ... However, the gap between asset shares and the typical smoothed maturity payout can give an indication of the level of miscellaneous surplus and earnings on the estate that companies are distributing to their policyholders.

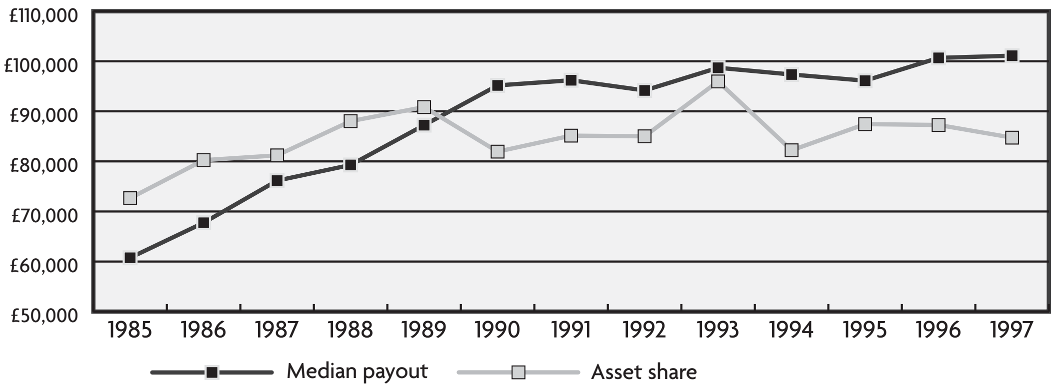
GAD repeat the main caveats set out in their previous annual report. GAD's report presents the following results of their analysis:

Comparison of actual median maturity payout and theoretical asset share for the years 1984-97 for a £50 per month conventional with-profits 10 year endowment policy (£)



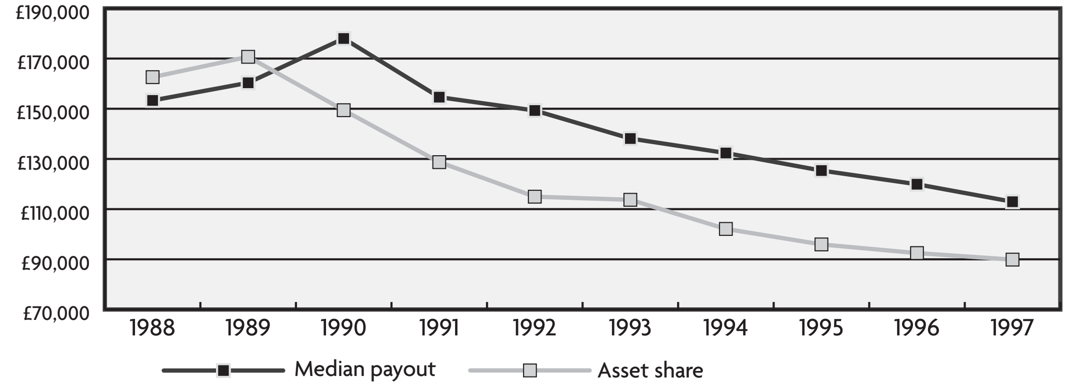
The appendix to GAD's report shows that they calculate that Equitable's maturity payout of £9,926 for this type of business is 126% of the theoretical asset share.

Comparison of actual median maturity payout and theoretical asset share for the years 1985-97 for a £50 per month conventional with-profits 25 year endowment policy (£)



The appendix to GAD's report shows that they calculate that Equitable's maturity payout of £86,355 for this type of business is 102% of the theoretical asset share.

Comparison of actual median maturity payout and theoretical asset share for the years 1988-97 for a £200 per month conventional with-profits 15 year pension policy (£)



The appendix to GAD's report shows that they calculate that Equitable's maturity payout of £109,211 for this type of business is 122% of the theoretical asset share.

GAD then report:

> *Bearing in mind the caveats that opened this Part of the Annual Report, and problems arising where terminal bonus declarations are infrequent, there is, as expected, a noticeable smoothing of maturity payouts. The general effect is of payouts roughly tracking asset shares, but at a considerable excess over these basic asset shares in the 1990s. There is a range of possibilities at work here, including the introduction of more accurate methods of setting terminal bonus, competitive pressures in a harsher market and dividend demands in the proprietary companies.*
>
> *The real interest is whether this situation can continue, as companies recognise limits to the amount of miscellaneous surplus and estate that they can distribute; or whether, as at least some companies currently arguing over the attribution of their estates contend, payouts are bound to fall closer to asset shares.* [A named insurance company] *has separately complained bitterly in public about over paying companies setting unrealistic long term hopes. All of this goes to the heart of PRE arguments and the division of prior accumulated surplus.*

GAD's report considers *'Possible future actual payouts'*. It states:

> *The precise excess actual payouts over our crude basic asset share is of less interest than the general trend of actual payouts into the future. The investment return on a typical with profit fund has been in the region of 17% per annum over the last 25 years. This compares to inflation over the same period of 6% per annum and thus has delivered a real return of 11% per annum. The likelihood of lower future inflation and a slowing of what has been an astounding real rate of return (i.e. the 11% p.a.) mean that a different future is likely. Our crude asset shares can be pushed forward on assumptions of investment returns and expenses to plot a possible picture of the likely path of real payouts. This is given in figure 12.10 below.*
>
> *This forecast accords with more precise and calibrated work elsewhere. Namely, while the shortest terms have a forecast of a relatively gentle decline in future payouts, the reverse is true for longer term contracts. These could see a comparatively steep fall in underlying asset share values in the next few years – as modest investment years replace the good investment years of the past.*

It is quite possible that such trends, if borne out in practice, will pose other problems in relation to the longer term policies – not just falling payouts disappointing policyholders. The past accumulation of guaranteed bonuses, and future compound bonuses on top, mean that on quite plausible future investment scenarios these guaranteed endowment maturity values or guaranteed pension values will exceed accumulated asset shares.

While this conforms to the concept of with profit business – smoothed returns underpinned by guarantees the industry will need to be careful in negotiating such a scenario. Put bluntly, the industry is likely to face a future where its terminal bonus cushions are far thinner, and the management of real guarantees becomes more important.

(Note: the bodies under investigation have told me that it should be noted that: *'the charts selected for this entry all show maturity payouts for regular premium contracts only. By contrast, the bulk of Equitable's business was recurrent single premium. These charts therefore have very little significance for Equitable. This comment also applies to the corresponding charts provided in the reports prepared by GAD for* [other] *years'.)*

03/11/1998 GAD provide HMT with comments on Equitable's letter of 30/10/1998. GAD disagree with Equitable's analysis on the grounds that it *'does not take account of the key point that the existence of a guaranteed annuity rate increases the level of cash that needs to be paid in substitution for that annuity (as otherwise policyholders would not agree to take the cash sum in place of the guaranteed annuity)'.*

GAD advise that:

... appropriate mathematical reserves need to be established for the full value of these guaranteed benefits and the associated obligations to policyholders in accordance with Part IX of ICR94, including in particular Regulation 64. It is not acceptable in this context to regard these guarantees as covered by a "first charge" against a final bonus for which no provision is made. This has clearly not yet been recognised by Equitable Life (and they have not even attempted as we requested at the meeting to quantify the reserves on this basis).

I believe that you should write to them along the above lines ... and invite them back to a further meeting in the very near future to explain how they propose to establish the appropriate level of mathematical reserves. If they are unable to meet this obligation, then intervention under either Section 37 or Section 11 may be warranted.

The issue over the adequacy of their mathematical reserves is quite separate from that of whether their interpretation of how the guaranteed annuity rates should be applied is consistent with policyholder reasonable expectations. Even if the Equitable's interpretation of PRE is accepted, then, as explained above, we believe that substantial additional mathematical reserves are needed for the guaranteed annuities ...

While we accept as a general reserving standard at present that no provision is needed for discretionary final bonus, this cannot apply to the extent that the company is obliged to pay a final bonus, in order to "buy out" the guaranteed annuities.

GAD state that £170m *'commercial cost'* would be quite inappropriate as an estimate of the additional mathematical reserve that is needed. GAD continue:

Where companies have identified the existence of annuity guarantees on a block of contracts, then we believe that appropriate mathematical reserves do need to be established on a satisfactory basis in accordance with Part IX of ICR94, including regulation 64. It is not acceptable to regard these guarantees as a "first charge" against a final bonus for which no provision has been made. Indeed we believe that this principle is generally accepted by the actuarial profession and is being followed by all other companies.

Consequently, we believe that the mathematical reserves do have to reflect the full value of the guarantees that have been given.

GAD conclude:

I believe that we need to write to them urgently making the above points and inviting them to a meeting in the next few days to explain how they propose to fund the mathematical reserves that are required.

05/11/1998 HMT write to Equitable, repeating the points made in GAD's note of 03/11/1998, including the references to Regulation 64. HMT seek an urgent meeting to agree a way forward. HMT say that this would offer an opportunity to discuss further issues concerning policyholders' reasonable expectations arising from Equitable's treatment of guaranteed annuities.

On the same day, HMT's Head of Life Insurance advises FSA's Managing Director and Head of Financial Supervision (Managing Director A) of HMT's intention to provide guidance to companies on meeting the cost of guaranteed annuity options. The Head of Life Insurance refers to Equitable's *'controversial policy of paying the guaranteed annuity rate only on the guaranteed sum built up in the fund (ie not on the discretionary terminal bonus)'*. He says that their preliminary view is that Equitable are entitled to do this, but that their principal concern is over Equitable's ability to reserve adequately for the guarantees. The Head of Life Insurance concludes: *'The information received to date is unconvincing, and raises serious questions about the company's solvency'*.

(Note: after the House of Lords judgment this note was leaked to The Guardian newspaper (see 19/12/2000 [**entry 13**]). Commenting on the last point in the note, FSA's then Line Manager wrote: *'We were subsequently satisfied that* [the Society] *was solvent and it remains solvent today'*.)

06/11/1998 [entry 1] HMT's Director of Insurance writes to the Head of Life Insurance Division having seen GAD's *'very helpful'* note of 03/11/1998. The Director of Insurance says:

We agreed that we should seek an urgent meeting with Equitable probably in advance of replying to [Equitable's Appointed Actuary] *raising the points* [GAD's Directing Actuary B] *has highlighted. The purpose of the meeting would be to make it clear to the Equitable that we need to satisfy ourselves:*

a) that the Equitable is taking a proper view of the liabilities which arise under the policies in question. This [seems] *to me to cover not only the actuarial issues to which* [Directing Actuary B] *draws attention but also the question of whether the Equitable's interpretation of the legal rights arising under these policies is one which the courts would support. As you know I think we may need to require the Equitable to provide to us (to the extent they have not already) samples of policy documents, promotion literature etc etc in accordance with criteria specified by us. I have no reason to believe that the Equitable have "cherry picked" the documents they have provided so far but equally I would not wish it to be possible for anyone to suggest that they had. Our legal advisers will no doubt be able to express a view on the security of the Equitable's legal position, but it may be appropriate for us, if there is any doubt, to seek Counsel's opinion too.*

b) To take a view on whether the approach being taken by the Equitable, even if secure as a matter of contract law, is consistent with its obligation to "conduct its business with due regard to the interests of policyholders" as required by [paragraph 7] *of Schedule 2a to the Insurance Companies Act and more generally whether it accords with PRE.*

06/11/1998 [entry 2]	FSA's Chairman writes to HMT's Director of Insurance to ask for advice about questions which had been put to FSA about guaranteed annuity rates and, particularly, about Equitable's approach. These include whether Equitable were right in their view that they could fund a guarantee by reducing bonuses, or whether that was inappropriate and should be prevented by the regulators; whether there had been a failure of prudential supervision if the with-profits fund could not bear the cost of these guarantees; and what would happen if the funds were not available to pay up, except by reducing the size of the fund below a level which actuaries felt was required to deal with other policyholders' reasonable expectations. In these circumstances, '[would] *not regulators then be invited to pay Peter by robbing Paul, and how would these decisions be made?*'.
09/11/1998	FSA write to HMT in response to their note of 05/11/1998. FSA comment that it is *'critical'* that HMT seek further information to test their view that Equitable are entitled to pay the GAR only on the guaranteed sum and not on the terminal bonus.
11/11/1998 [entry 1]	Equitable write to HMT in reply to their letter of 05/11/1998. Equitable apologise that they appear to have misinterpreted what was requested at the meeting on 02/10/1998. Equitable explain that, as at 31 December 1997: *... the basic additional reserve on the basis indicated in your letter, before any allowance for cash commutation or any entitlement to pay future premiums, would have been around £675m. The corresponding increase in reserves on the same basis, including the standard resilience tests, would have been at a similar level.* Equitable estimate that, as at 31 December 1998, assuming valuation interest rates of 5%, 5.5% and 6%, additional basic reserves would be £1,375m, £1,160m or £955m, respectively. A manuscript note on the HMT and GAD copy of the letter suggests that *'Reserves if assume 5% interest rate and 20% needed for resilience'* would be £1,650m.
11/11/1998 [entry 2]	GAD's Directing Actuary B asks Scrutinising Actuary E to *'review the various policy documents and literature we have received, in order to see what further information may be needed to assess the reasonableness of their approach on GAOs in terms of PRE'*.
12/11/1998 [entry 1]	GAD's Scrutinising Actuary E produces a note of the *'fundamental questions'* to be raised with Equitable at the meeting now arranged for 13/11/1998. GAD's questions include: *1. When did the Board decide that different final bonus entitlements would apply if a policyholder elected to utilise the guaranteed annuity option? Was it in 1995, when it appears that a Note (2) was first incorporated in the Bonus Statement?* *2. Has the company made the possible variation of final bonuses sufficiently clear to policyholders? The 1998* [With-Profits] *Guide makes a passing reference only (at the bottom of Page 5); Note (2) in the Bonus Statement is very much "small print". Unless further evidence can be provided, it might be felt that previous policyholder expectations have not been adequately modified.* *3. Was the tweaking of bonus policy, in relation to the introduction of a differential final bonus, in itself an action contrary to policyholders' reasonable expectations – that had previously been built on notices and statements referring to the build-up of a policy fund?* *4. The letter of 30th October from* [Equitable's Appointed Actuary] *implies that policyholders who do not elect to take guaranteed annuity benefits are not given credit for the higher "Policy Annuity Value" forgone. How can this be justified in relation to the terms on which the contract was issued?*

The Scrutinising Actuary lists the documents that Equitable should be asked to provide, those being:

> *(1) copies of Board papers relating to the decision that alternative (lower) final bonuses should be added where policyholders elect to take advantage of the guaranteed annuity rate;*
>
> *(2) copies of any communications with policyholders issued prior to the 1995 Bonus Statement that might have indicated that a two-tier bonus allocation could apply;*
>
> *(3) any documents that lend support to the adoption of the two-tier final bonus structure, as a modification of policyholders' previous expectations – that would almost certainly have previously been built on the accumulation of a simple "policy fund", that would ultimately be converted into an annuity.*

Scrutinising Actuary E concludes: *'Even if the two-tier final bonus practice of the company were found to be acceptable, it would seem clear from the policy document already supplied that each policyholder is entitled to a "Policy Annuity Value" that is based on the guaranteed annuity available, whether or not they elect to take such* [a] *guaranteed annuity. The company should be asked to confirm that such a minimum value is paid, notwithstanding the impression given in the letter from* [Equitable's Appointed Actuary] *of 30th October, or alternatively, should justify its current payment policy'*.

12/11/1998 [entry 2] PIA discuss FSA's note of 06/11/1998. A PIA official says that there are marketing as well as prudential aspects to the issue. The official explains that, while PIA have not formed a view on Equitable's actions, their experience of with-profits cases has shown that *'it is difficult to prove a complaint which would restrict a company's flexibility in the way that it declares bonuses'*. The official comments that he has not seen the wording of Equitable's policies, which would clearly be significant. Nevertheless, in his view, while Equitable might just be able to reduce bonuses, *'they are acting in poor faith'* in doing so.

13/11/1998 HMT (Director of Insurance, Head of Life Insurance, Line Manager D, Line Supervisor C and Legal Adviser B) and GAD (Directing Actuary B and Scrutinising Actuary E) meet Equitable's Chief Executive and their Appointed Actuary. The note prepared by HMT records that the meeting noted that the reduction of terminal bonuses where guaranteed annuity options were biting had become a high profile industry issue; that further information from Equitable was required so that the regulators would be able to assess policyholders' reasonable expectations; that Equitable had instructed their solicitors to advise and that Leading Counsel had endorsed their approach; and that Equitable's Chief Executive agreed to provide any Board papers concerning discussion of the policy of reducing terminal bonus.

HMT's note records: '[Equitable's Chief Executive] *confirmed that it was in 1995 in a climate of reducing interest rates that the policy was first applied, there had been plans to introduce the policy earlier in 1993 but subsequent higher interest rates had taken this policy revision off the agenda'*. (Note: it has been put to me by one of the Society's attendees that HMT's record of what was said at the meeting is incorrect. It is suggested that, while the level of interest rates between early-1994 and mid-1995 meant that the differential terminal bonus policy had no practical effect, it is clear that the policy had been introduced in 1993, with effect from 1 January 1994.)

HMT's note records:

> *The company agreed that there had been a case (reported in the media) whereby a policyholder had obtained an extra settlement from the company, this was effectively giving him a biting GAO on top of unadjusted terminal bonus. The company argued that this policyholder received this amount as redress for administrative failings and delays*

encountered in settling the policy. The case was not routine and junior members of the company had given the policyholder misleading information. In additional age was a factor in deciding to give compensation, the policyholder was 73 and wanted to retire. However, the Equitable did not elaborate on why they decided to give compensation in this manner rather than giving an ad hoc payment to cover this.

Equitable's Chief Executive states that he is *'satisfied that the Board had acted correctly in using their discretion to reduce or remove terminal bonuses from policies with biting GAOs'* and that *'terminal bonuses were not guaranteed and the literature has always stated that'*. He also adds that some policyholders had written to the Society in support of its stance. HMT state that *'to properly understand the PRE implications of this we would want to get a feel of what impression had been given to policyholders over the years'*.

There is continuing disagreement on the reserving issue. Equitable's Chief Executive argues that 100% reserving would have *'severe commercial implications from low solvency cover which would have to be reported'*. HMT and GAD argue *'that it was a statutory requirement to reserve on this basis and unless Equitable could put up a compelling argument to the contrary we would expect the company to reserve on this basis'*.

Equitable's Appointed Actuary says he is convinced that the Society remained solvent, and that he was considering a section 68 Order application with respect to the resilience calculations, in order to assume that only 50% of policyholders took the GAR option.

Equitable agree to provide a copy of Counsel's opinion which endorses their differential terminal bonus policy, and they defend their argument about asset shares.

HMT and GAD say that, in order to properly understand the policyholders' reasonable expectation implications, they want to see a selection of the documents sent to policyholders *'to get a feel of what impression had been given to policyholders over the years'*. They agree to select some policy numbers at random from a list of policies that had matured over the last three years.

16/11/1998 [entry 1] GAD's Scrutinising Actuary E writes to Chief Actuary C setting out points discussed that day. This includes the view that *'provided alternative Accumulation Values* [the value applicable to premiums paid for retirement annuity policies set out in Table A of the policy document] *are permissible, then the current practice of the Society* [to apply a lower Accumulation Value where a policyholder takes the GAR option] *would seem to be legally acceptable'*. Scrutinising Actuary E notes that:

We have observed that the possibility of reducing terminal bonuses if policyholders elected to take a guaranteed annuity rate was first mentioned in Schedule 4 of the returns as at the end of 1993 – so the Society clearly became aware of the potential strains fairly early. However, it does not appear to have communicated its intentions to policyholders at that time. It seems that the first Bonus Notice to give any indication that the final bonus might be reduced to take account of the existence of guaranteed annuity rates was that issued in January 1996 covering the end 1995 declaration (in Note (2)). The With-Profits Guide that was issued in July 1995 certainly made no mention of it. [The 1998 With-Profits Guide now includes a reference to special rules applying in some circumstances, such as where particular benefit guarantees apply.]

It is accepted that the Directors have absolute discretion over the amounts of any bonuses to be declared and have the power to modify their methods of allocation from time to time.

It is also recognised that they are reluctant to grant bonuses to particular policyholders that effectively give those policyholders benefits of value materially in excess of *accumulated "asset shares" – to the detriment of the expectations of other policyholders. However, it is still an open question as to whether the different Accumulation Values are consistent with policyholder expectations.*

The Scrutinising Actuary copies his note to HMT.

16/11/1998 [entry 2] HMT write to Equitable to confirm the follow-up action and information required from Equitable after the meeting on 13/11/1998. This includes: literature provided to policyholders; Counsel's opinion; worked examples where some or all of the policy proceeds are taken in cash; an estimate of Equitable's free assets and solvency cover, indicating the level of additional reserves assumed for annuity guarantees; and information on what margins there are in the current reserving basis which might be released.

18/11/1998 Equitable tell HMT that, as at 30 October 1998, '*on the basis of the draft figures, the surplus assets and implicit items, before any reserves for GAOs, are around £2bn, which confirms the comments we made last Friday about the current solvency position'.*

19/11/1998 The Assistant Private Secretary to the Economic Secretary informs Line Manager D that the Minister is unhappy with the proposed guidance sent to her on 26/10/1998. The Assistant Private Secretary explains:

The Minister has commented that surely if people bought a contract, it is a guarantee and they should not now expect to pay for the guarantee themselves. The Minister is minded to think that the shareholder should bear some/all? of the costs themselves.

The Minister has asked about Orphan Assets asking if some appropriate use could be made where they exist. The Minister would welcome a fuller justification and consideration of other issues before she is prepared to agree a way forward.

23/11/1998 [entry 1] Equitable provide HMT with the documents requested on 16/11/1998, including Counsel's opinion on differential bonuses, which had been sought following the regulator's questioning on the issue.

23/11/1998 [entry 2] HMT's Line Manager D provides a brief for a Minister who is visiting Equitable but who holds no responsibility for prudential regulation. HMT urge him not to comment on current exchanges with Equitable. She says: *'There remain a number of unresolved issues surrounding the company's exposure to guaranteed annuity options. Insurance Division within HMT are addressing these matters'.*

24/11/1998 [entry 1] Equitable write to GAD following the meeting on 13/11/1998 and HMT's letter of 16/11/1998. Equitable state that there appears to be some misunderstanding about the precise nature of the policy benefits in question which had not been resolved at the meeting. Equitable seek to clarify the position by setting out some examples of how benefits are calculated when a differential terminal bonus is applied. They suggest that these make clear *'why the vast majority of clients select the cash fund form of benefit'*.

Equitable state that they still feel that their approach to reserving for annuity guarantees under Regulation 64 as previously explained is valid. They add that it is also *'the approach which GAD have tacitly accepted since 1993'* and that the consequences for Equitable of adopting GAD's approach (of reserving on the basis that 100% of benefits are taken in guaranteed annuity form) are *'potentially extremely serious'*. Equitable state that they *'cannot see why prudency with "appropriate margins" necessitates assuming that 100% of benefits will be taken in the most onerous form when that flies in the face of the logic of the situation and the practical experience'*.

Equitable provide information about their estimated solvency cover as at 30 October 1998, as follows:

> *The estimated "Form 9" position (excluding linked business) at 30 October 1998, before taking account of implicit items or making any allowance for additional reserves for guaranteed annuity rates was as follows:*

	£m	*£m*
Value of assets		*24076*
Reserves – Form 58	*21205*	
– resilience	*781*	
		21986
Available assets		*2090*
Required minimum margin		*926*
Surplus assets		*1164*

Equitable say: *'The Society has a section 68 order allowing implicit items of up to £850m to be brought into account. Financial conditions have changed so as to improve the solvency position since 30 October so it is clear from the above figures that there is no question of basic solvency being currently in question. The figures also, of course, include resilience reserves in accordance with the normal GAD guidelines, which I should not necessarily consider appropriate, if very substantial additional reserves were also required for guaranteed annuity rates'*.

Equitable then disclose the reserves required when accounting for annuity guarantees. This is presented as:

	Proportion of benefits assumed taken on guaranteed annuity rate terms			
Reserves	*0%*	*25%*	*50%*	*100%*
	£m	*£m*	*£m*	*£m*
Form 58	*21205*	*21548*	*21892*	*22579*
Resilience	*781*	*644*	*720*	*1201*
Total	*21986*	*22192*	*22612*	*23780*

Equitable then disclose: *'There are some margins in the basis, particularly on assurance mortality, which could be released. I would not, however, anticipate those releasing more than £100m of reserves. Since the bulk of the Society's business is investment in nature it is the regulatory restrictions on yields which primarily govern the strength of the basis. By virtue of the fact that a substantial resilience reserve is required on top of "full face value" reserves, it follows that there are no significant margins in the interest assumptions released'*.

On a copy of the letter, an official has written:

24,076
23,780
£300m
+£100m
850m

Equitable describe the options available to them in the event that reserving at *'the onerous end of the spectrum'* was required. These include:

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(i) Passing the bonus declaration, either for all business or for the classes incorporating guaranteed annuity rates.

(ii) Raising capital either through further subordinated debt (limited scope at present) or financial reassurance.

(iii) Trying to obtain some sort of protection based on derivatives. [An option explored by GAD, see 13/08/1998.]

(iv) Publishing a Form 9 where the required minimum margin is only just covered.

(v) Making a sizeable switch from equities to fixed interest or cash.

Equitable go on to explain:

Of the above (ii) is now probably rather difficult to put in place by 31 December and there must be doubts as to how effective (iii) could be. Approaches (i) – (iv) carry very significant PR risks – possibly of a scale which would threaten the continued independence of the Office. Approach (v) will damage the future prospects of policyholders for a number of years.

Equitable conclude by saying that unless they and GAD could come to an agreement on the interpretation of Regulation 64 they would need to consider what steps to take in terms of consulting with the profession.

24/11/1998 [entry 2]	Every Appointed Actuary is sent by the Government Actuary a copy of DAA10 on the resilience test. The Government Actuary explains that, in the light of current volatility in equity markets, GAD have decided to revise the second of the three resilience tests set out in DAA6 (see 30/09/1993 [**entry 2**]).
24/11/1998 [entry 3]	GAD's Scrutinising Actuary E writes to HMT's Line Manager D. The Scrutinising Actuary sets out some points to put to the Economic Secretary, in order to explain in more detail the thinking behind the proposed guidance. He notes the difficulty for insurers such as Equitable who have no shareholders or free estate and for whom the residual cost of the guarantee is relatively high. In their case, the guarantees fall to be met by either the beneficiaries or the remaining policyholders. In response to the note HMT's Head of Life Insurance comments that they should make clear *'that there is not one right answer, & that different solutions are possible, each of them fair'*.
25/11/1998	GAD send HMT a copy of the report of the results of the survey on reserving for annuity guarantees produced on 27/10/1998. GAD caution that the quality of responses was not sufficiently rigorous as to draw conclusions about individual companies, that events have since moved on, and that there is no intention to publish the results in any detail.
26/11/1998	GAD provide HMT with a *'2nd Update'* on the *'Effect of Current Market Conditions on UK Life Insurers'* for them to provide to the Tripartite Standing Committee. This follows the assessment on 22/10/1998. GAD say that they had identified eight companies that should be *'called in'* to discuss their current financial position and state that: *With the possible exceptions of Equitable and* [another named company], *I would expect each of these to be covering their margin of solvency at present, but without much cushion for further adverse movements in market conditions.*

GAD's second update says that:

> *Figures for Equitable Life at 30 October indicate that the company was just solvent assuming that 100% of policyholders exercise their GAOs (the company is disputing the need to assume such a high take up rate). While this is reassuring it should be realised that publication of such a low solvency position is likely to severely undermine the company's reputation in the market and could threaten its survival as an independent entity. Equitable's annual returns are due to be published next July. Discussions are on-going on the appropriate reserving basis to be used and the acceptability of the company's approach to charging policyholders for the cost of the GAOs.*

01/12/1998 GAD provide HMT with comments on the enclosures in Equitable's letter of 23/11/1998. In relation to Counsel's opinion, GAD say:

> *The legal opinions do not wholeheartedly support the actions taken thus far by the Society.*
>
> *Counsel advise that the Board of the Society might have sufficient discretion under their articles to apply different bonus rates to different classes of policyholder and, within any class, to different policyholders depending on the policyholders' choice of benefits subject to any limitations in the contract or statements made to policyholders. <u>We do not disagree with this advice</u>.*

GAD agree with Counsel that Equitable's documentation to date has *'not adequately described the bonus methodology that the Society are now adopting'*. GAD note that the *'question remains as to whether past vesting policyholders have been treated fairly'*, and that Counsel advises that *'the Society ought to be able to defend its position in Court'*. GAD say:

> *We do not feel sufficiently competent to offer an opinion on this legal question. The presentation adopted by the Society in its bonus notices, of the benefits available at maturity, does not appear to have been in strict accordance with the policy conditions, but it is difficult to see how this might have created a breach of contract. It remains possible that policyholders could successfully argue that they were not led to expect a differential terminal bonus rate dependent upon the benefit they chose at vesting.*

GAD provide HMT with comments on Equitable's letter of 24/11/1998. Under the heading *'Reserving Issues'*, GAD describe Equitable's arguments on Regulation 64 as unconvincing, asserting that Regulation 64(3)(c) on *'taking account of options (e.g. in this case to take cash or a different form of annuity) needs to be read in conjunction with Regulation 72 which requires a provision on a prudent basis to cover any <u>increase</u> in liabilities caused by policyholders exercising options'*. GAD continue:

> *There is nothing in the regulations that specifically allows a reduction in liabilities because of the existence of policyholder options (see for example Regulation 74 which considers the effect of voluntary discontinuance) and indeed, in our view, it would not be prudent to make such an assumption.*

GAD set out why they are unconvinced by Equitable's arguments on reserving less than fully for their annuity guarantees. In relation to resilience reserves, GAD write:

> *I would have some sympathy though over the additional provision of £1.2 Bn apparently required by our standard resilience test (and which would not normally be included as a provision in the Companies Act accounts). Nevertheless, we believe that a "fair value" of the guaranteed annuity, assessed on derivative-base methods, would include a significant part of this £1.2 Bn provision. Moreover, they would of course have to find all this amount if the investment scenario postulated in the resilience test were to materialise.*

> *Accordingly, I do not think that we could openly encourage them to reduce this "resilience" provision, albeit that the "advice" in* [the Government Actuary's] *letter is not a regulatory requirement. They would also of course have a PR problem in explaining why they chose a different "resilience test" scenario if they decided to pursue such an avenue. It should also be recognised that in the resilience scenarios which assume a fall in the yield on gilts the guaranteed annuity benefit is more likely to be selected by clients.*

On Equitable's *'Form 9 Position'*, GAD advise that:

> *According to the figures presented in his letter, Equitable would have a surplus of assets over liabilities of some £300M (before any declaration of bonus) if they reserve in full for 100% of the benefits in guaranteed annuity form (or equivalent) including an amount of £1.2 Bn in respect of the standard resilience test. With an implicit item for future profits of around £850M (which may need to be adjusted slightly), they would just have sufficient cover for their required margin of solvency as at 30 October 1998.*

GAD continue:

> *While we recognise that this may not suit them commercially, we believe that this would place them on a consistent basis with other offices. It also indicates that they are very reliant on future surplus, largely arising from significant potential returns on equity investment, in order to fund their future bonuses, including the discretionary final bonuses. They have not provided any figures (admittedly, we had not specifically requested these at present) to suggest that this would be an unfair conclusion. (For example, it would be instructive for us to see a figure for their aggregate asset shares which could be compared with assets, including any inadmissible assets. A copy of any financial condition report by the appointed actuary, under GN2, would also be helpful.)*

Commenting on the options, as identified by Equitable, GAD state that:

> *It seems likely that they will need to consider* [in the short term] *some suitable combination of these for this current year-end. In particular it is difficult to see how they could justify declaring any bonus at this year end.*
>
> *In the medium term, though, I believe that they will need to look for some ongoing form of capital support if they are to remain viable under difficult investment and trading conditions.*

02/12/1998 HMT's Legal Adviser B sends Line Manager D a draft advice note. She explains that her note was not complete legal advice, because *'we are not yet at the stage where that is possible'*.

The Legal Adviser casts some doubt on whether a failure by Equitable to reserve 100% for annuity guarantees would provide grounds for regulatory action. She suggests that Regulation 64 is very wide and sets out an objective standard. Legal Adviser B states that it is not for HMT to decide whether liabilities have been properly provided for, but for a court. She agrees that GAD's and HMT's approach on reserving is within Regulation 64, but says that it is less clear whether Equitable's view is in breach. If Equitable are not in breach, it is not clear on what basis HMT might take action against them.

Legal Adviser B argues that it is for HMT to show a breach, and only where Equitable could be shown to be *'significantly out of sync'* with accepted practice, or were clearly acting unreasonably, would the onus fall on Equitable to demonstrate compliance. On Equitable's Counsel's opinion, she says:

> *... I find it hard to take issue with what he says. He thinks that on balance a Court would accept that Equitable's practices were valid in terms of contract and trust law. However, I understand it to be your view that considerations of PRE may go beyond determining what is a legally acceptable construction of the contract or exercise of a discretion under or in conjunction with the contract. If so, then* [Equitable's Counsel's] *opinions (even if you accept them) are not an end to the matter. You will still wish to make your own examination of the documents, events and policyholders' representations to come to your own view on PRE.*

03/12/1998 HMT and GAD meet Equitable to discuss reserving for annuity guarantees. HMT prepare a note of the meeting. HMT begin the meeting by confirming their position that Equitable *'would need to reserve for all guaranteed benefits under the contracts'*. Equitable's Appointed Actuary argues that Equitable's reserving methodology is:

> *... not new and that GAD should have been aware from the returns that the company was writing GAO business. The reserving basis had been, until now, tacitly accepted.*

In response, GAD *'rejected this argument and countered that whilst they were aware that the Equitable had written GAO business it was not possible to tell the construction of the contracts or the reserving basis from the return'*.

HMT's note records:

> *GAD further commented on the reduction in the resilience reserve given in the solvency illustrations recently supplied to* [GAD's Directing Actuary B]. *They expressed the view that the holding of substantial mathematical reserves to cover guaranteed annuity options did not appear to be a sound argument for reducing the stringency of the resilience test applied. Although the resilience tests specified by the Government Actuary were not legally binding, companies had to be satisfied of the actuarial prudence of the test used. It was explained at the meeting that the Government Actuary could be expected to wish to discuss with* [Equitable's Appointed Actuary] *the basis for any relaxation of the resilience tests applied by the company.*

Equitable's Chief Executive states that *'the reserving basis required was excessively prudent and bore no resemblance to commercial reality and policyholders would be damaged by this (through a change to a more conservative investment policy, passing bonuses or through there being a run on the office)'*. The note of the meeting goes on to record:

> [Equitable's Chief Executive] *asked whether there was any scope for HMT to give any concession on this issue and what would be the consequences of the company not following this requirement*. [HMT's Head of Life Insurance Division] *responded that he could not see any scope for issuing a concession in these circumstances. Furthermore, the requirements derived from EC Directives and there was limited scope to give concessions in these circumstances.* [He] *said that we would take appropriate measures to ensure compliance.* [The Chief Executive] *asked whether there was any scope for appeal,* [the Head of Life Insurance] *said that any scope for appeal would be limited to judicial review,* [the Chief Executive] *said that he might well have to take up this option.*

GAD comment that:

> *... if the company had not been mistaken in its interpretation of the regulations it would not have been in the past so generous in its bonus declarations. Questions were also raised about the prudence of trying to operate a company without an estate.* [Scrutinising Actuary E] *stated that from his interpretation of last year's bonus declaration that a fair proportion of reversionary bonus was paid out of asset value gains.* [Equitable's Appointed Actuary] *argued that since 1986 reversionary bonus rates*

have been managed down although he did admit that it was possible that there had been times when the value of accumulated policyholders' asset shares had been greater than Equitable's assets. Nevertheless he argued that he did not believe that it was in the interests of policyholders for the Equitable to build up a large estate.

Equitable's Appointed Actuary confirms that he has considered reinsurance *'as* [an] *option for protecting the balance sheet'*, but he *'was reluctant to broadcast the Equitable's position to potential reinsurers at this time and he had hoped that the regulatory position might change at this meeting'*. He points out that a reinsurance agreement is unlikely to be in place by the end of the year. HMT *'thought it would be possible to give a concession so that the effect was post dated to cover the 1998 year end position'*.

Equitable's Appointed Actuary continues that he *'was concerned from a professional point of view that he was being forced to adopt a reserving approach that was "wildly prudent" and he thought he would need to consult professionally regarding this'*. GAD say that they do not think that there is a professional issue to consider and that there is *'a distinction between the legal position as required by Regulation 64 and the resilience reserve where there was more scope for professional judgement and interpretation'*.

There is further discussion of the implications for policyholders' reasonable expectations of the differential bonus policy. HMT and GAD tell Equitable that they still have some way to go before coming to a conclusion. They say that they believe policyholders' reasonable expectations would be met in the future if Equitable's Counsel's advice about the wording of annual statements were followed; the issue is whether expectations had been met in the case of policies that have matured: *'... since the way in which the contracts and the company's bonus policy had been described did not appear to be fully in line with the approach adopted by the company'*. HMT request further documentation in order to consider this point.

04/12/1998

HMT's Legal Adviser B sends Line Manager D her advice. She says that: *'The following is not intended to be final or complete legal advice. We are not yet at a stage where that is possible. We await, for example, one more submission from Equitable. But I hope it assists to clarify the issues and to set out my views at this stage'*. The Legal Adviser states:

"Liabilities" are defined in [Regulation] *58 to mean amounts calculated in accordance with Part IX of the Regulations in respect of the items shown at C and D under the heading "Liabilities" set out in* [paragraph] *9 of* [Schedule] *9A to the Companies Act 1985. Broadly,* [Regulation] *64 says that long term liabilities must be determined on actuarial principles, making proper provision for all liabilities on prudent assumptions that shall include appropriate margins for adverse deviation of relevant factors. Pursuant to* [Regulation] *64(2), the determination must take account of all prospective liabilities as determined by the policy conditions for each existing contract. Factors to consider are guaranteed benefits, bonuses to which policy holders are contractually entitled, options available, PRE and the nature and term of the assets representing the liabilities and the value placed upon them. I note that there is provision in* [Regulation] *66 to avoid future valuation strain and in* [Regulation] *72 to cover any increase in liabilities caused by policy holders exercising options under their contracts.*

The advice continues:

[Regulation] *64 is very wide. It also sets out an objective standard. In other words, it is not for HMT to take the final decision as to whether liabilities have been properly determined, but for a Court. Generally speaking, however, there seems to be room for more than one reasonable actuarial view as to "proper provision" and "prudent assumptions". Having said that, it seems to me that any entity which adopts the*

> *GAD/HMT view on reserving would be within* [Regulation] *64. What is not so clear is whether Equitable Life's view (or any position between that of Equitable and HMT) is in breach of* [Regulation] *64. If Equitable is not in breach, I am not clear on what basis HMT might take action against it. (As to what action might be taken, see below.)*

The Legal Adviser notes that *'Equitable seems to agree that the prospective liabilities here are those under the policies themselves and not those under any other available options, and there seems to be no dispute about the amount of the liabilities, but Equitable argues that* [Regulation] *64(2) does not necessarily require provision to back 100% of that amount'*. The advice continues:

> *On first glance, the Equitable position is appealing in purely legal terms.* [Regulation] *64(2) requires that a determination of the amount of long term liabilities "shall take account of all prospective liabilities" under the policies. It does not say in terms that the amount must equal 100% of the value of such liabilities. The overarching general requirement in* [Regulation] *64(1) requires the making of "proper provision for all liabilities on prudent assumptions" which also suggests that provision need not necessarily equal 100% of the liabilities – it might be more or less.*
>
> *However, reading* [Regulation] *64 together with the rest of Part IX and with* [Article] *17 of the First Council Directive 79/267 (as substituted by Directive 92/96) which Part IX is intended to implement, it can also be reasonably argued that Part IX contemplates 100% provision unless there is a respectable actuarial position that the provision might be lower. The tenor of Part IX is cautious and the intent is clearly that determinations should be relatively stringent.* [Article] *17 of the First Directive offers some small support for this view stating, for example, that prudent valuation must not be a "best estimate", but must include appropriate margins.*

The Legal Adviser says that, for this reason, a court *'would accept that Equitable's position is untenable (even though supported by its actuary)'*. However, she adds that, although she is not convinced that a court would accept that Regulation 64 required that prospective liabilities be 100% reserved, the court is likely to accept that *'100% (or thereabouts) is required in this case, if Equitable continues to maintain its position at the low end'*. She discusses what action might be taken if Equitable do not accept HMT's and GAD's position:

> *It appears that Equitable is or will be in breach of the 1994 Regulations, the Insurance Companies (Accounts and Statements) Regulations 1996 and Sections 17 or 18 of* [ICA 1982]. *You say you do not think it will be in breach of Sections 32 or 33* [of ICA 1982] *(solvency and minimum margins). Equitable might be pursued for the breaches, but you are minded to proceed rather by way of intervention under Section 45* [of ICA 1982] *to require full determination of the amount of liabilities on the grounds that the criteria of sound and prudent management are not being met (*[paragraph] *6 of* [Schedule] *2A to* [ICA 1982]*). (Action under section 45 assumes the purpose of intervention cannot be appropriately achieved under sections 38 to 44.) Assuming* [that there is a] *breach, such intervention is unlikely to be successfully challenged in the Courts as long as its terms are not* Wednesbury *unreasonable.*

The advice continues: *'As an aside, the issue of breach raises the question of burden of proof. Is it for HMT to show breach of the 1994 Regulations or for Equitable to show compliance? I think that it is for HMT to show breach. Only where Equitable could be shown to be significantly out of* [step] *with accepted practice or clearly acting unreasonably would the onus fall on it as a matter of fact to demonstrate compliance'*.

Legal Adviser B says that she understands it to be HMT's view that *'considerations of PRE may go beyond determining what is a legally acceptable construction of the contract or exercise of a discretion under or in conjunction with the contract'*. She notes that HMT would wish to examine *'documents, events and policy holders' representations'* in order to come to their own view on what policyholders' reasonable expectations might be. Legal Adviser B records that she had discussed with Line Manager D certain aspects of Counsel's opinion, which may indicate further grounds for Equitable having to increase their reserves. The advice states:

> *It is conceivable that the Unfair Terms in Consumer Contracts Regulations 1994 might also apply. However, the term(s) in question (to the extent they may be viewed as terms of the contract, rather than of a trust) arguably do not themselves cause "a significant imbalance in the parties' rights and obligations ... to the detriment of the consumer". It is the exercise of the discretion which does or might have that effect. One would have to argue that it was the open-ended nature of the discretion which was unfair. I find it difficult to say whether this line of argument might be successful, but nevertheless am left with the feeling that the more profitable lines of examination are those discussed by Counsel and PRE.*

07/12/1998 HMT write to Equitable to record the outcome of the meeting held on 03/12/1998. HMT say that their letter takes account of the regulator's further consideration of the issues, in the light of the points made by the Society at that meeting, and subsequent advice from GAD. Their letter states that:

> *As we indicated at the meeting we consider that Part IX of the Insurance Companies Regulations 1994 (ICR 1994) requires a life office to calculate its liabilities (and hence to reserve) on the basis of all the benefits offered under the contract. Regulation 64 of the Regulations requires long-term liabilities to be determined "on actuarial principles", and to "make proper provision for all liabilities on prudent assumptions". Regulation 64(2) makes clear that the determination must "take account of all prospective liabilities as determined by the policy conditions".*

HMT set out their view that:

> *In the majority of cases, Equitable Life's pension contracts appear to have been written so that the principal benefit provided is an annuity, and there is an option to take benefits in cash form. In the case of such a contract, the effect of Part IX of the ICR 1994 is in our view to require full reserving for the liabilities to provide the annuity benefits to the value already guaranteed under the contract (i.e. to assume that 100% of policyholders take their benefits in annuity form), plus any additional liabilities arising from the cash option. While we accept that the precise wording of Regulation 64(1) which refers to "proper provision for all liabilities on prudent assumptions" may suggest some flexibility in appropriate cases, we are not persuaded that any credit can be properly taken for any reduction in reserving requirements that would result from assuming policyholders would exercise their option to take their benefits in the form of cash. The guaranteed annuity appears to be effectively the benchmark for minimum liabilities, whatever "option" is chosen by the policyholder.*

HMT explain that:

> *To the extent that regulation 64 of the ICR 1994 could be disapplied under section 68 of the Insurance Companies Act 1982, HMT would not be inclined to make such an order. This is because, as indicated above, we consider that "prudence" requires that, even if other options are available and actually selected by the policyholder, reserves should be established at or very close to 100% of the value of the guaranteed benefit.*

HMT argue that, for policies written to provide a cash benefit and which include an option to convert this benefit to an annuity at a guaranteed rate, Equitable should reserve for the terminal bonus up to the level required for the guaranteed annuity, since that level of terminal bonus could no longer be considered discretionary.

In relation to resilience reserves, the letter says:

> *HMT commented that there might be room for debate regarding the level of resilience reserves Equitable Life is required to maintain. The resilience tests specified by the Government Actuary are not legally binding in themselves. Companies could adopt an alternative test provided that they were satisfied of the actuarial prudence of the test used. This said the holding of substantial mathematical reserves to cover guaranteed annuity options did not appear to be a sound argument for reducing the stringency of the resilience test applied. It was explained at the meeting that the Government Actuary could be expected to wish to discuss with* [Equitable's Appointed Actuary] *the basis for, and prudence of, any relaxation of the resilience tests applied by the company, particularly if the basis adopted was not universally accepted by the market.*

In relation to reinsurance, the letter says:

> *Reinsurance was suggested as a possible means of overcoming the difficulties that Equitable Life would face in reserving on the assumption that 100% of policyholders took their benefits in the form of a guaranteed annuity. You pointed out that it would be difficult to put in place such an arrangement before the end of the month. We acknowledged this but indicated that we would be willing to consider the possibility of treating any such reinsurance arrangement as having been effective from the year end provided that at least the broad terms of the agreement were in place by that date and a firm intention to enter into the agreement could be shown.*

(Note: an earlier draft of this letter included a note in relation to the section on reinsurance that *'this paragraph still requires revision by GAD to take account of the technical difficulties of reinsurance identified since the meeting'*. It does not seem that anything about technical difficulties was added. However, the following drafting was removed from the final version of the letter: *'Reinsurance of the guaranteed annuities would enable the company to reserve purely for its liabilities under the cash option within the contracts'*.)

HMT repeat the points about policyholders' reasonable expectations set out in the note of the meeting and refer to the request for additional documentation from Equitable so that HMT could consider the issue further.

HMT conclude: *'We also indicated that we expected an appropriate statement on contingent liabilities to appear in your regulatory returns, related to the risk* [of] *successful challenge to the Equitable Life's bonus practice with regard to guaranteed annuities'*.

08/12/1998 GAD send HMT a note about reserving for annuity guarantees. GAD suggest that:

> *... it could be reasonable to assume that less than 100% of policyholders elected to take the guaranteed annuity provided that the reserve held in respect of those policyholders who are assumed to take an alternative annuity benefit is based on a realistic value of that alternative.*

GAD suggest a mathematical formula that might be applied to Equitable and say they would not object to Equitable being allowed to phase in this formula over a reasonably short period of time. However, GAD recommend that HMT:

> *... obtain some commitment from the Society to reduce declared reversionary bonus for the effected contracts until such time as full provision has been made. We should also require the Society to fully disclose in the HMT Returns the basis that it has adopted.*

GAD refute Equitable's claim that their reserving basis had been tacitly accepted by the prudential regulators. GAD state:

> *There was a suggestion at the last meeting with the Society that they had disclosed their current reserving basis in their Returns and we had not challenged that basis and hence they were entitled to assume that their existing reserving basis was adequate. We dismiss this argument as being without substance. Schedule 4 of the 1997 Returns discloses the existence of the guarantees as "Some older contracts contain minimum guaranteed rates for annuity purchase at retirement". This brief statement gives no indication of the significant exposure to guarantees that actually exists. The Actuary then goes on to say that "It was considered unnecessary in current conditions to make explicit provision for other guarantees and options described in paragraph 4." The other guarantees referred to in this statement include the annuity guarantees. There is no further explanation offered as to how the Actuary reached this conclusion. As the Actuary signed a certificate which confirmed that the liabilities had been determined in accordance with the regulations we had no reason to challenge that Actuary's basis. However we have subsequently been challenging his basis following receipt of the Society's response (dated 29th July 1998) to GAD's questionnaire on guaranteed annuities which disclosed the Society's significant exposure to such guarantees.*

(Note: the note of 03/12/1998 did not only specify the Society's 1997 returns.)

GAD raise the possibility that there might be grounds for seeking to censure Equitable's Appointed Actuary in that he had signed the 1997 returns which had, by doing so, confirmed that the liabilities had been determined in accordance with the regulations. GAD note that the approach adopted by Equitable was, broadly, one of the approaches set out in the November 1997 report of the Annuity Guarantees Working Party. The Working Party had gone on to comment that the approach *'could be viewed as being unsound because no explicit provision is made for an explicit guarantee'*. However, GAD also note that the Working Party had not recommended an approach to reserving *'because of the variation between products and the approaches of different companies to managing the guarantees'* and that they had commented that *'there is no industry consensus on reserving for guarantees'*.

GAD conclude by saying that it might be appropriate for the Government Actuary to discuss the matter with the Society's Appointed Actuary, if HMT felt that they wished to take issue with the Society's reserving stance.

09/12/1998

HMT send the Economic Secretary a further draft of a letter to companies on determining how the costs of annuity guarantees should be met. The briefing provided says:

> *A particular difficulty arises for mutual insurers (such as Equitable Life) that do not have any "orphan assets" or "estate" from which the residual costs of guaranteed annuity options can be met. In this situation, the ultimate residual cost of the guarantees must either be met by the policyholders who benefit from the guarantee or be spread across all with-profit policyholders who share in the overall profits and losses of the relevant business. Unfortunately Equitable Life has given these guarantees on a substantial portfolio of its policies (approximately 25% of its with profits business by liability value) and the level of the guarantee is comparatively high. Consequently, the residual cost of the guarantees is relatively large and will necessarily impact on the total amount of bonuses that can be paid to policyholders.*

10/12/1998

HMT's Head of Life Insurance sends Line Manager D a note of a telephone call with Equitable's Chief Executive. The Chief Executive had told him that Equitable still disagreed with HMT and GAD on what constituted a prudent reserve for annuity guarantees and that they had received *'favourable'* legal advice on the question of reserving and were also seeking Counsel's opinion on the issue.

The Head of Life Insurance records that '[The Society's Chief Executive] *made clear that if we could not reach agreement, the Equitable were prepared to challenge any use of our powers through Judicial Review'*. His note goes on to record that:

> *Meanwhile, they were pursuing the possibility of financial reinsurance. They had approached two reinsurers, both of whom thought that they might be able to help. The Equitable were also considering possible asset reallocation; but they did not see much scope for this before the year end; the markets were not favourable to any major reallocation.*

The Head of Life Insurance outlined the approach to reserving that GAD had set out in their note of 08/12/1998. The Chief Executive's reaction was that this approach did not provide much flexibility.

HMT and Equitable had agreed that there would be another meeting between HMT, GAD and Equitable within the next week or so. Equitable's own record of the call concurs with this account.

11/12/1998 HMT's Legal Adviser B advises the Head of Life Insurance in response to questions that he had raised at a meeting the previous day. The questions were whether:

> *(a) a breach of section 17(1) and (2) of the ICA 82 and the Insurance Companies (Accounts and Statements) Regulations 1996 (*[especially Regulation] *4) would give rise to a mens rea offence or one of strict liability (where intent need not be proved); and*
>
> *(b) if* [HMT] *were of the view that the accounts were in breach of the Regulations, the company allegedly in breach might be required to reissue the accounts in a manner which brought them into compliance.*

The advice provided is as follows:

> *The relevant offence provision appears, by a process of elimination, to be subsection 71(3)(a) of the ICA 82:*
>
> > *"any insurance company which makes default in complying with, or with a requirement imposed under, any provision of this Part of this Act, being a default for which no penalty is provided by the foregoing provisions of this section ... shall be guilty of an offence and liable, on summary conviction, in England and Wales and Scotland to a fine not exceeding level 5 on the standard scale ..."*
>
> *None of the defences in subsections (5) - (7) of section 71 apply.*
>
> *The words "makes default" do not seem to me to suggest intent as do words used in other provisions of section 71 such as "knows to be false" or "intentionally obstructs". I take the phrase to mean "fails to do what ought to be done". This imports the idea of a wrongful act, but need not mean a wilful or intentional act. Indeed the phrase "wilful default" is often used in offence provisions and might have been used here if that was what was meant. Clearly though, if we approach a decision as to whether to prosecute, this is a matter on which Counsel should be instructed.*

The advice continues:

> *As to whether a company might be required to "reissue" or amend accounts when it has breached* [Regulation] *64 of the Insurance Companies Regulations 1994, I can find no provision in the Act or any Regulations which contains such a power. There is a provision in section 22(5) ICA 82 allowing the Treasury to "communicate with the company with a view to the correction of any such inaccuracies and the supply of deficiencies", but this imposes no obligation on the company and in any event it is very doubtful that it would apply to a breach of* [Regulation] *64. Such breach would not be an "inaccuracy" or a deficiency in the sense of a failure to "complete" the account.*

I think a Court would expect that the [Insurance Division] *would prosecute a clear breach of the Accounts and Statements Regulations or, if we considered* [Regulation] *64 to be met, to amend it if we thought that appropriate in policy terms (or to act under section 45 if we considered* [Regulation] *64 insufficient in any particular case). In any event, a decision to intervene to direct that past published accounts should be corrected and republished would have to be supported by good grounds under section 45(1). We will need to discuss any such grounds nearer the time.*

GAD's Chief Actuary C annotates his copy of the advice:

The breach is s18(4).

This leads to a breach of [sound and prudent management] *Sch 2A – Para 8(a).*

S37(2)(aa) gives grounds to exercise powers.

S42(1) could be exercised or s45(1)(b).

(Note: all these references are to ICA 1982.)

15/12/1998 [entry 1] The Economic Secretary confirms that she is content with the further draft of a letter to companies on determining how the cost of annuity guarantees should be met, sent to her on 09/12/1998.

15/12/1998 [entry 2] GAD's Chief Actuary C writes to HMT's Legal Adviser B (copied to HMT's Director of Insurance, Head of Life Insurance, Line Manager D, Line Supervisor C and GAD's Scrutinising Actuary E) in response to her note of 11/12/1998. The Chief Actuary says that GAD are:

... surprised that you believe that there is no power in the Act or any Regulations which would enable HMT to require a company to "reissue" or amend accounts when it has breached reg 64 of the Insurance Companies Regulations 1994. In our opinion there are grounds to require reproduction of the abstract of the actuary's report and resubmission of the returns produced by the company.

The Chief Actuary continues:

There is a failure to undertake the actuarial investigation required by s18(1)(a) of the Act in accordance with s18(4), as the liabilities have not been determined in accordance with the applicable valuation regulations (i.e. Part IX of the Insurance Companies Regulations 1994). Furthermore, the form of the abstract of the actuary's report, required to be made under s18(1)(b), has not been produced in the form prescribed under s18(5) as it does not meet the requirements of [Regulation] *4(a) of the Accounts and Statements Regulations.*

Both of the above counts result in breaches of Paragraph 8(a) of the Criteria of Sound and Prudent Management (Schedule 2A to the Act). S37(2)(aa) of the Act seems to give the grounds to exercise the power under s42(1) of the Act in respect of the first breach. The [Secretary of State] *would thereby have the power to require a company to produce an abstract in accordance with s42(3) of the Act. The second breach would also seem to give the grounds to exercise the power under s45(1)(b) of the Act, which could be used to require a company to resubmit the returns in accordance with the Accounts and Statements Regulations (i.e. to include the correct abstract of the actuary's report) in order to ensure that the criteria of sound and prudent management are fulfilled.*

15/12/1998 [entry 3] HMT (Director of Insurance and Line Manager D) meet FSA (Chairman and Managing Director A) to brief them about Equitable prior to FSA assuming responsibility for prudential regulation. HMT supply a note in advance of the meeting. This appears to be an unsigned and undated note headed *'Financial position at end October 1998'*.

In the note, HMT set out the Society's financial position at the end of October 1998, as follows:

If reserve for 100% of GAOs		*If reserve for 25% of GAOs*	
	£m		*£m*
Assets	*24926*	*Assets*	*24926*
Reserves	*23780*	*Reserves*	*21548*
Assets to cover RMM	*1146*	*Assets to cover RMM*	*3378*
RMM	*926*	*RMM*	*926*
Free Assets	*220*	*Free Assets*	*2452*

> *i.e. the company is just solvent if it reserves fully for its guaranteed annuity options.*

HMT continue:

> *However, it should be noted that the free assets figure makes no allowance for the declaration of bonuses. The cost of annual bonuses, assuming they are maintained at their current level, is £500m, so the company would appear to have insufficient assets to declare a bonus in 1999.*
>
> *Also it should be noted that £850m of the assets available to cover the* [required minimum margin] *are implicit items (allowance for future profits). Only 5/6th of the* [required minimum margin] *can be covered by implicit items. The company is therefore close to breaching this requirement when GAOs are fully reserved for. A relatively small fall in equities or gilt yields could wipe out the company's explicit free assets.*

HMT explain the arguments surrounding the level of reserving required. HMT set out a '*Strategy for Regulatory action*'. This was to form the basis of a further meeting with Equitable before Christmas which would be used to:

- *Clarify that HMT* [are] *not minded to take action against the company for its failure to reserve fully for GAOs in its 1997 returns. (This would be consistent with* [the] *approach taken with other companies);*
- *Formally put the company on notice that the reserving approach that the company is proposing (assuming this remains to reserve for 25-35% of the GAOs) is not acceptable in HMT's view;*
- *Indicate that in the context of settling its year end position it is for Equitable to decide the reserving approach that it intends to adopt in its 1998 returns since it is for the company to comply with the Regulations. But make the company aware that if in FSA's view the returns submitted at the end of June are not compliant, FSA will take action;*
- *Seek an undertaking from the company that it will not declare any further bonuses without prior discussion with HMT. If necessary use the lever/threat of intervention action on the grounds of sound and prudent management to obtain agreement from the company.*

HMT state that intervention action would be likely to take the form of closing the company to new business. HMT say:

- *If we are unable to obtain agreement from the company not to declare further bonuses without prior discussion with HMT we will need to take intervention action immediately.*
- *If agreement is obtained intervention action would only become necessary when the company indicated its intention to declare a bonus which would have the effect of*

making the company breach its [required minimum margin] *if the GAOs were fully reserved for. (The company usually declares bonuses in February.)*

- *If agreement is obtained and no bonus is declared the need for intervention action/prosecution would probably not arise until July when the annual returns were submitted and it was clear from those returns that the GAOs had not been adequately reserved for.*

HMT warn that Equitable could be expected to seek judicial review of any intervention action on reserving for annuity guarantees.

HMT's note concludes, under the heading *'Other regulatory action to be taken'*:

> *In December/January we would analyse the policyholder documentation issued by the Equitable in order to reach a view on whether the company's approach of reducing terminal bonus to meet the cost of GAOs was consistent with PRE in the case of policies maturing before this year end.*
>
> *In January we would seek to issue a Dear Director letter to all life companies setting out our interpretation of the reserving requirements for GAOs (ie that full reserving was required) and that adequate disclosure was required in the returns of the reserving basis used for GAOs.*

According to Line Manager D's note of the meeting, FSA's Managing Director queries the amount of future profits that could be taken into account to cover the required minimum margin, and asks why no action had been taken on Equitable's 1997 returns when they showed no reserving for annuity guarantees. On the latter point, the note records: *'It was explained that the approach taken by the company had not been clear from the return*. [FSA's Managing Director A] *considered it defensible for HMT to have changed its view as the picture filled out and the significance of GAOs changed'*.

HMT's note records:

> [FSA's Chairman] *was concerned that if Equitable were forced to pass a bonus this would amount to commercial suicide. No advisor would subsequently recommend the company's products. It was agreed that it would be commercially very damaging for the company to pass its bonus. At this stage it was not clear whether this would be necessary (for instance there might be some margins in the reserving basis which could be released and the financial position might improve ahead of the date for setting future bonuses). From HMT's perspective it was vital that the company was not permitted to make itself insolvent (assuming 100% reserving for GAOs) by declaring further bonuses.*

The financial position of other companies was discussed and it is noted that:

> *Other companies had seen their financial position severely affected by GAOs but were expected to pull through.*

HMT's note records the following discussion:

> *Equitable had stated its willingness to take the reserving issue to judicial review. However, it was not certain that it would do so in practice.* [FSA's Chairman] *noted that the fiduciary duties of Equitable's directors might point in the direction of seeking a buyer for the business rather than challenging the HMT position and risking intervention action such as being closed to new business. It was clear that Equitable wished to avoid being taken over and it was agreed that a takeover would not be a good result for the company or HMT.*

FSA's Chairman asks if Equitable had any significant exposure to pension mis-selling. HMT explain that: *'It was thought the company's liabilities were small and that the reserves established ... were reasonably generous in comparison with those of other companies'*.

The Chairman also asks about the potential impact of a policyholder challenge to the differential terminal bonus policy. HMT state that Equitable's financial position would not be made worse, assuming they had reserved on a 100% basis. The only additional costs to the Society would arise from topping up payments to policyholders who have already retired.

At the end of the meeting, the note records: *'It was concluded that* [the] *situation was not a happy one but in the circumstances HMT appeared to be taking the only sensible approach'*.

17/12/1998 [entry 1] Equitable provide HMT with a schedule of the items that HMT and GAD had requested at the meeting on 03/12/1998, annotated to show what had been found and was now enclosed. The schedule shows that HMT had sought documents from the previous 40 years, relating to retirement annuity, individual pension plan and transfer plan policies.

17/12/1998 [entry 2] HMT send FSA a copy of the guidance letter on annuity guarantees and policyholders' reasonable expectations, approved by the Economic Secretary and due to be issued the next day. HMT comment that the letter sets out general principles, intended to ensure a consistent and fair approach overall. They note that commentators are likely to view it as relating primarily to Equitable and that '[some] *will see it as support for the Equitable's position; some will see it as a shot across their bows'*.

18/12/1998 [entry 1] Every insurance company is sent by HMT's Director of Insurance a guidance letter, *'Guaranteed Annuity Option Costs and Policyholders' Reasonable Expectations'*. This reflects the draft that had been approved by the Economic Secretary (09/12/1998).

HMT advise that policyholders entitled to some form of annuity guarantee or option on guaranteed annuity terms could reasonably be expected to pay some premium or charge towards the cost of the guarantee or option. HMT explain that:

> *Generally we consider that it would be appropriate for the level of the charge deemed to be payable by participating policyholders for their guarantee (or annuity option) to reflect the perceived value of that guarantee (or option) over the duration of the contract. This could be achieved in some cases through some reduction in the terminal bonus that would be payable if there were no such guarantee (or option) attached to the policy. However the selected treatment by each office would need to depend on the wording of the contract involved and how it had been presented to policyholders.*

HMT further advise that they would expect:

> *... that for most companies the present guaranteed cash benefits (including declared bonuses) would be converted, as a contractual minimum, to the annuity on guaranteed terms. However as indicated above, it would appear possible, depending on the particular circumstances relating to the contract, that any terminal bonus added at maturity may be somewhat lower than for contracts without such options or guarantees, and that this terminal bonus could in some cases be applied at current annuity rates.*

HMT add that *'the appropriateness of any adjustments to bonus allocations for participating policyholders would need to be assessed by each office in the context of the reasonable expectations of policyholders. This assessment will be influenced by their policy documents and any representation made through marketing literature, bonus statements or elsewhere'*.

18/12/1998 [entry 2] GAD write to HMT in response to their note of the meeting with FSA on 15/12/1998. GAD dispute that no action had been taken on the 1997 returns, pointing out that the current discussions on annuity guarantees followed directly from questions that GAD had raised on the reserving bases in the returns. GAD note:

> *It should be remembered by HMT that GAD invited* [Equitable's Appointed Actuary] *to a meeting on 28th May this year (following consideration of their 1996 returns), at which we discussed the reserving bases appropriate to accumulating with-profits business, attempted to clarify certain PRE aspects of the bonus notices being issued by Equitable and urged great restraint in the granting of guaranteed bonuses.*

GAD say that they disagreed with the statement by the FSA Chairman that it would be commercial suicide if Equitable were to award no guaranteed bonuses that year. GAD say:

> *As a non-commission paying office, Equitable does not rely on* [independent financial advisers] *to recommend its products. GAD does not believe that it would necessarily amount to commercial suicide if no additional guaranteed bonuses were granted this year in relation to contracts containing GAOs, provided the reasons were properly explained to policyholders – indeed we consider that such a step is probably necessary for the prudent management of the Society. It should be recognised that this would not prevent the company from indicating further growth in the value of the cash option alternative available under these contracts. [From figures so far provided to us, it is hoped that the financial position of Equitable will not be so tight at the end of 1998 as to inhibit the granting of some additional guaranteed bonuses on other contracts – i.e. naturally including those currently being marketed. Admittedly, this is not yet certain.]*

18/12/1998 [entry 3] Equitable send HMT a copy of Leading Counsel's opinion in support of Equitable's stance on reserving for annuity guarantees. Equitable express the hope that the forthcoming meeting (arranged for 22/12/1998) would lead to a mutually satisfactory outcome. Equitable tell HMT that:

> *On the advice of Leading Counsel the Society has decided to take one or more test cases to the High Court in order to confirm that the Society's Directors have acted entirely properly and within their powers in adopting the system of final bonus additions which applies to policies containing GAOs. Although not directly pertinent to our current discussions, I hope that you will regard this action as a demonstration of the Society's confidence in its position and its determination to maintain it for the future.*

Equitable's Counsel explains that, over the last five years, *'only a tiny proportion of policyholders have elected to take an annuity based on GARs'*. Counsel says that this low take-up will have been *'substantially influenced'* by Equitable's differential terminal bonus policy. Counsel says:

> *This approach has been notified to the Treasury (and previously to the DTI) in the returns made by the Society pursuant to its obligations under Schedule 4 of the Accounts and Statements Regulations for all years from 1993 through to 1997 consistently. To quote from the 1993 to 1995 versions of the return: "It was considered unnecessary in current conditions to make explicit provision for the other guarantees described in paragraph 3", and paragraph 3 stated in relation to Relevant Policies that "the premium provide a cash fund at the pension date, to which (for policies issued prior to 1 July 1988) a guaranteed annuity rate is applicable." The 1996 and 1997 returns adopted the same wording as regards the absence of provision (save that in that case the cross-reference was to paragraph 4), and the cross-reference was to the following statement: "older contracts contain minimum guaranteed rates for annuity purchase at retirement."*

Further, we understand that the Treasury has been well aware of the existence of such policies throughout the relevant period, and that the GARs referred to were higher than CARs, in the light of experience from 1994 onwards. We note that the Society's returns made under Schedule 4 of the Accounts and Statements Regulations for the years 1993 to 1997 quoted verbatim the text of the resolutions of the Society's Board which declared differential final bonuses which adjust such final bonuses for the fact that GARs exceeded CARs: see paragraph 16(vi) of the 1993 to 1995 versions of the return, and paragraph 16(viii) of the 1996 and 1997 returns.

Counsel for the Society continues:

The ICR came into force on 1 July 1994. Thus the obligations imposed on the Society by the ICR have been applicable at all material times – that is at all times when GARs have exceeded CARs. This notwithstanding we are instructed that the Treasury did not seek to take the point now being taken against the Society in respect of the valuation dates falling in 1994, 1995, 1996 or 1997. And yet circumstances giving rise to the alleged necessity to make a reserve will have existed in each of those years (and at the 31 December 1995, 1996 and 1997 valuation dates in particular), if indeed it is necessary on a proper understanding of the ICR to make a reserve at all.

In each of those years, the Society has in good faith declared annual bonuses and allotted and paid final bonuses on the assumption that there was no need to make any such reserve. It is obvious that had the Treasury raised with the Society in any of the years 1994 to 1997 the point of interpretation of the ICR which it now seeks to take, the Society would not have been able to declare and allot bonuses to Relevant Policies at any such level, if at any level at all. Further, the Society's investment strategy over the relevant period would have been different had the Treasury required that the Society make such a reserve. None of this can be undone today. The Society's reliance on the Treasury's previous interpretation of the ICR infects 1998 also, in that the bonus declarations for the year ending 31 December 1997 were made in February 1998, some ten months prior to the 31 December 1998 valuation date in respect of which the present issue arises; and the Society's investment strategy for 1998 is also history.

Equitable's Counsel argues that:

Had the Treasury sought to take a consistent line on this issue from 1994 onwards, it would have been possible for the Society to absorb any need to make reserves progressively, as the downward trend of annuity rates over the 1994 to 1998 period would have dictated a steady increase in reserves. The consequence of the Treasury seeking to impose its interpretation of the ICR on the Society at the end of 1998 for the first time is to require the Society to make a one-off reserve of approximately £1.5 billion, which is massive by any standards, and which threatens the statutory solvency of the institution.

The opinion states that *'it is impossible for the Treasury validly to conclude in the face of these matters that a 100% reserve is necessary in respect of the value of GARs under Relevant Policies'.*

21/12/1998 Equitable send HMT more of the documents they had requested.

22/12/1998 [entry 1]	HMT and GAD meet Equitable. HMT prepare a note of the meeting.

Equitable undertake to articulate the problems they would face if they published a low solvency cover, and to apply for a section 68 Order for a larger future profits implicit item. HMT and GAD promise to send a response to Equitable's Counsel's opinion as quickly as possible and to consider any case Equitable put forward for the phasing in of reserves. HMT stress:

> *... that it was for the Equitable to reserve how it saw fit. However, HMT would take regulatory action if the Annual Returns disclosed that the reserves were inappropriate or if the company's actions imperilled solvency margin cover. The bonus declaration was of particular importance here and if HMT felt that bonus levels declared were imprudent it would take action.*

Equitable's Appointed Actuary states that he *'did not agree that the reserve should be 100% and that the regulatory regime did not require reserving for terminal bonus, this was something that HMT was suddenly applying'*. HMT repeat their position that *'terminal bonus was effectively guaranteed up to the value of the guaranteed annuity'.*

GAD reject the contention in Counsel's opinion that they had tacitly accepted Equitable's reserving practice, saying that *'the information disclosed in the return was limited and gave them no reason to question the validity of the reserving basis'*.

The note records that '[the Appointed Actuary] *believed that HMT's approach would disadvantage policyholders'* and that '[if] *the Equitable had to reserve for the full amount of the guarantees this would seriously constrain investment strategy and low solvency would threaten the company's future'*. Equitable's Chief Executive agrees to write further *'on the consequences of taking this reserving hit as* [HMT] *had some difficulty in accepting all of his arguments'*.

The note goes on to record that there was *'no agreement between HMT and the company on the fundamentals of the argument'*, with Equitable arguing that the approach taken by HMT was not in the interest of policyholders – and with HMT's Head of Life Insurance saying that HMT *'did not want policyholders or potential* [policyholders] *to be misled or disadvantaged by the company mis-reporting its financial position in the annual returns'*. The Head of Life Insurance stresses that *'whilst he expected the company to accept the principle of reserving outlined by HMT we were sympathetic to aiding the company in softening the blow in getting to this position, as we understood there was the potential for policyholders to be adversely affected by a sudden hit of this magnitude'*.

HMT's note of the discussion records that:

> [Equitable's Appointed Actuary] *said that there were margins in the reserving that could be released giving the company approximately c£200m further free assets. The company could apply for a larger implicit item (up to £1.9bn) HMT stated that if a Section 68 Order request was received from the company we were likely to treat this application sympathetically. The company agreed to apply for this larger implicit item before the year end and it could then decide at a later date whether to use some or all of the amount allowed under the concession.* [Equitable's Chief Executive] *felt that it would take a period of 4-5 years to manage the problem down, if the HMT reserve were required.*

Manuscript notes made by HMT's Head of Life Insurance and GAD's Chief Actuary C at the meeting reflect the above concerns and points.

22/12/1998 [entry 2]	Equitable apply to HMT for a section 68 Order for a future profits implicit item of £1.9bn, for possible use in their 1998 returns.

23/12/1998	GAD advise HMT on Equitable's section 68 Order application. GAD say: *I am happy to confirm that we are comfortable that the figures used in relation to the original submission of 26 June remain appropriate and would support the amount now requested.* *[This conclusion is supported by the presumption that had higher reserves been established at the end of 1997, as we now think appropriate, these would have been supported by increased transfers from investment reserve (as carried in line 51 of Form 14) and would not have affected the level of emerging surplus shown in form 58 in that year.]*
30/12/1998	HMT send Equitable the section 68 Order for a future profits implicit item of £1.9bn, for use in their 1998 returns.
31/12/1998 [entry 1]	Equitable press HMT for their views on their Counsel's opinion, following the meeting on 22/12/1998. Equitable explain that Equitable have received an offer in respect of a financial reinsurance arrangement. They enclose a copy of a fax from Irish European Reinsurance Company (IRECO), which confirms that a meeting is to take place on 7 January 1999 where they hope that the remaining issues could be resolved to enable a contract to be drawn up. Equitable also enclose a copy of an internal note, which sets out that: *The reassurance would cover the retirement annuity portfolio with the following costs:–* *a) an annual non-refundable premium of £50,000; and* *b) in the event of a claim, 2% of the claim amount.* *A claim would occur under the reassurance treaty if in any year the guaranteed funds to which guaranteed annuity rates applied (i.e. for those policies for which the option was effected) exceed 25% of the total guaranteed funds for all retirements in that year.* *It is proposed that any claim would be repaid by the Society to the reassurer over a period of about 3 years. That repayment would be taken out of investment returns in excess of those required for the statutory valuation.* (Note: this note was altered before it was sent to HMT. On the original, the final sentence above continued '*... which means that no reserves would need to be set up for this liability*'. The sentence '*As you are aware, we have also been talking to* [another reinsurance company] *but we have had no offer as yet*' was also removed from the copy sent to the regulators.)
31/12/1998 [entry 2]	HMT's Legal Adviser B sends the Head of Life Insurance a first draft of a letter to Equitable about the opinion. She states that the opinion does not cause HMT to change their views, as set out in their letter of 07/12/1998. The Legal Adviser adds: *... we are firmly of the view that returns made by the Society since 1993 could not be viewed as constituting notice to DTI or HMT of the Society's reserving practice. As we noted in the meeting, the statements in the accounts are brief in the extreme and do not disclose the reserving method or the rate of guarantee. Nor does the text of resolutions of the Society's Board reveal that GARs actually exceeded CARs. The problem (which in any event was not significant before 1995) was not revealed until HMT began to consider the responses to the relevant questionnaire in 1998. We raised the matter with the Society and others very soon after that. DTI/HMT was not aware from 1994 that the GARs referred to were higher than CARs.* *The HMT position on reserving is not in any event a change of policy, but a view that in the changing economic circumstances guaranteed annuities must, as a matter of prudence, be fully reserved.*

31/12/1998 [entry 3] HMT's Legal Adviser B writes to GAD, in reply to their note of 15/12/1998. The Legal Adviser clarifies that, in her view, only section 45 of ICA 1982 could be used to require a company to reissue or amend accounts. The Legal Adviser doubts, however, that this would be the appropriate or most proportionate remedy to ensure sound and prudent management or to protect policyholders.

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01/01/1999 HMT contract out most of their functions and powers in respect of the prudential regulation of insurance companies to FSA. (Among the powers retained by HMT is the authority to approve section 68 Orders.) Supervisory staff and legal advisers transfer to FSA.

04/01/1999 GAD advise FSA that they have been reviewing the issue of the level of mathematical reserves established by Equitable in respect of annuity guarantees. GAD explain that there are three actions now needed:

- to tell Equitable in writing that GAD are not happy with the fact that they have zero reserves for annuity guarantees in their 1997 returns;
- to seek a number of items of specific information from Equitable about mathematical reserves and asset shares, together with a *'copy of the most recent Financial Condition Report produced by the Actuary in accordance with professional guidance note GN2'*. GAD explain that this information would *'help us to form a better understanding of* [Equitable's] *current financial condition, and resilience to changing investment conditions'*; and
- to provide comments on Counsel's opinion obtained by Equitable (see 18/12/1998 [**entry 3**]).

On the last point, GAD comment that Counsel had overlooked that the prudent assumption of the proportions of policyholders who might exercise each option (a guaranteed annuity or cash/current annuity):

> *... ought to depend on the relative value of these benefits. If the value of the guaranteed annuity is some 20-30% higher than the value of the alternative guaranteed cash, then we believe that almost all policyholders would reasonably be expected to opt for the annuity benefit.*

GAD state that Equitable have offered policyholders an additional discretionary cash sum if they chose the cash benefit over the guaranteed annuity. GAD say that this recent experience is not relevant as Equitable:

> *... cannot sensibly take account in the valuation of the increased proportion therefore taking the cash benefit, since they do not propose to maintain any provision on the balance sheet for this additional cash bonus.*

On the subject of the earlier 1993-1996 returns, GAD:

> *... accept with hindsight that we might have addressed the issue rather earlier by asking some pointed questions about their guaranteed annuities. However, the presentation of their valuation methodology in their returns was somewhat obscure, and required the reader to pick up comments in three quite separate parts of the return and draw certain inferences from them. There was nothing said to indicate that the level or extent of these guaranteed annuities were regarded as significant.*
>
> *For example, the wording in paragraph 5 refers to no explicit provision being made in current conditions for the "other" guarantees in paragraph 3, without clarifying exactly which guarantees have or have not been included, or saying whether allowance had been made implicitly for guarantees within the methodology adopted or within the other valuation assumptions.*

GAD add that *'the materiality of this issue at end-1996 and earlier would have been much lower'*, as market interest rates were then more than 3% higher compared with present levels.

GAD also stress *'that we have not accepted the reserving basis apparently adopted in the 1997 returns, and indeed have not had any direct communication with the company about these returns'*.

GAD dispute that the additional reserve required for annuity guarantees at the end of 1996 would have prevented the declaration of bonuses. GAD state that at no time did Equitable seek to discuss the reserving basis with GAD and HMT.

GAD have *'some sympathy'* with Counsel's argument that, had the regulator taken a consistent line on the issue of reserving from 1994, it would have been possible for Equitable to absorb the need to make reserves gradually. However, GAD note that *'most of the increase in the £1.5bn provision has arisen in 1997 and 1998 …'*. GAD observe that they could consider the question of *'phasing-in'* higher provisions once they had the additional information sought from Equitable.

Legal Adviser B (who transfers to FSA to the position of Chief Counsel, Insurance and Friendly Societies (Chief Counsel A)) sends the Head of Life Insurance a further draft of a letter to Equitable about their Counsel's opinion.

05/01/1999 GAD send FSA an amended version of the proposed letter to Equitable, which includes changes suggested by the Government Actuary.

07/01/1999 FSA's Director of Insurance submits proposed letters of guidance to Appointed Actuaries and Managing Directors and the proposed letter to Equitable about Counsel's opinion to FSA's Chairman for him to note. The Director of Insurance says that the letters make clear that HMT's and FSA's policy in relation to the level of reserve required for annuity guarantees had not changed. The Director of Insurance explains:

> *… we would expect the reserve established to be essentially the same whether the contracts involved are written as an annuity with the option to take a cash fund or the other way round. In addition, the focus is on actuarial prudence which requires a reserve at or within a few percentage points of 100% of the value of the GAO rather than the strict letter of the reserving requirements in the Insurance Companies Regulations 1994. Focus on the latter might encourage the argument that the legal requirements should be waived in this instance on the basis that they are excessively burdensome; and this is an argument we have already considered and rejected.*

The Director discusses three *'options'* for dealing with companies which had submitted their 1997 returns on the wrong basis. He says:

> *We are clear that action to prosecute the companies for supplying improper returns would be a disproportionate response and in any event very unlikely to succeed. We have considered the options available in terms of other intervention action, none of which is attractive, and concluded that the least bad approach is to ask those companies whose 1997 returns were not prepared in accordance with the guidance, and would have shown a materially different financial position if they had been so prepared, to accelerate submission of their 1998 returns. The advantages and disadvantages of the 3 main options are set out below.*

The three *'options'* put forward are:

'Option 1 – Take no action in relation [to] *past returns'*
FSA's Director of Insurance explains:

> *This would involve allowing the currently submitted 1997 returns to remain on the public record although we could still make clear to companies that this did not mean that FSA was accepting as valid the basis on which they had been prepared. This would appear a*

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weak regulatory stance and would leave us in a very difficult position in respect of arguments that prospective policyholders might be misled by inaccurate 1997 returns.

This said, arguments could be made that any risk of prospective policyholders being potentially misled is short-term (6 months for the vast majority of companies) and is small in size. We consider the risk small as in the vast majority of cases it appears that any inadequacy in the reserving for GAOs would not have had a material impact on the company's apparent financial strength. In those cases where the impact would have been significant there are other arguments why it is unlikely that prospective policyholders would be misled as to the financial strength of the company:

a) there has been a capital injection or reinsurance arrangements have been put in place since the end of 1997 which means the company is currently in no worse a financial position than its 1997 returns suggested;

b) the company is closed to new business so there are no prospective policyholders; or

c) the company would in any case have been classed as one of the weaker offices so that financial strength would not have been a significant factor influencing the policyholders' choice of office.

In addition it could be argued that there is only a small likelihood of payouts to those who become policyholders between now and June being significantly reduced as a result of companies having to meet additional liabilities for GAOs which were not apparent in their 1997 returns. This is because companies determine their payouts to policyholders on an asset share basis. This involves ensuring the return largely reflects the investment performance of the policyholder's premiums. Any additional cost incurred in respect of GAOs is likely to be met out of a company's free reserves or by an adjustment to the payouts for those existing policyholders with GAOs – thus not affecting the bonuses of new policyholders.

However, it is clear that all the above are complex technical arguments which could not be expected to run well in the media or to be readily accepted by consumer groups.

'Option 2 – Require correction of "misleading" 1997 returns'
FSA's Director of Insurance explains:

This would demonstrate the FSA's willingness to take action where insurance companies fell short of meeting their obligations. However, there are significant doubts about whether the legislation empowers us to require companies to correct their returns where we consider them to have been prepared on an inappropriate basis. Each case would have to be considered on its merits and in many cases we doubt we would have sufficient grounds to intervene. Therefore, it is unlikely that such action would produce a clearer position for the public – certainly in the period before publication of the next returns.

Even if such action could be enforced, we would need to allow companies time to do the necessary work. In practice, companies would be unlikely to be in a position to correct their 1997 returns much before they were superseded by their 1998 returns (at best the end of February assuming the request were issued immediately and instantly accepted by the company). Bearing in mind that the overall financial position in the resubmitted returns might look little different in the majority of cases (see below) and would already be more than a year out of date we believe that the costs of such an approach would be disproportionate to the benefits.

*'Option 3 – Require accelerated 1998 returns from companies who submitted "misleading" 1997 returns'*
FSA's Director of Insurance argues that:

Again this would demonstrate a proactive approach by the FSA and would tackle directly the main concern – i.e. that prospective policyholders might be misled by inaccurate data which had been published by companies in the past.

Under the legislation we could require companies to accelerate preparation of their annual returns by 3 months (so they would be available by the end of March). The difficulty of determining which companies should be asked to provide accelerated returns could be overcome by requiring companies to provide us with information about whether their 1997 returns complied with the line in the guidance and would have appeared materially different had they done so; and, in cases where this applies, whether they have taken steps to strengthen their financial position.

However, other difficulties would remain. The approach brings with it a significantly increased risk of challenge. In particular, on the basis of our discussion with them to date, Equitable Life arguably now have a legitimate expectation that they have until the end of June to settle how they present their 1998 position (subject to their not in the interim declaring a bonus which would threaten their solvency). Therefore requiring Equitable Life to submit an accelerated return would mean a real risk of a successful judicial review. However, leaving them out of any such approach would not be defensible from a consistency perspective. Spreading the focus of regulatory action to a wider group of companies would be helpful to Equitable Life but increases the number of companies with a particular incentive to challenge the guidance and enhances the possibility of a collective industry challenge (something that would clearly have more force than challenge by a single company).

FSA's Chairman ticks the first two paragraphs. Against the last paragraph, he writes: *'I'm not clear why the timing point increases the risk of a _successful_* [judicial review]*, though I can see why it increases the risk of a* [judicial review] *of some kind'*.

FSA's Director of Insurance recommends to the Chairman that he notes that FSA are proposing to follow 'Option 3' – that they *'propose to ask companies to submit their 1998 returns early where their 1997 returns were not prepared in compliance with the line set out in the guidance and where they presented a materially misleading impression as a result'*.

08/01/1999 The FSA's Chairman responds to the Director of Insurance's recommendations of 07/01/1999 that the Chairman notes:

a) the general industry guidance and the specific letter to Equitable Life that we propose to issue;

b) the draft press notice, which I have discussed in general terms with [a HMT official]*;*

c) that we propose to ask companies to submit their 1998 returns early where their 1997 returns were not prepared in compliance with the line set out in the guidance and where they presented a materially misleading impression as a result.

FSA's Chairman writes:

I am content with the letters – subject to one point (marked). On the press handling, it seems to me inevitable that this will get into the public domain, given the interest in certain letters, so I would favour a press release which allows us to get in first, rather than *allowing a company, or lawyer in support, saying "snoutrage". A* [press release] *would also allow us to explain, in a note, the HMT-FSA shift, which will confuse people. If* [an HMT official] *has some powerful countervailing arguments, I will hear them, but my inclination is to go ahead as* [the Director of Insurance] *suggests.*

11/01/1999 FSA write to Equitable in response to their letters of 18 and 31/12/1998 and following their meeting of 22/12/1998. FSA explain that Equitable's Counsel's opinion does not cause FSA to change the views set out in HMT's letter of 07/12/1998. FSA say that, in their view, the company's discretion not to pay additional bonuses is '*substantially fettered*' and that *'prudence would require that the actuary hold a reserve which is within a few percentage points of the reserve required for the guaranteed benefit'*.

FSA reject the view that Equitable's returns since 1993 could be viewed as constituting notice to DTI or HMT of their reserving practice. FSA state:

> *As we noted in the meeting* [see 22/12/1998] *the statements in the returns are brief in the extreme and do not disclose the reserving method, the rate of guarantee or the volume of business affected. (In fact, as an aside, we have some concerns about Equitable's compliance with paragraphs 4(1)* [which requires full description of benefits for accumulating with-profits policies] *and 6(1)* [which sets out the principles and methods to be adopted in the valuation] *of Schedule 4 to the Insurance Companies (Accounts and Statements) Regulations 1996 which we hope will be put to rest in the 1998 return.)*

FSA go on to state:

> *The HMT (now FSA) position on reserving is not in any event a change of policy. Our view remains that guaranteed annuities must, as a matter of prudence, be fully reserved. It is a consequence of the changing economic circumstances that the quantum of reserves required has increased significantly over the last year or two. The Equitable has so far presented us with no reasonable argument as to why ... reserves should be established at a level significantly less than 100% of the value of the guaranteed annuities ...*
>
> *... To the extent that the Society wishes to argue that a requirement of close to 100% would have a severe impact on the Society which would unduly prejudice policyholders, and that such requirement should not in the short term be enforced (and intervention action should not be taken), clear and convincing arguments need to be put to the FSA ...*
>
> *Any such arrangement which fell short of the normal reserving requirement would need to be disclosed in the Society's statutory return, so that potential policyholders and their advisors were not materially misled as to the overall financial position of the Society.*

12/01/1999 FSA send Equitable copies of *'the near-final drafts'* of the proposed letters of guidance to Appointed Actuaries and Managing Directors. FSA explain that the letters were likely to generate particular press interest in Equitable's position and so were being sent to them in advance, in strict confidence, to give them time to prepare for any questions.

13/01/1999 [entry 1] Every insurance company is sent by FSA's Director of Insurance a letter about reserving for annuity guarantees. The Director of Insurance says:

> *... in view of your ultimate responsibility for ensuring that your company establishes proper reserves, I thought I should alert you to* [the Government Actuary's guidance (see 13/01/1999 below)] *and the FSA's views on the action which companies should take.*

FSA's Director of Insurance writes:

> *I am concerned that the 1997 returns produced by some companies may not be fully consistent with the line set out in the guidance and as a result may in some instances*

present a materially misleading impression of companies' financial positions as at the end of 1997. In such cases I think it important that accurate data should be made available as early as possible.

Accordingly I should be grateful if you would discuss with your appointed actuary:

a) whether your company's 1997 returns were prepared in a way that is consistent with the guidance in the Government Actuary's letter;

b) if they were not so prepared, whether this had a material effect on the overall financial position presented in the companys returns, taking account, for example, of the relative importance to the company's business of guaranteed annuities and of the amount of any available margins that may exist elsewhere in the valuation basis.

Where there was a material effect on the overall financial position shown in the 1997 returns, and where the company has not subsequently taken commensurate action to strengthen its financial position, it is the FSA's view that it would be appropriate for such companies to submit their 1998 returns early – and in any case not later than 31 March – so that the FSA and potential policyholders and their advisers can form a proper view of these companies' financial position.

13/01/1999 [entry 2] Every insurance company is sent by the Government Actuary a copy of DAA11, on reserving for annuity guarantees. The Government Actuary writes:

... Part IX of the Insurance Companies Regulations 1994 (ICR 1994) requires a life office to calculate its liabilities (and hence to reserve) on the basis of all the benefits offered under the contract. Regulation 64 of the Regulations requires long-term liabilities to be determined "on actuarial principles", and to "make proper provision for all liabilities on prudent assumptions". Regulation 64(2) makes clear that the determination must "take account of all prospective liabilities as determined by the policy conditions".

The Government Actuary explains that, where there is a guaranteed level of annuity, a company should reserve fully for their liabilities to provide annuity benefits to the value guaranteed. In assessing their liabilities, companies must make a *'prudent assessment'* of the extent to which options are likely to be exercised. He advises:

In general it would not ... be prudent to assume that policyholders will choose a benefit form that is of significantly lower nominal value to them, although some limited allowance (of a few percentage points of the reserve) could in some cases be made for a reduction in the liability on the grounds of the additional flexibility or other perceived advantages to policyholders of any alternative benefits.

The Government Actuary acknowledges that, where companies adjust terminal bonuses to bring the value of the annuity guarantee closer to the value of the alternative benefits, there might be an argument that it was not necessary to reserve on the assumption that almost all policyholders would take the guaranteed annuity benefit. However, the Government Actuary points out that, although the benefits formally '*guaranteed*' under the alternative form of benefit might be lower than those under the annuity guarantee, the company's discretion in setting the value of terminal bonus applied to the alternative benefit *'is limited as a result of the existence of the guaranteed annuity'*. The Government Actuary considers that close to 100% of policyholders would exercise the annuity guarantee, unless the company set terminal bonuses at a level which ensured that the alternative benefit was at least as valuable as the guaranteed annuity. Accordingly:

... this constraint will need to be reflected in the valuation assumptions made about either the proportion of policyholders opting for the alternative benefit or the value of that alternative benefit. Consequently any reduction in the reserves held by the insurer by more than a few percentage points below the full value of the guaranteed annuity for this reason would require very careful justification by the actuary.

The Government Actuary adds that, although in the past many policyholders had exercised their right to take up to 25% of the benefits of their pension policy in the form of a tax-free lump sum, he *'would not consider it prudent to use past experience alone in this regard for reducing the proportion of benefits assumed to be taken in the guaranteed annuity form'*.

The Government Actuary also states that companies needed to assess the extent to which a resilience reserve was required, and that he expected them to apply the tests and advice set out in the letter of 30/09/1993, as amended by the letter of 24/11/1998. The need to hold substantial mathematical reserves to cover annuity guarantees would not, in his view, be a sound argument for reducing the stringency of the resilience test applied. He states that the level of reserves established for annuity guarantees was likely to be a matter that FSA and GAD would review particularly closely in the 1998 returns. He points out:

It should be remembered that Schedule 4 of the Insurance Companies (Accounts and Statements) Regulations 1996 requires the actuary's report in the annual returns to include detailed information about the contracts written ...

The annual returns should include sufficient information for the FSA and GAD to make an assessment of the extent of the guarantees offered, the reserving basis adopted by the company and hence the scope for guaranteed annuity options to impact on the financial position of the company.

13/01/1999 [entry 3] HMT brief the Economic Secretary on the possible responses to the guidance on reserving. HMT explain that the costs of meeting guarantees (estimated to be £8bn) coupled with the costs of the pensions mis-selling review (estimated to be between £8bn and £11bn) would be borne largely by with-profits policyholders. HMT point out that many, if not most, with-profits policyholders would not have been mis-sold pensions or bought guaranteed annuities, and they might reasonably ask why the return on their savings should be reduced as a result of errors of judgement elsewhere in the business.

HMT refer to the lower investment returns in the 1990s. They also explain that an undistributed amount of profits is held as a float or reserve, so that when profitability is poor, payments to policyholders could be smoothed. However, in the 1980s *'payments of terminal bonuses ... to existing policyholders may have been too generous. The companies were competing by highlighting the size of such bonuses'*.

HMT conclude that there was considerable scope for ill will and criticism of companies and their regulation. They say that, in the first instance, FSA should be answerable for their actions. HMT would be answerable to Parliament if it were alleged that the regulatory framework was inadequate, or that the performance of the regulator had been poor or over-zealous.

14/01/1999 FSA issue a press release to accompany the guidance letter. They produce in-house briefing notes in anticipation of follow-up questions. In response to the possible query: *'Have companies in the past failed to set up reserves in line with the guidance now issued?'*, FSA state: *'This is what the current exercise is designed to establish'*.

In response to the possible query: *'Guidance endorses Equitable Life's approach?'*, FSA state:

Guidance does not endorse or criticise any particular company's approach. Do not wish to comment on individual cases. Accept that guidance allows for the possibility of a *company to* [reduce] *terminal bonus in respect of contracts carrying a guaranteed annuity provided this is in line with the reasonable expectations of policyholders.*

In response to the possible query: *'How can it be legitimate for insurers to reduce terminal bonuses?'*, FSA state:

> *Terminal bonus is not normally guaranteed and companies generally make clear to policyholders that the value of any terminal bonus is not guaranteed. Terminal bonus is typically used by insurers to adjust the total benefits received by policyholders to ensure that they reflect a fair return on their investment. Against this background adjusting the level of terminal bonus to take account of the value of the benefit provided by a guaranteed annuity option would not appear to be out of line with normal practice.*

15/01/1999	Equitable seek a declaration by the Court that Article 65 of their Articles of Association (see 01/10/1998) gives them discretion to apply a differential terminal bonus policy when guaranteed annuity rates are higher than current annuity rates.
18/01/1999 [entry 1]	FSA ask Equitable for information about their reserves and asset shares at the end of 1998 '[in] *preparation for the discussions we have agreed to hold about your plans for bonuses this year'*. The information they request reflects GAD's advice of 04/01/1999.
18/01/1999 [entry 2]	A PIA Manager writes to a PIA Director about the press release FSA issued following the letters of 13/01/1999. The Manager comments that this publicises the guidance issued by HMT on 18/12/1998. He expresses concern that FSA *'has issued guidance which represents the position of one part of FSA, when other bits of FSA have not had an opportunity to consider the matter properly. This is particularly relevant as on this occasion when our position may differ from that of the Insurance Directorate'*. The Manager explains that his instinct from a *'selling and marketing'* point of view is to establish how the guarantees were promoted and, if appropriate, *'require firms to honour their promises'*. He notes that HMT's and FSA's approach is to agree that bonus rates can be reduced to policyholders with guaranteed annuities. The PIA Manager states: *It's a clear conflict between conduct of business regulation and prudential supervision ...* *Presumably there is some mechanism within FSA to co-ordinate regulatory activity.*
20/01/1999	FSA's Head of Life Insurance informs Line Manager D and GAD that Equitable hoped to provide the information requested on 18/01/1999 in a couple of days. The Head of Life Insurance reports Equitable's Chief Executive as having said that he expected the Court case to take place in late September, but that an appeal would push it into 2000.
21/01/1999 [entry 1]	Equitable write to FSA in response to their letter of 18/01/1999. Equitable explain that the Board had had some preliminary discussions about the bonus for 1998. Their initial view was that it would be appropriate to make a substantial reduction in declared bonuses to reflect current and prospective financial conditions. Equitable state that they do not have a single document constituting a Financial Condition Report (see 04/01/1999). Equitable explain that: *Currently the main elements of* [Financial Condition Report] *during the course of a year are covered in the following regular reports, supplemented by occasional individual reports on specific topics:* *(i) annual financial projections*

(ii) monthly financial reporting including estimates of the statutory solvency position

(iii) a more detailed quarterly review of revenue experience and solvency

(iv) a monthly analysis of the sensitivity to short-term changes in investment conditions produced to assist the Investment Committee in formulating strategy.

Examples of items (i) – (iv) from the 1998 board papers are enclosed for information.

Equitable enclose copies of reports on *'Projections for 1998-2000'*, *'Revenue – Review of First Six Months'*, *'Solvency Matrix'* and *'Monthly Business Statistics – Period Ending 30/11/98'*. This last report on monthly business statistics included a chart which showed that Equitable's cover for the required minimum margin, excluding any provision for annuity guarantees, had dropped from around 3.5 in July 1998 to below 1.5 in September 1998.

(Note: Equitable did not send FSA a copy of their most recent quarterly review of revenue experience and solvency, *'Revenue – Review of First Nine Months'*, dated 22 October 1998, which showed Equitable's cover for the required minimum margin under the current proposed valuation basis, and excluding any provision for annuity guarantees, to be 1.4 as at 30 September 1998.)

Equitable inform FSA that:

... we have entered into a financial reassurance arrangement with effect from 31 December 1998, as you helpfully suggested in your letter of 7 December 1998 ...

Equitable explain that the details are as outlined in their note of 31/12/1998. Equitable attach draft terms and say they will check direct with GAD that they have the *'intended reserving effect'*.

21/01/1999 [entry 2] FSA's Director of Insurance provides FSA's Board with a pre-Board briefing on their regulatory responsibilities. In advance of the meeting, FSA circulate background papers on inherited estates and on guaranteed annuities. The latter paper notes Equitable's approach to dealing with the cost of meeting guarantees and outlines the guidance issued by HMT (see 18/12/1998 [**entry 1**]). The minutes of the meeting record that the Head of Life Insurance:

... focused on key issues facing the regulator including the attribution of surpluses in with-profit funds in inherited estates, the cost implications of pensions mis-selling, the spiralling cost of meeting annuity guarantees, and insurance liabilities, and systems questions associated with the Year 2000.

22/01/1999 FSA produce a further update for the Tripartite Standing Committee on the *'Effect of Current Market Conditions on UK Life Insurers'* (see 22/10/1998). This reflects earlier comments provided by GAD.

FSA state that *'there are 4 companies giving cause for concern principally as a result of their exposure to guaranteed annuity options ...'*, one of which is Equitable. On Equitable, FSA report the following:

The company's difficulties primarily stem from GAOs. It has some pension mis-selling liabilities but these are relatively small and appear to have been reserved for reasonably fully (£72m provision at end March 1998). The company appeared just solvent at the end of October (available assets of £1,150m to cover a solvency margin of under £1000m) on the basis of the reserving standard in the Government Actuary's recent guidance (the company is disputing the need for such a high reserve). The company is exploring the possibility of reinsurance for its GAO liabilities, and has sought and received an increased *future profits implicit item (£1,900m in lieu of £850). However, at the moment it is questionable whether it will be able to declare its usual annual bonus to policyholders (cost - £500m).*

FSA's update goes on to report:

The company has agreed to discuss with FSA in advance any proposed bonus declaration. Clearly it would be commercially damaging if the company had to pass or limit its bonus in February and to publish a low solvency position in April; there is a significant risk that the company's survival as an independent entity could be threatened in these circumstances.

FSA continue:

Equitable Life has just initiated a court case in an effort to obtain a ruling supporting its practice of limiting the cost of the GAOs by reducing terminal bonus paid to any policyholder exercising the option. Should the case go against the company its financial position would become even more precarious (there would be a potential liability to enhance past settled claims) and it would have to reduce the level of terminal bonus paid to its other policyholders – thus upsetting its status in the market.

Provided the company sets up reserves in accordance with the Government Actuary's standard, the company would be exposed to further falls in long term interest rates only to the extent that its assets and liabilities were mismatched and the reserves proved insufficiently resilient to market moves. With its present portfolio of assets, the company has indicated that a ½% fall in interest rates would increase its basic GAO liability by about £200m. A fall in equity markets would also be potentially damaging as it would reduce the amount of free assets available to the company and hence its ability to declare future bonuses on all its business. This problem would be more acute if the company declared further guaranteed bonuses in the interim. A fall in either gilt yields or equities could also damage the interests of other with profits policyholders if this led to the complete elimination of terminal bonus on policies with guarantees – the cost of the guarantees would have to be recouped from reductions in those other policyholders' terminal bonuses.

26/01/1999 [entry 1] FSA write to Equitable, thanking them for their letter (with enclosures) of 21/01/1999. FSA ask for copies of additional documents (relating to bonus recommendations made to the Board within the past 12 months, and to the valuation carried out by the Appointed Actuary at the end of 1997) which FSA *'would normally expect to see included within the scope of any Financial Condition Report'*. FSA also note that they and GAD have arranged to meet Equitable's Appointed Actuary to discuss the terms of the reinsurance agreement.

Following a telephone conversation between FSA and Equitable earlier the same day, Equitable's Appointed Actuary writes to FSA in response to their request of 18/01/1999 for information about the Society's reserves and asset shares as at the end of 1998. The Appointed Actuary provides the following information to FSA:

You will appreciate that some of the figures are provisional at this stage but final figures are unlikely to be significantly different.

The mathematical reserves and total policy values at 31 December 1998 before allowance for GARs and resilience reserves are as follows:

	Mathematical reserves	*Total policy value*
	£m	*£m*
Retirement annuities	*2978*	*4274*
Individual pensions	*584*	*855*
Transfer plans	*79*	*118*
Group pensions	*866*	*1119*
	4507	*6366*

Notes: *(i) If new declared bonuses were added at the level indicated in the 21 January 1999 letter, the mathematical reserves would increase by £66m.*

(ii) The overall resilience reserve in respect of with profits business at 31 December 1999 is estimated at £920m. If that is apportioned to individual lines of business in a manner consistent with the 1997 Form 57 exercise, the resilience reserve on the above mathematical reserves would be £235m. On this basis Test 3 continues to produce the highest resilience reserve. That would not be the case when reserves for GARs were included, when Test 2 would produce the higher reserves.

(iii) Under our bonus system the total policy values equate to a smoothed asset share. The values shown reflect the overall growth rate of 9% which has applied to pensions business during 1998.

Equitable's Appointed Actuary says that: *'The total mathematical reserves for with profits contracts at 31 December 1998 were £18450m. Addition of declared bonuses at the levels indicated in the 21 January 1999 letter would add £365m to those reserves. As noted above, the resilience reserve on the basis indicated was £920m. Total with profits policy values (i.e. smoothed asset shares) amounted to £23140m. That aggregate smoothed asset share was 103% of the value of the actual assets attributable to with profits business'.*

26/01/1999 [entry 2] FSA's Chief Counsel A replies to a request from the Director of Insurance for comments on a response the latter had drafted to an MP who had received a complaint from a constituent about Equitable and PRE. The Chief Counsel notes that the MP had requested a copy of FSA's guidance on PRE. She comments that, since FSA *'are now providing the guidance letter on PRE to members of the public,* [perhaps] *the letter should be made public like the guidance on reserving'*. The Chief Counsel adds that, in her view, FSA could continue to examine the issue of policyholders' reasonable expectations, even though the matter was now before the courts. However, in addition to seeking information from Equitable, FSA should invite comments from Equitable's policyholders. She also suggests that it would be helpful to see papers relating to Equitable's Court case.

Chief Counsel A copies her response to the Head of Life Insurance and Line Manager D. Both comment that FSA should await the result of the Court case before taking a view on whether to intervene in respect of policyholders' reasonable expectations. Line Manager D reminds her colleagues that the guidance on policyholders' reasonable expectations was already in the public domain, as HMT had issued a press notice (see 18/12/1998 [**entry 1**]).

27/01/1999 [entry 1] GAD inform FSA that they have reviewed the reserving effects of the financial reinsurance agreement which Equitable had sent to FSA on 21/01/1999.

GAD state:

> *The treaty is between Equitable and Irish European Reinsurance Company (*[IRECO] *– which is a Dublin based subsidiary of* [a named company]*). We have no details of the financial strength of* [IRECO] *or of the extent, if any, of any support which* [the parent company] *may be prepared to guarantee to* [IRECO].

Under *'Description of the Treaty'*, GAD advise FSA that:

> *The treaty is a financing arrangement which provides support to Equitable in any year when more than 25% (by value) of the guaranteed business vesting in that year select the guaranteed annuity option – this is called a "Reinsurance Claim Event" and the amount of support provided is called the "Reinsurance Claim". The support provided is the cost of the guaranteed annuity benefit less the fund available, including final bonus. The support is not paid in cash, but a debtor is created in Equitable's balance sheet called "amount due from reinsurers". The treaty limits* [IRECO's] *overall exposure at any time to £100m. When a Reinsurance Claim Event has occurred, Equitable is required to pay a "Recovery Amount" to* [IRECO] *in each preceding year which is offset against this debt until the debt is fully repaid. The Recovery Amount is expressed as 35% of the Reinsurance Claim. In addition, if a Reinsurance Claim Event occurs, Equitable must pay, in cash, a "Risk Amount" of 2% per annum on any outstanding support provided by* [IRECO]*. These two sums together are called the "Adjustment Premium". However the Adjustment Premium payable in any year is in some way limited in relation to the emergence of surplus in that year. (Note: the form of this limitation will need to be clarified with the company.)*
>
> *The cost of this treaty to Equitable is £150K (increasing by* [the retail prices index]*) for each year that the treaty remains in force – the Equitable can cancel the treaty for the future by giving 3 months notice.*
>
> *Either party can cancel the treaty, retroactively to the previous 31st December, if certain events occur – such as insolvency, transfer of business, change of control, failure to meet the obligations under the treaty and if the other party loses more than 50% of its paid-up capital.*
>
> *The treaty can also be cancelled if Equitable changes its practice on GAOs, presumably including if it lost its Court case.*

Under the heading *'The Intention of the Treaty'*, GAD advise FSA that:

> *The intention of the treaty is to enable the Equitable to maintain a reserve, in respect of policies with guaranteed annuity rates, which is equivalent to providing for the additional cost of the guarantees on only 25% of the business rather than the near 100% which we are demanding. We believe that the treaty will not achieve the intended reserving effect for a number of reasons.*
>
> *A reinsurance liability arises in any year when the percentage of policyholders (measured in terms of the value of the underlying guaranteed benefits) choosing the guarantee exceeds 25%. The reinsurer's liability is then calculated as the additional cost of the guarantee on any excess over 25%. This would be satisfactory if the additional cost was correctly defined in accordance with the reserving principles which we believe apply (as set out in the* [Government Actuary's] *letter). Unfortunately the treaty defines the cost as the difference between the cost of the guaranteed annuity benefit and the total funds available to provide for the benefit including final bonus ... We believe that this would result in a requirement to reserve for terminal bonus on the 75% part of the liability which is covered by the reinsurance treaty. This is demonstrated mathematically in the annex. The problem would be resolved if the reinsurance liability were to be expressed as the difference between the cost of the guaranteed annuity benefit and the guaranteed*

funds available to provide for the benefit ... This would increase the reinsurer's exposure, but this could be offset by requiring the Equitable to pay an additional adjustment premium equal to the reinsurance share of the amount of any final bonus allocated ...

GAD continue:

The treaty provides for the treaty to be cancelled retroactively by either party in a number of situations, as described above. On cancellation in these circumstances, the Equitable would be required to immediately repay any outstanding finance and increase its mathematical reserves. This seems to negate the benefit of the arrangement to the Equitable, particularly where the reinsurer has an option to cancel the treaty. These problems might be resolved if:

a) the obligation to repay the outstanding finance was restricted to any surplus funds available after meeting the solvency requirements of the Act (or meeting all liabilities to policyholders in the event of insolvency);

b) the scope of the clause which permits cancellation limited the ability of the reinsurer to terminate the treaty only to events such as insolvency; and

c) the retroactive application was removed.

The treaty limits the total withheld reinsurance claims balance to £100m at any 31 December or otherwise the treaty would have to be restructured. It is difficult to reconcile this with their intention to allow a reinsurance credit in their returns of around £700m. We believe therefore that there should be a commitment for the treaty to be continued, but that the schedule of reinsurance payments to the reinsurer could be revised in the event of this credit of £100m being exceeded.

GAD also provide, as an annex to their advice, a simplified example *'for the purposes of demonstrating that the reinsurance treaty fails to achieve its intended reserving effect'*.

27/01/1999 [entry 2] FSA attend a meeting of the Tripartite Standing Committee. FSA report that some insurance companies are experiencing pressure on their solvency margin, and that a *'major outstanding issue'* is a dispute with Equitable over their reserving policy and the size of their bonus.

28/01/1999 GAD and FSA meet Equitable's Appointed Actuary and an actuarial consultant working for the Society to discuss the reinsurance treaty. GAD raise the three concerns recorded by Chief Actuary C in his note of 27/01/1999, indicating how these could be resolved. According to FSA's note of the meeting, their third concern:

... that reaching the £100m limit on the balance of the reinsurance claims should not provide grounds for cancellation of the treaty was explained ... [The Appointed Actuary] *explained that there was no intention that this should be the case, and it was only intended that the limit should provide a right to review the terms of the treaty. If no agreement could be reached on revising the terms, the treaty would continue unamended. Equitable would look at redrafting the position so that it was clearer.*

GAD raise a fourth concern, that:

... there was no provision which would enable Equitable to demand settlement of any claim under the treaty. It was considered that there should be some provision for Equitable to draw down reinsurance claims money if needed in order for the reinsurance debt to be considered to be a realisable asset. Such a provision was likely to need to be subject to Equitable paying a market rate of interest on the money, received from the

reinsurer. The timeframe within which payment would be required could be very long (e.g. 30 years, 10 years after the vesting of the last GAO contract, or perhaps be linked to when the outstanding claims reached the £100m limit which would in any case prompt a review of the treaty).

FSA's note also records that:

The question was also raised of whether Equitable Life was satisfied that the proposed reinsurer (Irish European Reinsurance Company) was sufficiently financially strong to be able to fulfil the potential obligations under the treaty (i.e. to cover a potential £1b+ liability). Equitable Life appeared to be relying on the company's AAA rating for comfort as to the reinsurer's financial strength. The Actuary was reminded that it was his responsibility to be satisfied with the security of the reinsurance for which he was [taking] *credit in his valuation.*

Equitable's Appointed Actuary asks how the reinsurance arrangements might be presented in the annual returns. FSA record the discussion, as follows:

[Equitable's Appointed Actuary] *was keen not to have to show a £1b+ reserve for GAOs since he thought this would be seized on by the press and interpreted as indicating the real cost of GAOs to the company. This would be damaging when the company had been at pains to make clear that GAOs were unlikely to have a significant financial impact on the company. He would like to show a net reserve figure (after deduction of the reinsurance) in the forms, but would be content to include in Schedule 4 a statement that the reserve had been established at the 25% level because reinsurance provided protection for liabilities in excess of this level. GAD were concerned that this was not consistent with the Directive requirements which required insurers to calculate their gross liabilities and then deduct the liabilities covered by reinsurance. It was also potentially inconsistent with the guidance issued by the* [Government Actuary] *and endorsed by FSA. It was emphasised that FSA's main concern was that the reserving basis should be clear from the annual returns. FSA would explore the implications of the presentation Equitable Life were seeking to adopt before expressing a definitive view on the issue. [Comment: having reviewed the structure of the relevant forms, it is clear that any presentation which did not show separately the gross liability and reinsurance cover would be artificial and hence potentially misleading. In view of the significance of the reinsurance treaty to the company's solvency position it was important that the level of dependence on the reinsurance was clear to readers of the returns.]*

Equitable provide Board papers relating to their bonus declarations and valuations for 1997 and 1998. Equitable indicate that they now expected to reduce the future profits implicit item to the originally agreed £850m.

29/01/1999 GAD telephone Equitable to discuss the valuation bases underlying the draft valuation result shown in one of Equitable's Board papers ('*Valuation and Bonus Declaration as at 31 December 1998*', dated 22 January 1999). In his note of their conversation, Scrutinising Actuary E records that '[the Appointed Actuary] *was, in truth, rather vague as to how he justified the percentages of the total liabilities for which he assumed benefits were being taken in the GAR form*'. The Scrutinising Actuary explains that the Appointed Actuary also:

... revealed ... that the GAR reserve included an allowance of about £450m in respect to future premiums. Thus, the additional reserve held for existing GAR liabilities was actually in the region of £1bn. Under questioning about the effect of moving to 90% of full GAR reserves, he suggested that perhaps another £150m might be needed — but, perhaps, he would then lower the allowance for future premiums to £300m at this time.

He seemed to be gradually accepting the ultimate need for establishing full provisions, but appeared to be hoping that HMT would look kindly on the idea of phasing-in, which he suggested had received a favourable mention at an earlier meeting.

With regard to the draft treaty, it seemed that no further progress had been made, but he expressed satisfaction that no major problems seemed to arise and he seemed to be hopeful that final agreement could be reached next week.

GAD inform FSA that the papers which Equitable had handed over at the end of their meeting the previous day showed that Equitable:

... are sensibly seeking to balance out the considerations of reducing progressively the amount of additional guaranteed benefits that are added each year, with maintaining a reasonably competitive position, and smoothing the bonus declarations from year to year in line with the perceived expectations of policyholders.

The cost of the declared bonus for 1998 would be some £365 Million (compared with £508M in 1997). This would leave the overall financial position of the company as shown in their draft 1998 returns as showing cover of 250% for the solvency margin (ie similar to 31/12/97) assuming that the reinsurance ... is completed (and accepted by FSA as allowing a significant reduction in the reserves for GARs), or 110% if the ... reinsurance is not taken into account. In the latter situation, they would though be able to take credit for a larger future profits implicit item which could boost the apparent solvency margin cover to around 200%, though the explicit cover for the guarantee fund would be very thin.

Therefore, the financial position shown in their 1998 returns is likely to appear as reasonably satisfactory following their proposed declaration of bonus, though they would be potentially close to regulatory action under Section 33 [i.e. on failure to maintain the minimum margin] *if their proposed reinsurance is not completed satisfactorily. Accordingly I believe it would be difficult to object formally to their proposed course of action, though we would need to continue to monitor their position carefully.*

GAD state that the Board papers Equitable had provided at the meeting showed *'graphically'* the variation in their cover for the required minimum margin. They note that, in the autumn of 1998, Equitable had just covered the margin once, with no significant excess cover, even with the then minimal allowance for guaranteed annuities. GAD understand that Equitable:

... do not have much scope to reduce the margins in their valuation basis in those conditions [where investment returns in 1998 are close to 0%], *and they would very likely either have to seek some additional concessions from FSA in their reserving requirements, find some further financial reinsurance or switch their investments from equities to fixed interest. The scope for the two latter options may though be quite limited in practice due to market limitations.*

GAD explain how the figures presented by Equitable allowed GAD to compare the policy values attributed to all with-profits policies with the mathematical reserves held. GAD comment: *'These figures suggest to me that our current reserving standard is not unreasonably harsh, with the possible exception of the resilience reserve requirement on the policies with GARs which will though be dealt with by the proposed financial reinsurance'*.

GAD note that Equitable continue to issue annual notices to policyholders showing a high level of projected benefits, *'thereby generating further expectations'*. GAD propose writing to Equitable to say that GAD have no objection to the Society's current proposed rate of declared bonus, while at the same time voicing concerns about their:

... apparent vulnerability to changing investment conditions. They should also be asked to produce some contingency plans for how they would react if an adverse investment return were to appear over the next 1-2 year period, which reduced their solvency margin cover to close to or even below 100% of the required minimum level.

01/02/1999 FSA write to Equitable after the latter had telephoned to ask about FSA's attitude to Equitable declaring a bonus. FSA say that the paper put to Equitable's Board on 22 January 1999 (see 29/01/1999) confirms that, without reinsurance, Equitable were in a weak position. FSA point out that they had doubts about a number of aspects of the reinsurance treaty and that, without a robust treaty, FSA would not consider it prudent for Equitable to declare a bonus for 1998. FSA note that, if allowance were made for the proposed reinsurance treaty, Equitable's financial position would appear to be significantly stronger:

However, even in these circumstances we consider it necessary for the company to consider carefully the scope for declaring a bonus because of the uncertainties surrounding the financial implications of the court case in relation to the company's payment practice in respect of contracts carrying guaranteed annuity options. In particular it would appear necessary for Equitable Life to consider the prudence of declaring a bonus in the light of the risk of losing the court case and the potential costs that might be incurred as a result. We also consider it necessary for the company to take account of the risk, even after the terms of the reinsurance treaty have been revised as discussed with GAD, of the treaty being cancelled by the insurer ...

FSA add that these points are a matter of judgement for Equitable:

But on the basis of the information you have provided to us (and assuming the reinsurance treaty is revised to resolve the concerns expressed by GAD) we are not minded to object to the proposed bonus declaration.

FSA also explain:

You will appreciate that any decision by FSA not to intervene over the bonus declaration should not be taken as an endorsement of what you propose. Nor is it the end of the matter; we remain concerned about the on-going financial health of Equitable Life, because of the relatively low level of explicit free assets and the apparent sensitivity of the free assets to future rates of investment return. On the basis of the 1997 projections for the solvency position at the end of 1998, it appears that a high rate of return (of the order of 16.5%) is necessary for the company to maintain its free asset ratio. In the circumstances I think it would be helpful to discuss this issue again soon, so that we can gain a better understanding of the key factors influencing the company's longer term solvency position.

FSA conclude by asking Equitable for revenue and solvency projections for 1999 and beyond, as well as contingency plans in respect of any fall in equities.

03/02/1999 Equitable write to FSA and note the points made in their letter of 01/02/1999. Equitable explain that discussions were continuing with the reinsurer to amend the treaty so that it met FSA's concerns. Equitable say that they had considered the position in the *'unlikely event'* that Equitable lost the Court case and would discuss this and FSA's comments about the possible cancellation of the reinsurance treaty with the Board.

Equitable say it would take a little time to produce the requested projections because of competing priorities, but they would be provided as soon as possible. They advise that a response to FSA's letter of 13/01/1999 was well in hand.

08/02/1999	Equitable write to FSA in response to their letter of 01/02/1999. Equitable explain that the figure of 16.5% in the papers FSA have seen was an error and should have read 10.5%.
12/02/1999 [entry 1]	Equitable send FSA a copy of the revised reinsurance treaty. Equitable state: *Since we have managed to strengthen the reassurance terms to address the concerns raised on the first draft, and we have considered and satisfied ourselves on the points raised in ... your letter of 1 February 1999* [the prudence of Equitable declaring a bonus, in the light of the risk of losing the Court case]*, there would now seem to be no impediment to our proceeding with our bonus declaration as planned this month.*
12/02/1999 [entry 2]	Equitable respond to FSA's letter of 13/01/1999. Equitable say that their 1997 returns had not included additional reserves for annuity guarantees at a level consistent with the Government Actuary's recent guidance (DAA11). If those returns had done, however, *'the Society would have made full use of the permission to bring £700m of future profits into account, rather than restricting the use to £371m as in the actual returns. There were also some margins in the liability valuation basis which could have been released'*. Equitable estimate that, with these changes, cover for the required minimum margin would have fallen from 2.5 to 2.0 and add: *'Whether or not such a difference means that there was "a material effect on the overall financial position shown in the 1997 returns" is, of course, a matter of judgement'*. Equitable state that the reinsurance arrangement they have entered into, coupled with use of the future profits implicit item of £850m, would result in a cover for the required minimum margin in the 1998 returns similar to that published at the 1997 year end. Equitable conclude: *I hope you will agree that we have subsequently taken action to strengthen our financial position in the terms described in ... your letter of 13 January and thus that there is no necessity for our 1998 returns to be submitted earlier than normal.*
12/02/1999 [entry 3]	FSA's Managing Director presents a monthly *'Financial Supervision Managing Director's Report'* to FSA's Board. The Managing Director informs the Board that FSA had been considering the position of life companies in the light of the combined effects of the costs of meeting guaranteed annuities and pensions mis-selling. He notes that particular attention was being given to Equitable, adding that Equitable normally declared their annual bonus in February.
16/02/1999	FSA write to Equitable in response to their letter of 12/02/1999. FSA explain that they still had one significant concern: *As drafted, the reinsured is not entitled to request a cash payment of outstanding reinsurance claims until after the termination of the last policy covered by the reinsurance; and then only to the extent of 10% of the outstanding reassurance claims. As a result of the partial nature of the right to settlement, and the long period before payment could be required, the value which could be attributed to the reassurance treaty (and hence offset against the Society's gross liabilities) would be substantially less than the reinsurer's potential liability. The value would have to be heavily discounted to reflect the long delay (probably more than 30 years) between a claim arising and being settled.* FSA suggest a further meeting between Equitable, FSA and GAD.
18/02/1999	Equitable provide a further amended version of the reinsurance treaty with a revised definition for *'Settlement of claims'*.

GAD advise FSA that this did not fully address the points made in the letter of 16/02/1999, *'as only 10% of the reinsurance amount can be called at any one time'*. GAD say that this point would have to be pursued at the meeting (now arranged for 19/02/1999). In reply, FSA say:

> *I hope though that we only ask for further changes if they are absolutely necessary, especially as we have already made requests which go further than what we had indicated in earlier discussions.*

GAD respond to FSA, pointing out that they had indicated to Equitable that they saw difficulty with the discounting that would be required, given the very lengthy settlement period proposed (see 28/01/1999). GAD caution against giving firm agreement to the full effect of the treaty without seeing the final wording. However, GAD explain that they:

> *... certainly agree that we should endeavour to keep any request for further changes to a minimum. Moreover, we ought to be in a position that FSA can give a "no objection" indication to Equitable following the meeting, as any detailed wording changes at this stage should only effect the value of the offset that may be taken into account rather than the principle of the acceptability of the treaty.*

19/02/1999 GAD's Directing Actuary B and FSA's Head of Life Insurance meet Equitable's Appointed Actuary – see 22/02/1999.

FSA's Director of Insurance submits a Weekly Report to Managing Director A. An entry on Equitable records that their bonus declaration was still subject to satisfactory reinsurance arrangements being put in place to offset the liability created by the reserve needed for guaranteed annuities. The report continues:

> *We and GAD are discussing the reinsurance details. If we can be satisfied that the reinsurance is effective, the Equitable Board is likely to approve a 5% bonus on pensions business – a drop of 1.5%, and at the low end of industry declarations for 1999 but better than at one stage seemed possible.*

22/02/1999 [entry 1] GAD write to Equitable to record the outcome of the meeting on 19/02/1999. GAD explain that they:

> *... accept the principle that this agreement will allow a reinsurance offset to be taken in the valuation of liabilities as at 31 December 1998. Our overall objective is therefore to reach a view on the value that may be placed on the reinsurance offset for which credit is taken under the agreement.*

GAD note that the meeting had considered four parts of the draft agreement (settlement of claims, risk amount of adjustment premium, fee payable on cash settlements and the termination clause) to see how each might affect the value that could be placed on the reinsurance offset under the ICR 1994. On *'Settlement of claims'*, GAD say:

> *As presently drafted, we believe that this paragraph would require the reinsurance offset to be treated as a zero yielding "asset" with an average term of about 5 years. Accordingly, it would be available to hypothecate against liabilities of this term valued at a 0% rate of interest.*
>
> *If, instead, it is intended that it might be hypothecated against liabilities valued at some long-term rate of interest under Regulation 69(9), then we believe that this could be achieved by amending the words of this paragraph in the agreement to read "However, at any 31 December, the Reinsured will be entitled to request a cash payment of up to 100% of the outstanding Reinsurance Claims if such assets are required in order to enable the Reinsured to properly satisfy the requirements of s35A(1)(a) of the Insurance Companies Act 1982". Although not discussed at our meeting, this would also seem to*

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have the advantage of providing greater protection for policyholders through making a sum of money available from the reinsurer in the event of other assets being insufficient to cover all the liabilities.

Subject to resolution of outstanding queries, GAD conclude that:

... the proposed wording of the reinsurance agreement will have the effect of allowing an appropriate reinsurance offset to be made corresponding to the difference between the gross reserves established and the value of benefits assuming 25% of policyholders take their benefits in the form of a guaranteed annuity. We do of course still need to see the final version of the reinsurance treaty to ensure that the detailed wording is in line with our understanding of the reinsurance agreement.

22/02/1999 [entry 2] FSA write to Equitable to confirm FSA's stance on a bonus declaration, prior to a forthcoming Board meeting. FSA say:

The FSA's position following Friday's meeting is unchanged: subject to the reinsurance treaty having the effect of allowing an appropriate reinsurance offset to be made (i.e. an offset broadly corresponding to the difference between the gross reserves established and the value of the benefits assuming 25% of policyholders exercise the guaranteed annuity option), we are not minded to object to Equitable Lifes proposed bonus declaration. Revision of the provision on the settlement of claims, as discussed on Friday, appears the most important in relation to ensuring the necessary credit can be taken for the reinsurance treaty. Clearly the points in my letter of 1 February remain applicable regarding other factors which we would expect the board to take into consideration in deciding the scope for declaring a bonus.

FSA add that they would write shortly on the issue of the timing of Equitable's 1998 returns.

23/02/1999 The High Court appoints a named policyholder to represent the interests of all policyholders or former policyholders whose policies contain a guaranteed annuity rate in the legal action initiated by Equitable. The High Court appoints Equitable to represent the interests of all other policyholders.

24/02/1999 [entry 1] FSA write to Equitable in response to their letter of 12/02/1999. FSA state:

As I mentioned on the phone last week, we think that the returns might have given potential policyholders a misleading impression as to Equitable Life's financial position at the end of 1997. You indicate that there would have been a net decrease in the coverage of the required minimum margin from 2.5 to 2 times after allowing for the use of margins which existed in the valuation basis and taking account of a much larger future profits implicit item. We consider that such a decrease is material and that some account must be taken for the greater reliance on implicit items that would have been necessary (and apparent in the returns) if a further reduction in the solvency margin coverage was to be avoided.

FSA add that they do not consider the actions that Equitable have taken to address the situation sufficient to make early submission of the 1998 returns unnecessary. FSA ask Equitable to agree by 3 March 1999 to submit their returns by 31 March 1999, otherwise *'we would need to consider taking appropriate regulatory action, in particular whether to require the company to submit its 1998 returns early'*.

4/02/1999 [entry 2] FSA report to the Tripartite Standing Committee that they were still discussing Equitable's plans for reinsurance of some of the risk of policyholders choosing to take up annuity guarantees. If those plans were approved, then Equitable would pay a 5% bonus, which would be at the lower end of market expectations.

24/02/1999 [entry 3]	GAD's Directing Actuary B advises Chief Actuary C and Scrutinising Actuary E that Equitable's reinsurer had offered to include a clause to the effect that interest would be payable to Equitable on any reinsurance balance. The Directing Actuary's view is that, in principle, this seemed acceptable, but that GAD needed to see the draft wording to consider the matter properly.
25/02/1999 [entry 1]	Equitable fax GAD a copy of the amended reinsurance terms. Equitable note that the reinsurer had amended the terms *'so that the outstanding reinsurance claims balance becomes an interest bearing asset if that is required for the purposes of statutory solvency'*.
25/02/1999 [entry 2]	FSA's Line Manager D asks Chief Counsel A whether the names of companies that had been asked (or have offered) to accelerate their 1998 returns could be disclosed to the public. The advice received is that they could not.
26/02/1999 [entry 1]	GAD's Directing Actuary B informs Chief Actuary C and FSA that Equitable would be making further amendments to the draft reinsurance treaty. The Directing Actuary says: *You will now have seen the latest version of the text with just 1 amendment to the settlement of claims clause.* [Equitable's Appointed Actuary] *phoned again this morning, and I said that I was surprised to see no provision now for any "capital" payment in respect of the settlement of claims clause. He offered to go back to the "payable after all the claims have gone off the books" clause, but I said that this seemed very remote, given also the interest on interest that would accumulate over that period.* *Accordingly, we agreed that he would seek to have the payment of 10% per year of "capital" reinstated, in addition to the new "interest amount".* *They are also still discussing the detail of the "termination" clause, and he will contact us again with further details of the revised agreement shortly.* The Directing Actuary also notes that the ratings agency Standard & Poor's have placed Equitable on *'credit-watch'* pending further discussions with the Society.
26/02/1999 [entry 2]	Equitable inform FSA that they agreed to submit their 1998 returns by 31 March 1999.
26/02/1999 [entry 3]	FSA's Director of Insurance submits a Weekly Report to FSA's Managing Director A. The Director of Insurance records that Equitable have now arranged satisfactory reinsurance for their guaranteed annuity rate liabilities and that this had '*cleared the way for them to decide on bonus rates which they will announce (5% for most pension policies) next week*'.
02/03/1999	FSA's Head of Life Insurance advises the Chairman on how to deal with questions about the early submission of returns. The Head of Life Insurance explains that identifying individual companies would breach confidentiality and he suggests that FSA take the following line: *1. Responses to the guidance which we issued in January indicate that life offices are now reserving for guaranteed annuities to a common minimum standard, approved by the Government Actuary. This is an important safeguard for policyholders.* *2. Discussions are continuing with a number of offices over whether it is appropriate for them to bring forward publication of their 1998 returns.* *3. Cannot comment on the position of individual companies.*
03/03/1999	Equitable's solicitors seek FSA's agreement to a modification of the terms of the subordinated loan. The Society's solicitors explain that the modification is for tax reasons.

05/03/1999	FSA ask GAD for their comments on Equitable's solicitors' request. FSA state:

> *I am a bit mystified why we gave this concession in the first place, although I expect you remember the background. I have ordered back copies of files at our end so that I can understand the basis of the original concession.*

10/03/1999 HMT and FSA hold their first quarterly meeting on insurance regulation issues. The minutes record that:

> *... regular meetings would help to provide a structured framework for an exchange of views on current and strategic issues relating to insurance and friendly society regulation and related matters. It was important to remember the high public profile of regulation and the need to ensure Ministers were kept well informed in advance of developments.*

On guaranteed annuities, FSA's Head of Life Insurance explains that there might be a problem with the way in which some companies were reserving for such guarantees, that FSA would need to monitor those companies and might request early submission of the 1998 returns. The Head of Life Insurance notes that '[complications] *may yet arise from some companies who have special circumstances, and the press may pick up on the need for special reporting and misinterpret the reason*'.

18/03/1999 FSA's Managing Director presents his *'Managing Director's Report: Financial Supervision'* to FSA's Board. The Managing Director records that FSA: *'have been reviewing life offices' exposures to guaranteed annuities, following the guidance on reserving for these liabilities issued in January. The company most affected is Equitable Life; after setting aside reserves consistently with the guidance, its free assets were so low that the prudence of paying a bonus this year was questionable. Equitable have now put in place a reinsurance treaty to cover the additional liability for guaranteed annuities, and will declare a reduced bonus of 5% (which is at the lower end of the industry range for 1999). Equitable have also (along with* [another named insurance company]*) agreed to submit their next set of regulatory returns early, so that a comprehensive and up to date picture of their financial position is available to policyholders. Equivalent early submission of returns is being discussed with three other life offices'*.

19/03/1999 FSA's Line Manager D sends the Head of Life Insurance a note headed *'Summary of Positions of Companies with Significant Exposures to Guaranteed Annuity Options (GAOs)'*.

The Line Manager deals with the circumstances of 13 companies. In a covering note she explains that she had sought to list the companies in order of the level of concern to which they gave rise, with the most serious first. The Line Manager's note begins with Equitable.

Line Manager D explains that Equitable's *'financial position has been very severely affected'*. She notes that *'despite having given generous guarantees on a significant proportion of its pensions business'*, Equitable had not established any reserve for annuity guarantees at the end of 1997, that they had no estate to meet unexpected costs, and, as a mutual, no ready mechanism to raise capital.

Line Manager D suggests that Equitable would have to establish a reserve of £2.9bn at the end of 1998, and that they would only just be able to cover their solvency margin, with free assets of less than £100m. She notes that Equitable were seeking to finalise a reinsurance agreement, which would reduce their reserving requirement by some £2bn and increase the cover for their solvency margin to *'a more acceptable'* 2.5. She continues:

> *We remain concerned about the financial viability of the company in the longer term. It has declared high levels of guaranteed bonuses in the past and its ability to honour these*

guaranteed bonuses appears heavily dependent on the company continuing to achieve high investment returns. The company's liabilities for GAOs could also increase significantly if the yields on long gilts [i.e. government bonds with a long period until maturity] *fall further.*

The Line Manager notes that Equitable had agreed to submit their 1998 returns by 31 March 1999 and to provide financial projections for the next three years. She says this information should enable FSA to make a more accurate assessment of the longer term position. She also notes that, should Equitable lose the test case on their differential terminal bonus policy, they could incur significant compensation costs.

In her covering note, Line Manager D explains that Equitable and five other companies can all be described as *'at risk'* from annuity guarantees, and that their statutory solvency position could be threatened if economic conditions deteriorated. She notes that, in most cases, a further fall in long term interest rates would have the most detrimental effect.

The Line Manager explains that, of the other seven companies, five are of slightly lesser concern as, despite substantial exposure to annuity guarantees, they have, or are acquiring, well capitalised parent companies. She explains that she sees no immediate threat to the solvency of the remaining two companies.

23/03/1999

FSA's Head of Life Insurance informs Line Manager D that FSA had agreed to approach one of the six companies described as *'at risk'* from annuity guarantees. (Note: that company was not Equitable.) The Head of Life Insurance asks whether they should also write to one of the five companies that are of slightly lesser concern (see 19/03/1999). Both companies appeared to be operating a differential terminal bonus policy similar to Equitable's.

The Head of Life Insurance copies his note to GAD.

24/03/1999

GAD's Chief Actuary D writes to FSA's Line Manager D in response to the Head of Life Insurance's email of 23/03/1999. Chief Actuary D says:

> *... there is a serious danger in picking on a few companies, perhaps with worse financial positions than average because they are at the front of our thinking, and putting pressure on them to adopt a more generous line. Meanwhile less threatened companies carry on with the same policy on terminal bonus without question.*

In response, the Line Manager points out that FSA had asked Equitable, and one other company, how their differential terminal bonus policies were compatible with PRE. She states that the *'reason for picking on* [the two companies referred to by the Head of Life Insurance] *is concern that we are not acting consistently towards these companies and Equitable* [and the other company identified by Line Manager D]'.

FSA add that, due to resource implications, they had sought information about differential terminal bonus policies and policyholders' reasonable expectations only where such a practice had come to their attention, *'ie we weren't going to go looking for trouble but thought we needed to be seen to do something where the issue was raised. That said I take your point that there is a case for a more systematic approach'.*

In response, GAD's Directing Actuary B comments that most companies were probably awaiting the outcome of Equitable's Court case. He suggests another survey, once the case is resolved.

25/03/1999

GAD suggest that the figure of £2.9bn for Equitable's reserve (in Line Manager D's note of 19/03/1999) had been slightly overstated. GAD say the gross figure was probably closer to £2.5bn. The reinsurance agreement was in fact worth £1.5bn and this would reduce the gross figure to a net figure of £1bn.

Submission of the 1998 regulatory returns

30/03/1999 [entry 1] **Equitable submit their 1998 regulatory returns to FSA**. Due to the early submission of those returns, they are not accompanied as in previous years by copies of the Society's annual report and accounts, prepared in accordance with the Companies Act 1985. These accounts are submitted to FSA on 29/04/1999.

The returns include the following information about Equitable's business and their financial position as at 31 December 1998.

Equitable's returns are submitted in one part covering Schedules 1, 3, 4 and 6 to the ICAS Regulations 1996.

GAD's copy of the 1998 returns includes various annotations. I am satisfied that some of these were made by Scrutinising Actuary E during the scrutiny programme on or around 09/04/1999, when the Scrutinising Actuary completed his Initial Scrutiny note (which was countersigned by Chief Actuary C). However, for ease of reference mention of these annotations is made here.

Schedule 1 (Balance sheet and profit and loss account)
Schedule 1 of Equitable's returns consists of Forms 9, 10, 13, 14, 15 and 17. Form 9 summarises the Society's financial position at 31 December 1998 as follows:

Long term business admissible assets	*£28,238,041,000*
Total mathematical reserves (after distribution of surplus)	*£26,338,124,000*
Other insurance and non-insurance liabilities	*£225,986,000*
Available assets for long term business required minimum margin	*£1,673,931,000*
Future profits	*£850,000,000*
Total of available assets and implicit items	*£2,523,931,000*
Required minimum margin for long term business	*£1,007,534,000*
Explicit required minimum margin	*£167,922,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£1,506,009,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	*£1,516,397,000*

In Form 13, Equitable set out their admissible assets.

In Form 14, Equitable set out their long term business liabilities and margins.

(Note: on 07/12/1998, HMT had asked Equitable to include a note on contingent liabilities in the returns relating to the risk of a successful challenge to their bonus practices. I am advised that this note would have been expected to have been made in Form 14 as required by Regulation 13 of the ICAS Regulations 1996. I have been unable to find such a note in Form 14 or anywhere else in Equitable's 1998 returns.)

Schedule 3 (Long term business: revenue account and additional information)
As in previous years, Schedule 3 consists of Forms 40 to 45.

In Form 40, Equitable provide a revenue account. GAD circle the figures provided for interest payable before deduction of tax (being £30,655,000 for 1998 and £15,777,000 for the 1997 returns).

Schedule 4 (Abstract of valuation report prepared by the Appointed Actuary)
As in previous years, Equitable present two valuations of their long term liabilities (their main and appendix valuations). The results of the main valuation are carried forward, unadjusted, from Form 58 to Form 14 and on to Form 9.

Schedule 4 – main valuation (text)
Schedule 4 of Equitable's returns provides the information required by paragraphs 1 to 23 of Schedule 4 to the ICAS Regulations 1996 and includes Forms 46 to 49, 51 to 58, 60 and 61.

Equitable state that this valuation is made in conformity with Regulation 64 of ICR 1994.

In response to paragraph 4, Equitable provide 11 pages of information about their non-linked contracts. Most of the description provided is identical to that supplied in the previous returns.

GAD underline the statement that *'Pension contracts – old series'* contain a guaranteed interest rate of 3.5% and that *'some older contracts'* contain guaranteed annuity rates.

Equitable provide a fuller description than in previous years of the guarantees which existed on some deferred annuity policies, disclosing:

> *For UK retirement annuities the option to purchase an annuity on minimum guaranteed rates at retirement can be exercised at any age between 60 and 75. The form of the annuity is restricted to a single life, level non-profit annuity with no guaranteed period paid quarterly in advance. The minimum guaranteed rates are based on a(55) ultimate mortality and 7% interest except for some older contracts which are based on 4% interest.*

GAD note that this description is new and they underline *'a(55) ultimate mortality and 7%'*.

In response to paragraph 5, Equitable provide 71 pages of information about their linked contracts.

In paragraph 6, Equitable set out the general principles and methods adopted in the valuation.

As in previous years, Equitable state:

> *For with profits retirement annuity and personal pensions benefits ... the benefits have been valued on the basis that the benefits will be taken at age 60 or, if that age has been attained, at the valuation date.*

As in previous years, Equitable disclose:

> *The valuation method makes specific allowance for rates of future reversionary bonus additions, the levels of which are consistent with the valuation interest rates employed having regard to the Society's established practices for the determination of declared bonus rates. The balance of the total policy proceeds, consistent with policyholders' reasonable expectations, will be met by final bonus additions at the time of claim. Such additions are not explicitly reserved for in advance but are implicitly covered by the excess of admissible assets over mathematical reserves.*

As in the 1997 returns, Equitable state that they have made an explicit provision for their liability for tax on unrealised capital gains (in relation to business other than that linked to their internal funds), which they now estimate as not exceeding £97.9m. The provision made is £100m, which they say is shown in the Appointed Actuary's certificate in Schedule 6 of the returns.

In paragraph 6(1)(g) relating to investment performance guarantees, as in previous years Equitable state that they do not consider it necessary, in current conditions, to hold a reserve for the guarantee they offer on a unit-linked annuity.

In paragraph 6(1)(h), Equitable disclose that they had set up reserves for the annuity guarantees on their *'Pension contracts – old series'* business. They explain the assumptions used in establishing these reserves relating to assumed take-up rate of the annuity at a guaranteed rate and cash commutations. Equitable's returns state:

> *The combined effect of the allowances made is to assume that of those policies which survive to retirement date (mortality in deferment based on AM80 ult -5 years) the following proportions of benefits are taken in guaranteed annuity form:*

UK retirement annuities	*70.0%*
UK individual pensions (1st series)	*82.5%*
UK transfer plans (1st series)	*82.5%*
UK group pensions (1st series)	*82.5%*

GAD question the figures used for these adjustments.

Equitable also disclose the interest rate basis used to value the guaranteed annuities, stating that:

> *Annuity benefits have been valued at an average interest rate based on 5% for annuities taken out during 1999 with lower rates of interest assumed for future years to take account of 69(9)(a) of the Insurance Companies Regulations.*

As in previous years, Equitable disclose that, for certain non-profit deferred annuities, the valuation rates of interest used were those assumed in the premium basis. Equitable, again, do not elsewhere disclose the rates used in the premium basis.

As in previous years, in paragraph 6(2), Equitable state that, in determining the provision needed for resilience reserves, they have taken account of the fact that the long term fund has been valued at book value.

As in their 1996 and 1997 returns, Equitable explain in paragraph 7(5) that they consider the reserves for future bonus within the valuation to be fully able to withstand any future strains which would arise if there were significant changes in mortality or morbidity experience. They say that, accordingly, the Society did not consider it necessary to establish any additional reserves in this respect.

In paragraph 7(6), Equitable disclose that they have tested the need for resilience reserves against the three scenarios contained in DAA6, as amended by DAA10. They state that the most onerous scenario tested is scenario b (a 10% reduction in fixed interest yields, a 25% fall in equity values, a 20% fall in property values and a 10% increase in index-linked yields).

Equitable disclose that a resilience reserve of £600m had been provided for.

In paragraph 7(8)(a), Equitable disclose the changes made to valuation assumptions and methods in the resilience scenarios. They explain that, in the resilience scenarios, they had used the appendix (net premium) valuation method rather than the main (gross premium) valuation method, but with some changes to the valuation described in the returns. As in their 1996 and 1997 returns, Equitable disclose that the changes include:

> *... for all accumulating with profits business, an annual loading of 0.25‰ increasing by 4% per annum compound of the basic benefit was reserved which is considered to be a prudent allowance for ongoing expenses: for accumulating with profits pensions business, ½% per annum of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses.*

Equitable also disclose, in paragraph 8(a)(iv), that, in the resilience scenario, they had reduced the reserve for their potential liability to tax on capital gains to £20m.

In paragraph 8(b), Equitable state that: *'For accumulating with profit business the valuation rates of interest shown in Form 52 are net of a 0.25% interest rate reduction as a reserve for future expenses'*.

In paragraph 8(d), Equitable state:

> *A further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994. The resultant aggregate liability is less than the aggregate liability on the methods and bases described in this report. The report on the net premium valuation is given in an appendix following Form 61 of this report.*

In paragraph 9, Equitable provide information on the valuation of their linked contracts. GAD make various annotations on this section.

Paragraph 12(2) of Schedule 4 to the ICAS Regulations 1996 required that:

> *For each treaty of reinsurance where the company is the cedant and under which business is in force at the valuation date—*
>
> *(a) the name of the reinsurer;*
>
> *(b) whether the reinsurer is authorised to carry on insurance business in the United Kingdom;*
>
> *(c) whether the company and the reinsurer are connected;*
>
> *(d) an indication of the nature and extent of the cover given under the treaty;*
>
> *(e) the premiums payable by the company under the treaty during the report period;*
>
> *(f) the amount deposited at the valuation date in respect of the treaty under any deposit back arrangements;*
>
> *(g) the extent to which provision has been made for any liability of the company to refund any amounts of reinsurance commission in the event of lapses or surrender of the contract; and*
>
> *(h) whether the treaty is closed to new business.*

In their returns, at paragraph 12(2)(viii), Equitable in response state:

> *(a) The reinsurer is Irish European Reinsurance Company Ltd.*
>
> *(b) The reinsurer is not authorised to carry out insurance business in the United Kingdom.*
>
> *(c) The Society and the reinsurer are not connected.*
>
> *(d) The reinsurer provides surplus cover for the costs arising from the exercise of guaranteed annuity rates in respect of Retirement Annuity policies, Individual Pension Plans and Transfer Plans issued before 1 July 1988. If, in any calendar year, the proportion of terminations due to retirements exercising the guaranteed annuity option exceeds 25% of the total retirements in that calendar year, as measured by the guaranteed funds for those policies, the reinsurer's gross liability is the value of the guaranteed annuity in excess of the guaranteed policy funds for that proportion of retirements effecting the guaranteed annuity option which is in excess of 25%.*
>
> *(e) The premium payable since the last investigation was £150,000.*
>
> *(f) There is no deposit back arrangement.*
>
> *(g) Not applicable.*
>
> *(h) The treaty is closed to new business.*

GAD mark this section as *'NEW'*.

In response to the information required by paragraph 12(3) of Schedule 4, Equitable state:

> *There were no financing arrangements in force at 31 December 1998.*
>
> *In the event of a claim under the treaty described ... above, the reinsurance would become a financing arrangement. There were no undischarged obligations under this treaty at 31 December 1998.*

In paragraph 13, Equitable say: *'The Society has no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund'*.

In paragraph 14, Equitable set out a statement of their aims with regard to bonus distribution and how they maintained equity between different generations of policyholders. The information provided is the same as for 1996 and 1997 – with the exception that, in relation to surrender values, Equitable have added the statement:

> *There are, however, no guarantees whatsoever as to the way in which surrender values will be determined.*

GAD mark this sentence as new.

In paragraph 15, Equitable disclose that they had set reversionary bonuses for the main policy classes at 1.5% (previously 3%). As in previous years, Equitable disclose that they offered loans under a *'loanback'* arrangement to some retirement annuity, individual and group pension policyholders.

In paragraph 16, Equitable set out final bonus rates. The returns again contain a description of Equitable's differential terminal bonus policy:

> *If the contract guarantees minimum rates for annuity purchase the aggregate final bonus otherwise applicable is reduced when benefits are taken by the amount, if any, necessary such that the annuity secured by applying the appropriate guaranteed annuity rate after such reduction, is equal to the annuity which would be secured by applying the Society's annuity rate for an equivalent annuity in force at the time benefits are taken to the cash fund value of the benefits before that reduction, subject to a minimum value for the final bonus after such reduction of zero.*
>
> *If the contract guarantees minimum rates for annuity purchase and a reduction has been made under the immediately preceding paragraph, then where benefits are not taken in a form to which those minimum rates apply an additional amount of final bonus will be made available to the policyholder at the time benefits are taken equal to the reduction if any made under the immediately preceding paragraph. Such additional amount of non guaranteed final bonus will not constitute a "related bonus" or bonus allotted under the contract.*

In paragraph 21, Equitable explain that they used risk-adjusted yields on assets other than land and equity shares by restricting them to 6%, which is that available on the highest yielding risk-free security held by Equitable. Equitable also explain that, where they considered this appropriate, they risk-adjusted yields on land and equity shares.

<u>Schedule 4 – main valuation (forms)</u>
In Form 46, Equitable provide information on changes to their ordinary long term business.

In Form 47, Equitable provide an analysis of their new ordinary long term business.

Form 48 shows that 51% of Equitable's non-linked assets are invested in equities, 6% in property and 36% in fixed and variable interest securities (compared with 53%, 6% and 38% respectively in 1997). GAD circle the figure of 6.04% as the yield on '*All other assets*' producing income.

As in previous years, in Form 49 Equitable disclose that the gross redemption yields on fixed interest securities issued or guaranteed by any government or public body are, for certain durations, higher than for those not issued or guaranteed by any government or public body.

In Form 51, Equitable set out the mathematical reserves held for various types of non-linked contracts (excluding accumulating with-profits contracts) along with information on the number of contracts in force, the benefits valued, and rates of interest and mortality assumptions used.

In Form 52, Equitable set out the mathematical reserves held for accumulating with-profits policies, along with information on the number of contracts in force, the benefits guaranteed and the rates of interest and mortality assumptions used in valuing them. The Form 52 for *'Pension business'* discloses that the gross total reserve for *'Options and guarantees other than investment performance guarantees'* (i.e. the reserve for annuity guarantees) is £1,593m. The Form also shows that this reserve has been reduced by reinsurance of £809m to a net total reserve of £784m. GAD circle these figures and note that they refer to annuity guarantees.

The Form 52 summarising the totals for all of Equitable's accumulating with-profits business discloses that the valuation has assumed a discounted value of current benefits of £15,739,015,000 (against the current benefit value of £15,740,152,000). This is a discount of just over £1m (and relates only to the Society's School Fees Trust Plan).

In Form 53, Equitable set out the mathematical reserves held for the various types of property-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death, and the rates of interest and mortality assumptions used in valuing them. They again disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 54, Equitable set out the mathematical reserves held for the various types of index-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity, and the rates of interest and mortality assumptions used in valuing them.

In Form 57, Equitable provide matching rectangles illustrating the notional allocation of assets to each category of liabilities, showing the valuation rates of interest supported, and the ability of the matching assets to cover the reserves in the resilience scenarios.

In Form 58, Equitable set out the valuation result and composition and distribution of fund surplus. Against the figure of £16,532,642,000 (which had been discounted from the current benefit value by £1m) for *'Mathematical reserves for accumulating with profit policies'*, GAD add the corresponding figure from the appendix valuation of £16,115,623,000 (which had been discounted from the current benefit value by £795m).

<u>Schedule 4 – appendix valuation (text)</u>
Equitable explain that the appendix valuation:

> *... was undertaken for the purposes of demonstrating that in aggregate the mathematical reserves determined by the valuation undertaken using the gross premium method, the results of which are reported on the preceding pages, are not less than an amount calculated in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994.*

Equitable's appendix valuation provides the information required by paragraphs 1, 6 to 8, 10, 11, 20, 21 and 22. The Society states that the information required by the other paragraphs in Schedule 4 is the same as that provided in the main valuation (apart from paragraph 23 – being a statement of the required minimum margin in the form set out in Form 60 of Schedule 4 which, having had *'regard to the purpose of the valuation'*, has not been provided).

In paragraph 6, Equitable set out the general principles and methods used in the appendix valuation.

Equitable disclose that they assume a retirement age for personal pension policies of 60.

In paragraph 6(1)(b), Equitable again state that the valuation rates of interest were chosen with due regard for policyholders' reasonable expectations and the Society's established practices for determining reversionary bonuses.

As in the main valuation, Equitable state in paragraph 6(1)(g) that they do not consider it necessary, in current conditions, to hold a reserve for the guarantee they offer on a unit-linked annuity.

In paragraph 6(1)(h), like in the main valuation, Equitable disclose that they had set up reserves for the annuity guarantees on their *'Pension contracts – old series'* business. They explain the assumptions used in establishing these reserves relating to assumed take-up rate of the annuity at a guaranteed rate and cash commutations.

In paragraph 7, Equitable state that a resilience reserve provision of £1,236m had been made. GAD annotate this part of the returns with the corresponding figure from the main valuation and note that the difference between the two figures is £636m. GAD also write:

> <u>*Identical*</u> *with* [unclear] *in liabilities shown by Net* [premium valuation].

As in their main valuation and the previous returns, Equitable disclose in paragraph 7(8)(a) the changes made to the valuation assumptions and methods in the resilience scenarios, including that:

> *... for all accumulating with profits business, an annual loading of 0.25‰ increasing by 4% per annum compound of the basic benefit was reserved which is considered to be a prudent allowance for ongoing expenses: for accumulating with profits pension business, ½% per annum of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses.*

As in the main valuation, Equitable explain that they risk-adjusted the yields on assets other than land and equity shares by restricting them to 6%, which is that available on the highest yielding risk-free security held by them. Equitable also explain that, where they considered this appropriate, they risk-adjusted yields on land and equity shares.

<u>Schedule 4 – appendix valuation (forms)</u>
In the appendix version of Form 51, Equitable set out the mathematical reserves held on the appendix valuation basis for various types of non-linked contracts (excluding accumulating with profit) along with information on the rates of interest and mortality assumptions used in valuing them. GAD annotate the Forms with some of the rates used in the previous returns.

In the appendix version of Form 52, Equitable set out the mathematical reserves held on the appendix valuation basis for accumulating with-profits contracts, along with information on the number of contracts in force, the benefits guaranteed, and the rates of interest and mortality assumptions used in valuing them.

The form covering *'Pension business'* discloses that the gross total reserve for *'Options and guarantees other than investment performance guarantees'* (i.e. the reserve for annuity guarantees) is £1,556m. The Form also shows that this reserve has been reduced by reinsurance of £793m to a net total reserve of £763m. GAD circle these figures and note that they refer to annuity guarantees. GAD also mark some of the policies as *'NEW'*.

This Form also discloses that the valuation of this pensions business had assumed a discounted liability of current benefits of £12,939,338,000 (against the current benefit value of £13,614,745,000). Next to this GAD write: *'£675m below face value'*.

The Form 52 summarising the totals for all of Equitable's accumulating with-profits business discloses that the valuation had assumed a discounted liability of current benefits of £14,945,576,000 (against the current benefit value of £15,740,152,000). This is a discount of just under £795m.

In the appendix version of Form 53, Equitable set out the mathematical reserves held on the appendix valuation basis for the various types of property-linked contracts along with information on the number of contracts in-force, the value of current benefits, the level of benefits guaranteed on death, and the rates of interest and mortality assumptions used in valuing them. They also disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In the appendix version of Form 54, Equitable set out the mathematical reserves held on the appendix valuation basis for the various types of index-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity, and the rates of interest and mortality assumptions used in valuing them.

As in the main valuation, Equitable provide appendix versions of Form 57 giving the notional allocation of assets to each category of liabilities on the appendix valuation basis, showing the valuation rates of interest and the ability of the matching assets to cover the reserves in the resilience scenarios. On the Form relating to life assurance and annuity business, GAD circle and note with question marks some of the risk-adjusted yields used. GAD also circle some of the risk-adjusted yields used in respect of certain pensions business.

<u>Supplementary notes to the returns</u>
In the notes to the returns, disclosed at the end of Schedule 4, Equitable disclose that they have been granted a section 68 Order which permits them to include in aggregate form details of their *'Personalised Funds'* in Forms 43, 45 and 55.

Equitable disclose that they have been granted a section 68 Order which permits them to take into account a future profits implicit item. The Society states that it has included an item of £850m and that this is within the maximum amount permitted by the Order.

Equitable disclose that they have been granted a section 68 Order enabling them to disregard amounts owing under the subordinated loan up to an amount not exceeding 50% of the required solvency margin.

The notes to the returns also disclose that Equitable had been issued a section 68 Order *'to the effect that figures in Form 46 exclude recurrent single premiums from the annual premium figures as the Company cannot at present calculate a meaningful figure'*. GAD sideline this note and underline the words *'cannot at present calculate a meaningful figure'*.

<u>Schedule 6 (Certificates by directors, actuary and auditors)</u>
Three Equitable Directors provide the certification required by Regulation 28(A) of the ICAS Regulations 1996. Equitable include in their Directors' certificate the statement that the required margin of solvency had been maintained throughout 1998.

Equitable's Appointed Actuary provides the certification required by Regulation 28(B) of the ICAS Regulations 1996. Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

30/03/1999 [entry 2] FSA note that Equitable have a priority rating of 3 (but see 20/05/1999).

30/03/1999 [entry 3] Equitable apply to FSA for a section 68 Order for a future profits implicit item of £1bn, for possible use in their 1999 returns. Equitable provide financial calculations in support of the application, suggesting they could seek an Order up to the value of £2.96bn.

These calculations include, for the estimated annual profits, that:

Year ending	*(A) Total surplus*	*(B) Exceptional items*	*(C) Surplus arising from solvency margin*	*(A)-(B)-(C) Ordinary surplus*
	£m	*£m*	*£m*	*£m*
31.12.94	*520.0*	*0.0*	*19.3*	*500.7*
31.12.95	*662.8*	*0.0*	*0.0*	*662.8*
31.12.96	*802.5*	*0.0*	*0.0*	*802.5*
31.12.97	*895.6*	*0.0*	*0.0*	*895.6*
31.12.98	*838.4*	*0.0*	*0.0*	*838.4*
				3,700.0

Average annual profit = 3700.0/5 = £740.0m

GAD tick these figures.

The calculations state that the average period to run for the Society's in-force contracts is again eight years. Equitable explain:

> *The periods to run have been reduced to take account of premature withdrawals based on the Society's recent experience of such withdrawals. In respect of retirement annuity and personal pension contracts for which a range of retirement ages is available, it has been assumed that retirement benefits are taken at the lowest possible age, or immediately if that age has already been attained.*

The calculations suggest that the maximum future profits permissible is 50% of £740m multiplied by eight years – that being £2,960m.

Equitable explain that they have used a future profits implicit item in their 1998 returns to the sum of £850m.

30/03/1999 [entry 4] GAD reply to FSA's note of 05/03/1999 about Equitable's subordinated loan. GAD had discussed the matter with an accountant at Equitable and are satisfied that there is no good reason why FSA should object to the change, as it is:

> *... largely a change in accounting procedure, and does not have any implications that suggest that the subordination principle is being breached in relation to the original Loan Agreement. The revised position is adequately covered by the existing Section 68 Order.*

GAD offer no comments on the circumstances under which the concession was originally agreed.

	FSA write to Equitable's solicitors to confirm that their proposal would not require any change to the section 68 Order dated 19/08/1997.
30/03/1999 [entry 5]	FSA write to Equitable's Managing Director (similar letters were also sent to all other life companies that are affected by the PIA's review into pensions mis-selling), seeking an update on their liability for pensions mis-selling. FSA explain that, since this information was sought a year ago (see 08/05/1998 [**entry 1**]), there had been a number of developments that were likely to affect companies' liabilities.
01/04/1999 [entry 1]	**GAD complete the A1 Initial Scrutiny check on the Society's 1998 regulatory returns**. GAD identify no concerns.
01/04/1999 [entry 2]	Equitable advise FSA of changes to the requisite details for their branch in Germany, following the marketing of a new product. (Note: Equitable's Appointed Actuary on this day sent IRECO a letter of understanding, not intended to be legally binding. The letter said that *'both parties agree that should the withheld fund exceed £100,000,000 sterling and no solution can be found'* under the terms of the agreement, then the treaty would be cancelled. GAD had previously expressed concerns to Equitable that the treaty could be cancelled and received assurances that this was not the case — see 28/01/1999. Equitable did not disclose the letter of understanding to FSA or GAD, and it did not come to light until 24/09/2001. In June 2004, FSA concluded that the Appointed Actuary had been wrong not to disclose the letter to FSA. They made an order (under section 56 of the Financial Services and Markets Act 2000) prohibiting him from holding a significant management role within a regulated company until May 2010.)
08/04/1999	**GAD complete the A2 Initial Scrutiny check on the Society's 1998 regulatory returns**. The form for the A2 check follows the format adopted for the 1996 and 1997 returns and includes the following: <u>Strength of valuation basis</u> GAD circle both yes and no when answering the question as to whether the interest rates used for with-profits business appeared to make provision for policyholders' reasonable expectations and comment that it would be necessary to *'review implications of discount rates shown for* [unitised with-profits] *business'*. They note that other management expenses, at £8.5m, are material. GAD confirm that Equitable have applied the resilience test in accordance with the Government Actuary's latest published guidance. GAD say that they judge the overall interest basis to be *'adequate'* but refer to their comments about reviewing the implications of the discount rate used. GAD also judge the valuation basis to be *'adequate'*, but comment: *'But, gross* [guaranteed] *annuity reserves have been established assuming that would not be taken in all cases – allowances appear to be greater than suggested in* [the Government Actuary's] *guidance. N.B. Higher gross reserves would have been offset by higher reassurance credit'*. <u>Solvency position</u> GAD note that the absolute cover for the required minimum margin was '*adequate*' and comment: *(1) We still need to be satisfied that* [the reinsurance] *treaty with* [IRECO] *works in the way intended — <u>REQUEST COPY OF TREATY</u> as finally agreed.* *(2) Loss of the Court case on treatment of* [Guaranteed] *Annuities would put position in doubt — would need to cut all bonuses.*

GAD describe the trend in the level of cover for the required minimum margin over recent years as *'flat'* and add *'(Increasing use of* [Implicit Future Profits] *Item has raised line 44 margin* [excess of available assets and implicit items over the required minimum margin]*)'*.

Operating results
GAD note that the level of surplus/deficit emerging and its trend over recent years were not a current cause for concern *'but fall shown for 1998'*. GAD note that the level and trend of capital injection into Equitable were not current causes for concern *'but remember £350m Subordinated Loan issued in 1997'*. GAD note that the amount of reinsurance was material and that there was *'a material exposure to non-UK authorised reinsurers without deposit back'*.

PRE issues
GAD circle both yes and no to the question as to whether the answer given by Equitable in paragraph 4(1)(a)(ii) of Schedule 4 to the returns was satisfactory. GAD comment: *'Reserve is normally less than asset share, but* [surrender values] *only limited to asset share* [and] *normally achieved by reducing terminal bonus i.e. Society would normally pay out more than reserve carried'*.

Current issues
GAD note that Equitable had a material exposure to annuity guarantees and that this was the '[reason] *for early submission of their Return'*.

Aspects that look worrying
GAD identify the following:

(1) Consider 6(1)(h) [assumptions on the take-up rate of guaranteed annuity options] *response.*

(2) Need to examine [the reinsurance] *treaty.*

(3) Possible loss of court case – implications for the Society?

GAD identify items 1 and 2 from *'Aspects that look worrying'* to be notified to HMT, to be taken up immediately with Equitable. GAD raise Equitable's priority rating from 4 to 2.

Accompanying the scrutiny check is a new *'Initial Scrutiny Summary Form'*, which includes certain key figures disclosed in the 1994 to 1998 returns.

09/04/1999 **GAD send FSA a one and a half page report on their initial scrutiny of the 1998 returns.** GAD note that the cover for the required minimum margin is 2.5, although without the future profits implicit item it would have been 1.6.

GAD explain that Equitable reached this position after including additional gross reserves for annuity guarantees of £1,593m, reduced by reinsurance of £809m to a net provision of £784m. GAD observe that Equitable's gross reserve was lower than GAD would have hoped. This was because Equitable had made greater allowances for non-take-up of GARs than might have been expected in the light of the Government Actuary's guidance (DAA11 – see 13/01/1999). GAD comment that they assumed that Equitable were reluctant to disclose any higher figures for their gross liability or the extent of their resultant reliance on reinsurance. GAD note that the solvency implications for Equitable were *'negligible'*, but that GAD needed to consider further the implications for other companies if they accepted Equitable's arguments.

GAD point out that they had not yet seen a copy of the finalised reinsurance treaty and suggest that FSA should urgently request a copy, *'so that we can assess any questions that may need to be raised about the value being placed on the reinsured liability'*.

GAD note that Equitable had made an application for an increased future profits implicit item of £1bn, and explain that they had set a target to complete the combined scrutiny of the 1997 and 1998 returns by the end of June 1999.

12/04/1999	GAD ask FSA for a copy of Equitable's section 68 Order for a future profits implicit item that they have used in their 1998 returns, as they did not have one on file. GAD state that they needed this for the background section of their scrutiny report.
13/04/1999	A trustee of a company pension scheme telephones FSA to express concern about the solvency of Equitable. FSA's Line Manager D advises: *Explained take intervention action if policyholders at risk.* [An Independent Financial Adviser whom the trustee] *had spoken to had a vested interest in casting doubt on* [the] *financial position of Equitable Life. Recommended talking to Equitable Life about the position and not to take any <u>rushed</u> decisions to transfer the occupational pension scheme elsewhere.*
15/04/1999 [entry 1]	FSA ask Equitable for the revenue and solvency projections and contingency plans, requested on 01/02/1999. FSA also ask for a copy of the reinsurance treaty. FSA do not chase Equitable for a copy until 28/09/1999.
15/04/1999 [entry 2]	FSA write to a German resident who had asked whether Equitable were of *'sound financial state'* and whether the British Government offered indemnity to EEC residents in the event of the insolvency of a British insurer. FSA state that Equitable are registered in the UK to conduct life assurance business and have complied with their statutory obligations. FSA add that they do not comment on the financial state of any of their regulated institutions and that the British Government did not offer the sort of indemnity sought to either British or other EEC residents.
20/04/1999	Equitable write to FSA explaining that they were awaiting the final reinsurance treaty but have asked that this be progressed as a matter of urgency. Equitable enclose a copy of the term sheet on which the treaty would be based. Equitable also provide, in strict confidence, a copy of a detailed report for the Board, prepared by the Appointed Actuary, on measures available to Equitable to improve their statutory solvency position. The Appointed Actuary identifies six measures which he says it would seem sensible for Equitable to pursue: increasing the subordinated loan (he says it had always been Equitable's intention to use the maximum permitted level of 50% of the required minimum margin); use of reinsurance; shifting the equity portfolio from lower to higher-yielding stocks; limiting the extent of exposure to development property situations; exploring the merits of a new bonus class for GAR policies while actively encouraging policyholders to give up their GARs; and introducing new policies with no entitlement to declared bonuses. The Appointed Actuary also proposes to apply for the maximum possible future profits implicit item in future and to bring into account in the returns approximately 5/6 of the minimum margin.
21/04/1999	FSA pass a copy of Equitable's letter of 20/04/1999 to GAD. FSA ask: *Am I being pedantic here but if the reinsurance treaty has not yet been finalised can The Equitable take credit for it in their 98 returns?*
26/04/1999	Equitable provide FSA with an update on their liability for compensation as a result of pension mis-selling. Equitable estimate that their liability at 31 March 1999 was nearly £63m and that they held a reserve in their 1998 returns of £70.6m. As at 31 March 1999, the total cost already incurred was nearly £60m.

27/04/1999 GAD write to FSA in response to their query of 21/04/1999. GAD say:

> *We understand that the FSA have agreed in principle that, where there is a letter of intent in place at the valuation date, credit may be taken for the existence of a reinsurance agreement. Indeed we believe that this position was clearly signalled to Equitable in earlier discussions.*

GAD compare the draft term sheet provided on 20/04/1999 with that provided on 25/02/1999. GAD observe that Equitable are now entitled to request interest on the outstanding reinsurance claims amount or request that 10% of this amount is settled in cash. They also note that the annual *'Deposit Premium'* payable by Equitable has increased from £150,000 to £400,000. GAD explain that they are content with the way payments of additional premiums in the event of a claim have now been subordinated to policyholders' rights. GAD say that other aspects of the treaty remain broadly unchanged.

GAD also comment on the report to Equitable's Board sent at the same time. GAD note that such measures as maintaining the future profits implicit item at the maximum level, increasing subordinated debt, making further use of reinsurance *'look to be fairly plausible – but may only have marginal impact, bearing in mind the existence now of the overarching* [reinsurance] *treaty ...'*. GAD further state that applying policy conditions to limit the impact of existing annuity guarantees would have a strong adverse impact on the image of the Society, while inducing policyholders to give up their GARs may be in conflict with statements made in product and marketing literature. GAD acknowledge, however, that *'in principle, a reasonable charge could be made to asset shares to reflect the cost of GAOs'*.

29/04/1999 [entry 1] A PIA official writes to PIA's Head of Policy about some correspondence from MPs on behalf of policyholders with Equitable and another company, who are concerned about not receiving a terminal bonus if GARs were honoured. The PIA official explains that as most, if not all, complaints were about policies sold before the FS Act 1986 came into force, there is little action PIA could take. The official adds:

> *... we are aware that there is a possible conflict between the position taken by the Insurance Directorate in terms of prudential supervision and the conduct of business regulation.*

The official attaches PIA's note of 18/01/1999.

29/04/1999 [entry 2] Equitable send FSA copies of their statutory annual report and accounts and their annual report and financial highlights for 1998, prepared in accordance with the Companies Act 1985 and dated 24 March 1999.

In their *President's Statement*, Equitable say that the year had been unusual, given the unfavourable publicity about their differential terminal bonus policy. They give some background to the issue and report their decision to fund a representative action in the High Court to confirm that their approach was lawful, was within the terms of the guaranteed annuity rate policy document and was within the Board's powers under the Articles of Association. Equitable explain that they adhered to the philosophy of distributing profits fairly to members and without deliberate cross subsidy between different contract types or durations of saving. They therefore strived to ensure that all their members received benefits that represented a fair and highly competitive return on the contributions they had made.

In their *Management Report*, Equitable reiterate that they operated a full distribution policy to avoid the unfairness created by the retention of profits earned by one generation of policyholders for the benefit of successors. Equitable state that, despite having such a full distribution policy, investment strategy was driven by investment, rather than technical, considerations. They report that the return for the with-profits fund in 1998 of 13.3% and the average return of 14.5% over the last four years were significantly in excess of inflation, which averaged less than 3% pa. They explain that, in a reflection of the general trend towards lower average returns in a low inflation environment, the Directors had decided to allocate an overall rate of return of 10% for recurrent single premium pensions business. Equitable state that, in the face of falls in yields during 1998 and the likelihood of a sustained period of future low returns, they had reduced the element of return which was given in guaranteed form (i.e. reversionary bonuses) to 5% for an illustrative contract. Equitable report that, as in 1997, the *'expense rebate'* would be extended to all in-force pension policyholders, regardless of the amount contributed.

29/04/1999 [entry 3] Equitable ask FSA to provide a letter stating that FSA have no objection to the Society applying to the United Arab Emirates Central Bank for consent for Equitable's representative office in Dubai to carry on the business of a financial consultancy in that country.

30/04/1999 Equitable's President writes to the Economic Secretary to the Treasury, after meeting her at a dinner on 21 April 1999.

The President elaborates on concerns he expressed at the dinner about the impact on Equitable of the Government Actuary's guidance on reserving for annuity guarantees (DAA11 — see 13/01/1999). The Society's President explains that Equitable had been including in their accounts a prudent provision of £200m; but the guidance required an additional reserve of no less than £1.6bn in their regulatory returns. He comments that the Economic Secretary had suggested that, if he wrote to her, she would *'ensure the matter was considered in the right quarter of Government'*. The President warns that such a requirement would result in excessive constraints on investment policy and thus lower benefits to policyholders.

Equitable's President acknowledges that FSA and GAD have sought to be as helpful as they can but believes they have limited room for manoeuvre. He suggests that Equitable and others in the industry are being subjected to *'extremely onerous reserving requirements which bear little resemblance to commercial reality'*. He suggests that it might need the intervention of the Economic Secretary to secure *'a more commercial and satisfactory outcome'*.

The President attaches a paper of the same date, prepared by the Society's Appointed Actuary on the cost of reserving for annuity guarantees. The paper reiterates the Appointed Actuary's view that the Government Actuary's guidance is excessively prudent in that the guidance assumed a take-up of annuity guarantees at around 80%. He points out that, for many policyholders, the extra value of exercising a guarantee was outweighed by the attractions of a more modern type of annuity which could only be achieved by taking the cash form. He explains that Equitable's experience to date was that less than 5% of benefits had been taken in guaranteed form.

The Appointed Actuary acknowledges the argument that policyholders only take the cash form of the benefit if there were a discretionary bonus added to it and that companies must therefore reserve for this in advance. However, he states that the existence of an element of discretionary bonus is already *'implicit in the regulatory system'* and allowed for in the required minimum margin and resilience reserve. The Society's Appointed Actuary suggests that the assumption implicit in the guidance:

> *... that there will be no discretionary bonuses available at any time in the future at which the relevant policies mature seems excessively prudent, particularly in view of the margins of prudence already provided in the statutory reserves.*

04/05/1999 [entry 1]	FSA write to the Governor of the Central Bank of the United Arab Emirates, confirming that they have no objection to Equitable applying for consent to carry on the business of a financial consultancy (see 29/04/1999 [**entry 3**]).
04/05/1999 [entry 2]	Equitable send FSA a further paper on solvency (*Projections of the Society's Financial Position*), which Equitable's Board had considered the previous week. The paper is written by their Appointed Actuary. He looks at Equitable's projected solvency position at the end of 1999 and in the longer term having regard to a range of assumptions. He concludes that Equitable remain statutorily solvent under all those different scenarios, that the longer term projections are for an improving technical solvency position, and that the shorter term position could be strengthened by a number of the options previously discussed by the Board. He states that Equitable are actively pursuing these measures. The Society's Appointed Actuary also notes that the impact of an unfavourable outcome to the Court case is difficult to model. However, he does attempt to do so. One of the assumptions applied to an unfavourable *'but not the worst possible'* outcome is that an immediate provision of £400m would be needed to compensate policyholders who had retired between 1995 and 1998. In his summary, the Appointed Actuary says that, in the event of an unfavourable outcome to the Court case: *'the key solvency consideration is replacement or modification of the reassurance arrangement. That too is being actively pursued'*.
05/05/1999	FSA and PIA agree that FSA would deal with queries from policyholders about annuity guarantees and the acceptability of insurers applying a differential terminal bonus policy. FSA agree to take the lead on this, as it is largely an issue of policyholders' reasonable expectations.
11/05/1999	HMT and FSA hold their second quarterly meeting on insurance regulation issues. HMT ask FSA to provide a contribution to a letter of complaint about Equitable.
18/05/1999	FSA write to GAD, following the letter from Equitable's President (see 30/04/1999). FSA explain that the Economic Secretary to the Treasury has remarked that '*she finds Equitable's comment about the need for an additional reserve of £1.6bn odd, and if true, disturbing. She has therefore requested an explanation of the point*'.
19/05/1999	GAD's Directing Actuary B suggests to Chief Actuary C that they need to point out to the Economic Secretary that £1.6bn is *'indeed a reflection of the potential economic value of these GAOs (assessed on a prudent regulatory basis) and is not an unreasonable financial imposition on Equitable'*. The Directing Actuary acknowledges that companies could hold less than the *'fair share of the fund'* in recognition of the discretionary nature of the final bonus, *'for which no provision is normally required'*. However: *... where the company provides a GAO, then this removes much of this discretion for the insurer and it is necessary for the provision in the balance sheet to be increased accordingly.*
20/05/1999	**GAD provide FSA with their scrutiny report on the Society's 1998 regulatory returns**. (A copy of this scrutiny report is reproduced in full within Part 4 of this report.) The report uses a detailed format similar to that adopted for the 1993, 1994, 1995 and 1996 returns (see 15/11/1994 [**entry 1**], 23/01/1996 [**entry 1**], 01/11/1996 [**entry 1**] and 16/12/1997), but incorporating revisions agreed in 1998 to reflect changes deriving from the Insurance Companies (Accounts and Statements) Regulations 1996. GAD explain that it combines comment on activity in both 1997 and 1998.

In the heading to the report, GAD state that Equitable have a priority rating of 2.

The body of the report comprises 15 sections as follows:

(1) Key features
GAD set out some key statistics for both 1997 and 1998, including:

- Equitable had available assets of £2.1bn in 1997 and £2.5bn in 1998;
- they had used an implicit item of £371m in 1997 and £850m in 1998; and
- they had a subordinated loan of £346m in both 1997 and 1998.

GAD set out Equitable's required minimum margin. GAD note that the last visit to Equitable had been in November 1996.

(2) Action points
GAD explain that they have raised no points with Equitable as a result of their scrutiny. GAD note however:

- that FSA and GAD needed to consider the final terms of the reinsurance treaty; and
- that FSA needed to decide whether to challenge the assumptions Equitable had used in setting reserves for their annuity guarantees (see section 10 below).

(3) Executive summary
GAD state that Equitable try *'to provide fair benefits to each generation of its policyholders, on maturity or surrender – without holding back any excessive estate'*, but that, as a result, they have lower free asset margins than might be expected *'for such a well thought of institution'*. GAD note that Equitable have used a future profits implicit item for the last five years, and took out a subordinated loan in 1997.

GAD explain that the solvency position has been *'complicated on this occasion'* by the need to carry reserves for annuity guarantees. They state that Equitable's cover for their required minimum margin is 2.51, that this was unchanged since the end of 1997 and that, without the implicit item of £850m, the cover falls to 1.66.

GAD note that, although new business fell between 1997 and 1998, total gross premiums received rose from £3.45bn to £3.7bn. They state that Equitable's expense ratios remain the lowest in the industry. GAD note that Equitable's asset performance is *'a little disappointing'*.

(4) Background
GAD reiterate information included in the Background section of their reports on the 1993, 1994, 1995 and 1996 returns, namely that Equitable are the oldest mutual life assurance society in the world and that they never pay commission to third parties. GAD explain:

> *This background is typified by a determination to provide fair bonuses to policyholders, with no deliberate holding back of profits from one generation to another, by unit linked products which often have discretionary surrender values, and by using a gross premium bonus reserve valuation method. (However, the returns also show the results of a net premium valuation on a minimum basis – and the free asset position shown is identical.)*

GAD repeat that Equitable gained a controlling interest in Permanent Insurance in June 1997.

GAD explain that Equitable have increased their overseas activity in recent years (in the Republic of Ireland, Germany and Guernsey) and that these branches are producing increasing amounts of new business; however, Equitable have expressed dissatisfaction with the cost effectiveness of the German branch. GAD note that, from August 1998, Equitable have provided insurance in Greece. GAD state, as in their reports on the 1994, 1995 and 1996 returns, that Equitable regard overseas activity as *'missionary work'*. GAD note that Equitable have provided systems support to other companies.

GAD provide details of Equitable's subordinated loan.

GAD emphasise that Equitable have been:

> *... heavily criticised in the press, of late, for the approach that it is taking of reducing terminal bonuses to meet the costs of guaranteed annuity options attaching to some of its pension contracts. A test case to be brought before the Courts in July 1999 will try to obtain legal clearance for the practice.*

GAD provide details of the four section 68 Orders in force at the end of 1997, being:

- to allow Equitable to use a future profits implicit item not exceeding £700m (see 14/10/1997);
- to allow Equitable to exclude recurrent single premiums from the '*annual premium*' figures in the returns (see 13/06/1997);
- to allow Equitable to aggregate the details of their total personalised funds (see 31/01/1997); and
- to allow Equitable to make use of the subordinated loan (see 20/08/1997).

GAD explain that, for the 1998 valuation, Equitable had also been granted an Order allowing them to take into account a future profits implicit item of up to £1,900m.

GAD note that, following the retirement of Equitable's Appointed Actuary and Chief Executive on 31 July 1997, the roles had been filled by two different people. GAD state that the last visit to Equitable had been made in November 1996 (see 08/11/1996 [**entry 2**]).

<u>Business developments during the year</u>

(5) <u>New business</u>
GAD set out the new products Equitable have developed and the sources of their business. GAD explain that Equitable target *'high net worth individuals'*. They provide tables showing recent history of new regular premiums and new single premiums and a new business index. GAD note that, as Equitable are not able to produce meaningful in-force premium figures for renewable single premium business, the annual premiums recorded in the returns ignore this business and that this has been sanctioned by a section 68 Order.

GAD comment that Equitable *'may have underperformed the industry average in 1998 in terms of increases in new business. This could, though, be put down to the Society's starting position – having achieved excellent growth in 1997'*. GAD note, however, that in 1997 Equitable were reported to be the largest writer of pensions business in the UK.

(6) <u>Changes in business in force</u>
GAD produce a table showing *'Recent history of regular premiums received'*. GAD reiterate that, while revised regulations in 1996:

> *... were intended to help give appropriate recognition to renewable single premium business and classify it as regular premium business, the flexible nature of Equitable's products has made it difficult for them to quote a basic regular premium payment. As a somewhat perverse result, from 1996 onwards the Returns of Equitable actually show lower regular pension premiums and higher single premiums.*

GAD note the rise in gross premiums received.

GAD produce tables showing: *'Claims experience'*; *'Persistency experience'*; and *'Recent history of combined surrender, lapse & paid-up conversion rates'*.

GAD note that, although pensions was the major class of Equitable's business, persistency data was not available, due to the flexible nature of the contracts written.

GAD explain: *'These are excellent results, reflecting the fact that business is largely bought rather than sold!'*.

(7) Expenses
GAD produce a table showing the history of expenses from 1994 to 1998. They comment that Equitable's reported expense ratios have again reached *'astonishingly low levels'* and are the lowest in the industry. GAD state that Equitable's low expense ratio is a positive marketing image, which helps to explain the strong sales figures and is thus *'part of a virtuous circle'*.

GAD note, as an exceptional item, that Equitable claim to have invested some £70m in redeveloping all their operating systems over recent years.

Situation at year end

(8) Non-linked assets
GAD produce tables showing Equitable's: *'Recent history of asset mix'*; *'Recent history of asset mix attributable to UK with-profits business (%)'* (taken from Equitable's 1998 With-Profits Guide); *'Movement in asset values over the last year'*; and *'Investment performance in 1998'*.

The latter shows a return of 13.8%. GAD comment:

> *This return slightly underperforms what might have been hoped for in 1998 – but is probably in line with returns generally achieved. The correspondingly calculated 1997 figure of around 19.1% was somewhat higher than the average return achieved by with-profit offices in that year, of 18.5%. [However, it may be noted that in the Society's accounts the return claimed for* assets matching with-profit liabilities *is lower than the figures generated by us: it was only 17.2% in 1997, and was just 13.3% in 1998.]*

(9) Assets held to match linked liabilities
GAD provide details of internal linked funds, other assets matching property-linked liabilities, mismatching to property-linked liabilities, assets matching index-linked liabilities and policyholders' reasonable expectations (issues on linked funds). On the latter, GAD comment:

> *Where a fund invests in an Equitable Unit Trust, the annual management charge is reduced by ½%, and charges are also adjusted where a fund invests in units of another fund to ensure that only one levy is made.*

GAD observe no particular problems.

(10) Valuation basis
Overall strength – GAD explain that Equitable produce their published returns:

> *... on the basis of a gross premium valuation for non linked business, with some modest allowance for future bonuses, but the resilience reserve included is determined such that the total liability is identical with the results of a net premium valuation – that is shown as an Appendix to the Returns, and is largely the basis on which the strength of the reserves is monitored by GAD.*

GAD consider the bases used to be generally acceptable, subject to concerns about the Society's reserves for annuity guarantees. GAD note that Equitable inform holders of *'accumulating with profit contracts of the amount of their accumulating final bonus (although clearly stating that it is not guaranteed), but only holds reserves for a discounted sum compared with the current guaranteed value'*.

GAD state:

> *It is known, having been acknowledged by the Society, that total current "asset shares" (indicated to members as their policy value) exceed total current admissible assets.*

GAD note that Equitable have taken out a reinsurance contract in an attempt to mitigate the strain of carrying reserves to meet annuity guarantees.

Interest – GAD produce a table showing the interest rates used in the net premium valuation for major classes. GAD raise no concerns.

Mortality – GAD explain that the bases used are reasonably conservative and that '[the] *Appointed Actuary states in his report that these tables contain sufficient allowance for future reductions in rates of mortality'.*

Expenses – GAD state that the total provisions seem to be more than adequate, and note the Appointed Actuary's statement that no additional provisions are needed to cover the continued sale of new business or to cover closure.

Resilience – GAD explain:

> *A resilience reserve requirement under the net premium valuation method is reported as £1,236m in 1998 (£1,022m in 1997). Whereas, for the gross premium bonus reserve (GPBR) valuation a resilience reserve is shown of £600m (£325m). The modified resilience reserve figures shown in the published GPBR valuation are designed to ensure that the amount of free assets disclosed is the same as would be shown by the Net Premium Valuation!*
>
> *It may be noted that the most adverse scenario at the end of 1998 involved a reduction of 10% in fixed interest yields combined with a 25% fall in equity values, whereas at end 1997 it had been the combination of a 3% rise in fixed interest yields with a 25% fall in equity values.*

Other factors – GAD note that Equitable have included a reserve of £70m for pensions mis-selling. GAD state that Equitable had established a capital gains tax reserve of £75m at the end of 1997, increased to £100m at the end of 1998, reducing to £20m in the most onerous resilience scenario. (Note: these are both points GAD had queried following their scrutiny of the 1996 returns – see 16/12/1997.)

Options and guarantees – GAD explain that as a result of current economic conditions, annuity guarantees are proving extremely onerous, although Equitable attempt to restrict the ultimate value to policyholders by use of a differential terminal bonus policy. GAD state that this approach is being tested in the Courts, and that loss of the case (by Equitable) *'would result in a need for the Society to reduce its level of terminal bonus additions to a wider group of policyholders – maybe all!'*.

GAD state that, notwithstanding Equitable's approach, the Government Actuary has determined:

> *... that there is a need in the statutory valuation to recognise the accumulated option liability attaching to the minimum level of benefits already guaranteed – without taking credit for any possible future emerging surplus offset.*

GAD note that, accordingly, in the net premium valuation Equitable have set up a reserve of £1,556m, with £793m ceded to the reinsurer. In the bonus reserve valuation, Equitable have set up a reserve of £1,593m, with £809m ceded to the reinsurer.

GAD state that Equitable's assumptions about the take-up of annuity guarantees *'somewhat stretched the concessions offered by the* [Government Actuary]' in the guidance letter of 13/01/1999. GAD produce a table which shows that Equitable have assumed take-up rates of between 70% and 82.5% and refer to three assumptions disclosed in the returns, namely:

> *(1) that allowance of a few percentage points has been made for the additional flexibility and other perceived advantages of alternative forms of benefit available and for the bonus system that the Society operates in relation to these contracts;*

(2) that a modest allowance has also been made for the availability of cash commutation options, and

(3) where it would be advantageous for higher rate tax-payers to commute for cash and buy a purchased life annuity, then a further allowance of a few percentage points has been made.

GAD explain that it is necessary to consider whether Equitable's assumptions should be challenged.

GAD note that Equitable have not supplied any information about how the reinsurance offset has been determined, and in particular what allowance has been made for the premiums payable.

(11) Financial results
GAD provide an overview. GAD note that Equitable's cover for their required minimum margin is 2.51, unchanged since the end of 1997. GAD continue:

Without the implicit future profits item of £850m, cover for the [required minimum margin] *would be reduced to a factor of 1.66. Further, we are still not entirely clear that provisions made to cover the currently guaranteed level of annuity liabilities are as strong as they should be.*

A large proportion of business is written on a participating basis, so that, provided the currently high level of annual emerging surplus continues, the Society should be able to work its way out of its current solvency margin problems. However, it does seem highly desirable for the Society to mitigate the risks posed by a possible downturn in asset values, by holding back more emerging surplus by declaring lower guaranteed bonuses – although it can still pay out appropriate final benefits to its members with declarations of "non-guaranteed final bonuses".

To be fair, the Society appears to be proceeding down this path – although mindful of the need to sustain a competitive position in the marketplace.

Under *'Summary of results for main classes'* GAD produce three tables, showing liabilities for non-linked and linked business and a valuation summary, for the years 1994 to 1998. The valuation summary shows, under the bonus reserve valuation, that Equitable's cover for the required minimum margin in 1997 and 1998 is 2.51 (compared with 2.53 in 1996). There is no figure for cover under the net premium valuation.

The table shows, in summary form, that Equitable's free asset ratio fell to 3.80% in 1997 (from 3.84% in 1996) and then rose to 5.37% in 1998. (Note: however, the detailed data contained within the table indicated that GAD's figure for 1998 was incorrect and that Equitable's free asset ratio had in fact fallen further, to 2.36%.)

In a note to the valuation summary, GAD state:

Although the Net Premium Valuation showed a lower non-linked liability of [£21.5bn] *and a lower reserve for declared bonuses of* [£340.5m] *it was shown to require a resilience reserve £636m higher than the GPBR valuation. Thus, as intended, the total of Long Term liabilities ... for the NPV is identical with the result shown above.*

GAD produce a further table showing composition and distribution of surplus. They make no comment on this.

(12) Bonuses
GAD produce tables showing the cost of bonuses declared and the recent history of key bonus rates. GAD explain that Equitable's:

... method of annual bonus declarations for unitised type contracts is unusual. As well as a declared guaranteed annual bonus, based on a proportion of accrued income and capital appreciation, a further annual bonus is quoted, which is not guaranteed (in that it may be withdrawn and/or reduced in future), but which makes up the total quoted accrued policy value at the valuation date. This non-guaranteed final bonus is declared in a similar way to reversionary bonuses, as a percentage of benefit, and the amount payable at maturity is the sum of these total annual "declarations", subject to the proviso that the final non-guaranteed bonus can be withdrawn.

GAD reproduce Equitable's table from their 1998 With-Profits Guide, showing gross investment returns at market value and the rate allocated in fixing bonuses, updated to include 1997 and 1998:

	1994	*1995*	*1996*	*1997*	*1998*
Earned	*-4.2%*	*16.6%*	*10.7%*	*17.2%*	*13.3%*
Allocated	*10.0%*	*10.0%*	*10.0%*	*13.0%*	*10.0%*
Guaranteed	*7.5%*	*7.5%*	*7.5%*	*6.5%*	*5.0%*

GAD produce tables showing final bonuses for traditional life contracts and deferred annuities, according to duration of the contract.

Under *'PRE (issues on with-profit business)'*, GAD state that Equitable:

... reserves the right to penalise early surrenders, even in relation to guaranteed bonuses added under unitised contracts, and it might be desirable for this possibility to receive greater prominence in the literature distributed. Further, with such a large proportion of unitised business and with the level of guaranteed bonuses declared taking account of some asset appreciation, it would seem to be desirable that policyholders were given some greater warning about the possible implications for future bonuses of a substantial market setback.

(Note: this same point had been made in the scrutiny report on the 1996 returns — see 16/12/1997.)

Under *'Recent history of maturity payouts'*, GAD produce a table of Equitable's payouts from 1994 to 1998, set against the industry average, and a chart showing payouts as a percentage of asset share. GAD comment:

It is clear that, while Equitable strives to be fair to all its policyholders, and pays much more generous surrender values than most other offices, its maturity payouts fall well short of the best in the market, particularly for conventional life contracts.

Nevertheless, the chart ... shows that policyholders seem to be receiving quite fair returns — no doubt helped by the low expense charges levied by the Society.

(13) Reassurance and financing
GAD state that Equitable make little use of traditional reinsurance *'other than for very large sums assured (retention being £400,000 for UK life risks and DM250,000 for German risks), and for supplementary disability and accident risks'*.

GAD repeat details of the reinsurance treaty entered into in order to cover costs arising from the exercise of annuity guarantees and note that this allows Equitable to reduce the reserves they hold for these policies.

(14) Compliance
Under *'HMT compliance problems'*, GAD state *'None observed'*.

Under *'PIA and other compliance problems'*, GAD note that a reserve of £70m has been included for pension mis-selling.

(15) Professional requirements
GAD certify that their report conforms to the requirements of the Institute and Faculty of Actuaries, as set out in their Memorandum of Professional Conduct and Advice on Professional Conduct. GAD also certify that the report has been prepared in accordance with the Service Level Agreement between HMT and GAD, signed in November 1998, as that agreement had been continued between FSA and GAD, following an exchange of letters in December 1998.

GAD's scrutiny report runs to 23 pages.

21/05/1999 [entry 1] GAD's Directing Actuary B suggests to Scrutinising Actuary E that they should ask Equitable to consider other possible scenarios, in addition to those considered in the Board paper sent to them on 04/05/1999 – such as gilt yields at 5% and a 10% fall in equities. The Directing Actuary says that they should also ask the Appointed Actuary to confirm that he had allowed for the expected cost of bonuses as at 31 December 1999, and that the estimated reserves on that date had been calculated on the same basis as the previous year, apart from changes to the valuation rate of interest. The Directing Actuary expresses surprise that, in the *'central scenario'*, which assumed a modest rise in gilt yields to 5% and broadly unchanged equity values, Equitable's mathematical reserves increased by only £1.2bn over 1999, despite a projected cash flow of over £2bn.

FSA write to HMT seeking to address the Economic Secretary's concern about whether it was reasonable to require Equitable to hold such a large reserve for annuity guarantees. The note reproduces undated comments made by GAD. FSA state:

> *Insurance legislation requires insurers to establish reserves for "all guaranteed benefits" on the basis of "prudent" assumptions. It also specifically provides that insurers must reserve for any additional costs of policy options. These requirements form part of the UK's implementation of the EC Third Life Insurance Directive.*

FSA explain that £1.6bn:

> *... is a provision for the additional liabilities the company would face in applying the annuity rates that it has guaranteed to policyholders to the cash benefits arising under its pension contracts (to the extent that these cash benefits are guaranteed).*

FSA say that Equitable's provision is the largest in absolute terms, reflecting their position as the leading United Kingdom provider of individual pensions. FSA explain that the cost of annuity guarantees and the reserving requirement had become significant because of *'the recent falls in long term interest rates'*. FSA go on to explain: *'Where Equitable Life has guaranteed rates in the region of £110 pa per £1000 cash available, the best current market rate for an equivalent annuity is now only of the order of £80 pa per £1000 of cash pension fund'*.

FSA say: *'The reserving standards applied in Treasury returns are almost invariably more onerous than general accounting standards ...'*.

FSA state that it should be noted that the Government Actuary's guidance had been *'widely endorsed within the actuarial profession'*, whilst there were a few actuaries (including Equitable's Appointed Actuary) who thought it unduly onerous and a *'significant number'* who thought that the standard was not strong enough. FSA conclude that they are *'content that the reserving standard ... strikes an appropriate balance'*.

FSA have no comments on the draft of a reply to Equitable's President, prepared by HMT.

21/05/1999 [entry 2]	Equitable ask FSA for confirmation that FSA have acted on Equitable's letter of 01/04/1999.
21/05/1999 [entry 3]	The Consumers' Association write to PIA, expressing their concern at the failure of some pension providers to honour guarantees (by either refusing to pay up or by concealing information) and at the potential for insolvencies. PIA pass the correspondence to FSA.
24/05/1999 [entry 1]	FSA write to Equitable in response to their letter of 21/05/1999. FSA confirm that all the appropriate action has been taken. FSA send a copy of a letter they have written that day to the German regulatory authority, in which they ask if there was anything outstanding.
24/05/1999 [entry 2]	FSA's Line Manager D sends the Head of Life Insurance an extract from GAD's scrutiny report on Equitable's 1998 returns. Referring to section 10, *'Options and Guarantees'*, the Line Manager states: *I think we will have to challenge the GAO reserving assumptions. Making allowance for cash commutation is contrary to specific guidance given by the* [Government Actuary] *and a reserving level of 70% seems unacceptably low. Please can we discuss handling.*
25/05/1999 [entry 1]	FSA write to GAD to say that FSA have agreed that a *'low-profile approach'* should be made to Equitable *'seeking clarification of the GAO reserving (including the determination of the reinsurance offset) and present this as a normal request for clarification of actuarial assumptions'*. FSA ask GAD to draft a letter to Equitable and to show them the draft before finalising and sending it.
25/05/1999 [entry 2]	HMT explain that the Economic Secretary to the Treasury has asked for a fuller reply to Equitable's President's letter of 30/04/1999, and that she wishes to deal in particular with Equitable's assertion that the assumed take-up rate of annuity guarantees is too high.
25/05/1999 [entry 3]	FSA agree to meet The Consumers' Association to discuss their letter of 21/05/1999.
27/05/1999	GAD write to Equitable, having cleared their letter with FSA. GAD explain that, although they had discussed various aspects of Equitable's reserving methodology earlier in the year, a number of points remained about the Society's approach in the 1998 returns. GAD note that Equitable had assumed a reduced take up rate (ranging from 70% to 82.5%) for annuity guarantees in each class of business. GAD ask Equitable to *'clarify exactly how these reduced proportions have been justified, since we find the description given in the returns to be rather imprecise'*. GAD ask Equitable to provide details of *'how the reinsurance offset was calculated in relation to these guaranteed benefits, including an explanation of how allowance was made for the premiums that would become payable if this reinsurance was called on'*. GAD also seek some additional information in the light of the paper to Equitable's Board, provided on 04/05/1999, taking up the points made by Directing Actuary B (see 21/05/1999 [**entry 1**]).
28/05/1999	PIA comment on The Consumers' Association's letter of 21/05/1999. PIA suggest that any refusal to honour a guarantee is a matter for FSA, as prudential regulators, but that any concealing of information from policyholders would be a matter for PIA, as conduct of business regulators.

01/06/1999	FSA explain to PIA that they understood The Consumers' Association's main concern to be that policyholders were not being told, when their policies matured, that those policies contained annuity guarantees, and that policyholders might, therefore, end up buying a lower value market annuity.
02/06/1999	After further discussion of the issues raised by The Consumers' Association, PIA say that the position was unclear. PIA note that there were issues about whether policies had been sold before or after the FS Act 1986 had come into effect; whether advice had been provided at the time of sale and by whom (a representative of the insurer or an independent adviser); and where a company's responsibilities lay. PIA explain that they had sought legal advice on the matter and were awaiting a reply.
03/06/1999	HMT fax FSA a note prepared in response to the Economic Secretary's queries about the reserving standards applied in HMT's regulatory returns.
04/06/1999	FSA send GAD a copy of their note prepared in response to the Economic Secretary's queries about reserving for annuity guarantees.
09/06/1999 [entry 1]	FSA prepare a paper discussing possible outcomes of the Court case and their implications for Equitable and FSA. FSA identify four scenarios: • Equitable win totally; • Equitable win in part (in that it is now acceptable to reduce the terminal bonus, but had not been so in the past); • Equitable win (in total or in part) on contractual grounds, but FSA would have to take a view on the outcome's acceptability from the perspective of policyholders' reasonable expectations; or • Equitable lose (in that reducing the terminal bonus where an annuity guarantee was exercised was unacceptable). On the third scenario, FSA note that they would expect to conclude that Equitable's current practice is consistent with PRE, but they would be more doubtful about past practice because *'bonus notices* [were] *of dubious clarity'*. On the fourth scenario, FSA explain that they would need to determine Equitable's solvency position and serve a notice under section 32 of ICA 1982 if Equitable were in breach of their required minimum margin. FSA state that they would need to consider closing the company to new business or suspending their authorisation if there was a significant risk that Equitable could not meet their liabilities to policyholders or their reasonable expectations. FSA caution that there could be potential for allegations that FSA should have prevented Equitable writing new business earlier. FSA also consider the implications for Equitable of the fourth scenario, under which Equitable's reinsurance treaty would be invalidated. FSA note that, without reinsurance in place, Equitable was likely to only just be able to cover their required minimum margin - even after taking full account of future profits implicit items. FSA note that coverage might be *'slightly more comfortable if the current level of gross reserving for GAOs was accepted, allowance was made for the improvement in the Society's position since the year end ... and some of the solvency boosting measures currently being considered had been put in place'*. FSA also consider other implications for Equitable, such as having to: reduce substantially terminal bonus payments; consider switching assets from equities to gilts; and pay compensation to

policyholders who had taken benefits in guaranteed annuity form and had suffered from reduced terminal bonus payouts as a result.

GAD comment on FSA's paper. GAD explain that it needed to be read alongside the paper presented to Equitable's Board at the end of April 1999 (see 04/05/1999 [**entry 2**]). GAD note that they await a reply to their letter to Equitable of 27/05/1999. They emphasise that, unless Equitable's practices are given full clearance by the Court, they would need to modify or replace the reinsurance arrangement.

09/06/1999 [entry 2] HMT send FSA a revised draft of a reply by the Economic Secretary to Equitable's President's letter of 30/04/1999. The draft explains that HMT's more onerous reserving standards reflect the fact that the regulations required a prudent valuation, which included an appropriate margin for adverse deviation of the relevant factors.

The draft acknowledges the concern that the guidance assumed that nearly all benefits would be taken in the guaranteed annuity form, but suggests that this was an example of the *'prudential principle'*. HMT's draft continues:

> *If, by exercising the option of taking an annuity with a guaranteed rate of return, the policyholder will obtain a return that is in excess of that which may be available elsewhere, then the rational policyholder will exercise that option. It is reasonably foreseeable that the guaranteed annuity rate will exceed the rate which will be available more generally in the annuity market. Past experience and projected experience are less relevant when circumstances may reasonably be foreseen to be going to be different.*

FSA's Line Manager D comments that:

> *... why Equitable have to reserve effectively on the assumption that all GAOs are exercised is somewhat complicated and I don't think the current draft would stand up (Equitable could argue that the annuity benefit is not more valuable to the policyholder in most cases – I won't bore you with the details of why).*

The Line Manager suggests some alternative wording, being that:

> *If the guaranteed benefits under the annuity option are higher than those available in cash form it must be prudent to reserve for the higher value benefit. Low take up of an option in the past does not necessarily mean it is reasonable to reserve on the assumption that take up will remain low in future. This is especially true when past practice is likely to have been influenced substantially by factors that may change (eg the payment of additional bonuses to those not exercising the option when those payments have not been reserved for and therefore cannot be guaranteed to continue).*

11/06/1999 FSA telephone Equitable and ask for copies of material relevant to the Court case.

14/06/1999 [entry 1] The Economic Secretary to the Treasury writes to Equitable's President in reply to his letter of 30/04/1999. The Economic Secretary explains by way of background that:

> *... companies have to err on the side of underestimating the value of their assets' future income and overestimating their liabilities. In this way it is ensured companies have some spare capacity to withstand adverse economic circumstances. The determination of how conservative the assumptions should be has been derived from past experience and is embodied in guidance to appointed actuaries.*

The Economic Secretary's letter includes the wording suggested by FSA (see 09/06/1999 [**entry 2**]) in response to the President's concern that the reserving requirement was excessively prudent.

FSA's Line Manager D informs officials at FSA and GAD that Equitable, subject to legal advice, have agreed to provide the Court papers. She says that the hearing was due to begin on 05/07/1999 and was expected to last two or three days, but that there might be significant delays before a judgment was published.

The Line Manager attaches a revised scenarios paper prepared by FSA. This now describes three scenarios:

- Equitable win totally;
- Equitable win in part (in that it is now acceptable to reduce the terminal bonus, but had not been so in the past); or
- Equitable lose (in that reducing the terminal bonus where a GAR option was exercised was unacceptable).

FSA's discussion of the implications of each outcome reflects the points made in the note of 09/06/1999. FSA also deal with consideration of policyholders' reasonable expectations issues under the second scenario.

14/06/1999 [entry 2] FSA, GAD and PIA meet The Consumers' Association. Prior to the meeting, FSA prepare a briefing note.

FSA state that life insurance companies were required to meet their contractual obligations and PRE. FSA state that they were unaware of any company failing to meet their contractual obligations. Whether or not a reduction in terminal bonuses was consistent with policyholders' reasonable expectations *'will depend on what policyholders were told at the time they took out the contract and subsequently'*. FSA explain that annuity guarantees were an additional benefit for which it was reasonable to make some charge if costs were incurred in providing it.

FSA state that they were not aware of insurance companies deliberately concealing from policyholders their right to take a guaranteed annuity. Complaint mechanisms existed for those who suffered loss as a result of poor or incomplete advice from companies.

FSA note that they had used the GAD survey to identify companies with the most significant exposure to annuity guarantees and that the situation had been discussed in detail with any company that appeared to face a solvency threat. FSA are content that companies are reserving fully for their annuity guarantees liabilities. They note that a number have controlled their liabilities through measures such as reinsurance.

FSA prepare a note of the meeting. FSA observe that there appeared to be much more common ground between FSA and The Consumers' Association than FSA had expected. FSA state that they were able to alleviate the Association's concerns that insurers were not honouring their guarantees. The Association had acknowledged the difficulty of being fair to all policyholders in meeting the costs of annuity guarantees and the appropriateness of the costs being met from the with-profits fund.

15/06/1999 FSA write to the Personal Investment Authority Ombudsman confirming arrangements for a meeting on 23/06/1999 to discuss the complaints the Ombudsman had received concerning Equitable's differential terminal bonus policy. FSA say that they wished to discuss the Personal Investment Authority Ombudsman's jurisdiction over complaints and how those complaints would be handled.

FSA advise PIA that advice about GAR options given to, or withheld from, policyholders by companies after 29 April 1988 – when the FS Act 1986 came into force – would be subject to the conduct of business rules, even if the policy had been sold before that date. Failure by a company to tell policyholders on maturity about their rights to GARs would undoubtedly breach PIA principles.

16/06/1999	Equitable's solicitors provide FSA with a pack of materials relating to the Court case. GAD write to FSA, following a query they had received from a mutual company about how they should present a subordinated loan in their returns. GAD conclude that two different approaches to drafting section 68 Orders appear to have been used, and that those have generally resulted in two different presentations in the returns. The first presentation was a much more explicit one, while the second could lead to a distorted asset/liability picture in circumstances where a company was in financial difficulty. GAD state that Equitable used a slight variation on the first presentation.
17/06/1999	FSA and PIA hold a bilateral meeting, at which they note that Equitable's Court case would be a key milestone on the guaranteed annuities issue. FSA and PIA agree to pilot *'supervisory cooperation'* involving meetings between prudential and conduct of business supervisors to discuss such issues.
18/06/1999	Equitable's solicitors seek confirmation from FSA that they would agree to the modification of the terms of the subordinated loan (see 30/03/1999 [**entry 4**]).
21/06/1999	Equitable write to FSA enclosing a note about contingency plans for the expected Court decision. Equitable identify six possible scenarios, ranging from complete success for Equitable to a ruling that their approach is invalid. Equitable say that their advice was that anything other than complete or qualified success was highly unlikely. Equitable add that they were discussing amendments to their reinsurance arrangement to mitigate the risk that their approach was ruled invalid, and have also been in discussion with other reinsurers regarding other types of arrangements. Under the worst case scenario, Equitable list that the possible effects would include: very high retirements immediately and on an ongoing basis; likelihood of a large volume of surrenders; and an almost certain requirement to make further payments in respect of past retirements.
22/06/1999	FSA prepare a summary of the papers provided by Equitable in relation to the Court case. FSA note that Equitable's argument in support of their differential terminal bonus policy revolves around their asset share methodology for determining payouts and the fact that terminal bonuses were not guaranteed. FSA observe that Equitable do not mention PRE. (Note: it has been suggested to me that FSA's comment related solely to Equitable's opening submission to the Court, as the expert reports served by both sides and the Appointed Actuary's affidavit all dealt with PRE at some length.) GAD also prepare a summary. GAD note that Equitable had discussed the adoption of a two-tier terminal bonus structure by reference to a Board resolution in February 1998. GAD say: *This initially gave me some concern that it had not been formally introduced at the time that GARs first began to bite, in 1993. However, I have now found a copy of 1993 board minutes that clearly explain that for recurring* [single premium] *pension GAR contracts, "the amount of final bonus payable is reduced by the amount, if any, necessary such that the annuity secured by applying the appropriate guaranteed annuity rate to the cash fund value of the benefits, after that reduction, is equal to the annuity secured by applying the equivalent annuity rate in force at the time benefits are taken to the cash fund value of the benefits before such reduction". This would seem to adequately demonstrate that the Board were cognizant and had taken action on this matter at the earliest moment that it became relevant.*

GAD note that Equitable have argued that if they lost the case they would seek to spread the cost of providing benefits at a higher level amongst policyholders with an annuity guarantee and ensure that payouts to policyholders without such guarantees were not affected. Against this, an official has written *'good grief'*. GAD comment that it is unlikely that the Court would ignore consideration of policyholders' reasonable expectations or ask FSA to consider this aspect. (Note: comments on their note (*Why?*) suggest others did not agree with this assessment.)

GAD suggest that they and FSA should clarify why Equitable were asking the Court to consider their practice up to 31 March 1999, as their subsequent practice was also likely to be questionable. GAD suggest that they should also clarify the extent of the Personal Investment Authority Ombudsman's jurisdiction.

23/06/1999 FSA and GAD meet the Personal Investment Authority Ombudsman. According to a note made by FSA, the meeting was held at the Personal Investment Authority Ombudsman's request to discuss jurisdiction over complaints. The Ombudsman explained that Equitable have accepted that the Ombudsman had jurisdiction prior to 1988 but that they could not arbitrate on matters concerning Equitable's Board policy. While for the most part, complaints about reduced terminal bonus were for the courts to decide, they might still consider complaints of misleading bonus notices. The Personal Investment Authority Ombudsman said that they *'would only look at PRE in terms of misrepresentation – eg if Board deliberately did not change bonus notices even after the Board had decided to adopt a differential* [terminal bonus] *policy'*.

FSA's Chief Counsel A comments that the note had not been cleared with her and was not entirely accurate.

24/06/1999 [entry 1] GAD send FSA some thoughts on what position FSA should take if the High Court referred the issue of policyholders' reasonable expectations (in relation to Equitable's differential terminal bonus policy) to FSA. GAD say:

> *... taking account both of the relative ambiguity of the material presented to policyholders and also the Equitable's long-stated position on the financial management of the society (with no estate being maintained), their position that GAR policyholders should receive benefits equivalent in value to asset share (except where the guaranteed fund applied at the GAR provides larger benefits) is tenable on both counts. While they could have reached an alternative position that gave some higher benefits to these policyholders, I would doubt that we could insist on this if we apply the above test.*

GAD note:

> *Equitable do appear to have ... informed policyholders of their change of practice on the application of GAR's, in annual bonus notices, and each policyholder does have the right to cancel the contract and switch to another provider.*

Against this FSA have written: *'No – this is* [very] *much debatable'*.

GAD also discuss the extent to which illustrations of final bonuses give rise to an expectation of how the GAR would be applied. GAD doubt that a reasonable policyholder would interpret the illustration as being binding in all circumstances. GAD suggest that a more plausible approach would be to regard the final bonus as variable *'in line with underlying investment conditions but not otherwise'* or variable *'subject only to smoothing over some reasonable period of time'*.

24/06/1999 [entry 2] FSA ask PIA if they had yet come to a view on whether they could consider information given to holders of policies bought before 1988.

FSA also ask if PIA had jurisdiction in relation to annual bonus notices issued to policyholders, for both pre- and post-1988 policies. FSA explain that they have: *'for sometime been unhappy with the format of Equitable Life's bonus notices because we think that the way terminal bonus is indicated is potentially mis-leading. A figure is quoted for terminal bonus and this is then added to the guaranteed benefits under the policy to give a total benefits number. You have to read the notes over the page to appreciate that terminal bonus is not guaranteed'*.

FSA say that the annuity guarantee issue has again focused their attention on the issue *'because it is arguable that the format of the notice would have encouraged policyholders to think that their guarantee would apply to the full fund including terminal bonus'*. FSA ask if PIA had any powers to require Equitable to change their bonus notices.

In response, PIA comment that bonus notices were not advertisements but were still communications which could be potentially misleading. PIA consider that it would be easy to argue that notices were issued in the course of relevant business, although this only applied to those issued after 18 July 1994, when Equitable had become a PIA member. PIA also consider that any explanation by Equitable of options available on maturity would be caught by PIA's rules.

PIA conclude that it would be worth looking at the current bonus notices and ask FSA for a copy.

25/06/1999 [entry 1] Equitable write to GAD in reply to their letter of 27/05/1999.

Equitable provide details of the reductions in the assumed take-up rate for the annuity guarantee in each class of business and the reasons for those reductions. Equitable explain that the adjustments combined to produce the overall proportions set out in GAD's letter of 27/05/1999.

Equitable state:

> *The reinsurance offset has been calculated assuming that any guaranteed benefits taken in guaranteed annuity form above 25% are covered by the reinsurer to be paid back from future surpluses. The value of the deposit premium of £400,000 pa has been calculated assuming it increases in line with* [the retail prices index] *and has been deducted from the reinsurance offset. The risk premium of 2% of any outstanding claim amount should the reinsurance be called on is payable out of future surpluses and therefore, as discussed on previous occasions, has not been included in the reserves for guarantees.*

Equitable provide the additional information requested in the light of the paper to their Board (see 27/05/1999). Equitable explain that, under the alternative scenario suggested by GAD (see 21/05/1999 [**entry 1**]), cover for the required minimum margin would be 1.4. Equitable confirm that their projections assume a declared bonus at 0.5% below that for 1998 and that there has been no change in the valuation bases. They explain that the projected cash flow is for non-linked and linked business, while the figures for projected solvency related only to non-linked business.

GAD pass a copy of the letter to FSA.

An undated note written by FSA's Line Supervisor C queries whether Equitable had yet replied to GAD's letter of 27/05/1999. The Line Supervisor writes:

- *What is present bonus notice practice, can we see an example.*
- *What do they think of how old bonuses were reported, don't they think they are vulnerable & that it misrepresents PRE.*
    - o *Did* [Chief Counsel A] *sort out position of various Ombudsmen (*[insurance] *v PIA)*
    - o *Need to make clear we are thinking of PRE.*
    - o *Ask Equitable to flesh out scenarios.*
    - o *Have they considered things envisaged in our scenarios.*

25/06/1999 [entry 2] FSA's Line Manager D writes to the Head of Life Insurance, outlining her own thoughts on the implications for FSA, should they have to express a view on whether Equitable's differential terminal bonus policy was consistent with PRE. The Line Manager explains that FSA's own legal advice (from Chief Counsel A) was that they should assess if it was *'reasonable'* to consider that Equitable's approach was consistent with PRE, rather than whether it was the best possible approach in the context of PRE.

The Line Manager explains that '[further] *analysis of the policy documentation provided by Equitable could be undertaken ahead of the court case, but it was not considered practical to reach a formal preliminary view on PRE until the court judgment had been digested'*. However, Line Manager D indicates her intention to do more work on the PRE issue ahead of the Court case, so that FSA might arrive at a preliminary view relatively quickly after the judgment was given. She adds that, at FSA's meeting with Equitable the following week, they should remind Equitable that PRE remained a live issue.

Line Manager D also explains that she had asked PIA if they had the power to change bonus notices. The Line Manager comments that these notices were currently the main factor supporting the argument that Equitable's approach was not consistent with PRE. The Line Manager says:

> *Even in the context of non-GAO policies the notices appear liable to lead policyholders to have potentially unrealistically high expectations of their total payouts because of the prominence given to the total accumulated benefits figure which includes undeclared terminal bonus. The format of bonus notices is something we have raised with Equitable previously (before the GAO issue arose) but we never made any progress in obtaining changes.*

28/06/1999 GAD comment to FSA that the note by Line Manager D of 25/06/1999 is a useful summary of the current position and a sensible way forward. GAD send FSA a copy of their thoughts of 24/06/1999 and add that they feel the PIA and/or the Personal Investment Authority Ombudsman might have a greater role to play if there were any suggestions of mis-selling by the sales force.

FSA's Line Manager D explains to Chief Counsel A that she has not commented on GAD's thoughts of 24/06/1999, as she did not know where to start or what to make of them. The Line Manager says that she would have expected an actuary to *'argue from a point of principle what constituted PRE rather than look at what might be a convenient result for FSA'*.

29/06/1999 FSA and GAD meet Equitable to discuss the implications of the pending Court case. FSA prepare a note of the meeting. FSA note that the policyholder would be arguing his case from a PRE perspective. Equitable maintain that the core of the case would be the scope of the Director's discretion in relation to bonuses. FSA record that:

> *The Equitable have thought through various outcomes and their implications, these were different to those envisaged by* [FSA]*, but broadly covered the same alternatives. Referring to the document sent under cover of their letter dated 21 June 1999 their lawyers believed that outcomes 1 and 2 were very likely (complete success or success but with some adverse comment in the judgement). Scenario 6 was deemed "inconceivable" (Equitable approach deemed invalid and final bonus rates on cash and annuity benefits must be equalised at the cash level) because it was thought that a Judge could not totally discount the scope for directors to exercise discretion over bonus levels.*

FSA's note continues:

> *The financial implications of scenario 6 had been covered in* [the Appointed Actuary's] *April Board paper* [see 20/04/1999]*, consistently running down all policyholders' bonus levels was not seen as a credible option.* [The Appointed Actuary's] *initial view if business dried up was that whilst it would be a serious commercial problem it would probably strengthen the solvency of the office. He confirmed that none of the mechanisms discussed in the April board paper for strengthening Equitable's financial position had been put in place, they were being retained as contingency plans.*

In relation to the IRECO reinsurance treaty, Equitable's Chief Executive tells FSA that, if the court ruling fell between scenarios 1 to 4, the reinsurance would remain in place, as they would not be forced to change their bonus policy. FSA note Equitable as saying:

> *As a contingency against losing the case the company had been in discussion with reinsurers about increasing the scope of reinsurance cover.* [A named reinsurance company] *had been prepared to offer a form of surplus relief reinsurance and even offered to take over the company's existing reinsurance with* [IRECO]*. However at the eleventh hour* [the company's] *Head Office backed off from the proposal claiming "capacity problems".*
>
> *Following this the company had decided to wait until the outcome of the Court case before talking to other reinsurers, they did not want to tout around the reinsurance market at such a sensitive time.* [Equitable's Chief Executive] *believed that there was room to extend the scope of the existing reinsurance contract if Equitable were to lose the case and that premium rates would be practical and consistent with the existing treaty. GAD made the point that any extension in the scope of these treaties could have implications for the size of the company's future profits implicit item.*

FSA stress that:

> *... even if The Equitable gained a total or partial victory at the Court this would not necessarily be the end of the matter as far as we were concerned; we would need to investigate PRE aspects of the company's policy.* [FSA's Head of Life Insurance] *added that we had some concern about what policyholders had been actually been told in bonus notices and we had not yet reached a view on this.* [Equitable's Appointed Actuary] *said that the Court might assume that we have already examined PRE.* [Chief Counsel A] *did not think that the Court would make such a statement but if it did we would strongly refute it.*

Following discussion of the fact that the Personal Investment Authority Ombudsman had relinquished jurisdiction over complaints relating to the Court case, the Society confirms to FSA that '[it] *had in one or two cases paid unadjusted terminal bonus on biting GAO policies but this had been compensation solely in respect of bad administrative errors the company had made when handling these cases*'.

Equitable confirm to FSA that they had adopted a new approach to bonus payments that had been recommended by their lawyers. Under this approach, Equitable *'award an additional cash sum to policyholders that do not exercise a GAO as opposed to operating the other way around'*. Equitable agree to send FSA their latest bonus notice and accompanying literature.

FSA record that:

> [Equitable] *confirmed that despite the bad publicity business was holding up well, in the first quarter single premium business was up 8% and annual premium business was down 8%, CAT marked ISAs were also selling well. There had also been no increase in lapse rates.* [Equitable's Chief Executive] *regarded his sales force as an important asset and a crucial indicator of the health of the company, turnover of sales staff was still very low. He was concerned for presentational reasons at the lower S&P rating, although he argued that A+ was still a very creditable rating. The lower credit rating was less of an issue for a non* [independent Financial Adviser] *provider such as The Equitable and was considered unlikely to have a direct impact on company financially.*

FSA also record:

> [Equitable's Chief Executive] *confirmed that the company would continue to offer "good value" to policyholders by paying out as much as possible in bonuses. The company would not be building up any hidden estates, e.g. by reducing surrender values. The lack of an estate was a useful deterrent against predators who wanted to demutalise the Society, but this was a secondary outcome from the main historical objective of the Society, which was to pay out fair shares.* [He] *confirmed that a number of suitors had approached the company but he had told them that the company was committed to mutuality.*

(Note: in an interview with the FSA's Baird Inquiry, Chief Counsel A said that, following a meeting with Equitable (which the Baird Report believed to have been the meeting referred to in this entry), she had provided oral advice to FSA and GAD, which had been that: *'... it is probably true to say that if the Court takes a Chancery approach to this matter, that will favour the Equitable's position but, make no mistake, this is very high risk for the Equitable. You can never predict judicial outcomes. At the High Court level, they are more likely to get a judge who would take a Chancery approach, but we can't be certain about that. Courts are more and more inclined now to take a wider policy approach to these matters. There is no relevant case law. If Equitable get the wrong panel or the wrong judge, they could find themselves on the receiving end of a change in judicial approach. The Court ... might not like what the Equitable has done and might be influenced for that reason. Don't jump to conclusions on this'*.)

30/06/1999	Equitable provide FSA with an example of a retirement annuity statement for 1998 and the accompanying leaflet, and a copy of their letter to policyholders updating them on the Court case.
02/07/1999 [entry 1]	FSA write to Equitable's solicitors to confirm that they agreed to the modification of the terms of the subordinated loan and that no amendment was required to the section 68 Order.
02/07/1999 [entry 2]	FSA's Chief Counsel A explains to Line Manager D that the description of her views (see 25/06/1999 [**entry 2**]) was not quite right. The Chief Counsel notes that the steps needed to reach a decision on policyholders' reasonable expectations would be listed in the Line Manager's note to FSA's Managing Director.

02/07/1999 [entry 3] FSA's Head of Life Insurance informs Managing Director A that FSA had met Equitable to review the possible outcomes of the Court case due to begin in three days. The Head of Life Insurance states that the Court's decision *'could leave some issues for the regulator to settle'*. He explains that he would report to him separately on the possible regulatory implications.

05/07/1999 [entry 1] The proceedings in the High Court begin.

Equitable's solicitors send FSA copies of the opposing skeleton arguments and supporting affidavits, and a witness report prepared for the Court by an independent actuarial expert.

The actuarial expert sets out the background to Equitable's practice on annuity guarantees and their differential terminal bonus policy. He explains the concept of policyholders' reasonable expectations drawing on ICA 1982, the terms of the Minister's statement to Parliament in February 1995, HMT's letter of 18/12/1998, GN1, the first report of the F&IA joint working party on policyholders' reasonable expectations and a statement by the F&IA in March 1999. In summary, the actuarial expert notes:

> *Generally HM Treasury regards it as appropriate for GAR policyholders to meet the perceived value of that guarantee, in some cases through some reduction in final bonus, subject to the wording of the contract and how it has been presented to policyholders.*

The actuarial expert says that Equitable's Appointed Actuary's interpretation of the Society's policyholders' reasonable expectations is that they would each receive their smoothed asset share and that Equitable would make a full and fair distribution. He considers this interpretation to be fair and reasonable. He notes that, as Equitable have no estate, if policyholders with annuity guarantees were to receive more than their fair share this could only be at the expense of other policyholders and their reasonable expectations.

The actuarial expert considers Equitable's documentation (policy documents, Article 65 (see 01/10/1998), With-Profits Guides, bonus notices, annual statements, illustrations and statements and reports contained in Equitable's annual accounts). He concludes that *'the PRE to which they give rise is that policyholders will receive a fair return as represented by smoothed asset shares'*.

The actuarial expert charts Equitable's bonus payments from 1989 to 1998. He concludes that Equitable's approach to the smoothing of investment returns had been satisfactory and that there had been no abrupt change in practice and no inconsistency with PRE.

The actuarial expert concludes that he could see no basis for criticising Equitable's approach to policyholders' reasonable expectations or the determination of final bonuses for GAR policyholders. The expert notes the statement by Equitable's Appointed Actuary that if GAR policyholders did expect that they should receive the same final bonus, irrespective of the form in which they took their benefits, he would nevertheless recommend to the Directors that they did not change their current practice. The expert considers this to be a fair and reasonable approach for the Appointed Actuary and the Directors to take.

05/07/1999 [entry 2] FSA produce a further scenarios paper. This discusses, in slightly more detail, the three scenarios identified in the paper circulated by Line Manager D on 14/06/1999.

Line Manager D sends a copy of the paper to Managing Director A. She sets out Equitable's differential terminal bonus policy and the background to the proceedings. The Line Manager explains:

> *... unless the judgement definitely settles the matter, we will need to undertake a significant exercise to determine whether we should intervene to ensure that Equitable*

Life's approach is consistent with PRE pursuant to our powers under the Insurance Companies Act 1982.

In reaching a view on PRE we consider that we will need to address the following series of questions:

a) What is/was Equitable's payment practice?

b) In objective terms, what would policyholders as a class have expected?

c) Is there a difference between the company's practice and policyholders' expectations?

d) Were policyholders' expectations reasonable in all the circumstances?

e) If policyholders' expectations were reasonable, is intervention action by FSA warranted to ensure that policyholders' interests are met?

The Line Manager adds:

[PIA] *are considering the presentation of Equitable Life's bonus notices. It appears to us that the notices may be misleading to policyholders because of the emphasis they place on the projected total fund value which includes terminal bonus although it is not guaranteed.*

Line Manager D attaches to her note a list of suggested responses to possible press enquiries. In answer to the question: *'What would be the implications for Equitable if they lose?'*, she writes: *'Would not expect the judgement to have a significant impact on the level of reserves the company needs to hold to cover its liabilities to policyholders'*.

06/07/1999 FSA write to Equitable, explaining that FSA are still considering the Society's application for a section 68 Order (see 30/03/1999 [**entry 3**]) and hope to be in a better position to assess it *'later in the year'*.

07/07/1999 FSA's Executive Committee meet and suggest that the Director of Insurance circulate to interested members of the Committee the scenarios paper of 05/07/1999 on Equitable's Court case and on the possible consequences for the FSA.

14/07/1999 PIA pass a copy of the advice of 15/06/1999 to FSA. PIA note that the advice *'confirms ... what we all thought'* regarding PIA's jurisdiction over policies sold before 29 April 1988.

15/07/1999 [entry 1] GAD write to Equitable in response to their letter of 25/06/1999. GAD explain that they intend to defer consideration of Equitable's justifications for the proportions of policyholders assumed to take benefits in guaranteed annuity form until after the Court case. GAD caution that they still have some difficulty in accepting that reductions of between 17.5% and 30% are consistent with the *'few percentage points'* referred to by the Government Actuary in DAA11 (see 13/01/1999 [**entry 2**]).

In response to Equitable's projections of their financial position, GAD note that no material changes are assumed in the valuation bases used in the resilience scenario, other than taking due account of changed investment yields. GAD recognise that the figures quoted in the Society's Board paper (see 04/05/1999) relate only to non-linked business. GAD note the indication of the potential outcome in the suggested scenario.

15/07/1999 [entry 2] FSA's Managing Director A presents his monthly report to FSA's Board. He informs them of the progress of Equitable's Court case, indicates that it seemed unlikely that the Court would resolve all of the issues of potential concern and states that FSA were undertaking some contingency planning.

19/07/1999	Equitable write to GAD in reply to their letter of 15/07/1999. Equitable say that the Government Actuary's letter of 13/01/1999 contains several references to relaxing the assumption of a 100% take-up of annuity guarantees and that: *The letter does not imply that the combined effect of all relevant factors should be "a few percentage points" but that each factor should be considered individually.* Equitable also point out that the letter refers to the allowance being '*a few percentage points* ***of the reserve***' rather than of the assumed take-up rate. Equitable conclude: *Looked at in that way, even for the retirement annuities, where I have assumed the lowest take-up rate of 70%, the effective reduction in the overall reserve is less than 10%. That would seem to put a rather different light on the reserving assumptions.*
26/07/1999	FSA meet PIA for a Supervisory Co-operation Meeting. The aim of the meeting is to discuss ways in which they could more effectively supervise firms for which they have joint responsibility. Equitable were selected to be used as an example to see in which areas information could be shared and how it should be communicated. FSA highlight what they feel are the differences between FSA and PIA's visits to companies, those being: • [FSA's] *visits usually took the form of a half-day meeting spent in the boardroom with top management, as opposed to the 50-80 man-hour visits carried out by PIA on the "shop floor".* • [FSA] *had the advantage of a more objective third party contact at the firm in the* [appointed] *actuary. PIA's contact, the compliance officer, was often from an ex-sales background and the fact that his salary was paid by the firm automatically made him less objective.* • *Within* [FSA], *there was a greater emphasis on the Policyholders' Reasonable Expectation aspect of the process.* The note of the meeting records that '[generally], *it was agreed that Equitable Life was easier than many other companies to regulate because the company worked to high standards, had good quality personnel and staff turnover was low*'. It is noted that PIA Investigations were soon to visit Equitable, as part of a themed visit programme on income drawdown products. FSA and PIA decide that, in five areas, it would be possible to share information about Equitable, including: *1) PIA felt that they would benefit from information on the issue of solvency – because this impacts on risk ... and affects how much new business the company can afford to sell and how much pressure is put on salesmen.* *2)* [FSA] *felt they would benefit from more "nuts-and-bolts" type information on products and their selling gained by PIA.*
04/08/1999	FSA inform Equitable that the lack of '*Millennium preparedness*' in one part of the company (Equitable Unit Trust Managers Ltd) is a cause for concern. FSA say that '*should the situation deteriorate, we will need to consider what action, including the possible exercise of our formal powers, may be necessary to protect policyholders and prospective policyholders*'.
11/08/1999	FSA's Line Manager D informs the third bilateral meeting of FSA and PIA that the High Court judgment is expected on 09/09/1999 and that '[evidence] *suggests* [the] *case could still go either way*'.

12/08/1999	FSA's Line Manager D provides the Head of Life Insurance with a note summarising the transcripts of the High Court hearing and key affidavits. The Line Manager says that her impression is that the case could go either way, but that the most likely outcome looked to be a victory for Equitable. Chief Counsel A marks on the note: *'As you say, impossible to call'*.
17/08/1999	GAD write to Equitable and a number of other companies. GAD explain that they intend to introduce changes to the *'valuation of liability'* regulations in ICR 1994, but that, before making recommendations to HMT, they were writing informally to a range of companies seeking further information. GAD add that they are considering changes to the regulations to introduce a new method for assessing an appropriate yield on equities when determining the valuation rate of interest and corresponding changes to the resilience test. GAD attach a draft letter which is to be sent to all Appointed Actuaries which explains this in more detail. (Note: The attached letter was not held on file. It has been suggested to me that this was a draft version of DAA12 which was later issued on 30/09/1999.) GAD seek to arrange a meeting with Equitable to discuss the proposals and invite written comments in advance of this.
20/08/1999	Equitable inform FSA that the final round of testing of their internal and external business processes (in preparation for the new millennium) is under way and is expected to be completed ahead of schedule later that month (see 04/08/1999).
24/08/1999	PIA telephone FSA to seek information about annuity guarantees and the likely impact of the Court case. PIA subsequently confirm that the note to FSA's Managing Director of 05/07/1999 gives them the information required.
27/08/1999	Equitable write to GAD in reply to their letter of 17/08/1999. Equitable comment on the changes to the liability regulations. Equitable acknowledge that a non-contractual surrender value (for example, a transfer or early surrender) is the surrender value a policyholder would reasonably expect. However, Equitable point out that they make clear that they do not guarantee a non-contractual surrender value and that, on occasion, they have *'found it appropriate to apply an adjustment so as to protect the interests of the remaining with-profits policyholders'*. Equitable express concern that the proposed Regulation 72 might require companies to hold reserves for non-guaranteed payments on accumulating with-profits business at or above the level held for guaranteed payments. Equitable also comment on proposed changes to the resilience test. They express concern that the new test 2, contrary to the advice from GAD, might be more, rather than less, severe and that this also would require companies to hold increased reserves.
31/08/1999	GAD write to Equitable in reply to their letter of 27/08/1999. GAD point out that the surrender value a policyholder might reasonably expect depends on *'the representations made to policyholders by the Society, either at the inception of the contract or through subsequent bonus notices or illustrations'*. GAD accept that, accordingly, in the circumstances Equitable describe the reserves required by Regulation 72 could be lower than a policyholder's asset share. GAD dispute that the new resilience test 2 is more rather than less severe.

c31/08/1999	FSA's files contain an undated *'Initial Risk Assessment'* of Equitable as part of a new approach to company assessment. (Note: according to the Baird report, the assessment is prepared by FSA as part of a pilot for the introduction of risk assessment for all companies. It is based on already available information.) FSA's overall assessment is that Equitable are a high financial risk because of the level of benefits guaranteed to policyholders, the low free asset position and the difficulty in raising external finance. FSA note that Equitable are vulnerable to a sustained fall in equity prices. FSA assess organisational, strategic and management risks as low. Environmental risks are also low, with the exceptions of regulatory risks (as the effect of stakeholder pensions on the company's business is uncertain) and reputational risk (as a result of the current dispute over how the costs of annuity guarantees are met). FSA discuss Equitable's management. FSA comment that Equitable have a *'tendency to arrogant superiority'*, which could blind them to the financial risks of guaranteeing high benefit levels. However, FSA note that Equitable are open with them and that *'there are no particular concerns about the level of co-operation that has been shown in the past'*. FSA state that Equitable generally have a good record of compliance with both the prudential and conduct of business regulators. FSA discuss Equitable's solvency position. FSA note that Equitable's relatively low free asset position, together with their mutual status and policy of declaring high reversionary bonuses, means that they are *'highly vulnerable'* to a change in economic circumstances. FSA state that Equitable have taken heed of their concerns about the level of bonuses and taken steps to reduce these this year; further reductions would be needed in future years. FSA note that Equitable use future profits implicit items and have already issued close to the maximum admissible subordinated debt. They state that Equitable have set a reserve of £1.5bn in respect of annuity guarantees, half of which is covered by the reinsurance arrangement, but say that it is arguable that this should have been higher. FSA conclude that Equitable have a strong reputation in the insurance market, which could be tarnished by the outcome of the Court case. Against this, an official has written *'already tarnished'*.
07/09/1999	GAD's Pensions Policy Section write to Equitable to explain that they have been contacted by holders of Equitable's income drawdown policies who had seen the maximum income they could withdraw cut considerably at the first three year review. GAD say it appears that the policyholders have been told that this is due to the actions of GAD (who prepare tables against which maximum and minimum amounts of withdrawal are determined). GAD ask Equitable to not give such a misleading impression, pointing out that the basis of the tables had not changed, and that the cuts had occurred because falls in gilt yields had not been matched by investment returns in the funds. (Note: Equitable's sales of income drawdown policies were being investigated by PIA at the time. The matter was discussed briefly at the meeting on 06/12/1999 and then became the subject of further correspondence from 08/02/2000.)
08/09/1999 [entry 1]	Equitable advise FSA of changes to the requisite details for their branch in the Republic of Ireland, following the marketing of a new product.
08/09/1999 [entry 2]	Equitable write to GAD in response to their letter of 31/08/1999. Equitable welcome GAD's acceptance that the surrender value that a policyholder might reasonably expect could be lower than the asset share. Equitable reiterate their view that the new resilience test 2 is more, rather than less, severe.

08/09/1999 [entry 3]	FSA's Director of Insurance informs FSA's Executive Committee that the High Court judgment is expected the following day.
09/09/1999	Judgment is given in the High Court. The ruling is that Equitable are entitled to operate their differential terminal bonus policy. The representative policyholder is given leave to appeal. GAD send FSA some thoughts on the judgment, particularly in relation to PRE. GAD interpret the judgment as saying that policyholders who selected an annuity at a guaranteed rate in 1994, or shortly after, may have had a reasonable expectation that they would receive a final bonus based only on accumulated investment returns and to which the guaranteed annuity rate would apply. GAD suggest that FSA might need to consider whether to intervene in respect of those policyholders whose expectations had not been met. GAD query if FSA would be expected to express any views to the Court of Appeal.
10/09/1999	FSA's Chief Counsel A provides a summary of the judgment in the High Court by the Vice-Chancellor. The Chief Counsel describes as very significant the recognition that policyholders might have a reasonable expectation of benefits over and above contractually guaranteed benefits. Chief Counsel A notes that, on the issue of breach of contract, the Vice-Chancellor had found against the representative policyholder, in that the effect of Equitable's policy and practice was to allocate final bonuses to GAR policyholders on a conditional basis. She also notes that FSA have some evidence that *'on maturity and when options were being discussed with policyholders, the Equitable did <u>not</u> tell policyholders in terms that terminal bonus was conditional'*. She states that this was a matter for PIA. Chief Counsel A notes that, on the exercise of discretion, the Vice-Chancellor had found that GAR policyholders had a reasonable expectation that they would receive full terminal bonus with a GAR annuity, but that a reasonable expectation did not become a contractual right. Policyholders' reasonable expectations were one of several factors to be taken into account by Equitable's Directors. The Vice-Chancellor had not accepted that, in making their decision, Directors had failed to take their previous practice into account. In assessing the implications of the judgment for FSA, Chief Counsel A states: *... based on the evidence we have examined so far, we would be likely to come to the same conclusion* [that policyholders had a reasonable expectation that they would receive full terminal bonus with a GAR annuity] *... The next step then, would be for us to consider whether, under section 45 of the Insurance Companies Act 1982, action should be taken to ensure that the criteria of sound and prudent management are fulfilled. These criteria, in Schedule 2A to the Act, include:* *a) carrying on the business of the society with integrity (para 1); and* *b) conducting business with <u>due regard</u> to the interests of policyholders and potential policyholders (para 7).* *The* [Vice-Chancellor] *concluded that the directors of the Equitable had properly had regard to PRE; the question for us goes beyond that and is whether sufficient or due regard was had to PRE.* *As we have already discussed, if we were to take the view that due regard was <u>not</u> had to PRE, there is real awkwardness in taking action against the Equitable for all sorts of reasons (which I won't go into here) including the need to rely on grounds which are primarily directed at good management, soundness and prudence, rather than conduct of business as such.*

Chief Counsel A adds that there was *'also a PIA "ring" to this case'*, although she could not comment on the extent to which PIA could or should get involved.

(Note: in April 2001, Chief Counsel A was questioned by the FSA's Baird Inquiry on the point quoted above that *'there is real awkwardness in taking action against the Equitable for all sorts of reasons (which I won't go into here)'*. The transcript of that interview records that Chief Counsel A had explained that:

> *In ... my summary of the Scott judgment, I say that if, assuming the Scott judgment not to have been appealed, that we were to have done our investigation and taken the view that due regard was not had to PRE – obviously, Scott himself took that view ... that PRE had been breached – that in that context it had not been properly considered, there would be a real awkwardness in taking action against the Equitable, for all sorts of reasons which I won't go into here, and I didn't go into in this note because it had been copied around to all and sundry around FSA and it didn't seem to be either the time or place to get into that sort of analysis, including the need to rely on grounds which were primarily directed at good management, soundness and prudence, and I said that there was a PIA "ring" to the case, and part of the reason for that was that Scott found that there had been* [a] *breach of PRE, not with respect to the contract itself, but rather with respect to point of sale documentation and post-point of sale documentation. As soon as you get into that area, obviously someone concerned with prudential regulation starts thinking, "This is starting to feel a bit like conduct of business, getting a bit uncomfortable from the point of view of applying criteria of sound and prudent management".*
>
> *I think that there was still good argument to be made there, that what the Equitable had, was doing, was a sort of globally applied management policy; the arguments were there to be made. But, for me, there was an area of discomfort beginning to creep in. In addition, when the starting point is that the contractual relationship was perfectly fine, legally speaking, but rather PRE was to be derived from the bonus notices and so on, then you are also getting into a situation which is starting to look more like misrepresentation. You start getting into an analysis which is along the lines of, "Well, they didn't have any PRE when they signed up to the contract, but instead that PRE began to build up post-contract. Well, it couldn't have affected their decision, or might not necessarily have reflected their decision at point of sale, but that perception increased returns developed as time went on".*
>
> *How do we as a Regulator respond to that? It starts to look as though the analysis is one of misrepresentation and reliance, and then you start asking yourself about loss, then you start asking about what intervention would be appropriate in that sort of situation, particularly taking into account the interests of other groups of policyholders.)*

Chief Counsel A notes that Line Manager D has decided to defer reaching a decision on whether to take action pending the appeal. The Chief Counsel suggests, however, that FSA check if PIA were adopting the same position.

GAD's Directing Actuary B informs FSA that his understanding of the judgment in relation to policyholders' reasonable expectations differs slightly from those of the Director of Insurance and Chief Counsel A. The Chief Counsel advises the Directing Actuary that, in her view, *'the Court clearly found that PRE had not been fulfilled for holders of GAR options (but the Court also held that that was OK)'*.

13/09/1999 FSA write to GAD to inform them that FSA had suggested to Equitable the possibility of a visit to discuss the broader picture, and that their suggestion had been well received.

14/09/1999	FSA's Line Manager D prepares a note about the High Court judgment. She says that the judgment has had little effect on Equitable. The Line Manager suggests that, while the case was subject to appeal, it would be inappropriate for FSA to reach a view on whether Equitable had had due regard to policyholders' reasonable expectations and, if not, whether FSA should take intervention action.
15/09/1999	FSA write to PIA. FSA say that they are keen to look at the issues arising from the judgment from the perspective of all the FSA constituent bodies, and that any possible action should be considered in the same way. However, no action should be decided or initiated until the Court of Appeal's decision is known. FSA pass to GAD details of the changes to Equitable's Republic of Ireland branch. They suggest that the changes are uncontroversial but seek GAD's views. FSA add: *... more importantly we still have the implicit item concession outstanding* [see 06/07/1999]. *We probably need to make a decision on this as it looks unlikely that the Court decision will be appealed during 1999.*
16/09/1999	FSA's Managing Director A presents his monthly report to FSA's Board. The Board note the High Court judgment.
20/09/1999 [entry 1]	FSA ask GAD when they expected to complete their scrutiny of the Society's 1998 returns. In response, GAD explain that their detailed scrutiny report had been submitted to FSA on 20/05/1999. GAD say that no questions of the *'conventional kind'* had been raised with Equitable but that GAD had left two points outstanding. The first is further consideration of the final terms of the reinsurance treaty. GAD ask if Equitable have yet sent the final wording. The second is the assumptions made by Equitable when reserving for annuity guarantees. GAD refer to the exchange of correspondence from 27/05/1999 and say that GAD need to consider Equitable's last letter of 19/07/1999.
20/09/1999 [entry 2]	FSA write to Equitable to arrange a company visit, pointing out that it is nearly three years since the previous one (see 08/11/1996 [**entry 2**]). FSA note that much of the contact in the last year had been on the issue of guaranteed annuities and that now would be an opportune moment to discuss Equitable's overall position and future plans. FSA set down six matters they would expect to cover: *1. Overview of corporate management structure of Equitable Group.* *2. General market outlook and business strategy.* *3. Marketing approach including product development and distribution.* *4. Role of the Appointed Actuary.* *5. Systems and Controls.* *6. Investment Policy and Asset Management.*
22/09/1999	FSA's Line Manager D prepares a further note summarising the background to the High Court case and the judgment. The Line Manager says that the judgment appears consistent with the guidance on annuity guarantees and policyholders' reasonable expectations, issued by HMT (see 18/12/1998 [**entry 1**]), *'that insurers might charge for the additional costs of the guarantee via a reduction in terminal bonus provided such a reduction was consistent with PRE'*.
23/09/1999	PIA write to FSA, having reviewed a selection of Equitable's bonus notices that FSA had provided to them. PIA tell FSA that they had concluded that the Society's notices were not poorly presented or inaccurate. As a result, PIA did not intend to pursue Equitable for a breach

of the requirement that anything said, written, sent, given or shown to a policyholder or potential policyholder should be clear, fair and not misleading.

PIA add that they have not previously pursued a company in relation to this requirement as PIA's scope:

> *... covers the activities of dealing, arranging deals in, managing and advising on certain types of investments. The ongoing servicing of policies does not seem to fit comfortably within these activities. And we would therefore have to have serious concerns about a document issued in the course of servicing a policy to attempt to breach the firm concerned.*

FSA note: *'A surprisingly unqualified endorsement for the bonus notices'*.

24/09/1999 GAD write to FSA about Equitable's application for a section 68 Order (see 30/03/1999 [**entry 3**]). GAD confirm that *'the calculations provided are in line with the guidance and that the figure of £2,960m appears to be a fair estimate of 50% of "Estimated Future Profits"'*. GAD say that the amount sought (£1,000m) was about a third of the maximum amount that could have been claimed (£2,960m), and substantially less than the amount approved in 1998 (£1,900m). GAD advise FSA that they *'have no real doubts that such a sum can be reasonably accepted by the FSA'*.

However, GAD suggest that FSA should ask the Society's Appointed Actuary to certify:

> *... that the amount applied for does not exceed the present value of future profits that may be expected to arise in the future on the long term business in force on 31 December 1998, in excess of sums that may be required to meet claims recovery premiums payable under the* [reinsurance] *treaty ....*

GAD advise FSA to take the opportunity, when doing this, to ask for a copy of the reinsurance treaty as finally signed.

In the same note, under the heading *'Returns as at 31 December 1998'*, GAD comment on the reserving assumptions made by Equitable in respect of GARs, following their letter of 19/07/1999:

> *We are not inclined to take this matter any further at this time, even though we remain somewhat uncomfortable that* [Equitable's] *assumptions are not fully in line with expectations based on our interpretation of the* [Government Actuary's] *letter on this subject, since, with the reinsurance now in place, a stronger interpretation would raise the Society's gross liability but not its net liability. (It would of course raise to a modest degree the* [required minimum margin] *of the Society.) The topic could be discussed again at the proposed FSA visit.*

GAD conclude that they *'now consider* [their] *scrutiny of these Returns to be closed'*.

On the same day, GAD advise FSA that they have no objections to Equitable's changes to the requisite details of their Republic of Ireland branch.

28/09/1999 FSA ask Equitable to provide certification in respect of the matter suggested by GAD on 24/09/1999. GAD also ask for a copy of the final signed version of the reinsurance treaty.

29/09/1999 Equitable send FSA income and expenditure figures relating to the company's activities in Germany, Republic of Ireland and Greece.

30/09/1999 Every Appointed Actuary is sent by the Government Actuary a copy of DAA12, making further revisions to the second of the three resilience tests (see 30/09/1993 [**entry 2**] and 24/11/1998 [**entry 2**]).

01/10/1999	GAD's Scrutinising Actuary E sets out why he considers the High Court judgment to be more favourable to Equitable on the question of policyholders' reasonable expectations than FSA's Chief Counsel A had implied in her summary (see 10/09/1999). The Scrutinising Actuary notes the conclusion in the judgment that GAR policyholders had a reasonable expectation that they would receive full terminal bonus with a GAR annuity. The Scrutinising Actuary points out, however, that this conclusion only referred to the period *'up to 1994 and perhaps for a while thereafter'* and that the practice followed by Equitable, up to 1994, had been consistent with this. He cites subsequent comments in the judgment which suggested that there was no basis for policyholders taking benefits in fund form to have a similar expectation, or for policyholders to expect Equitable to apply the same rate of bonus to all policyholders. Scrutinising Actuary E cites a further comment in the judgment that there was no basis for concluding that Equitable had failed to take into account policyholders' reasonable expectations when exercising their discretion regarding final bonus. Subject to some doubts about what was done *'for a while'* after 1994, Scrutinising Actuary E concludes that: *'On the basis of this judgement, it would seem to me that sufficient or due regard was and continues to be given to PRE'*.
11/10/1999	FSA and PIA hold their fourth bilateral meeting. FSA's Line Manager D explains the implications of the court judgment for both FSA and PIA. The minutes of the meeting record that: > *Although the judgement was in favour of the Equitable, the* [FSA] *view is that although Equitable had regard to PRE they did not meet it so there is the possibility of intervention. In terms of Conduct of Business issues there may for example be misleading bonus notices supplied to investors or firms may have churned investors into new contracts without guarantees.*
14/10/1999 [entry 1]	Equitable provide FSA with a copy of the final signed version of the reinsurance treaty, dated 11 October 1999. The treaty is reproduced in full in Part 4 of this report.
14/10/1999 [entry 2]	Equitable confirm to FSA that they are happy to include GAD's suggested wording (24/09/1999) in their application for a section 68 Order. On the same day, Equitable seek a section 68 Order to allow them to raise the limit on the admissibility of share holdings in the returns from 2.5% to 5% for the stocks of four companies.
c20/10/1999	In an undated note, FSA write to GAD suggesting some proposed wording in response to Equitable's request of 14/10/1999 regarding limits on the admissibility of share holdings. FSA also request that GAD should review the final version of the reinsurance treaty recently received from Equitable.
21/10/1999 [entry 1]	FSA write to Equitable in response to their letter of 14/10/1999. FSA explain that they have put together a formula to consider requests for section 68 Orders to raise the limit on the admissibility of share holdings. FSA ask Equitable to apply the formula to each of the companies concerned. (Note: In an earlier draft response, FSA had suggested that Equitable should make their application in mid-November when GAD would be in a better position to assess it.) FSA advise GAD of a meeting held that day with PIA to discuss the annuity guarantees issue and Equitable.

FSA explain that PIA are likely to conclude that they do not have the power to act in relation to any misleading bonus notices, as these were not marketing literature. As regards the sales process, PIA needed to establish if there was a material number of policies in their remit to justify an investigation. To this end, FSA would write to Equitable to ask about the number of policies sold after April 1988, when the FS Act 1986 came into force, and the number of top ups sold after June 1988, when Equitable had stopped selling the basic contract written to provide an annuity at a guaranteed rate.

FSA explain that PIA needed to consider the position of other companies. To this end, FSA ask GAD to provide information on companies' exposure to annuity guarantees, drawn from the responses to the survey in 1998 (see 20/06/1998).

21/10/1999 [entry 2] FSA write to the other regulators involved in the supervision of Equitable (PIA's Pensions Review Team and the Investment Management Regulatory Organisation (IMRO)). FSA seek information about recent regulatory activity, including visits and disciplinary action, in preparation for a *'college meeting'* (that is, a meeting of all the regulators involved in the supervision of Equitable) on 26/11/1999.

21/10/1999 [entry 3] FSA's Managing Director A presents his monthly report to FSA's Board, in which he notes that Equitable had won their court case and advises that FSA *'shall await the outcome of the appeal before considering whether any further action by FSA is called for'*.

22/10/1999 GAD advise FSA that the revised certificate for the section 68 Order was exactly in the form required.

GAD confirm that the reinsurance agreement:

> *... is totally in accord with the Draft Term Sheet that was examined in detail in April.* [It is my understanding that the construction of the reinsurance agreement as set out in the draft term sheet was considered to be acceptable at that time.]

29/10/1999 FSA ask Equitable how many policies with GARs the Society had sold after 29/04/1988 when the then current conduct of business regime under the FS Act 1986 came into force. FSA also ask how many GAR policies had been *'topped up'* after April 1988 and if top ups were still being made in 1994 and more recently.

November 1999 GAD send FSA their annual report on the life insurance industry for the year ending 31 December 1998. The report follows a similar format to that used for previous years.

In the Executive summary, GAD note:

> *Once again, the low level of income yields available and the modest growth seen in dividends makes it likely that the strong investment performance of 1998 will only really enhance the free assets of those companies that entered the year already in a healthy position. Further, it is important to recognise that for companies paying terminal bonuses, a proportion of their reported free assets are in fact needed to cover their obligation to provide these bonuses (in respect of which there is no requirement under the regulations to establish explicit reserves) and that apparently increased free assets are in fact largely needed to cover increased hidden obligations to provide these bonuses.*

In the section on *'Free Assets'* and under the heading *'Economic Background & Impact on Life Offices'*, GAD's report states:

> *A standard UK life office would be expected to have secured a rise in capital value of assets of about 10.5% over 1998, an income return of about 4.5% and a total gross investment return in the region of 15.0%.*

Nevertheless:

Since prospective yields have again fallen substantially over the year, valuation interest rates will need to have been reduced further - raising the amount of the disclosed liabilities for all conventional contracts. This in turn will have had an upward impact on required minimum margins. It also remains clear that recent bonuses declared under at least some accumulating with-profit contracts, and those bonuses that seem likely to be declared in the future, are being supported partly by capital gains. To be prudent, most bonus enhancement should be paid in terminal form, and reversionary bonus rates reduced.

Once again, the low level of income yields available and the modest growth seen in dividends makes it likely that the strong investment performance of 1998 will only really enhance the free assets of those companies that entered the year already in a healthy position. Further, it is important to recognise that for companies paying terminal bonuses, a proportion of their reported free assets are in fact needed to cover their obligation to provide these bonuses (in respect of which there is no requirement under the regulations to establish explicit reserves) and that apparently increased free assets are in fact largely needed to cover increased hidden obligations to provide these bonuses.

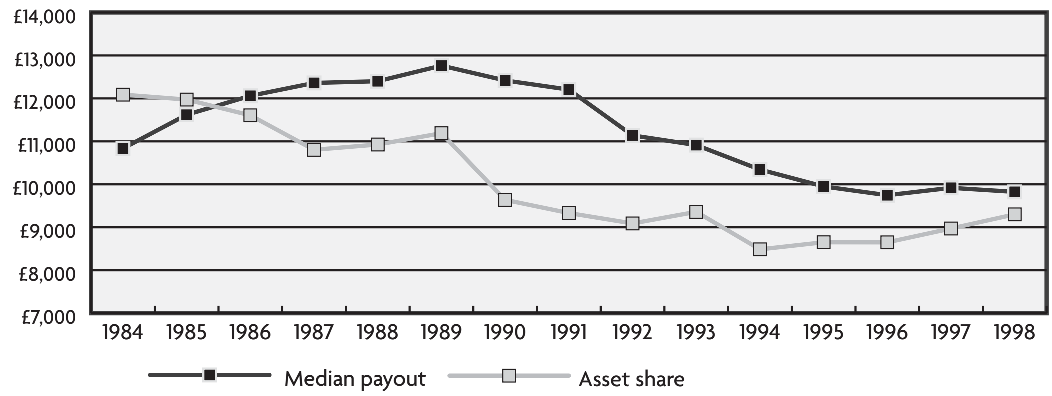
In commenting on the free asset ratios of individual companies, GAD say that Equitable *'purports to carry out a bonus reserve valuation but, in practice, this gives effectively the same answer as a net premium valuation'*.

On maturity payouts for a 10 year endowment policy, GAD report that Equitable and another company show the largest falls in payouts over the five years to 1998. For a 25 year endowment policy, GAD report that Equitable remain *'among the poorer performers'*. In relation to surrender values, however, GAD note that Equitable and four other companies *'all show to advantage'*.

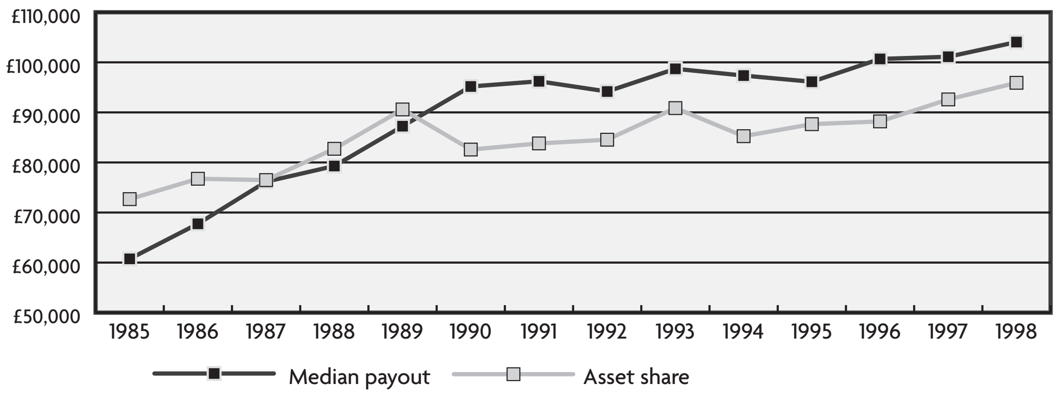
Unlike in previous annual reports, GAD's annual report to FSA does not include a comparison of maturity payouts against their own calculations of theoretical asset shares. However, GAD's report still provides a review of maturity payouts across the industry. An appendix to the report shows that, for an endowment policy with contributions of £50 per month for 10 years, Equitable's maturity payout value is shown as £9,681, against a with-profits industry median of £9,825. For an endowment policy based on contributions of £50 per month for 25 years, Equitable's maturity payout value is shown as £84,418, against a with-profits industry median of £104,049. For a pension policy based on contributions of £200 per month for 15 years, Equitable's maturity payout value is shown as £98,303, against a with-profits industry median of £103,790.

I have seen that GAD still undertake their own analysis comparing maturity payouts to their estimates for the theoretical asset shares. Continuing their previous work, they prepare the following charts:

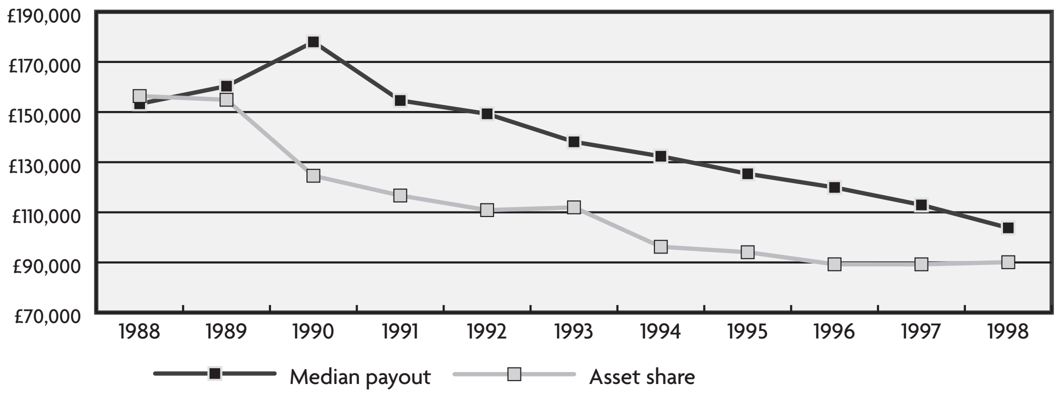
Comparison of actual median maturity payout and theoretical asset share for the years 1984-98 for a £50 per month conventional with-profits 10 year endowment policy (£)



Comparison of actual median maturity payout and theoretical asset share for the years 1985-98 for a £50 per month conventional with-profits 25 year endowment policy (£)



Comparison of actual median maturity payout and theoretical asset share for the years 1988-98 for a £200 per month conventional with-profits 15 year endowment policy (£)



Unlike in previous years, GAD do not appear to have undertaken an analysis of maturity payouts to theoretical asset shares for individual companies.

(Note: the bodies under investigation have told me that it should be noted that: *'the charts selected for this entry all show maturity payouts for regular premium contracts only. By contrast, the bulk of Equitable's business was recurrent single premium. These charts therefore have very little significance for Equitable. This comment also applies to the corresponding charts provided in the reports prepared by GAD for* [other] *years'*.)

03/11/1999 FSA provide a note to the Insurance Supervisory Committee, recommending that HMT should approve Equitable's application for a section 68 Order for a future profits implicit item of £1bn, for possible use in their 1999 returns.

By way of background, FSA explain that:

> *The company whilst solvent is not highly capitalised, this is mainly because the company has a policy of distributing a high level of the company's profits to policyholders. This has meant that the company has not built up an estate.*

FSA refer to Equitable's high profile due to their potential exposure to annuity guarantees and to the court case. FSA explain that Regulation 24 of ICR 1994 specifies the basis of calculation for an implicit item and that:

> *We have routinely given Section 68 Orders to companies for future profit implicit items provided that we have been satisfied that the basis of calculation provided for in Regulation 24 has been correctly carried out ...*

Under their analysis of the application, FSA explain:

> *Whilst there is still some debate at the margins between the company and GAD relating to the precise reserve for the GAOs, we are generally satisfied that the company is adequately reserved for this exposure. The reserve for the GAO exposure has been largely offset through reinsurance.*

FSA note that Equitable face the threat of the appeal. However:

> *... any Court decision on this issue should not effect the financial position of the Equitable as shown in the HMT Annual Return since our Regulations require the company to reserve fully for all GAO policies in any case.*

FSA state that Equitable's detailed calculations show that Equitable could have qualified for a future profits implicit item of almost twice that applied for. FSA note that GAD have reviewed the calculations and *'are content that the concession should be granted'*.

09/11/1999 HMT write to Equitable to explain that, on FSA's advice, they have agreed the application for a section 68 Order for a future profits implicit item. HMT enclose the Order for an implicit item of £1bn, for use in their 1999 returns.

10/11/1999 Equitable write to FSA in response to their letter of 29/10/1999. Equitable explain that they would in due course provide details of policies sold between 29 April and 30 June 1988. Equitable seek clarification of what FSA mean by *'topping up'*.

Equitable refer also to the proposed company visit, now arranged for 06/12/1999, and the forthcoming Court of Appeal hearing. Equitable explain that, at the company visit, they think it would be helpful for FSA to meet the general managers responsible for marketing and investment, in addition to the Appointed Actuary and the Chief Executive. Equitable caution that the Court of Appeal judgment might be delivered on 6 December 1999 and thus that they might have to postpone the visit. Equitable undertake to send copies of the skeleton arguments for the hearing as they become available.

11/11/1999	GAD write to FSA in response to their request for information on companies' exposure to annuity guarantees. The information is drawn in the main from companies' responses to the survey commissioned by GAD in 1998 (see 20/06/1998). GAD state that the information suggests seven companies which PIA might further investigate. Equitable are one of these. GAD explain that the seven companies sell predominantly through a direct sales force, sold products with annuity guarantees after 1988, and are those who, in response to GAD's annuity guarantee survey, had answered *'No'* to either or both of the following questions: • *'On with profits* [contracts] *with an annuity guarantee, do you make a general allowance for the guarantee when establishing maturity values.'* • *'On with profits* [contracts] *is your approach to setting terminal bonus rates for a cohort of policies influenced by whether or not an annuity guarantee is biting.'*
12/11/1999	Equitable write to FSA with a revised application for a section 68 Order to raise the limit on the admissibility of share holdings. Equitable explain that they have applied the formula provided by FSA on 21/10/1999.
15/11/1999	FSA write to Equitable to seek the following information prior to the visit on 06/12/1999: (1) Equitable's latest Financial Condition Report. (2) Structure charts for the Equitable Group and senior management. (3) Details of the Board's sub-committees. (4) Copies of Equitable's latest business plan and papers on future strategy. (5) Details of their investment policy and terms of reference for the Investment Manager. (6) The latest report from the Investment Manager on fund performance, especially the main fund. (7) Equitable's internal audit programme for 1998 and 1999, along with details of any additional special studies conducted in 1999. (8) Internal audit's most recent report to the Board/senior management. FSA request the information by 26 November 1999. The letter incorporates changes suggested by GAD, who were sent on the previous day a draft on which to comment.
17/11/1999	FSA prepare an *'Overall Assessment'* of Equitable, in the light of information received in response to their note of 21/10/1999 and in preparation for the college meeting on 26/11/1999. FSA assess Equitable as medium to high risk, predominantly due to their exposure to annuity guarantees. FSA say that PIA have assessed the parts of Equitable that they supervise as average risk and that PIA's Pensions Review Team have identified no particular concerns on Equitable's handling of the pensions review. FSA note that IMRO have significant concerns and had recently fined Equitable Unit Trusts Managers Limited £80,000 for breaches of IMRO rules in 1998 and had identified further significant compliance issues at a visit in June 1999. Both FSA and IMRO express concern over Equitable's *'slight institutional arrogance about being a mutual'*.

FSA summarise Equitable's present financial position, drawing on the initial risk assessment (see c31/08/1999). FSA observe that Equitable have *'gone too far in distributing surplus to policyholders to the extent that the company is dangerously under capitalised and exposed to a market downturn'*. FSA note that Equitable have taken heed of their concerns about the level of reversionary bonuses and have made some effort to reduce them this year. FSA note that Equitable's reserving basis overall is *'acceptable (but not particularly strong)'*. FSA also note that, while Equitable were not alone in *'being caught out'* by the annuity guarantees issue, they did not wake up to the issue quickly enough and their unclear communication to policyholders had left them open to criticism.

18/11/1999	FSA's Managing Director A presents his monthly report to FSA's Board, in which he notes that the Court of Appeal hearing had been set to commence on 29 or 30/11/1999.
23/11/1999	Equitable's solicitors send FSA copies of the skeleton arguments for the appeal hearing.

24/11/1999

FSA's Legal Adviser A passes Chief Counsel A a copy of an unsigned and undated paper, prepared by FSA, discussing the degree to which companies can assume, for reserving purposes, that policyholders choose to take part of their policy proceeds as a cash sum rather than as an annuity at a guaranteed rate.

FSA cite the Government Actuary's guidance (DAA11 – see 13/01/1999) that assumptions regarding the number of policyholders choosing to take benefits in a form other than an annuity at the guaranteed rate could lead, at most, to a reduction of *'a few percentage points'* in the reserve. FSA explain that when the guidance was formulated:

> *... our thinking internally was that up to a 5% reduction in the reserves could be considered to constitute "a few percentage points". A 5% reduction in reserves generally equates to an assumption that 20% of policyholders take the maximum tax free cash ...*

However, FSA note that a number of companies have interpreted the guidance as permitting an assumption of 10% of policy proceeds being taken in non-guaranteed annuity rate form. Some companies have gone further, *'Equitable Life assuming 20% of the proceeds are taken in other forms ...'*.

FSA note that no action has been taken to criticise the standard of reserving adopted by Equitable (or any other company), and that FSA need to settle their approach before the year end. FSA discuss the possibility of setting a minimum reserving requirement of 90% or 80%. It is noted that the former approach might give the impression that FSA were singling out Equitable for criticism. The latter approach would *'avoid conflict with Equitable'* but move FSA *'an unacceptably long way from the reserving level the guidance was originally intended to indicate'*.

FSA favour retaining their original interpretation of the guidance, but articulating to companies that there are two alternatives:

- to assume up to 5% of policy proceeds are taken in non-guaranteed annuity rate form; or
- to assume up to 20% of policyholders choose to take the maximum tax free cash permitted under the policy.

Chief Counsel A passes the note to Line Manager D. The Chief Counsel says:

> *I thought we had required Equitable to reserve at 95%. Or was the difference covered by the reinsurance?*

The Line Manager responds that Equitable are as bound by the guidance as everybody else. But that the Society's interpretation of a few percentage points had *'proved to be 20%'*. The Line Manager says that FSA knew Equitable *'would go for as high a figure as they thought they could get away with'*. The Line Manager says that, as part of the scrutiny of their annual returns, FSA had asked Equitable *'how they got to an assumption of 20% of the proceeds being taken in non-GAO form'*, but, as yet, FSA had not expressed a view on the Society's arguments as to why this allowance was prudent (see 27/05/1999, 25/06/1999 [**entry 1**] and 15/07/1999 [**entry 1**]).

Chief Counsel A comments in turn:

> *Your paper gives the impression I think that you have implicitly accepted the returns (or decided to do nothing about them).*

25/11/1999	Equitable write to FSA to provide information in response to each of the eight points set out in FSA's letter of 15/11/1999. Under point (1), Equitable provide copies of their letter of 21/01/1999 and the report to their Board sent on 04/05/1999, together with a copy of the latest report to their Board on revenue and solvency matters. Under point (6), Equitable enclose the latest report to their Investment Committee on the investment performance of the main fund, and updated schedules showing the with-profits fund and linked fund performance to 31 October 1999. Under point (7), Equitable explain that they have operated a unit called the *'Systems and Controls Review Group'* which has performed an internal audit role and made regular reports to the Audit Committee. They enclose copies of the Group's terms of reference, a summary of all its reviews, and copies of reports put to the Audit Committee in October 1998 and October 1999.
26/11/1999 [entry 1]	FSA write to Equitable in response to their letter of 10/11/1999. FSA explain that they are discussing with others in FSA whether it would be useful to have Equitable's information about *'top ups'* (i.e. the right of a policyholder to pay further premiums, or to effect new policies, under the same terms as an existing policy). FSA confirm that they would wish to meet Equitable's general managers on the investment and marketing side at the visit on 06/12/1999; they also ask to meet Equitable's head of internal audit. FSA enclose a draft agenda for the visit and confirm receipt of the skeleton arguments.
26/11/1999 [entry 2]	FSA and IMRO attend the college meeting (see 21/10/1999 [**entry 2**]) to discuss Equitable; PIA and their Pensions Review Team send their apologies. FSA prepare a note of the meeting. They summarise IMRO's actions towards Equitable Unit Trusts Managers Limited. FSA note that IMRO view Equitable Unit Trusts Managers Limited's regulatory history as poor and deem them to be a continuing high risk and thus on a ten month visit cycle. FSA reiterate their observations from the Overall Assessment (see 17/11/1999) and note that FSA intend to fill in some of the gaps in their knowledge at the company visit on 06/12/1999. The meeting agrees that those responsible for supervising Equitable should remain in touch.
26/11/1999 [entry 3]	FSA ask PIA to define what is meant by *'top up'*, as it is their definition that is the important one. FSA also query the usefulness of having information on the numbers of top ups, given that most would not have been connected with advice provided by Equitable or their representatives.
30/11/1999	The Court of Appeal hearing begins.

02/12/1999 [entry 1]	The Court of Appeal hearing ends. (The Court of Appeal gives its judgment on 21/01/2000.)
02/12/1999 [entry 2]	PIA write to FSA with comments on the documents provided by Equitable about their Systems and Controls Review Group (see 25/11/1999). PIA suggest that there are some confusing indicators in the documents, both regarding the *'Control Awareness'* of the organisation and the extent to which the Society's Systems and Controls Review Group have tested rather than documented existing control processes. PIA discuss a range of positive and negative factors indicated by the documents. They conclude: *Overall, like you, I read a few more negatives than positives. I formed the opinion that Equitable realise that maintaining strong effective controls is important to them. They seem to have heard some of the buzzwords about best practice. However, they have certainly not articulated in the documents we have seen that they are approaching this topic in a robust and action oriented manner.* PIA suggest that it would be helpful to explore the role of Equitable's auditors.
03/12/1999	Equitable write to FSA. Equitable explain that they sold 22,224 policies with GARs between 29 April and 30 June 1988. They say the level of business was exceptional, due to the imminent withdrawal of the product, and that it is likely that most policies were bought by clients on their own initiative (as Equitable only employed about 300 sales representatives at the time).
06/12/1999	FSA and GAD visit Equitable as a part of the regulators' rolling programme of company visits. The visit had been arranged on 20/09/1999. FSA prepare a note of the meeting. This shows that Equitable give an overview of their corporate management structure and explain the role of the Board and the executive management team. Equitable's Chief Executive reiterates that *'he was keen to run the company on a collegiate consultative basis (the suggestion had been made that his predecessor had been somewhat autocratic)'*. Equitable discuss the general market outlook and their business strategy. They explain that, when deciding their strategy, *'the Society did not use return on equity type analysis – it concentrated on assessing how it could meet the needs of clients and potential clients'*. Equitable discuss their investment policy and asset management. They explain that some income drawdown policyholders were upset at cuts in the amounts they could take from their pensions. Equitable suggest that this might be due to the cap imposed by the Inland Revenue. Equitable agree to look at some examples to see if this is the case. GAD express concern that Equitable's future projections *'did not fully take into account the scenario of a long-term stock market depression – which could have severe implications for the society'*. Equitable provide more information about the work of their Systems and Controls Review Group. They also confirm that the reinsurance treaty now covers group business as well as individual business and that this would reduce the gross annuity guarantees reserve of £1.56bn to a net exposure of £560m. FSA warn Equitable that they and the Government Actuary would be writing to companies before the end of the year, outlining more clearly the expected approach to reserving, and that this could mean that Equitable would need to increase their gross reserves. Finally, Equitable explain that they recognise that declared bonus rates would have to reduce further if the current investment return persisted. However:

… the Society proposed to pause for breath before cutting bonuses further, in order to see if yields would improve. Terminal bonuses were likely to be pushed up, however, if reversionary bonuses remained at 5% since the company would be allocating less than it had earned for the last 4 years.

Following the meeting, FSA and GAD are shown Equitable's paperless administration systems.

08/12/1999	FSA provide a note recommending that HMT approve Equitable's application for a section 68 Order to raise the limit on the admissibility of shareholdings.
10/12/1999	FSA attend a bilateral meeting with PIA. PIA report that they had met to consider the need for further regulatory action against Equitable in relation to guaranteed annuities, and that Line Manager D had attended from FSA. Line Manager D undertakes to provide PIA with Equitable's information on the number of policies sold between April and June 1988 (see 03/12/1999).
13/12/1999	Equitable advise FSA that they do not expect a decision from the Court of Appeal until January 2000.
14/12/1999	HMT write to Equitable to explain that, on FSA's advice, they have agreed their application for a section 68 Order to raise the limit on the admissibility of share holdings. HMT enclose the Order.
16/12/1999 [entry 1]	GAD send FSA a draft of a letter from the Government Actuary to Appointed Actuaries clarifying the guidance on reserving for annuity guarantees. FSA's Line Manager D advises the Head of Life Insurance that the guidance '*looks OK*'. The Line Manager suggests that there should be an accompanying letter from FSA to Chief Executives clarifying that FSA would not ask companies to resubmit 1998 returns if they had not been prepared in accordance with the revised guidance.
16/12/1999 [entry 2]	FSA's Managing Director A presents his monthly report to FSA's Board. The managing Director notes that the appeal hearing had been heard in the first week of December but that FSA did not yet know when the judgment would be given.
20/12/1999 [entry 1]	FSA write to Equitable to announce the introduction of enhanced lead supervision. Under these arrangements, a lead supervisor (Line Supervisor C) is responsible for maintaining an overall assessment of Equitable and producing a co-ordinated supervisory plan. The intention is to ensure that '*supervisory activity is co-ordinated and structured in a way so as to avoid, where possible, overlap and underlap*'.
20/12/1999 [entry 2]	FSA's Line Manager D sends the Head of Life Insurance and Chief Counsel A and GAD (Directing Actuary B and Chief Actuary D) a draft of a letter to Chief Executives to accompany the letter from the Government Actuary (see 16/12/1999 [**entry 2**]). The draft includes a statement that FSA would not ask companies to resubmit 1998 returns if they had not been prepared in accordance with the revised guidance. The draft goes on to state that FSA would compare companies' returns for 1999 and beyond against the '*benchmark*' set by the letter. Where a company's reserving standard fell below the benchmark, FSA would consider publicising this fact '*to ensure that readers of the returns could not be mis-led as to the financial strength of the company concerned*'.
21/12/1999	FSA's Head of Life Insurance explains that he is content with a revised version of the letter to Chief Executives, which retains the points contained in the draft of 20/12/1999.

22/12/1999 [entry 1] FSA's Line Manager D provides Managing Director A with drafts of the letters FSA are preparing to send to all life insurance companies. The Line Manager asks for comments and adds that this:

> *... latest guidance has been shown to the actuarial profession and accepted by them, so should not be particularly controversial. Those companies that reserved at levels below those now being specified are also not expected to raise ... objections (very few reserved significantly below the specified level).*

The Head of Life Insurance explains that he now favours a shorter letter to Chief Executives, which does no more than draw their attention to the Government Actuary's guidance. The Head of Life Insurance explains:

> *This achieves our objective of clarification, and avoids raising questions of possible future intervention which may not otherwise arise, and some of which I think would need to be brokered more widely within FSA if we wanted to trail them in this letter. This simpler approach also deals with* [Directing Actuary B's] *concerns over the role of the profession.*

In response, Chief Counsel A comments:

> *You should be aware that failure to mention possible intervention by way of publication now will make it harder, and perhaps impossible, to publish as proposed next year. Companies would, not unreasonably I think, raise an argument of legitimate expectation based on our past behaviour.*

22/12/1999 [entry 2] Every Appointed Actuary is sent by the Government Actuary a copy of DAA13. The Government Actuary states that, having reviewed the majority of companies' 1998 returns, it appeared that some aspects of the guidance in DAA11 (see 13/01/1999 [**entry 2**]) had been interpreted in a variety of ways. He offers further clarification on the reserving standards that would normally be expected, as *'it is clearly important there should be consistency in the approach taken'*.

The Government Actuary reiterates his view that it would not generally be prudent to assume that policyholders would choose a benefit form that was of significantly lower value than the guaranteed annuity. In DAA11, the Government Actuary had indicated that he would expect any allowance for policyholders making such choices to be limited to *'a few percentage points'* of the reserve. He now clarifies that he was referring to:

> *... the total aggregate allowance that might prudently be made for all other benefit forms (whether cash or other forms of annuity) and that in my view an allowance in excess of 5% would not be considered to represent "a few percentage points".*

He acknowledges that there might be a stronger case for an allowance for policyholders taking a proportion of their benefits in a tax free cash sum. However, he says he does not consider it prudent to assume that more than 20% of policyholders would exercise this option. This would equate to a 5% reduction in the reserve, which is itself the maximum that GAD were likely to accept as prudent.

The Government Actuary states that *'for the avoidance of any doubt'*, GAD would expect full disclosure of the proportions of policyholders assumed to take any guaranteed annuity, along with underlying mortality and interest rate assumptions. They would also expect to see prudent allowance made for future mortality improvement.

On the same day, FSA's Head of Life Insurance sends a copy of GAD's letter to Equitable's Managing Director (and to Managing Directors of all other life companies). The letter is in the simpler form favoured by the Head of Life Insurance. FSA ask any company foreseeing difficulties in complying with the guidance to let FSA know of any such difficulties.

2000

12/01/2000	FSA write to PIA, further to FSA's note of 26/11/1999. FSA enclose a copy of Equitable's letter of 03/12/1999 in which details are given of the number of policies with guaranteed annuities sold after 29 April 1988. FSA note it is likely that most sales were not '*advised*' sales. FSA say that it would be difficult to identify those that were and thus that it was arguable that PIA could justify not pursuing the issue. FSA also note that the question of how a 'top-up' to a policy should be defined remains outstanding and that they needed to reach a view on whether the issue was worth pursuing *'given that ... only a small proportion of "top-ups" are likely to* [have been] *advised sales'*.
14/01/2000	FSA's Director of Insurance advises his Managing Director that the Court of Appeal's decision was expected on 21 January 2000. The Director of Insurance explains that FSA would review the press lines they developed at the time of the first judgment.

21/01/2000

The Court of Appeal overturns the High Court's decision of 09/09/1999 by a split decision, in which the two majority judges give differing reasons for finding in favour of the policyholder. The Court of Appeal finds that Equitable were not entitled under their policies to award differential final bonuses. Equitable are given permission to appeal, and the application of the judgment is suspended in the meantime.

Equitable send FSA a copy of a press release that they have produced, following publication of the Court of Appeal judgment. The press release states that the case had hinged on two key issues; one relating to the nature of the Society's contracts and the other relating to the way in which Equitable's Board had exercised their discretion. Equitable set out a table showing the conclusions on these two issues which had been reached by each of the four judges who have given judgment in the case so far:

Judge	*Contract*	*Discretion*
High Court		
Vice-Chancellor	*FOR*	*FOR*
Court of Appeal		
Master of the Rolls	*AGAINST*	*AGAINST*
Lord Justice Morritt	*FOR*	*FOR*
Lord Justice Waller	*AGAINST*	*FOR*

Equitable say that they *'took the case to the Courts to establish clarity. This has not yet been achieved'*.

FSA advise PIA that the judgment gave no cause for panic. FSA note that the bad publicity was likely to seriously dent Equitable's sales *'but that is not a major disaster'*. FSA explain that Equitable's reserving requirement would not be affected by the judgment, so their financial position was largely unaltered.

GAD advise FSA, on the basis of the summary of the judgment they have seen, that most of the advice in the letter of 18/12/1998 would still be relevant for annuity guarantees. GAD note, in particular, that the statement that there could be a reduction in the terminal bonus to reflect the perceived value of the guarantee over the duration of the contract:

> *... would for example appear to be fully consistent with the comments by* [Lord Justice] *Waller that the society could reduce the level of final bonus for all GAO policies (but must apply the same amount of bonus irrespective of whether the GAO is selected).*

GAD note, however, that the statement that the terminal bonus for policies with a guaranteed annuity might be somewhat lower than the bonus for policies without such a guarantee, and that this terminal bonus could in some cases be applied at current annuity rates:

> *... would no longer appear to be quite correct (albeit that the advice therein is heavily qualified). In particular, the current practice of a number of insurers whereby the terminal bonus is applied at current annuity rates rather than the GAO would no longer appear to be valid where their contracts are worded and presented similarly to the Equitable's.*

GAD suggest drawing this point to companies' attention and asking those companies to describe their bonus policy for policies with annuity guarantees.

GAD discuss the possible effect on Equitable if the judgment were to be upheld. GAD note that the number of policyholders choosing a guaranteed option was fairly low, so the cost to Equitable of increasing the benefits to those policyholders so that they received the same terminal bonus should be marginal.

GAD suggest asking Equitable if the reinsurance agreement would remain in place on its present terms and conditions. GAD comment that the recent supplementary advice on reserving (see 22/12/1999 [**entry 2**]) would now be even more appropriate, as the incentive to take cash rather than a guaranteed option would be much lower as a result of the judgment.

FSA produce in-house briefing notes in anticipation of questions they might receive. In response to the possible query: *'If the judgement is upheld what will the effect be on Equitable Life?'*, FSA's response is that they:

> *Would rather not speculate and do not comment on individual companies' circumstances. However, would not expect the judgement to have a significant impact on the level of reserves the company needs to hold to cover its liabilities to policyholders.*

In response to the possible query: *'Doesn't this show that the FSA failed to act to protect policyholders. Why was it necessary for policyholders to go to court?',* FSA's response is that:

> *FSA did not fail to protect the interests of policyholders. The Equitable itself chose to bring this test case, and was commended by the court for doing so. The key issue raised in this case was the interpretation of the detail of contracts issued by the company and the way discretionary powers were exercised by the directors. Once before the court it was right for the FSA to step back and await the outcome, while ensuring adequate reserves were in place.*

In response to the possible query: *'Lord Justice Morritt suggested that Equitable Life's practice had been "approved" by HM Treasury. Is this true?'*, FSA say:

> *HM Treasury issued guidance at the end of 1998 on the payment practice that it considered companies might legitimately adopt. This indicated that the Treasury accepted that it might be appropriate for insurers to make some charge in relation to the costs of annuity guarantees, and that this might be effected through a reduction in the terminal bonus paid to policyholders, <u>provided this action was consistent with the terms of the contract and policyholders' reasonable expectations</u>. It did not indicate approval or disapproval of any particular approach. However, we will be considering the need for any revision in this guidance in light of the judgement.*

FSA's Director of Insurance advises, separately, that the basic line is '*no comment on the substance while the case is still subject to appeal*'.

22/01/2000 FSA's Chairman asks the Director of Insurance if there was any substance to a report in the press *'that others in the industry think we have been indulgent towards the Equitable?'*.

24/01/2000 [entry 1]	PIA inform FSA that a pensions review monitoring visit had been scheduled to commence on 28 February 2000 and was to last for approximately two weeks. PIA ask if FSA had any comments or information which would be useful to the monitoring team.
24/01/2000 [entry 2]	FSA advise PIA and IMRO that they do not consider that the judgment affects the statutory financial position greatly, as Equitable already had to reserve fully for annuity guarantees that bite. However, FSA comment that the judgment was a severe blow for Equitable and was likely to dampen sales and increase uncertainty.
25/01/2000	FSA's Director of Insurance informs FSA's Executive Committee that the Court of Appeal decision was under consideration.
26/01/2000	FSA ask GAD for a list of companies who replied to the 1998 survey (see 20/06/1998) indicating that they took account of whether an annuity guarantee was biting when setting terminal bonuses. GAD reply that one other company took a similar approach, while replies from others were unclear on the point. GAD suggest writing to all with-profits offices to clarify the position.
27/01/2000	FSA's Director of Insurance responds to the Chairman's query of 22/01/2000. The Director of Insurance says that a number of companies, including Equitable, believe HMT and FSA have taken *'a very tough line on the reserving standards we expect in respect of GAOs'*. The Director of Insurance reminds the Chairman of the guidance which had been issued on 18/12/1998 on annuity guarantees and policyholders' reasonable expectations, and notes: *One of the appeal judges refers to this letter (wrongly) as HMT "endorsing" the Equitable's position. We are reviewing this letter, but at first glance it doesn't seem too bad even in the light of the Court's judgement. But this may have been picked up as an indication of our "indulgence".*
28/01/2000	FSA prepare a preliminary assessment of the judgment which is marked as not being based on considered legal advice. FSA caution that the judgment is subject to appeal, but set out some of the implications for the industry should it stand. FSA note that, while Equitable would need to revise their bonus policy for the future, the new approach need not lead to additional costs for them. FSA explain that the question of compensation to any policyholders whose policies had matured in the last five years could only be assessed in the light of the House of Lords' judgment, and that any reputational damage would only become apparent at a later date. FSA's Returns Reception and Validation Unit provides Line Supervisor C with a list of seven errors in Equitable's 1998 returns. The Unit ask if any of the matters should be taken up with Equitable. The Line Supervisor advises that this is not necessary.
31/01/2000 [entry 1]	FSA's Chief Counsel A writes to Line Manager D summarising the Court of Appeal judgment. The Chief Counsel notes that the three judges found for or against the representative policyholder and for or against Equitable for different reasons. The Chief Counsel says: *'... it is impossible to predict which way the House of Lords will jump'*. Chief Counsel A copies her note to other FSA staff and GAD.
31/01/2000 [entry 2]	FSA send a copy of their preliminary assessment of the Court of Appeal judgment (see 28/01/2000) to the Tripartite Standing Committee, in advance of their meeting on 03/02/2000.
01/02/2000	Equitable's Chief Executive writes to policyholders to bring them up to date and to *'reassure you about a number of misleading comments from third parties reported in the press in*

recent days'. FSA receive a copy of the letter from an FSA employee who is also an Equitable policyholder. Having explained the findings of the High Court and the Court of Appeal, the Chief Executive says:

> *Contrary to many of the reports which have appeared in the press, there would be no significant costs imposed on the Society if the Court of Appeal's decision were upheld in the House of Lords. The speculation regarding financial difficulties and costs to be borne by with-profits policyholders is therefore unfounded. Your Society remains, and will continue to remain, financially secure.*

03/02/2000

FSA attend a meeting of the Tripartite Standing Committee. FSA's Managing Director A reports that there were no immediate concerns resulting from the Court of Appeal ruling and that: '[Equitable's] *short term accounting position would actually be stronger if it received less new business. In addition, the situation was still not finalised, as there was a strong possibility that the House of Lords would overrule the Appeal Court's decision*. [Equitable] *itself was still a strong brand, and therefore likely to be taken over rather than fail. However, failure would have implications for financial stability, and so it needed to be monitored closely'*.

04/02/2000

FSA write to Equitable and 50 other companies who had indicated, in their response to the 1998 survey by GAD (see 20/06/1998), that they sold with-profits policies containing an annuity guarantee. FSA refer to the Court of Appeal's judgment that Equitable's differential terminal bonus policy was unlawful. FSA seek details of those companies' bonus practice.

08/02/2000

FSA's Line Manager D writes to PIA concerning a report to FSA's Executive Committee that Equitable were under investigation for the alleged mis-selling of income drawdown policies. The Line Manager asks for details of the investigation.

Line Manager D notes that Equitable faced a number of current difficulties and *'as prudential and lead supervisors for the group, I think it is particularly important that* [Line Supervisor C] *and myself are kept informed of investigations of this type'*.

PIA advise that the case is quite old. PIA explain that Enforcement carried out a series of theme visits at the end of 1998 and their understanding is that they *'did not find too many problems (so discipline case unlikely ...)'*.

PIA apologise for not keeping FSA informed (adding that: *'this has rather fallen down the priority chain from our point of view, especially given the time frame'*), and undertake to let FSA know of any further developments.

09/02/2000

FSA's Line Manager D writes to PIA to comment that the report they have seen makes the issue look more serious than suggested by PIA in their note of 08/02/2000.

PIA reply *'of course I may have* [misunderstood], *or things could have changed, but my general feel is that Enforcement don't have an appetite for this one'*.

11/02/2000

PIA provide FSA with a copy of an undated report headed *'FSA Internal Sensitive Investigation'*. PIA note that they had not previously brought this to FSA's attention *'as we did not envisage any material prudential concerns for Equitable arising specifically from this investigation'*.

PIA's report refers to potential mis-selling of income drawdown policies, a *'complex, relatively risky product to a vulnerable market'*. The report notes that there had been visits by Enforcement to Equitable and another provider, as the most active firms in the market. The visits had taken place in July. (Note: the report does not specify in which year; other documents suggest the visits had been undertaken in 1998).

PIA's report states:

> *Initial reviews of investors' files revealed serious concerns regarding suitability at Equitable. 7% of files reviewed have been classified by PIA as unsuitable on the basis of the information held in the file and 68% had inadequate evidence to demonstrate suitability. Additional concerns: lack of adequate compliance procedures, high level of execution only transactions and sales of maximum investment plans funded by withdrawals from* [pension fund withdrawal] *contracts.*

PIA's note provides an *'Update'*:

> *22 investors interviewed with inconclusive results. Generally investors told of risks but no account taken of risk attitude. Further visit to Equitable on 13-15 December confirmed no specific training on* [maximum income plans] *and 14 out of 30 execution only cases reviewed considered not* [execution only] *or insufficiently evidenced.*
>
> *Interview transcripts will be issued to investors by 11 February. Case conference during February to determine whether any further investigation is appropriate.*

Other documents suggest that the further visit on 13–15 December had taken place in 1999 and that the case conference was planned for February 2000.

17/02/2000 FSA's Managing Director A presents his Monthly Report to FSA's Board. The report notes that Equitable had been granted leave to appeal to the House of Lords and comments:

> *Equitable does not appear to face any immediate financial risk or any additional threat to its independence. If the appeal judgment was upheld, Equitable would need to revise its bonus policy, but potentially the new approach need not lead to significant additional costs. The reputational damage from the court case will only become apparent at a later date, but interestingly the judgment did not spark a significant surge in calls to the company's policyholder helpline. For now, the moderate reduction in new business that the company has been experiencing will actually help strengthen its finances.*

01/03/2000 FSA's Line Manager D prepares an *'initial crude categorisation'* of the responses to the letter of 04/02/2000. The Line Manager explains to other officials at FSA and GAD that the survey had not identified significant numbers of companies that were following an *'Equitable type approach (or other wise reducing payouts to people exercising a GAO)'* and of which FSA were not previously aware. The Line Manager says that several companies had indicated that they did not reduce bonuses to policyholders exercising a guaranteed annuity option but had not explained how the costs of the guarantees were met. Line Manager D says that she is seeking clarification from those companies on that point.

02/03/2000 [entry 1] FSA's Line Manager D writes to Equitable's Managing Director. (Note: similar letters were sent to Managing Directors of all other life companies affected by the PIA's review of pensions mis-selling.) The Line Manager encloses a questionnaire seeking an update on companies' provisions for potential liabilities from mis-selling. Line Manager D also seeks information on any provisions companies are holding for PIA's proposed review of Free Standing AVCs.

02/03/2000 [entry 2] FSA's Chief Counsel A asks Line Manager D, in response to her summary of 01/03/2000, if the practice of imposing the costs of GARs only on policyholders with annuity guarantees was in breach of policyholders' reasonable expectations and contrary to the Court of Appeal judgment. The Line Manager replies that companies had always declared bonuses by class of policies, and if higher expenses attached to a particular class, they would consider it reasonable for the company to declare a lower level of bonus for that class.

Chief Counsel A copies some of her correspondence to GAD. GAD comment that they had little difficulty in concluding that PRE, as defined by three of the four judges who had so far

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considered the matter, had not been breached by Equitable – except to the extent that a breach of contract was itself a breach of those expectations. GAD say that asset share, and other accepted means of determining terminal bonuses, would require some form of deduction for annuity guarantees. Alternatively, any loss to a company arising from such guarantees would usually be allocated to the class which had caused it. In response (on 3 March 2000), Chief Counsel A observes that the ICA 1982 requires that FSA do their own analysis and that the Court's view was only one factor to take into consideration *'(unless the Equitable's methodology is rejected by the* [House of Lords] *in a way that leaves us nothing to consider)'*. Chief Counsel A notes that Line Manager D would *'no doubt be setting up a meeting or some other mechanism to allow proper consideration of the issues when she has completed her fact finding'*.

03/03/2000	FSA write to PIA and IMRO, asking for feedback on any proposed activity and visits concerning Equitable over the last three months. FSA ask whether there were any firm dates for the visits planned by both IMRO and PIA for April/May 2000. FSA refer to their visit in December 1999, the report of which had been circulated. FSA also note that the Pensions Review Team had begun a monitoring visit on 28 February 2000. IMRO later inform FSA that, due to various factors, they had rescheduled their visit to February 2001.
08/03/2000 [entry 1]	FSA meet PIA to discuss Enforcement's investigation of Equitable's sale of income drawdown policies. The note of the meeting suggests that the case conference (see 11/02/2000) was now planned for April 2000 and that the main options for it to consider were further investigation, disciplinary action and requiring Equitable to review their sales of income drawdown policies.
08/03/2000 [entry 2]	FSA's Line Manager D writes to Equitable's Managing Director (similar letters were sent to Managing Directors of all other life companies writing Trustee Investment Bonds/Plans (i.e. pension contracts written for the trustees of occupational pension schemes)) seeking information about these. FSA's concern is that some insurers might be wrongly classifying the business.
09/03/2000	FSA's Line Manager D provides Line Supervisor C and GAD with a copy of the note of the meeting held on 08/03/2000. The Line Manager comments that the outcome of the meeting did not look good for Equitable, *'but it's not disastrous either – from a solvency perspective anyway'*. The Line Manager asks Scrutinising Actuary E whether falls in annuity rates meant that Equitable's investment performance in relation to income drawdown policies was irrelevant.
10/03/2000	GAD write to Equitable to remind them that, at the meeting on 06/12/1999, Equitable had undertaken to check some examples of income drawdown cases to see why cuts had occurred. GAD ask for Equitable's views on some possible explanations, and to clarify how they credit investment returns to with-profits business in the drawdown period.
20/03/2000	Equitable write to GAD in response to their letter of 10/03/2000. Equitable explain that the cut in drawdown payments at the first three year reviews *'has been the result of the significant reduction in the maximum rates of income withdrawal during the intervening three years as determined using the tables provided by GAD'*.
22/03/2000	GAD write to Equitable in response to their letter of 20/03/2000. GAD state that it is clear that the cut in drawdown income has been: *... due to the failure of the investment performance of a mixed portfolio to generate adequate returns to match the implied performance of long term gilts over the relevant*

	period. Recognising that some excess performance was really needed as an offset to mortality drag, this is obviously a disappointing outcome. GAD comment: *I am minded to believe that this has been a rather exceptional period, taking account of the particular pressures that have had such a marked effect on reducing available yields at the long end of the gilt market, and does not totally undermine the concept of income draw down as a way of preserving capital and deferring the purchase of an annuity.* GAD write to FSA in the light of Equitable's letter of 20/03/2000 and their response. GAD comment that there are risks involved in income drawdown policies and that they hope *'that all participants are made fully aware of them at the outset'*. GAD suggest that only pensioners with a large fund, or with other sources of income, *'should reasonably be invited to go down this route'*.
23/03/2000	Equitable provide FSA with details of their Trustee Investment Bonds and similar plans, in response to their letter of 08/03/2000.
24/03/2000	Equitable write to GAD in response to their letter of 22/03/2000. Equitable question if the yield used for income drawdown policies should be based on an average of experience rather than a spot yield at the time of the review.
29/03/2000	Equitable write to FSA in response to their letter of 02/03/2000. Equitable provide their completed questionnaire, updating their potential exposure to compensation claims for pension mis-selling. This shows that they held a reserve of almost £132m within their 1999 returns. Equitable say that they have not made any explicit allowance for the review of Free Standing AVCs, *'because the extent of the review process is still unclear. Based on the details contained in the consultation paper ... we believe the level of redress will be very low relative to the provisions for the pension review'*.
30/03/2000	Equitable apply to FSA for a section 68 Order to raise the limit on the admissibility of shareholdings in one particular company. Equitable say they wish the concession to take effect from 31 December 1999.
03/04/2000	GAD write to Equitable in reply to their letter of 24/03/2000. GAD note Equitable's comments, but explain that GAD could not become involved in the methodology for constructing the tables used for income drawdown policies.
10/04/2000	FSA's Line Supervisor C submits a report to the Insurance Supervisory Committee recommending that HMT do not agree the requested section 68 Order (see 30/03/2000). The Line Supervisor explains that the application is retrospective and that, in line with previous decisions, such concessions could not be granted. The Committee agree this recommendation. FSA inform Equitable of this decision. FSA invite Equitable to resubmit the application for use in the future.
11/04/2000	Equitable write to FSA in response to their letter of 10/04/2000. Equitable explain that they do not wish to resubmit their application for a section 68 Order for use in the 2000 returns, as market movements could make it out of date by the year end. Equitable say: *If no retrospection is to be allowed then it would seem that the concession is only ever going to operate in a somewhat arbitrary and approximate manner. Although the impact*

	on our 1999 Returns will be relatively modest and the point is, therefore, somewhat academic, there does seem to be a point of principle involved. It would be helpful if you could confirm whether there is any scope within the procedures to deal with such a situation – for example, by applying in advance for an "in principle" concession on all stocks that are close to the normal admissibility limit and then confirming the exact increased limit requested when the year end data is known. Equitable seek FSA's further comments.
17/04/2000	FSA write to Equitable, in response to their letter of 11/04/2000. FSA answer the question put by saying: *'We intend to develop this year a generic* [asset valuation rules] *Section 68 Concession that companies can apply for prior to the end of the financial year. This should mean that a company that obtains such an order would then be able to apply the benefit of this concession across all of their relevant share holdings. This should than address the concern raised in your letter'.*
15/05/2000 [entry 1]	Every Appointed Actuary is sent by the Government Actuary a copy of DAA14, making further revisions to the second of the three resilience tests (see 30/09/1993, 24/11/1998 and 30/09/1999.)
15/05/2000 [entry 2]	Every insurance company is sent by FSA a letter informing them of amendments made to ICR 1994.
23/05/2000	FSA's Line Manager D advises the Head of Insurance of possible disciplinary action against Equitable in relation to their sales of income drawdown policies. The Line Manager explains that Enforcement had found that a significant proportion of Equitable's sales had probably been inappropriate, in that investors had not been made aware of the risks they were taking on. The Line Manager says that Equitable's compliance monitoring of sales appears to be *'ineffective/incompetent'.* The Line Manager notes: *'unless Equitable present a credible challenge to the findings ...* [Enforcement] *would expect the* [Enforcement] *Committee ... to support a call for a fine and remedial action (including compensation to investors)'.* Line Manager D explains that Equitable had been asked to comment on Enforcement's report by 23 June 2000 and that: *... given Equitable's relatively precarious financial position we will need to keep close to this so we can assess the financial implications for the firm ahead of any* [Enforcement] *decision. The potential for further reputational damage is also a concern.* *I feel fairly well plugged into* [Enforcement] *on this issue and currently do not see problems in ensuring co-operation with them as things move forward.*
31/05/2000	Equitable's solicitors send FSA copies of their papers relating to the House of Lords' hearing. FSA circulate the papers to GAD.
02/06/2000	FSA's Line Manager D explains to others at FSA and GAD that she does not propose to approach the representative policyholder's solicitors for a copy of his case for the appeal. The Line Manager says that the reasons they would need to give for seeking the papers *'might suggest we would/could do something depending on the outcome of the case. I would not want to generate this expectation and I do not see problems in waiting until the case comes to court and the documents thus become public'.*
05/06/2000	FSA obtain a copy of Equitable's papers for the appeal. FSA explain to GAD that there did not seem to be anything new in them. In response, GAD observe that *'much of Equitable's presentation focuses of course on their firm belief that "asset shares" are the key benchmark,*

and that the bonuses should be adjusted so that the overall value of any benefits taken equates as closely as possible to these asset shares'. FSA note that the House of Lords' judgment on the application of policyholders' reasonable expectations to business decisions about bonus rates was likely to be of considerable interest to FSA and other insurers.

12/06/2000 The House of Lords' hearing begins.

27/06/2000 Equitable apply to FSA for a section 68 Order for a future profits implicit item of £1.1bn, for possible use in their 2000 returns. Equitable provide financial calculations in support of the application, suggesting that they could seek an Order up to the value of £3,304m.

These calculations include, for the estimated annual profits, that:

Year ending	*(A) Total surplus*	*(B) Exceptional items*	*(C) Surplus arising from solvency margin*	*(A)-(B)-(C) Ordinary surplus*
	£m	*£m*	*£m*	*£m*
31.12.95	*662.8*	*0.0*	*0.0*	*662.8*
31.12.96	*802.5*	*0.0*	*0.0*	*802.5*
31.12.97	*895.6*	*0.0*	*0.0*	*895.6*
31.12.98	*838.4*	*0.0*	*0.0*	*838.4*
31.12.99	*931.3*	*0.0*	*0.0*	*931.3*
				4130.6

Average annual profit = 4130.6/5 = £826.1m

The calculations state that the average period to run for the Society's in-force contracts is again eight years. Equitable explain:

> *The periods to run have been reduced to take account of premature withdrawals based on the Society's recent experience of such withdrawals. In respect of retirement annuity and personal pension contracts for which a range of retirement ages is available, it has been assumed that retirement benefits are taken at the lowest possible age, or immediately if that age has already been attained.*

The calculations suggest that the maximum future profits item permissible is 50% of £826.1m multiplied by eight years – that being £3,304.4m.

Equitable explain that they have included a future profits implicit item of £925m in their 1999 returns.

FSA copy the letter to GAD.

Submission of the 1999 regulatory returns

30/06/2000 [entry 1] **Equitable submit their 1999 regulatory returns to FSA**. Accompanying those returns are copies of the annual report and accounts for 1999, prepared in accordance with the Companies Act 1985 and dated 22 March 2000.

These documents include the following information about Equitable's business and their financial position as at 31 December 1999.

<u>Companies Act annual report and accounts</u>
The '*President's Statement*' says that:

> *1999 was a challenging year for The Equitable and I am pleased to say that it was a year of considerable achievement. We cannot, however, escape from the fact that the year was overshadowed by adverse publicity surrounding a single issue – guaranteed annuity rates. This is a complex matter and it is important that our members have a full and accurate explanation of the central points. We have therefore devoted a special section ... in this report to explaining this issue and the background to the recent court actions...*

The '*President's Statement*' also says that a disciplined approach had been taken to the setting of reversionary bonus in recent years, which allowed Equitable to maintain reversionary bonus in 1999 at the 1998 level. Investment returns during 1999 had been relatively high and so the growth allocated to total policy funds had been increased to 12%. The Society's bonus policy provided competitive payouts over a wide range of products and durations as indicated by its standing in surveys by financial publications. This was due in large part to Equitable's approach to mutuality and the fair and full distribution of profits. The statement also considered that the 1999 bonus statements were accompanied by a more extensive and improved explanation of the Society's bonus system.

The '*Management Report'* in the 1999 Companies Act report says that Equitable were able to provide an unbeatable range of benefits to their members, due to their approach to mutuality. This approach is described as (a) the provision of services to members at cost, (b) the full distribution of profits to each generation of policyholders, and (c) the fairest possible allocation of bonuses between all classes and durations of policies.

The report comments that arguments for demutualisation focused on the need for capital to fund growth and to access new distribution channels. Financial inducements were normally provided to existing members to enable this. However, the Society felt that, in its case, these arguments do not apply.

It was said that capital requirements had not placed any restrictions on Equitable's growth plans as demonstrated by the impressive growth in recent years. Substantial investments had been made to make Equitable the most efficient life office in the industry and they did not need the assistance of other companies in distributing their products.

Equitable's policy of full distribution of profits to each generation of policyholders meant that they had traditionally operated with a lower free asset ratio than other offices but this had not placed any restriction on the operation of their businesses. Equitable considered that, compared to other offices, their approach offered greater fairness and better returns to their members who recognised and valued the Society's mutuality. It followed that Equitable had no intention of surrendering their mutual status.

Under expense control, the report said that Equitable had steadily driven down their operating costs over the last decade, even though Equitable had grown considerably. These savings had been passed back to policyholders via reduced charges and increased benefits.

It was recognised that the adverse publicity surrounding the annuity guarantees issue had hit Equitable's sales, but it was said that these had still held up well, decreasing by only 7.9% compared to 1998. It was also noted that the industry in general had been affected by further adverse publicity surrounding pensions mis-selling. Equitable explained that pension sales were also affected throughout the industry, as potential policyholders deferred purchasing pensions in anticipation of the new Stakeholder Pensions.

In the section on guaranteed annuity rates, under the heading '*What effect do the guarantees have on other policies?*' the Society reported:

> *... in some cases the guaranteed annuity will provide a higher pension than would otherwise be available. Where that happens, as with any other policy guarantee, the cost of the additional benefits provided by the guarantee falls on the fund generally. We have projected that the cost of these additional benefits is unlikely to exceed £50 million in total over the coming years, and the experience in 1998 and 1999 was well within our expectations. However, for accounting purposes we have established a provision of £200 million in our balance sheet, to provide an allowance for more extreme future changes in financial conditions and mortality experience which could lead to more policyholders taking benefits in the guaranteed annuity form. These amounts are modest in the context of the Society's total assets and would have no material effect on the level of benefits under other policies.*

The Society also said that the *Hyman* case was expected to be heard by the House of Lords in June 2000 and Equitable expected a ruling soon afterwards. Equitable had established that this case was not the kind to be taken up by the European Court and so the House of Lords' decision would be final.

<u>The returns</u>
Equitable's returns are submitted in one part covering Schedules 1, 3, 4 and 6 to the ICAS Regulations 1996.

GAD's copy of the 1999 returns includes various annotations. I am satisfied that these were made by GAD during the scrutiny programme. Some of the annotations contained in GAD's copy of the returns were made by a GAD trainee actuary on or around 28/07/2000, at the time he completed the A1 Initial Scrutiny key checks. The trainee actuary's annotations are largely the addition of certain corresponding figures from the previous returns. The other annotations were added by Scrutinising Actuary F on or around 14/08/2000, at the time he completed the A2 Initial Scrutiny key checks. However, for ease of reference mention is made here of these annotations.

<u>Schedule 1 (Balance sheet and profit and loss account)</u>
Schedule 1 of Equitable's returns consists of Forms 9, 10, 13, 14, 15 and 17. Form 9 summarises the Society's financial position at 31 December 1999 as follows:

Long term business admissible assets	*£33,110,903,000*
Total mathematical reserves (after distribution of surplus)	*£29,933,754,000*
Other insurance and non-insurance liabilities	*£241,122,000*
Available assets for long term business required minimum margin	*£2,936,027,000*
Future profits	*£925,000,000*
Total of available assets and implicit items	*£3,861,027,000*
Required minimum margin for long term business	*£1,114,310,000*
Explicit required minimum margin	*£185,718,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£2,750,309,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	*£2,746,717,000*

In Form 13, Equitable set out their admissible assets.

In Form 14, Equitable set out their long term business liabilities and margins.

(Note: as in the previous year, the returns did not include a note on contingent liabilities regarding the risk of a successful challenge to Equitable's bonus practices.)

Schedule 3 (Long term business: revenue account and additional information)
As in previous years, Schedule 3 consists of Forms 40 to 45.

In Form 40, Equitable provide a revenue account.

In Form 41, Equitable provide an analysis of premiums and expenses.

Schedule 4 (Abstract of valuation report prepared by the appointed actuary)
As in previous years, Equitable present two valuations of their long term liabilities. The results of the main valuation are carried forward, unadjusted, from Form 58 to Form 14 and on to Form 9.

Schedule 4 – main valuation (text)
Schedule 4 of Equitable's returns provides the information required by paragraphs 1 to 23 of Schedule 4 to the ICAS Regulations 1996 and includes Forms 46 to 49, 51 to 58, 60 and 61.

Equitable state that this valuation is made in conformity with Regulation 64 of ICR 1994.

In response to paragraph 4, Equitable provide 11 pages of information about their non-linked contracts. Most of the description provided is identical to that supplied in the previous returns.

Paragraph 4(1)(a)(i) requires a description of the circumstances in which – and the methods by which – adjustments could be made to surrender payments. In response, Equitable state, in relation to all accumulating with-profits contracts, that:

> *The Society reserves the right to pay less than the full identifiable current benefit attributable to a policy where the contract is terminated by the policyholder at a time other than one at which the policy benefits can be contractually withdrawn. It is the Society's current practice only to make an adjustment to the full identifiable current benefit in circumstances where the policyholder is exercising a financial option against the Society, for example by requesting a transfer to another provider, and the full policy value exceeds the underlying share of assets. The current method of adjustment is to pay*

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> *only a proportion of the full final bonus in such circumstances but there is no guarantee that the amount of the adjustment cannot exceed the full amount of final bonus.*

In response to paragraph 5, Equitable provide 70 pages of information about their linked contracts. GAD note the additional description relating to new types of contracts.

In paragraph 6, Equitable set out the general principles and methods adopted in their main valuation.

For retirement annuity contracts, like in previous years, Equitable state that:

> *... benefits have been valued on the basis that the benefits will be taken at age 60 or, if that age has been attained, at the valuation date.*

For personal pension plan contracts, unlike in the previous year, Equitable state that:

> *... benefits have been valued on the basis that the benefits will be taken at age 55 or, if that age has been attained, at the valuation date.*

GAD mark this sentence as *'new'*.

As in previous years, Equitable disclose:

> *The valuation method makes specific allowance for rates of future reversionary bonus additions, the levels of which are consistent with the valuation interest rates employed having regard to the Society's established practices for the determination of declared bonus rates. The balance of the total policy proceeds, consistent with policyholders' reasonable expectations, will be met by final bonus additions at the time of claim. Such additions are not explicitly reserved for in advance but are implicitly covered by the excess of admissible assets over mathematical reserves.*

GAD note that the rates of future bonuses used in the valuation are unchanged from the previous returns.

Equitable again state that they have made an explicit provision for their liability for tax on unrealised capital gains (in relation to business other than that linked to their internal funds), which they now estimate as not exceeding £143.6m. The provision made is £150m, which they say is shown in the Appointed Actuary's certificate in Schedule 6 of the returns.

GAD note that provision of £100m was made in the 1998 returns.

In paragraph 6(1)(g) relating to investment performance guarantees, as in previous years Equitable state that they do not consider it necessary, in current conditions, to hold a reserve for the guarantee they offer on a unit-linked annuity.

In paragraph 6(1)(h), Equitable disclose that they had set up reserves for the annuity guarantees on their *'Pension contracts – old series'* business. They explain the assumptions used in establishing these reserves relating to assumed take-up rate of the annuity at a guaranteed rate and cash commutations. Equitable state that the *'combined effect of the allowances made is that of these policies which survive to retirement date ... the gross reserves are reduced by less than 5%'*.

GAD note the changes to the mortality assumptions from those used in the previous year. Scrutinising Actuary F notes what the *'GAD* [standard]' mortality tables are and that the assumptions used by Equitable are therefore *'ok'*.

Equitable also disclose the interest rate basis used to value the guaranteed annuities, stating that:

> *Annuity benefits have been valued at an average interest rate based on 5¾% for annuities taken out during 2000 with lower rates of interest assumed for future years to take account of 69(9)(a) of the Insurance Companies Regulations.*

GAD note the change in interest rate from that used in the previous year, which was 5%.

As in previous years, Equitable disclose that, for certain non-profit deferred annuities, the valuation rates of interest used were those assumed in the premium basis. Equitable, again, do not elsewhere disclose the rates used in the premium basis.

As in previous years, in paragraph 6(2) Equitable state that, in determining the provision needed for resilience reserves, they have taken account of the fact that the long term fund has been valued at book value.

In paragraph 7(5), Equitable again explain that they consider the reserves for future bonus within the valuation to be fully able to withstand any future strains which would arise if there were significant changes in mortality or morbidity experience. They say that, accordingly, the Society does not consider it necessary to establish any additional reserves in this respect.

In paragraph 7(6), Equitable disclose that they have tested the need for resilience reserves against the three scenarios contained in DAA6, as amended by DAA10. They state that the most onerous scenario tested is scenario c (a rise in fixed interest yields of 3%, a 25% fall in equity values, a 20% fall in property values and a 25% increase in index-linked yields).

Equitable disclose that a resilience reserve of £1,350m was provided for. Against this, GAD note that the resilience reserve in the previous returns was £600m and have written: *'weakened basis?'*.

In paragraph 7(8)(a), Equitable disclose the changes made to valuation assumptions and methods in the resilience scenarios. They explain that, in the resilience scenarios, they had used the appendix (net premium) valuation method rather than the main (gross premium) valuation method, but with some changes to the valuation described in the returns. As in previous years, Equitable disclose that the changes include:

> *... for all accumulating with profits business, an annual loading of 0.25‰ increasing by 4% per annum compound of the basic benefit was reserved which is considered to be a prudent allowance for ongoing expenses: for accumulating with profits pensions business, ½% pa of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses.*

Equitable also disclose that, in the resilience scenario, they had reduced the reserve for their potential liability for tax on capital gains to £53.2m. GAD note that the provision was reduced to £20m in the previous returns.

In response to paragraph 8(b) of Schedule 4, Equitable's description includes that: *'For accumulating with profit business, the valuation rates of interest shown in Form 52 are net of a 0.25% interest rate reduction as a reserve for future expenses'*.

In paragraph 8(d), Equitable state:

> *A further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994. The resultant aggregate liability is less than the aggregate liability on the methods and bases described in this report. The report on the net premium valuation is given in an appendix following Form 61 of this report.*

GAD sideline this paragraph.

In paragraph 9, Equitable provide information on the valuation of their linked contracts. GAD note where certain assumed rates are unchanged from the previous year.

In paragraph 12(2)(viii), Equitable describe the IRECO reinsurance treaty. The description provided is the same as in the 1998 returns, except for an additional statement that the contract also covers certain group business and a change in the premium payable since the last returns to £875,000 (previously £150,000). GAD note both of these changes.

In paragraph 13, Equitable disclose: *'The Society has no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund'*.

In paragraph 14, Equitable set out a statement of their aims with regard to bonus distribution and of how they maintained equity between different generations of policyholders. The information provided is the same as for the 1998 returns. GAD underline the words *'absolute discretion'* in the statement that:

> *The Society's Articles of Association give the Society's Directors absolute discretion as to the timing and nature of bonus distributions.*

In paragraph 15, Equitable disclose that they had set reversionary bonus for the main policy classes at 1.5%. As in previous years, Equitable disclose that they offered loans under a *'loanback'* arrangement to some retirement annuity, individual and group pension policyholders.

In paragraph 16, Equitable set out final bonus rates. The returns contain the same description of Equitable's differential terminal bonus policy as that provided in the previous returns.

In paragraph 21, Equitable explain that they used risk-adjusted yields on assets other than land and equity shares by restricting them to 6.75%, which is that available on the highest yielding risk-free security held by Equitable. Equitable also explain that, where they considered this appropriate, they risk-adjusted yields on land and equity shares.

<u>Schedule 4 – main valuation (forms)</u>
In Form 46, Equitable provide information on changes to their ordinary long term business.

In Form 47, Equitable provide an analysis of their new ordinary long term business.

Form 48 shows that 58% of Equitable's non-linked assets are invested in equities, 7% in land, 32% in fixed and variable interest securities and the remaining 3% in a variety of other assets.

In Form 51, Equitable set out the mathematical reserves held for various types of non-linked contracts (excluding accumulating with-profits contracts) along with information on the number of contracts in force, the benefits valued, and rates of interest and mortality assumptions used.

In Form 52, Equitable set out the mathematical reserves held for accumulating with-profits policies, along with information on the number of contracts in force, the benefits guaranteed, and the rates of interest and mortality assumptions used in valuing them. The Form 52 for *'Pension business'* discloses that the gross total reserve for *'Options and guarantees other than investment performance guarantees'* (i.e. the reserve for annuity guarantees) is £1,663m. The Form also shows that this reserve has been reduced by reinsurance of £1,098m to a net total reserve of £565m.

Unlike in previous years, the mathematical reserves are not discounted from the current benefit value.

In Form 53, Equitable set out the mathematical reserves held for the various types of property-linked contracts along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death, and the rates of interest and mortality assumptions used in valuing them. They again disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 54, Equitable set out the mathematical reserves held for the various types of index-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity, and the rates of interest and mortality assumptions used in valuing them.

In Form 57, Equitable provide matching rectangles illustrating the notional allocation of assets to each category of liabilities, showing the valuation rates of interest supported and the ability of the matching assets to cover the reserves in the resilience scenarios. The returns show that some of the risk-adjusted yields of the assets allocated are higher than the 6.75% maximum risk-free rate assumption that, in response to paragraph 21 of Schedule 4 to the ICAS Regulations 1996, the Society says it has used.

In Form 58, Equitable set out the valuation result and composition and distribution of fund surplus.

Schedule 4 – appendix valuation (text)
Equitable explain that the appendix valuation:

> *... was undertaken for the purposes of demonstrating that in aggregate the mathematical reserves determined by the valuation undertaken using the gross premium method, the results of which are reported on the preceding pages, are not less than an amount calculated in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994.*

Equitable's appendix valuation provides the information required by paragraphs 1, 6 to 8, 10, 11, 20 and 22. The Society states that the information required by the other paragraphs of the ICAS Regulations 1996 is the same as that provided in the main valuation (apart from paragraph 23 – being a statement of the required minimum margin in the form set out in Form 60 of Schedule 4 – which, having had *'regard to the purpose of the valuation'*, has not been provided).

In paragraph 6, Equitable set out the general principles and methods used in the appendix valuation.

As in the main valuation, Equitable disclose that, for personal pensions plan contracts, the assumed retirement age is 55 (previously 60 (see 30/03/1999)).

In paragraph 6(1)(b), Equitable state:

> *In determining the valuation interest rates due regard has been taken of the reasonable expectations of policyholders concerning the rate of future reversionary bonus additions having regard to the Society's established practices for the determination of declared bonus rates. The balance of the total policy proceeds, consistent with policyholders' reasonable expectations, will be met by final bonus additions at the time of claim. Such additions are not explicitly reserved for in advance but are implicitly covered by the excess of admissible assets over mathematical reserves.*

As in the main valuation, Equitable state in paragraph 6(1)(g) that they do not consider it necessary, in current conditions, to hold a reserve for the guarantee they offer on a unit-linked annuity.

In paragraph 6(1)(h), like in the main valuation, Equitable disclose that they had set up reserves for the annuity guarantees on their *'Pension contracts – old series'* business. They explain the assumptions used in establishing these reserves relating to assumed take-up rate of the annuity at a guaranteed rate and cash commutations.

In paragraph 7, Equitable state that a resilience reserve of £2,142m was provided for.

As in their main valuation and the previous returns, Equitable disclose in paragraph 7(8)(a) the changes made to valuation assumptions and methods in the resilience scenarios, including that:

> *... for all accumulating with profits business, an annual loading of 0.25‰ increasing by 4% per annum compound of the basic benefit was reserved which is considered to be a prudent allowance for ongoing expenses: for accumulating with profits pension business, ½% per annum of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses.*

As in the main valuation, Equitable explain that they risk-adjusted the yields on assets other than land and equity shares by restricting them to 6.75%, which is that available on the highest yielding risk-free security held by them. Equitable also explain that where they considered this appropriate, they risk-adjusted yields on land and equity shares.

Schedule 4 – appendix valuation (forms)
In the appendix version of Form 51, Equitable set out the mathematical reserves held on the appendix valuation basis for various types of non-linked contracts (excluding accumulating with profit), along with information on the rates of interest and mortality assumptions used in valuing them.

In the appendix version of Form 52, Equitable set out the mathematical reserves held on the appendix valuation basis for accumulating with-profits contracts, along with information on the number of contracts in force, the benefits guaranteed, and the rates of interest and mortality assumptions used in valuing them.

The Form covering *'Pension business'* discloses that the gross total reserve for *'Options and guarantees other than investment performance guarantees'* (i.e. the reserve for annuity guarantees) is £1,630m. The Form also shows that this reserve has been reduced by reinsurance of £1,079m to a net total reserve of £551m.

This Form also discloses that the valuation of this pensions business has assumed a discounted liability of current benefits of £13,961,655,000 (against the current benefit value of £14,659,684,000).

The Form 52 summarising the totals for all of Equitable's accumulating with-profits business discloses that the valuation has assumed a discounted liability of current benefits of £16,455,227,000 (against the current benefit value of £17,340,835,000). This is a discount of just over £885m.

In the appendix version of Form 53, Equitable set out the mathematical reserves held on the appendix valuation basis for the various types of property-linked contracts along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death, and the rates of interest and mortality assumptions used in valuing them. They also disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In the appendix version of Form 54, Equitable set out the mathematical reserves held on the appendix valuation basis for the various types of index-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity and the rates of interest and mortality assumptions used in valuing them.

Like in the main valuation, Equitable provide appendix versions of Form 57 giving the notional allocation of assets to each category of liabilities on the appendix valuation basis, showing the valuation rates of interest and the ability of the matching assets to cover the reserves in the resilience scenarios.

Supplementary notes to the returns
In the notes to the returns, disclosed at the end of Schedule 4, Equitable disclose that they have been granted a section 68 Order which permits them to include in aggregate form details of their *'Personalised Funds'* in Forms 43, 45 and 55.

Equitable disclose that they have been granted a section 68 Order, which permits them to take into account a future profits implicit item. The Society states that it has included an item of £925m and that this is within the maximum amount permitted by the Order.

Equitable disclose that they have also been granted a section 68 Order enabling them to disregard amounts owing under the subordinated loan up to an amount not exceeding 50% of the required solvency margin.

In relation to Form 46, Equitable disclose:

> *Under the Society's recurrent single premium contracts, the amount and frequency of contributions can be changed at any time without penalty, including ceasing future contributions completely. Most policyholders take advantage of this flexibility and there is consequently no precisely identifiable annual premium on recurrent single premium contracts. On Form 46 the annual premiums shown for recurrent single premium contracts are those which are not specifically identified as single premiums.*

Schedule 6 (Certificates by directors, actuary and auditors)
Three Equitable Directors provide the certification required by Regulation 28(a) of the ICAS Regulations 1996. Equitable's Appointed Actuary provides the certification required by Regulation 28(b) of the ICAS Regulations 1996. Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

30/06/2000 [entry 2] FSA note that Equitable have a priority rating of 3 (but see 24/11/2000).

03/07/2000 FSA advise Equitable that their application for a section 68 Order would be considered in due course.

04/07/2000 FSA's Managing Director A advises the Chairman of a telephone call from Equitable. The Managing Director explains that Equitable are aware of *'straws in the wind'* that the House of Lords would find against them. The Managing Director reports that Equitable have given some thought to what they should do in the event of an adverse decision, including the possibility of resignations by the President and the Chief Executive. Equitable seek FSA's comments.

05/07/2000 FSA's Managing Director telephones Equitable, explaining that FSA are anxious to ensure continuity among executives at Equitable, and that decisions to resign could be taken in such a way as to permit that. The Managing Director also explains that, while it would depend on what was in the judgment, *'on what we know so far it was unlikely that the FSA would be throwing brickbats at Equitable Life'*.

Line Manager D notes that the Head of Life Insurance agrees with these comments.

07/07/2000 GAD recommend to FSA that they should grant Equitable's request for a section 68 Order for a future profits implicit item of £1.1bn. GAD explain:

> *We have reviewed the Actuary's calculations in the light of the 1999 returns and are satisfied that they are consistent with the relevant Regulations and Guidance Note. Although the disclosure seems a little sparse in places there is a significant margin between the £1.1 bn applied for and the £3.3 bn the company could apply for based on the assumptions given.*

GAD note:

> *The Actuary's certificate also confirms that he has taken into account the effect of the GAO* [reinsurance] *treaty in determining the present value of future profits.*

12/07/2000 FSA's Director of Insurance informs FSA's Executive Committee that the House of Lords' decision is expected soon and that work on a press line was under way.

17/07/2000 Equitable seek a meeting with FSA to discuss scenario planning in advance of the House of Lords' decision.

18/07/2000 [entry 1] FSA and GAD meet Equitable to discuss the possible scenarios that Equitable have identified from the expected House of Lords' decision.

According to a note made by FSA, Equitable outline three possible scenarios – Equitable winning, the Court of Appeal judgment being upheld, or Equitable not being allowed to alter the rate of bonus for policies containing annuity guarantees. Equitable comment that this third scenario would be at odds with recent FSA guidance. It had not previously been considered a possibility, but had become one, following submissions during the hearing on behalf of the representative policyholder. Equitable consider it was an unlikely outcome, but, should it arise, it would have a profound effect on solvency and the reinsurance treaty would no longer be valid.

Equitable explain that the scenario has been discussed with the Board, who have agreed that, in those circumstances, Equitable should be put up for sale. Equitable say that they do not think that they would be insolvent, but were carrying out further scenario modelling.

Equitable explain that they are:

> *... keen to avoid any precipitous action from the FSA in the light of this adverse judgement. Mainly because this could have a detrimental effect on the value of the business, for example stopping the company writing business could lead to losses in the field force and this was a valuable asset for the society. Similarly, a need to rush into gilts could also have detrimental effects.*

FSA reassure Equitable:

> *... that we would not rush to take remedial action in these circumstances and understood the importance of maintaining the value of the society. We would, however, need to be convinced that a suitable buyer for the Society was likely to be found quickly.*

FSA note that Equitable think that they would be able to begin substantive sales negotiations with a number of potential partners in August, with a view to completing a sale before the end of the year.

Equitable explain that, if the House of Lords were to uphold the Court of Appeal's judgment, Equitable would have the right to offer a reduced rate of bonuses for all GAR policies, regardless of how the benefits were taken.

18/07/2000 [entry 2] FSA's Director of Insurance informs FSA's Executive Committee that the House of Lords' decision was expected on 20/07/2000.

19/07/2000 FSA's Line Manager D provides the Chairman with briefing on the possible outcomes of the House of Lords' judgment and the implications of those outcomes for Equitable and FSA. The Line Manager sets out three scenarios:

(1) That Equitable win, with or without critical comment on the way they had explained their approach to policyholders.

The Line Manager notes that this would have no direct financial implications for Equitable. FSA would need to consider if Equitable had had due regard to PRE.

(2) That Equitable lose, in that different levels of terminal bonus may not be paid according to whether or not a policyholder chooses to take advantage of an annuity guarantee, but that a GAR policyholder need not receive the same level of bonus as a non-GAR policyholder.

The Line Manager notes that this would allow Equitable to *'ring fence'* the costs of meeting guaranteed annuities amongst policyholders who have GARs. It would allow Equitable to declare one terminal bonus at the lower of the two levels currently available. FSA would need to consider whether the decision had implications for three or four other insurers who had adopted a similar bonus policy to that of Equitable, and whether the guidance issued on 18/12/1998 had been consistent with the judgment.

(3) That Equitable lose *'very badly'*, in that different levels of terminal bonus may not be paid, as in the second scenario, but that, in addition, the existence of GARs in a class of contract should not influence the level of bonuses paid to that class.

Line Manager D draws attention to the third scenario, which is *'not something that has been considered previously'* and would involve the court opining on the apportionment of bonuses between different classes of policyholders, rather than just in respect of GAR policyholders. The Line Manager explains that previous court hearings had focused on the narrow issue of the rights of GAR policyholders; however, *'the hearings in the House of Lords suggest they may consider the issue in its broader context'*.

Line Manager D notes that the financial implications for Equitable would be *'very serious'*. The Line Manager says that Equitable would have to declare one terminal bonus at the higher of the two levels currently available, and that, in view of the impact on market confidence, Equitable would seek a partner. The Line Manager notes that it was expected that there would be no shortage of potential partners. FSA would need to liaise with Equitable over their current and projected financial position and keep in touch with plans for the sale of the business. The Line Manager states that, even if Equitable's solvency margin were breached, it is *'unlikely FSA would need to take any public regulatory action since the company would already be taking steps to ensure its financial position was repaired'*.

Line Manager D notes that FSA would also need to consider the wider implications of such a judgment. She notes that it would be likely that the guidance issued on 18/12/1998 would be inconsistent with the judgment, that up to 20-25 other companies who sold policies with annuity guarantees might be affected, and that there might be implications for other companies with contracts containing unrelated guarantees.

20/07/2000 [entry 1] The House of Lords dismiss Equitable's appeal against the Court of Appeal's decision of 21/01/2000. Their ruling makes clear that Equitable cannot ring fence the problem by opting to reduce bonuses for all GAR policyholders, irrespective of how the benefits are taken. Equitable announce their intention to seek a buyer for the business. The Society sets 20 November 2000 as the formal deadline for bids.

FSA's Chief Counsel A prepares an immediate summary of the judgment. She says that, while it is *'the worst outcome for Equitable'*, the wider implications for other companies who have written policies containing annuity guarantees are unclear. She concludes that the judgment rests *'on the particular terms of the Equitable policy and the particular circumstances giving rise* [to] *an expectation that those terms would be met'*. Chief Counsel A acknowledges that

HMT's guidance on annuity guarantees (see 18/12/1998) would have to be revised *'to make its tone less positive'*, although they are not clear if substantial amendment would be needed.

FSA advise GAD that Equitable have promised to provide a note on their solvency position within a couple of days. FSA note that Equitable intend to reduce policy values immediately by 5% across the board. FSA hold out the prospect that, once Equitable have been sold, policyholders whose policies have matured in the intervening period would be eligible for a top up.

GAD agree that FSA should write to all companies with annuity guarantees on the implications of the judgment. GAD suggest that, in respect of 'ring fencing', the implications may go beyond annuity guarantees.

FSA produce in-house briefing notes in anticipation of questions they might receive. In response to the possible query: *'What action will the FSA take to make sure policyholders with similar contracts with other companies are properly protected?'*, FSA say:

> *Other companies will need to consider the implications of the judgement for their payment practices. We will be discussing their conclusions with them and the basis on which these have been reached.*

In response to the possible query: *'Doesn't this show that the FSA failed to act to protect policyholders. Why was it necessary for policyholders to go to court?'*, FSA state:

> *FSA did not fail to protect the interests of policyholders. The Equitable itself chose to bring this test case, and has been commended for doing so. The key issue raised in this case was the interpretation of the detail of contracts issued by the company and the way discretionary powers were exercised by the directors. Once before the court it was right for the FSA to step back and await the outcome, while ensuring adequate reserves were in place.*

In response to the possible query: *'Suggested that Equitable Life's practice had been "approved" by HM Treasury. Is this true?'*, FSA repeat the answer provided to a similar question at the time of the Court of Appeal judgment (21/01/2000), but state that FSA were now reviewing that guidance in the light of the judgment (having previously said they would consider doing so).

20/07/2000 [entry 2] The Director of FSA's General Counsel's Division (Director of GCD) explains the House of Lords' decision to FSA's Board. Managing Director A confirms that Equitable have decided to put themselves up for sale.

20/07/2000 [entry 3] FSA write to PIA and IMRO to inform them of the outcome of the court case and of Equitable's decision to put themselves up for sale. FSA warn that the terms of the ruling are such that there would be financial consequences for Equitable. FSA also ask for information about any future activity or visits in relation to Equitable.

21/07/2000 [entry 1] HMT ask FSA to consider a number of possible questions that may now be raised. These include:

> *<u>Guaranteed Annuities</u>*
>
> *Timing: how long to sort this out (will regulator be pressing for immediate increases in reserves or has that already been done?) ...*
>
> *<u>Did the regulator get it right?</u>*
>
> *FSA's Q and A suggests companies will need to consider their position and FSA will be in dialogue: but should that already have happened?*

Was the reserving guidance fairer to the companies than it was to the policyholders, appearing to suggest that there was damage limitation through looking to the letter of the contracts. (Newspapers suggest that the Law Lords decision did not turn on the letter of the policy, but on whether a discretion could be exercised in a way that appeared to nullify a provision of a contract.)

Equitable allowed the case to be brought, but should the regulator have been seen to be pushing them to do the decent thing?

Policyholders' reasonable expectations

How has our understanding changed, if at all?

21/07/2000 [entry 2] FSA (Chief Counsel A) prepare a fuller summary of the judgment. FSA's analysis of the implications remain as in the note of 20/07/2000. FSA state that the judgment rests '*on the particular terms of the Equitable policy which had to be read subject to the powers and decisions of the directors in respect of the declaration and payment of final bonuses*'.

21/07/2000 [entry 3] In response to the request of the previous day for information about regulatory activity in relation to Equitable, PIA inform FSA (as Equitable's 'Lead Supervisor') that they have completed a debrief concerning the Society following a supervision visit in June 2000. PIA say there are no issues from the visit that they expect to lead to disciplinary action. PIA also inform FSA that they are to conduct quarterly visits to Equitable from now on.

On FSA's *'Lead Supervisor'* file next to this email and marked with the date '21/07/00' is a copy of PIA's *'Debrief Decision Document'*, dated 21 March 2000, and attached *'Visit Synopsis'*.

24/07/2000 [entry 1] FSA prepare an action plan following the House of Lords' ruling. This includes establishing Equitable's current and projected solvency position; asking companies for their assessment of the implications of the ruling for their business; reviewing the guidance of 18/12/1998, and meeting Equitable within the next two weeks to discuss the sale. On the last point, FSA state:

> *We aim to keep in close touch throughout the process in order to ensure that we can identify at an early stage any regulatory concerns arising from any of the proposed purchasers or the structure of the sale.*

In commenting on the action plan, the Director of Insurance suggests that FSA advise companies that they are reviewing the guidance, and that, until the review is completed, companies should not rely on it.

24/07/2000 [entry 2] PIA write to FSA's Line Manager D seeking her views on various aspects of the House of Lords' ruling, insofar as it affects their review on pensions mis-selling. PIA understand that Equitable would be reducing the value of their with-profits policies. PIA suggest that the immediate implication of this for the review is that the losses experienced by those who have been mis-sold an Equitable policy would increase. PIA presume that Equitable were aware that their reserves would need *'beefing-up'*. PIA ask the Line Manager to bear in mind that there were pension review issues, and that they and colleagues dealing with the review needed to be kept abreast of what was happening. PIA also ask whether a sale of the Equitable business was 100% certain.

In response, Line Manager D confirms that Equitable would need to increase their provision for pension mis-selling but says that she does not think the increase would be significant. The Line Manager says that, while she could not say that a sale was 100% certain, *'it must be close to 99.9%'*. The Line Manager adds: *'The company see a sale as the only option and as far as I can see the only reason it would not go ahead would be if there was no suitable buyer and that appears unlikely'*.

24/07/2000 [entry 3] FSA write to GAD about the implications of the House of Lords' judgment. FSA note that, in Equitable's case, the *'falling away'* of the reinsurance treaty would have a knock-on effect on their reserves, but this was unlikely to be the case for other companies. FSA point out that they were already requiring companies to reserve fully, whether or not they declared a differential terminal bonus. Accordingly, FSA did not consider that there were any reserving implications for companies, other than for any compensation that might now be payable. The only new point was that ring fencing had been ruled out. However, as companies did not have to reserve for terminal bonuses and the ruling would only increase the level of terminal bonuses in the short term, FSA did not consider companies would have to increase their statutory reserves for annuity guarantees.

GAD agree with FSA's analysis, saying:

> *There should be no effect on the level of other insurer's reserves that need to be set up for GAOs and it justifies the tough stance that we took.*
>
> *Equitable was unique in the form of reassurance that it entered into, with its cancellation clause. In retrospect the Actuary is shown to have acted imprudently in taking credit for the reassurance. No doubt he was relying upon the Board's view, based upon legal advice, that they were unlikely to have to change their bonus policy.*

24/07/2000 [entry 4] FSA attend a meeting of the Tripartite Standing Committee. On the consequences of the House of Lords' ruling, FSA's Managing Director A reports that *'there would only be real problems if Equitable Life could not find a buyer by – say – the end of the year. But, currently, that problem did not seem at all likely to emerge'*.

26/07/2000 [entry 1] Equitable provide FSA with the promised information on their current estimated solvency position. The Society's estimated solvency position prior to the House of Lords' decision is disclosed, as follows:

> *An updated position to 30 June 2000, before the House of Lords' judgment but bringing the new regulations and resilience tests into account, was as follows:*

		£m
Value of non-linked assets		*29,930*
Future profits implicit item		*965*
		30,895
Mathematical reserves		
- Basic (including GAR)	*25,705*	
-Resilience	*1,900*	
		27,605
		3,290
Required minimum margin		*1,160*
Excess assets		*2,130*

The operative resilience test is Test 2.

2000

Equitable then disclose their current estimated solvency position:

Having examined both the old and new tests there appears to be somewhat of an anomaly in that, although the rationale for the new Test 2 was that it represented some relaxation to reflect the strengthening of the reinvestment assumption in the new regulations, the new Test 2 is in fact more onerous in these circumstances than the old test (and both are stronger than the new Tests 1 and 3). Having considered that I feel that the old Test 2 provides an adequate margin of resilience as required by Regulation 75. Revised figures as at 30 June 2000 on that basis are as follows (the basic reserves include an allowance of £150m for redress for increased benefits on past retirements):

		£m
Value of non-linked assets		*29,930*
Future profits implicit item		*1,000*
		30,930
Mathematical reserves		
- Basic (including GAR)	*27,-170*	
- Resilience	*2,295*	
		29,465
		1,465
Required minimum margin		*1,240*
Excess assets		*225*

Equitable explain:

Although the above margin is quite thin, a modest relaxation in some of the assumptions would give a significantly improved position. For example, if the equity fall assumed in Test 2 was 20% rather than 25% the excess assets would increase to around £1225m. Such a change could be seen as an offset to the impact of very low dividend yield stocks, such as [two companies]*, which the proposals to use P/E ratios rather than dividend yield in the regulations were designed to mitigate.*

The effective take-up rate of GAR options assumed is such that the gross reserves for GAR policies are reduced by less than 5%. That is in line with the guidance and is, I feel, even in the new circumstances, a very conservative assumption. A modest relaxation in the take-up rate so that reserves were reduced by nearer to 10% would increase excess assets to around £950m. I appreciate that that would not be consistent with the GAD guidance. The current reassurance arrangement does, however, remain in force for 3 months beyond 20 July 2000 and we are discussing the possibility of an amended treaty with a much higher take-up threshold which would give the same reserving effect.

On a continuing basis the position would be unacceptably weak. However, as you said last week, we have effectively implemented a plan to strengthen the position by taking the course of action which we have. Meanwhile I believe it is reasonable to regard the Society as continuing to meet its required minimum margin.

We will now work on some projected figures to confirm that new business has no material impact on the solvency position and I will aim to send those to you next week. If there are any points arising from the above which you would like to discuss before then, please do not hesitate to let me know.

26/07/2000 [entry 2] Equitable announce changes to bonus rates. With-profits policies are credited with no growth for the first seven months of 2000.

26/07/2000 [entry 3] FSA respond to HMT's questions of 21/07/2000. In response to the question about timing for any increases in reserves, FSA explain:

> *Equitable's reserves have come under strain as a result of the judgment but this is not because its liabilities for GAOs have increased but because the value of the assets it was holding to cover them has fallen. It had entered into a reinsurance treaty which provided some £1billion of cover for GAOs but this was conditional on it being able to maintain its differential bonus practice. The collapse of the reinsurance means the company needs to back the liability with other assets and has knock on effects elsewhere in the reserving eg the resilience reserve increases. Equitable is, as far as we are aware, unique in facing this difficulty. Assets which had previously been included in the company's free assets are now having to be used to cover its liabilities, but it expects to be able to show that it is currently covering its solvency margin (just).*

In response to the question *'Did the regulator get it right?'*, FSA answer:

> *On balance we did not do badly and indeed it would have been difficult for any guidance to have been consistent with the full range of different judgements that have appeared, first from the Vice Chancellor and then the Court of Appeal and now finally the House of Lords. The guidance on how the costs of GAOs might be met will need to be reviewed but it is not clear that it was "wrong". It indicated that bonuses could only be reduced if this was consistent with the terms of the contract and what policyholders had been led to expect. In Equitable's case the* [House of Lords] *appears to have concluded that the company's contracts did not allow for a reduction in bonus and it was not what policyholders expected.*

FSA accept that the emphasis of the guidance needed to be changed so that it did not suggest that most policies and policyholders' reasonable expectations would allow differential bonuses. FSA note that if they had *'got it wrong'*, so had the actuarial profession, and that the Institute of Actuaries had fully supported the guidance issued. FSA say that they do not consider that they could have anticipated the House of Lords' ruling and have *'every reason to believe that our guidance* [see 13/01/1999] *on the levels of reserve required was spot on'*.

FSA say that they are not convinced that HMT or FSA could or should have pushed Equitable to alter their bonus practice, which *'was not clearly unlawful'*. FSA say that:

> *The FSA did ensure that Equitable set up adequate reserves to cover their GAO exposure. As a result Equitable decided to enter into the reinsurance treaty in order to avoid having to take alternative courses of action that they considered to be against their policyholders' interests.*
>
> *Equitable had been told that if the court upheld their practice, we would nevertheless consider whether PRE had been breached and whether intervention was appropriate. Obviously FSA's consideration of this issue was suspended whilst the matter was before the courts.*

FSA note that they had warned Equitable that if the Court upheld their practice, they would *'nevertheless consider whether PRE had been breached and whether intervention was appropriate'*, but that this action had been suspended whilst the matter had been before the courts.

In response to the question on '*Policyholders' reasonable expectations'*, FSA note that the judgment had confirmed their view of what the relevant criteria were for determining policyholders' reasonable expectations (what policyholders were told, the company's past practice, and wider industry practice) and it had also confirmed that directors must have regard to those criteria when setting bonuses. However, FSA consider the judgment had made it less clear whether policyholders' reasonable expectations were only one of a number of factors companies had to consider when setting bonuses. FSA add that *'any clarity on this point should not necessarily inhibit us in intervention action which might be appropriate under the Insurance Companies Act 1982 for breach of PRE'*.

FSA conclude: *'Overall we are probably not much further forward in understanding/defining PRE'*.

26/07/2000 [entry 4]	FSA's Executive Committee discuss issues surrounding Equitable.
27/07/2000 [entry 1]	FSA write to Managing Directors of with-profits life companies, asking for their assessment of the implications of the House of Lords' ruling.
27/07/2000 [entry 2]	FSA's Director of GCD writes to Chief Counsel A about the proposed review of the 1998 guidance on guaranteed annuities. The Director suggests that there were three points in the guidance that FSA need to address, following the House of Lords' ruling. First, the Court had not endorsed the view that if a guarantee had not been paid for, a sum could be deducted from the final bonus by way of a notional charge after the event. Secondly, before a charge was made against a policyholder's terminal bonus, it had to be clear that he or she had agreed to this. Thirdly, a charge needed to be made to all those who had the benefit of the guarantee, whether or not they took it up. The Director of GCD adds: *And it needs to be calculated on the basis of the cost of providing the guarantee, not the cost of meeting it. To the extent that the guidance note suggests that the terminal bonus can be reduced by the value of the guarantee, it seems to me to need to be revised.* The Director of GCD suggests that the above was the minimum needed to ensure that FSA brought the guidance into line with the ruling. The Director cautions that, even with these amendments, the guidance might attract the criticism that FSA were encouraging companies to find ways round the ruling. Chief Counsel A circulates the comments. In response, the Head of Life Insurance agrees that, rather than waste time and credibility in justifying the earlier guidance (which he nevertheless considered to be justifiable), FSA should take the House of Lords' judgment as an opportunity to issue a new guidance note.
28/07/2000	**GAD complete the A1 Initial Scrutiny check on the Society's 1999 regulatory returns**. GAD identify no concerns.
31/07/2000 [entry 1]	FSA's Director of Insurance writes to the Head of Life Insurance, Line Manager D and Chief Counsel A and GAD about possible revision of FSA's guidance on annuity guarantees, following the House of Lords' ruling. The Director of Insurance says he believes that FSA would *'face some difficult questions in determining how "wide" an interpretation we need to accommodate in our revised guidance'*. The Director continues to say: *'Too narrow* [an interpretation] *and we could find the court determining some future case in a way inconsistent with our guidance. Too wide and we could be insisting on companies taking an approach inconsistent with current views of PRE ...'*.
31/07/2000 [entry 2]	The German regulatory authority write to FSA. The regulatory authority explain that they had received a number of enquiries from policyholders of Equitable's German branch who were concerned about Equitable's ability to meet their liabilities following the House of Lords' judgment. They ask about any action FSA might be taking in respect of Equitable.

02/08/2000	Equitable write to all their policyholders explaining the House of Lords' ruling, the intention to sell, and the impact on the GAR and non-GAR policies (as announced to the press on 26/07/2000).
04/08/2000 [entry 1]	Equitable write to FSA to confirm arrangements for a meeting on 11/08/2000 to discuss regulatory aspects of the sale process. Equitable refer to correspondence with GAD in 1999 (see 27/08/1999, 31/08/1999 and 08/09/1999 [**entry 2**]) about the new resilience test. Equitable say that: *... new Test 2 is actually more stringent than the old version for our portfolio, contrary to what was understood to be the intention.* GAD's file contains undated and unsigned manuscript notes, which appear to be a commentary on Equitable's calculations and which suggest that some are dubious. Equitable also report to FSA that: '*Discussions with* [IRECO] *for an amended version of the reassurance arrangement to give some degree of support to the statutory solvency position are proceeding well and I hope to be able to give you some further information on that next Friday*'.
04/08/2000 [entry 2]	Equitable write to FSA, further to their letter of 26/07/2000, to provide information on the impact on the Society's solvency position of new business. Equitable say: *In my 26 July letter, excess assets at the end of June were shown to be £225m. On the assumptions set out above, the equivalent figure at the year end assuming no new business would be virtually unchanged at £200m. If new business sales are then factored in there would be a marginal improvement in the position to £210m due to the effect in the resilience test conditions of the considerably less onerous guarantees in most of our new business contracts. These figures do not take any account of any benefit from an amended reassurance treaty for GAR contracts that we are currently negotiating.* *Looking forward another year, I have assumed that equity returns pick up with a total return on equities of 8% p.a. with gilt yields remaining stable. On that basis the end of 2001 would show an improved solvency position with excess assets in the region of £800m, although that does not allow for any declared bonus in respect of 2000.* Equitable express the hope that FSA would find this information reassuring.
07/08/2000	FSA reply to the German regulatory authority's letter of 31/07/2000. FSA explain that FSA are satisfied that Equitable remain able to cover the required margin of solvency, but that their level of cover was less than both FSA and the company would like to see. FSA explain that Equitable are putting themselves up for sale, and that it was anticipated that an injection of capital following the sale would increase the cover for the solvency margin *'to a comfortable level'*. FSA attribute the deterioration in Equitable's solvency position since the judgment as being: *... primarily ... the result of the termination of a reinsurance agreement to cover part of the liabilities under guaranteed annuity contracts* [see 11/08/2000] *... The company is currently seeking to renegotiate the reinsurance arrangement ... and, if it were to succeed in doing so, this would be likely to significantly improve its statutory solvency position.* FSA say that: *Given that Equitable Life is currently meeting its required minimum margin of solvency, we have not considered it necessary or appropriate to take any intervention action in respect of the company. We are monitoring the solvency position closely, but are content that the plans for the sale of the company can be expected to resolve the longer term concerns about the financial position.*

As regards the implications for policyholders of the German branch, FSA state that:

> *... except for a few policies still in force but issued to policyholders whilst the company's German branch was subject to supervision by the BAV (ie prior to the implementation of the Third Life Directive) policyholders of the branch will be in the same position as UK policyholders.*

08/08/2000 FSA ask PIA for an update on the two Enforcement cases of which they are aware. On income drawdown, they ask if Equitable have filed a response to Enforcement's preliminary findings sent in May 2000 (see 23/05/2000) and what the next steps might be. On pensions mis-selling, FSA ask what has happened to a possible Enforcement case that was identified in February/March 2000.

11/08/2000 [entry 1] FSA and GAD meet Equitable and their actuarial consultant, solicitors and financial advisers. According to FSA's note of the meeting, Equitable outline the sale process, which they anticipate being completed by June 2001. FSA warn that this was a tight timetable and that, given their limited resources, FSA might not be able to consider proposals as quickly as Equitable might wish.

Equitable explain that they were close to agreeing a renegotiated reinsurance treaty (Note: the previous treaty was void, given the fundamental change to the GAR bonus policy required by the House of Lords' ruling). On the Society's solvency position, FSA record that:

> *... the figures provided by the Society which took into account the revised reinsurance protection still showed a relatively low coverage of the* [required minimum margin], *with only £1.580bn of explicit assets covering* [a required minimum margin] *of £1.190bn. The figures provided did not allow for reversionary bonuses for the year put at c£500m last year ... it was possible that the decision on the level of bonuses for the year 2000 would be delayed next year. The* [required minimum margin] *coverage quoted was also based on the old resilience test 2. The new test 2 was thought by* [the Appointed Actuary] *to have a very severe effect on the Equitable and was likely to cost them a £600m reduction in the free asset figure.*

It appears that Equitable hand over *'Revised end-June solvency figures based on* [the] *new reinsurance treaty'*, which were as follows:

		£m
Value of non-linked assets		*29,930*
Future profits implicit item		*1,000*
		30,930
Mathematical reserves		
- Basic (including GAR)	*26,620*	
- Resilience	*1,730*	
		28,350
		2,580
Required minimum margin		*1,190*
Excess assets		*1,390*

2000

Equitable say that they believe a section 68 Order in respect of the valuation rate of interest, which had apparently been issued to two other insurance companies, would be of benefit to the Society. FSA say that they would consider any application from Equitable *'on its merits'*.

Equitable agree to provide FSA with monthly updates on solvency, as well as solvency scenario planning, together with sensitivity tests for the projected year end positions for 2000 and 2001.

Equitable's Chief Executive: *'confirmed that as disclosed in a recent newspaper article the Society was charging a MVA of about 20% of terminal bonus (equivalent to an approximate 5% reduction in policy value) for schemes that wanted to transfer out of the Equitable.* [He] *confirmed that this charge was a fairly standard adjustment to discourage transfers out and argued that other companies already did this and that some of them charged more than the Equitable.* [The Appointed Actuary] *confirmed that there had been a slight increase in surrenders since the judgement but most policyholders were taking a "wait and see" approach'*.

Equitable also explain that they were considering hedging their exposure to the interest rate risk of their annuity guarantees. FSA provide some advice on this.

11/08/2000 [entry 2] FSA respond to policyholders who have complained that Equitable misled them as to the possible costs of the GAR litigation. FSA say that they did not believe it would be appropriate for FSA to take further action.

FSA explain that Equitable's initial estimate of £50m had been based on the assumption that the courts would uphold their practice. FSA say that this assumption was not unreasonable at the time and had been supported by the High Court. Although the Court of Appeal had held that Equitable's practice was unlawful, that Court had also suggested that it was open to Equitable to pay differential terminal bonuses according to whether or not a policy contained an annuity guarantee. FSA say that they consider that Equitable were entitled to rely on this in stating that the Court of Appeal judgment would have no significant cost implications if it were upheld in the House of Lords.

FSA conclude that it only became clear that there would be increased costs following the House of Lords' ruling, which had gone further than merely upholding the Court of Appeal's decision.

14/08/2000 **GAD complete the A2 Initial Scrutiny check on the Society's 1999 regulatory returns**. The check is carried out by a new Scrutinising Actuary at GAD (Scrutinising Actuary F).

The form for the A2 check follows a similar format to that used for the 1996, 1997 and 1998 returns and includes the following:

<u>Strength of valuation basis</u>
GAD note that the position *'looks tight'*, when commenting on whether the interest rates used for with-profits business appeared to make provision for policyholders' reasonable expectations and that Equitable *'appear to value some life business* [at] *gross rates:* [but] *these are annuities'*. They note that other management expenses, at £13m, are material. GAD confirm that Equitable have applied the resilience test in accordance with the Government Actuary's latest guidance. GAD judge the overall interest basis and the valuation basis as *'adequate'*.

<u>Solvency position</u>
GAD note that the absolute cover for the required minimum margin is *'adequate' 'before House of Lords ruling!'* and that the trend in the level of cover in recent years has been *'volatile'*.

<u>Operating results</u>
GAD note that the amount of reinsurance is material and that there is '*a material exposure to non-UK authorised reinsurers without deposit back*'.

PRE issues
GAD circle both yes and no to the question of whether the answer given by Equitable in paragraph 4(1)(a)(ii) of Schedule 4 of the returns is satisfactory. They comment: *'Don't* [understand] *it – review* [Scrutinising Actuary E's] *correspondence post 1996 scrutiny'*.

Current issues
GAD say that Equitable are known to have material exposure to annuity guarantees and, in commenting on whether their approach is a cause for concern, GAD state that this would be '[an] *understatement on this occasion'*.

The sections *'Aspects that look worrying'* and *'Other notes'* have been replaced with *'General comments'*, under which GAD make the following comments:

> *Company now for sale.*
>
> *GAO treaty being renegotiated.*
>
> *Implicit item.*
>
> [Subordinated] *loan issued 1997.*
>
> *Review* [unitised with-profits] *reserving basis.* [Scrutinising Actuary E] *queried this following 1996 scrutiny (shown as 4% interest* [in the returns]*).*
>
> [Resilience] *reserve £2.1bn* [net premium valuation] *£1.35bn* [bonus reserve valuation].
>
> [Other management expenses] *£13m.*

The check no longer contains the section *'Items to be notified to HMT, to be taken up immediately with the company'*. GAD retain Equitable's priority rating at 2 *'because of* [company] *sale & adverse House of Lords ruling'*.

Accompanying the Initial Scrutiny check is an *'Initial Scrutiny Summary Form'*, which includes certain key figures disclosed in the 1995 to 1999 returns.

21/08/2000	FSA respond to a policyholder who has complained that Equitable had reduced her final bonus by 20%. FSA explain that this was a penalty for early surrender and, as such, is standard practice and not related to the impact of the House of Lords' ruling. FSA say that they did not propose to investigate the matter further.
22/08/2000	FSA's Chief Counsel A writes to FSA's Central Policy Department, setting out a timetable for internal consultation and agreement to the new guidance on reserving for annuity guarantees.
23/08/2000	FSA's Director of Insurance speaks to FSA's Executive Committee about Equitable and informs them that FSA plan to put out a *'green paper'* on the impact of the House of Lords' judgment.
24/08/2000 [entry 1]	FSA write to the Financial Reporting Council (the statutory body which regulates auditors and oversees the regulatory activities of the professional accountancy bodies) in response to two complaints that the Council had received about statements in Equitable's Annual Report for 1999. FSA say that they consider that the complaints (that Equitable's directors and auditors may not have disclosed sufficient information about the litigation then in progress and the potential financial implications for the company) should be dealt with by the Council.
24/08/2000 [entry 2]	FSA's Line Manager D reports to a bilateral meeting of FSA and PIA on the implications for Equitable and the industry of the House of Lords' judgment. She explains that FSA had sought from with-profits life companies their assessments on the implications of that judgment. The responses indicated a wide range of interpretations, in the light of which FSA were in the process of preparing guidance. The aim was to encourage a consistency of approach to setting

bonus policies and to avoid an *'unnecessarily wide interpretation'* of the judgment which had been, in FSA's view, very case-specific in a number of respects.

The report of the meeting records:

> *It was clarified that the judgment generally did not have solvency implications as the level of reserving had not been effected (it was just that some companies would experience higher real costs). Equitable Life had only experienced a weakening in its financial position because the reinsurance it held for GAOs had been terminated (because it was conditional on the company continuing to pay differential terminal bonuses).*

25/08/2000 FSA respond to a policyholder who had complained that Equitable had misled him as to the possible costs of the GAR litigation. FSA write in similar terms to their letters of 11/08/2000. The policyholder also asked FSA to take a controlling interest in the management of Equitable. FSA explain:

> *Our role in authorising and supervising insurance companies under the Insurance Companies Act 1982 is primarily concerned with ensuring that insurance companies have sufficient funds to meet their obligations to policyholders and are managed in a sound and prudent way by persons fit and proper to hold their posts. We have no evidence to suggest that the management of the Society are failing to meet these requirements or acting without due regard to the interests of policyholders. We have no general power to intervene in the day to day business of insurance companies, or to resolve disputes between companies and their policyholders.*

30/08/2000 FSA's Returns Reception and Validation Unit provides Line Supervisor C with a list of three errors in Equitable's 1999 returns. The Unit ask the Line Supervisor if any of the matters should be taken up with Equitable. FSA's note shows that Equitable have a priority rating of 3.

01/09/2000 [entry 1] Equitable write to FSA, following the meeting on 11/08/2000. Equitable provide a copy of the signed addendum to the reinsurance treaty, a copy of the addendum made last year to bring group business into the scope of the treaty, and a graph showing distribution of their fixed interest holdings over the last five years.

Equitable also provide the first of the requested monthly updates on their solvency position. The Society discloses that:

> *The estimated position as at 31 July 2000, on the same basis used for the 30 June 2000 figures provided at the 11 August 2000 meeting are as follows:*

		£m
Value of non-linked assets		*29,960*
Future profits implicit item		*1,000*
		30,960
Mathematical reserves		
- Basic (including GAR)	*26,665*	
- Resilience	*1,795*	
		28,460
		2,500
Required minimum margin		*1,200*
Excess assets		*1,300*

2000

The figures are little changed from the end-June position. The rise in markets during August should mean a rather stronger position at 31 August 2000.

01/09/2000 [entry 2]	FSA's Line Supervisor C provides a note for the Insurance Supervisory Committee, recommending that HMT should agree to the requested section 68 Order for a future profits implicit item (see 27/06/2000). The Line Supervisor says that Equitable were only seeking a third of the implicit item they could be entitled to, and that they were unlikely to be dependent on the item for coverage of their required minimum margin. The Line Supervisor explains that, while there were a number of uncertainties that could affect the balance sheet, these should not significantly affect the implicit item. The Line Supervisor says that GAD have reviewed and approved Equitable's calculations. Line Supervisor C states: *'In the particular circumstances faced by the Equitable it is important to carefully consider any request from this company that affects the form 9 position'* and *'the Society have provided the detailed calculations in relation to Regulation 24, these have been reviewed and approved by GAD who are fully aware of the context in which this concession would be granted'*.
01/09/2000 [entry 3]	FSA chase PIA for a reply to their query of 08/08/2000. In response, PIA explain: *Pensions review – case being dealt with ... but substantive work not yet started (and won't be for several weeks) because of other priorities. The matter does not appear to require investigation as such, only "prosecution".* [Pension fund withdrawals] – *Equitable's initial response received and detailed consideration of it will begin on 11 September. A further response from Equitable is due by 7 September. Initial response not extensive but is certainly contesting some findings.*
01/09/2000 [entry 4]	FSA's Head of Life Insurance writes to Managing Director A. The Head of Life Insurance refers to FSA's aim of getting early guidance to the life assurance industry on the implications of the House of Lords' ruling, which *'will have to be "green-edged"* [referring to the nature of a government Green Paper], *as we cannot pretend we know how a court will determine any particular case'*. He says that the guidance would be useful to a number of companies and that FSA were keen to encourage a reasonably consistent approach across the industry. He attaches current drafts of the guidance and covering letter and indicates that it would be helpful for the Managing Director to invite comments on the draft from the Financial Services Consumer Panel (a panel appointed by FSA's Board to provide advice on the interests and concerns of consumers and to report on FSA's effectiveness in meeting their statutory objectives) at their meeting to be held on 5 September 2000. (Note: it appears that the issue is actually considered by the Panel on 13/10/2000.)
04/09/2000	Equitable write to FSA to explain their approach to any windfall rights arising from the proposed sale.
11/09/2000	A member of FSA's Insurance Supervisory Committee writes to the Head of Life Insurance about FSA's note recommending agreement to the requested section 68 Order (see 01/09/2000 [**entry 2**]). The member of the Committee says that there are two issues: *First, the amount of the implicit item actually shown in Form 9 for the December 2000 return cannot exceed the amount that could be supported by a new application submitted with that return and bringing in the financial performance of the company in 2000. We expect a sharp fall in surplus in 2000 because of the* [House of Lords'] *judgment and this will need to be brought in to the figures ... In practice, the company may not actually be able to use the figure that we agree now.*

2000

Secondly, if the company does demutualise, the company to which the business is transferred will not be able to take advantage of surplus that has arisen in Equitable in earlier years to generate an implicit item for itself.

The member says that neither of the issues suggests agreement should be withheld, but that it might be useful to remind Equitable about them *'to reduce the possibility of future embarrassment'*.

12/09/2000 FSA's Line Supervisor C writes to Equitable to say that he has asked HMT to issue the section 68 Order for a future profits implicit item. The Line Supervisor points out that the amount of an implicit item shown in the returns for 2000 cannot exceed the amount that could be supported by a new application submitted with those returns. The Line Supervisor adds that any company to which Equitable's business is transferred would not be able to take advantage of the surplus that has arisen in Equitable in earlier years to generate an implicit item.

13/09/2000 HMT send Equitable the section 68 Order for a future profits implicit item of £110m (this is later corrected to read £1,100m), for use in their 2000 returns.

20/09/2000 HMT and FSA hold their seventh quarterly meeting on insurance regulation issues. HMT say that they have noticed that Equitable are still advertising for new business. FSA's Head of Life Insurance replies that Equitable's recent difficulties *'have not affected its solvency position, only its freedom to invest'*. On the possibility of including guidance in the proposed FSA handbook, the Head of Life Insurance says that:

... it will take time to determine what advice to give, as the judgment depended on three factors not present in all companies, so would not want to panic companies but too general a guidance would not be effective. FSA must not be seen to be helping companies "avoid" the judgment.

FSA may take a view on the impact of the judgment on the industry after guidance is issued, but are not at the present time concerned about solvency as regulation ensures that generous reserves are maintained at all times.

21/09/2000 [entry 1] GAD advise FSA on the contents of Equitable's letter of 01/09/2000. GAD explain that they are satisfied with the amendments to the reinsurance treaty. GAD note the information Equitable have provided on their fixed interest holdings, and explain that they do not wish to pursue this matter.

GAD note the solvency position at 31 July 2000. They comment:

Without the future profits implicit item, the excess assets would be just £300m (instead of £1.3 bn). Also the resilience reserve (which we take to have been calculated on the old basis) continues to be substantial, at £1.8 bn. However, we have no questions to raise with the Society on these figures at this time.

21/09/2000 [entry 2] FSA's Managing Director A presents his monthly report to FSA's Board. The report discusses the implications of the House of Lords' ruling and FSA's intention to issue guidance to the industry.

04/10/2000 FSA's public enquiries division pass to PIA a copy of a letter to Equitable complaining about Equitable's advertising campaign, in which Equitable are said to assert that they have delivered consistently strong results since 1762. FSA explain that the FSA's lead supervisor (i.e. Line Supervisor C) has suggested asking for PIA's comments on whether the advertisements had been misleading *'given the current situation of the company'*.

In response, PIA state that, while they could see why the statement (in the advertisement) would cause considerable annoyance to Equitable policyholders, Equitable undertook many business activities and the GAR issue was only part of those activities. PIA say that Equitable had achieved a record of success and had a good reputation, and the GAR issue did not totally overshadow all that. While PIA had not seen the advertisement in question, it appeared to them that the claims had been based on the past rather than the current position. Overall, PIA say that they do not think that they could support the call for the advertisements to be withdrawn.

FSA respond to the letter of complaint on 5 October 2000, noting the comments made.

06/10/2000 The OFT ask FSA if they have any concerns about the proposed acquisition of Equitable by a prospective purchaser (Prospective Bidder A).

09/10/2000 [entry 1] Equitable provide FSA with an update on their solvency position. The Society's estimated solvency position as at 31 August 2000 is disclosed, as follows:

		£m
Value of non-linked assets		*30,790*
Future profits implicit item		*1,000*
		31,790
Mathematical reserves		
- Basic (including GAR)	*26,670*	
- Resilience	*1,760*	
		28,430
		3,360
Required minimum margin		*1,195*
Excess assets		*2,165*

Equitable explain that the improvement since 31 July 2000 reflects the relative strength of the markets.

Equitable provide a *'solvency matrix'*, showing the effect on their required minimum margin of movements in equity values and yields on fixed interest holdings. At best (equity values remaining the same, yields rising by 0.5% or 1%), their cover is 2.8. At worst (equity values falling by 15%, yields remaining the same or falling by 1%), their cover is 0.9.

Equitable enclose a copy of a letter they have sent to policyholders who had, between 1 January 1994 and 19 July 2000, taken benefits from policies which included a GAR. The letter explains how the rectification scheme would be developed.

09/10/2000 [entry 2] Equitable inform FSA that, on 30 June 2000, they ceased to provide insurance services in Greece (see 08/07/1998).

09/10/2000 [entry 3] An FSA official suggests to Line Supervisor C, PIA and GAD that they should meet to discuss how to respond to the letter from the OFT (see 06/10/2000). The official notes that FSA had *'little or no interest in the competition angle to this proposed acquisition'* but they might have other concerns relevant to the OFT's consideration and any recommendation to the Secretary of State. The official attaches to his memo the documents received from the OFT and an appendix setting out the key issues.

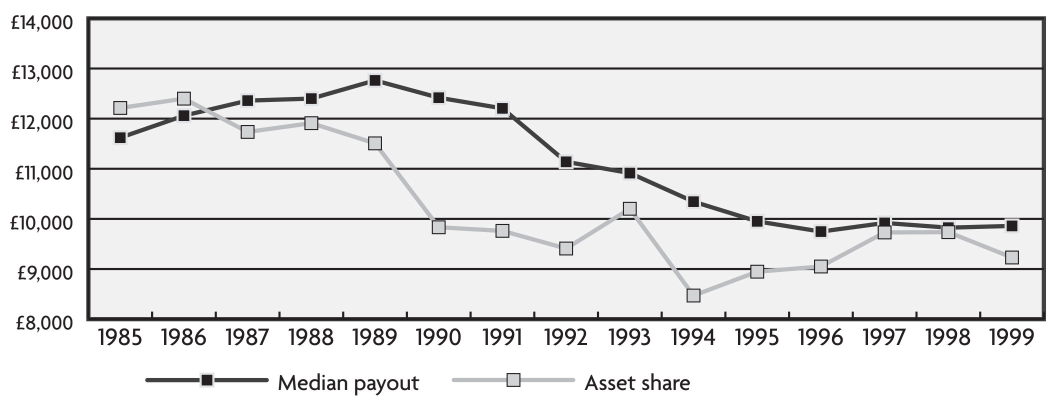
11/10/2000 [entry 1]	GAD write to FSA in response to their memorandum of 09/10/2000 about the proposed bid for Equitable by Prospective Bidder A. GAD's comments relate mainly to the position the combined entity would occupy in the pensions market.
11/10/2000 [entry 2]	FSA's Firms and Markets Committee discuss the progress of Equitable's sale.
12/10/2000	FSA advise the OFT that they have *'not identified any immediate problems that would be likely to be a serious impediment to the proposed acquisition'*. FSA explain that the main issue for FSA, arising from a bid by Prospective Bidder A, would be how the acquisition would be financed.
13/10/2000 [entry 1]	GAD write to FSA's Head of Life Insurance about the production of their 1999 annual report on the life insurance industry. In the light of initial comments from FSA, GAD's proposals for the scope of their report based on companies' 1999 returns is as follows:

- *We will not issue a comprehensive report in the same format as last year.*
- *We will issue separate reports corresponding to the more useful sections of last year's report.*
- *The sections identified for separate reports are new business, expenses, investments (non-linked assets), financial strength (*[required minimum margin] *cover), maturity payouts and bonus rates. We do not intend to report further on free asset ratios, which were covered in* [a GAD actuary's] *memo of 25 September 2000.*

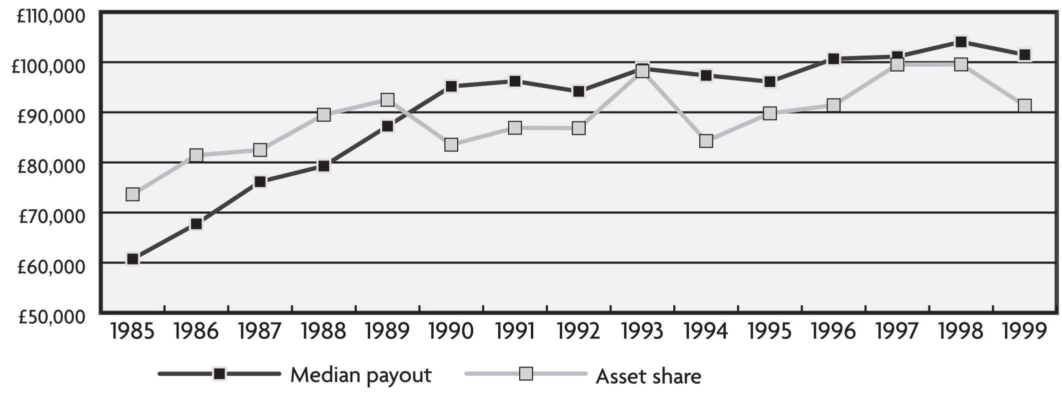
(Note: in the event, GAD only provide reports to FSA on new business, solvency cover and expenses. (See 20/10/2000 [**entry 2**], 03/11/2000 [**entry 3**] and 22/12/2000 [**entry 4**], respectively.) However, I have also seen that GAD continued their analysis of maturity payouts against their own calculations of theoretical asset shares.)

At some point around this time, GAD prepare the following charts:

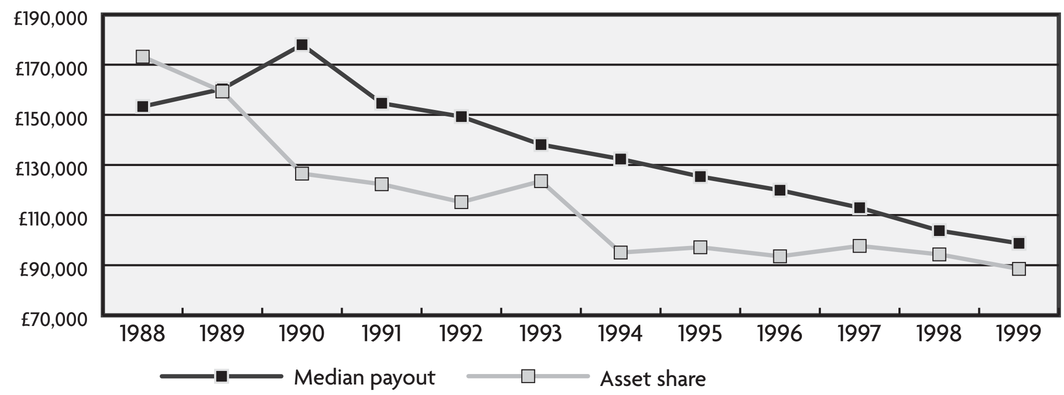
Comparison of actual median maturity payout and theoretical asset share for the years 1984-99 for a £50 per month conventional with-profits 10 year endowment policy (£)



Comparison of actual median maturity payout and theoretical asset share for the years 1985-99 for a £50 per month conventional with-profits 25 year endowment policy (£)



Comparison of actual median maturity payout and theoretical asset share for the years 1988-99 for a £200 per month conventional with-profits 15 year pension policy (£)



(Note: the bodies under investigation have told me that it should be noted that: *'the charts selected for this entry all show maturity payouts for regular premium contracts only. By contrast, the bulk of Equitable's business was recurrent single premium. These charts therefore have very little significance for Equitable. This comment also applies to the corresponding charts provided in the reports prepared by GAD for* [other] *years'*.)

13/10/2000 [entry 2] The Financial Services Consumer Panel meet and are presented with a paper by FSA on the implications of the House of Lords' judgment. FSA seek the Panel's views on their proposed approach to taking the issue forward of issuing guidance and holding a conference of senior lawyers and leading actuaries.

17/10/2000 [entry 1] GAD provide FSA with comments on Equitable's letter of 09/10/2000. GAD note that the solvency cover appeared adequate, but this was largely due to an increase in asset values. GAD note also that if equity values fell by 15%, the required minimum margin would be uncovered. GAD point out that this corresponded to a fall in the FTSE 100 Index to 5,700 from its end August level of 6,672. GAD note that the FTSE 100 Index had already fallen to 6,200 and add that *'this is something which needs monitoring closely!'*.

17/10/2000 [entry 2]	FSA's senior management and Director of GCD meet, following concerns expressed by a leading life insurance company. The company had received legal advice which suggested that their past practice in setting bonuses for guaranteed annuity contracts had been unlawful and they wanted to see the FSA guidance on the issue before deciding on what action to take. According to the note of the meeting prepared by Line Manager D, FSA agreed to produce their *'best stab'* at advice on what the House of Lords' judgment meant and how they have interpreted it in relation to their responsibilities. However, FSA note that the company should not close off the possibility of going to court to obtain a clarificatory ruling. FSA note that the guidance should be agreed with the Financial Ombudsman Service, with whom they might obtain a joint opinion on the most difficult points. FSA agree a proposal by the Director of GCD to hold a debate on the issues surrounding the case with Counsel who had been advising life companies and note that: *'The discussion should be used to identify areas on which there was a common understanding, then FSA might obtain Counsel's opinion on any outstanding points which there was not a consensus'*. FSA's Managing Director A explains to FSA's Firms and Markets Committee that *'many companies appear to be concerned about the implications of the Equitable Life judgement. They were receiving confused legal advice and there was an expectation that FSA would produce guidance on the issue'*.
19/10/2000 [entry 1]	FSA's Managing Director A presents his Monthly Report to FSA's Board. The Managing Director notes that Equitable have received three serious offers of purchase. He records that Equitable have indicated that the bids on the table are high enough to enable with-profits policyholders to gain restitution for the investment growth they lost in the first seven months of 2000, with additional goodwill on top. The Managing Director reports that draft guidance concerning the implications of the House of Lords' ruling is in preparation and that considerable uncertainty existed among other with-profit offices as to the implications for their own bonus policies. The minutes of the meeting record that the Managing Director: *... reported that the situation was becoming more complex and the giving of guidance more difficult. It was hoped to have some further discussions with leading Counsel and to come back to the Board with further information in November.*
19/10/2000 [entry 2]	FSA and GAD meet a second prospective purchaser of Equitable (Prospective Bidder B). It appears that Prospective Bidder B provide a copy of their presentation in advance of the meeting.
19/10/2000 [entry 3]	FSA's Director of GCD writes to certain senior practitioners known for expertise in insurance law to invite them to an informal discussion on the issues surrounding the House of Lords' judgment at FSA's offices on 01/11/2000.
20/10/2000 [entry 1]	FSA's Head of Life Insurance responds to a query from the Chairman about reports in the press that the potential bidders for Equitable might use their orphan estates to help finance any purchase.
20/10/2000 [entry 2]	GAD send FSA's Head of Life Insurance the completed *'New Business'* section of their 1999 annual report on the life insurance industry. GAD's report notes that Equitable have moved from being the third to the fifth largest writer of new business. GAD say this *'reflects a 14% reduction in its* [new business index], *presumably the result of bad publicity arising from its GAO saga'*.
25/10/2000 [entry 1]	FSA attend a meeting of the OFT Merger Panel to discuss Prospective Bidder A's bid.

25/10/2000 [entry 2]	FSA's files contain unsigned manuscript notes, which appear to reflect a discussion with PIA over possible action against Equitable on the sale of income drawdown policies. These indicate that PIA have continuing concerns about Equitable's actions which they are pursuing and which they say are likely to warrant disciplinary action.

27/10/2000

A PIA Enforcement Head of Department writes to PIA's Director of Enforcement seeking agreement to action against Equitable following an investigation into their sale of income drawdown policies.

The Head of Enforcement explains that PIA interviewed investors and reviewed investor files and Equitable's systems and procedures. The Head of Enforcement says that PIA had sent a preliminary findings letter to Equitable in May and have considered their response to this. (Note: I have not seen the findings letter or the response.)

The Head of Enforcement concludes that Equitable's sales process for income drawdown policies had been *'significantly defective'*, which gave rise to a risk of unsuitable sales. He says that '[the] *key defect in the process is that Equitable considers that disclosure of the risks inherent in* [an income drawdown] *contract is an adequate substitute for the assessment of the suitability of* [an income drawdown] *contract for an investor'*. The Head of Enforcement says that he considers that Equitable needed to change their sales process, and review past business to identify unsuitable sales and pay compensation where appropriate. He estimates that the review and compensation could cost in total £41m.

The Head of Enforcement explains that PIA are minded to recommend disciplinary action against Equitable, and to impose sanctions including a public reprimand, a fine of £500,000, and an order to conduct a review of past income drawdown business.

The Head of Enforcement attaches the draft of a proposed letter to Equitable, setting out PIA's concerns and seeking a meeting. He notes:

> *Given the current circumstances of Equitable (the company is up for sale and the House of Lords recently ruled against Equitable in respect of guaranteed annuity options), this matter is highly sensitive.*

The PIA Head of Enforcement copies his note to FSA officials, including the Head of Life Insurance and Line Supervisor C.

30/10/2000

Equitable provide FSA with an update on their solvency position. Equitable say that, as anticipated, the position is broadly comparable with the position in June and July. Equitable provide the following information:

		£m
Value of non-linked assets		*29,935*
Future profits implicit item		*1,000*
		30,935
Mathematical reserves		
- Basic (including GAR)	*26,705*	
- Resilience	*1,885*	
		28,590
		2,345
Required minimum margin		*1,205*
Excess assets		*1,140*

2000

31/10/2000 [entry 1] FSA's Firms and Markets Committee discuss the progress of Equitable's sale and the Chairman's concern over press reports that there was little interest in the purchase of Equitable. FSA note that, although there were only three potential bidders left, it was still thought likely that *'a good sale'* could be achieved.

31/10/2000 [entry 2] Further to their letter of 19/10/2000, FSA's Director of GCD writes to the senior practitioners attending the meeting scheduled for 01/11/2000, enclosing further background papers.

01/11/2000 [entry 1] FSA's Director of Insurance writes to the Chairman following a call from Prospective Bidder A. The Director of Insurance says that *'the main purpose of* [their] *call was to assure me that* [they] *were not behind the current rush of press reports (there seems to be some general attempt to "talk down" the perceived value of the Equitable) and to report on progress'*. The Director of Insurance adds that Prospective Bidder A had *'become convinced that at an operational level the Equitable would represent a very interesting acquisition for* [them]*'*; in particular, acquisition of the sales force would be '*very worthwhile*'. The Director of Insurance says that the bidder remains of the view that Equitable would represent a very interesting acquisition. However:

> [Prospective Bidder A] *are becoming increasingly concerned about the financial implications of a deal. The more work they do in the data room, the more they become convinced that the scale of the shortfall in the Equitable's funds is greater than the Equitable estimate themselves. Moreover they are concerned that the wording of the Equitable's policies would allow policyholders with guaranteed annuity options to increase the scale of their contributions (and hence the scale of the GAO liability) to the detriment of other policyholders in the fund.* [Prospective Bidder A] *are investigating whether this liability can be capped and if so how, but again are more pessimistic than the Equitable directors of this issue.*

The Director of Insurance explains:

> *I am following up with GAD the implications of* [Prospective Bidder A's] *comments as they affect the Equitable's own position ...* [Directing Actuary B] *will talk to the Appointed Actuary today, and we plan to see the company in the next few days. We are in any case due to discuss with them (again) the implications of recent changes to the liability valuation rules for unitised with-profits business introduced in May of this year* [see 15/05/2000] *(which the Equitable believe will have only minimal impact).*

The Director copies his note to other officials in FSA and to GAD's Directing Actuary B.

In response, FSA's Chairman writes:

> *A useful conversation. It does not lower my worry level about the Equitable. I think an early discussion with them is very much indicated.*

01/11/2000 [entry 2] A consulting actuary writes to GAD and FSA expressing concern about some recent advertising by Equitable. The consulting actuary considers that this advertising ignored their current problems and amounted to *'a blatant case of misrepresentation'*. The consulting actuary writes also to the Advertising Standards Authority. GAD's file contains press articles critical of the advertisement.

01/11/2000 [entry 3] FSA host a seminar with senior practitioners to discuss issues surrounding the House of Lords' ruling.

02/11/2000[entry 1]	FSA's Director of Insurance provides the Chairman with a confidential briefing note on the sale of Equitable for his appearance before the Treasury Select Committee on 7 November 2000. The Director of Insurance says that Prospective Bidder A remained the favourite but refers to his note of 01/11/2000 in which he had reported a number of the company's current concerns. The Director explains that FSA were meeting Equitable on 03/11/2000 to discuss the issue of their exposure to existing policyholders with contracts containing annuity guarantees topping up their policies, and the related issue of the changed resilience test. FSA's Director of Insurance notes that Equitable's solvency cover remained fragile, and that a fall in the FTSE 100 Index to 5,700 could lead to their breaching their solvency margin. He says that, should that happen, FSA would need to consider the position carefully. However, *'a decision to stop the Society writing new business would finish the Society off as a sellable enterprise ... It is hard to see that this would be in the interests of <u>current</u> policyholders but the position of those not already in would have to be considered carefully too'*. An FSA official advises the Director of Insurance and others of a telephone conversation with the OFT. The official explains that the OFT were likely to recommend that Prospective Bidder A were told that their bid did not appear to raise issues which needed to be referred to the Competition Commission.
02/11/2000 [entry 2]	GAD write to FSA in response to their note of 01/11/2000. GAD suggest: *'One possibility (that we could discuss with Equitable at some stage) would be to issue an Order preventing them from accepting more than £X million incremental premiums on GAO policies. This would certainly cap the liability and we could seek to ensure that they were fully reserved for this amount of future premiums. It would be much less drastic than a full stop order which would almost certainly kill their chances of a sale to a third party'*. Against this, Line Supervisor C queries what grounds there were to do this, and whether those could be challenged in court. GAD suggest, as second possibility, that Equitable could seek Court approval to limit the liability on policies containing annuity guarantees.
03/11/2000 [entry 1]	GAD and FSA (including a new Line Manager with supervisory responsibility for Equitable (Line Manager E)) meet Equitable and their actuarial consultant to discuss their present financial position and some detailed reserving issues. The meeting was held at FSA and GAD's request. GAD prepare a note of the meeting. The note records that Equitable have implemented a cut in bonus rates and consequent payouts with an aggregate value of £1.5bn and that: *'This is expected to cover the additional cost of paying GAR's on the full "asset shares" as in effect required by the recent* [House of Lords] *judgment'*. Equitable explain that, at present, around 35% of GAR policyholders were taking the guaranteed option. Equitable inform the regulators that they had received advice that they could not withdraw policyholders' rights to pay additional premiums, without giving adequate notice. Equitable say that they have drawn up a proposed scheme of compensation with an aggregate value of £200m for policyholders who have retired since 1994, which is currently being reviewed by an independent actuary and a Law Lord. This would negate any advantage to Equitable. Accordingly, Equitable were including an additional £550m in their reserves (£200m net of reinsurance). Equitable estimate that this might increase to £500m net of reinsurance and *'do not appear to believe that this issue was a serious concern therefore to the potential bidders'*.

GAD raise one *'technical issue'* arising for the 2000 returns. GAD point out that Equitable are applying a variant of the resilience test recommended by the Government Actuary in DAA14 (see 15/05/2000 [**entry 1**]). GAD say that Equitable could either *'present this publicly (which may give rise to some adverse comment) or seek a Section 68 Order (concerning valuation interest rates) which would allow them to apply the standard resilience test'*.

Equitable explain that cover for their required minimum margin was currently 2, but could fall to below 1 if the FTSE 100 Index fell by 10% to 5,750. Equitable confirm that there would not be any simple means to restore the margin of solvency and continue to write new business.

GAD conclude:

> *We believe that the society is covering its minimum capital requirement at present, but has very little room for manoeuvre in the event of even a modest fall in equity values ... With the recent cut in bonus rates ... new policyholders should not have to meet any* [of] *the cost of GARs, as indeed is likely to be their expectation. However, they will be joining a very weak fund.*
>
> *If the sale does not take place, then we shall almost certainly have to lean on them to stop writing new business, and they will very probably also need to rearrange their investment portfolio to a more defensive position. Otherwise, a full liquidation could be envisaged in the event of a substantial fall in equity values.*

FSA also prepare a note of the meeting. FSA note that Equitable were close to finalising a rectification scheme for GAR policyholders who had taken their benefits between January 1994 and 19 July 2000. FSA stress the need for FSA to be *'actively involved in the bidding process'*. Equitable confirm that bidders had received a report prepared by Equitable's actuarial consultants and full disclosure of all relevant materials *'so that a bidder could gain a thorough assessment of the valuation basis'*. FSA ask to see the report by Equitable's consultants and Equitable agree to obtain permission for it to be released. FSA note that Equitable no longer considered it viable to hedge the interest rate risk (see 11/08/2000 [**entry 1**]).

03/11/2000 [entry 2] FSA's Line Manager E passes the Head of Life Insurance a draft response to the complaints that Equitable's recent advertising had been misleading. The Line Manager suggests that there was not much to say, other than that Equitable are solvent and so can advertise, *'unless we thought we had grounds (and were intending) to use intervention powers to stop the firm writing new business'*. The draft response reads:

> *As regulator, the FSA does of course monitor the financial position of insurance companies carefully. However, we understand that Equitable continues to be solvent for Companies Act purposes and indeed continues to maintain the required margin of solvency over its liabilities as required under the Insurance Companies Act 1982. As the Equitable continues to be a going concern, complying with the relevant regulatory requirements, we do not share your view that it should be prevented from marketing its products, which could be damaging to the business. Nor do we believe that at a time when the statutory requirements continue to be met, and when there is a realistic chance of a successful sale of the business, that the newspaper advertisement inviting potential customers to request additional information from the company is misleading.*

In reply, the Head of Life Insurance replies that the response is right. The Head of Life Insurance agrees that this was an issue for FSA *'as it goes to solvency'*, but he copies the suggested response to PIA as it also concerned advertising. PIA comment in turn that they agreed that it *'is not reasonable (and probably illegal) to seek to suspend the legitimate marketing activity of the Equitable if it remains properly constituted and authorised'*. PIA add that, if they believed Equitable were in breach of their prudential requirements, this could affect the position.

03/11/2000 [entry 3] GAD send FSA's Head of Life Insurance the completed *'Solvency Cover'* section of their 1999 annual report on the life insurance industry. GAD list the companies with the strongest and weakest cover for their solvency margins. GAD also list the companies which have used implicit items.

03/11/2000 [entry 4] PIA write to FSA having considered what action, if any, they need to take to establish the population of clients sold contracts containing guaranteed annuity options by Equitable after April 1988 and to assess how they have been dealt with. PIA take the view that, in light of the House of Lords' ruling, guaranteed annuity rate policyholders were unlikely to have been disadvantaged in that they could exercise their options should they choose to do so. Accordingly, PIA did not propose to *'take this potential conduct of business issue any further'*.

06/11/2000 [entry 1] FSA and GAD meet a third prospective purchaser (Prospective Bidder C), their auditors and financial advisers. Both FSA and GAD prepare a note of the meeting. According to GAD's note, the meeting had been called to discuss detailed issues relating to Equitable's statutory solvency position and realistic financial strength. GAD note that they were generally unable to supply answers to the questions raised, since they had no authority from Equitable to divulge confidential information and would also have needed advance notice of the questions.

GAD's note also emphasised that: *'Those present (other than FSA/GAD) had also benefited from the contents of* [Equitable's actuarial consultants'] *Actuarial Appraisal of the Society (which FSA/GAD have not seen). This contains information about aggregate asset shares and embedded values, as well as possible additional information on statutory solvency, which is not otherwise in the public domain'*. GAD note that they had asked for a copy of this report at the meeting held on 03/11/2000 and that Equitable's Appointed Actuary had wished to consult his Board before releasing it.

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

The bidder expresses concern that Equitable's annual statements to policyholders, indicating terminal bonus values, had *'created a PRE expectation'*. GAD confirm that Equitable did need to meet PRE, but it was GAD's understanding *'that these statements were purely indicative and not guaranteed. That said we had not given these statements full legal scrutiny. It was, however, agreed that with-profit policyholders could only obtain the benefit of funds available'*.

GAD confirm that they currently have no evidence that Equitable's reserving for unitised with-profits was inadequate, but they would be unlikely to object if the company used a stronger valuation basis.

The bidder asks if the current section 68 Order for a subordinated loan could be continued. In response, GAD state that they could not see any reason why the company should not be able to maintain the loan. However, as the loan would become a liability of the shareholders' fund, the Order would not be suitable for carrying over to the reorganised group.

The bidder's auditors ask why, in the resilience scenario, Equitable effectively added 0.5% to the investment return. GAD, in their record of the meeting, note, by way of comment, that Equitable's returns state that, in the resilience scenario, 0.5% per annum of the benefit value is deducted as a charge for expenses. GAD add:

> *However, we do not know whether the deduction of ½% pa of the benefit value as a charge for expenses in the resilience scenario is in accordance with PRE. These are points we need to clarify with* [Equitable].

The company's auditors also ask *'whether the statutory valuation basis was sufficiently strong to cope with benefits being taken* [market value adjustment-free] *at a wide range of retirement dates (50-75).* [The auditors] *also thought that, in the resilience scenario, the Society assumed that benefits would be taken at age 55 rather than age 50'*. GAD explain that, whilst they were not entirely sure that the auditors were correct in these respects, GAD were unable to answer these questions at that time. In their note of the meeting, GAD comment that the returns provide no evidence of the assumption (as to what age benefits will be taken) being weakened in the resilience scenario. They also comment that it would be *'helpful to ask* [Equitable] *how* [the resilience reserve] *was calculated, to gain greater comfort that the reserving sufficiently reflects the Society's exposure to guaranteed benefits being available over a wide range of retirement dates'*.

06/11/2000 [entry 2] FSA's Managing Director A writes to the Director of Insurance, with a copy to the Head of Life Insurance. The Managing Director thanks the latter for his note on Equitable. The Managing Director refers to recent claims that policyholders had been misadvised about their options when choosing an annuity and asks if FSA needed to explore this. He says that the news on the impact of equity price changes was worrying and asks how far this would show up in the detail of the 2000 returns.

07/11/2000 [entry 1] FSA's Director of Insurance writes to Managing Director A in response to his note of 06/11/2000. The Director of Insurance states that he has been assured that the claims that Equitable misadvised policyholders about their annuity options were wrong. The Director of Insurance points out that the required solvency margin included the requirement to meet the resilience test. If Equitable just covered the margin once, with no significant excess cover, equating to a FTSE 100 Index level of 5,700, they would still be able to survive a 25% fall in equity markets. If no sale were achieved during this time, they would almost certainly have to close to new business. The Director states that *'all this will be pretty clear in the 2000 returns'* and that Equitable would not have the commercial credibility to go on writing new business in the longer term without the capital support to be achieved by a sale '[but] *... the market and the press already know this'*.

In response, the Managing Director comments that the protection of the resilience test would work better if there were a relatively slow fall in equity prices rather than a *'whirlwind'*. Managing Director A comments that the fact that much of Equitable's position would be evident from the 2000 returns would mean the market has to, or can, make decisions for itself.

The Director of Insurance comments in turn that an overnight drop of 35% in equity markets would be *'difficult'*. A steep but not overnight fall would also create problems if insurers needed to move from equities into gilts, of which there was already a shortage. The Director of Insurance notes that Equitable would need to move in this direction ahead of most of the market, which would help them.

07/11/2000 [entry 2] FSA's Director of Insurance provides the Head of Life Insurance with a copy of a paper produced for an informal seminar held on 01/11/2000 to discuss the implications of the House of Lords' judgment. The seminar had been attended by representatives of GAD and FSA, solicitors and Counsel.

The paper summarises the factual background to the judgment. It states that Equitable's 1994 bonus declaration (which would have been issued in March 1995) was the first to make a distinction between bonuses awarded to policyholders with GARs and bonuses awarded to those without. (Note: the paper incorrectly describes the intention of the Society's differential terminal bonus policy, which was to ensure that GAR policyholders received the same level of benefits whether they took an annuity at the guaranteed rate specified in their policy or elected to take an alternative option.) The paper quotes from the declaration:

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

The paper states that it appeared that Equitable had not previously notified policyholders of this *'change'* to their practice.

08/11/2000 FSA's Line Manager E tells the Head of Insurance and Line Supervisor C that he understands that Equitable are no longer running their current advertising campaign (see 01/11/2000 [**entry 2**]). The Line Manager expresses the hope that the story would now go away.

09/11/2000 FSA attend a meeting of the Tripartite Standing Committee. FSA's Managing Director A informs the Committee that FSA are seeking advice on *'whether they could issue guidance to insurers on limiting the damage to the industry that could be caused by the House of Lords judgement ...'*.

10/11/2000 [entry 1] FSA's Chairman advises the Director of Insurance of a telephone call from Prospective Bidder C. The company had been very interested in acquiring Equitable, which they believed had an excellent brand name and market positioning, and would fit in well with their own existing operations. But:

> *... they had decided that they were now not prepared to go ahead. They had reached the view that the Equitable's financial position was considerably worse than they had first thought. The hole was significantly larger than they had expected. So, while they had not completely closed the door, they planned to tell the Equitable shortly that they did not wish to proceed ...*
>
> ... [they] *said* [their] *main motive in telling me this was to alert me to the fact that the Equitable's position might be rather more doubtful than we had been led to believe.*

10/11/2000 [entry 2] FSA's Director of Insurance provides an update to FSA's Firms and Markets Committee on guidance on the implications of the House of Lords' judgment.

13/11/2000 [entry 1] FSA's press office write to the Director of Insurance about press interest in the possible consequences of Equitable not being sold. The press office explain that the line taken was that *'a profitable run-off was the worst thing that* [could] *happen (based on current info etc) – ie no disaster in the making etc'*.

FSA's press office add that there had been several press articles criticising Equitable's advertising campaign which quoted their *'wondrous past'* without mentioning the more difficult present. The press office understand that FSA had spoken to Equitable and that they were withdrawing their campaign, *'which is obviously very helpful'*.

13/11/2000 [entry 2] FSA prepare a note about Equitable. FSA relate Equitable's current problems to their sale of with-profits GAR policies in the 1970s and 1980s. FSA explain that, during the 1990s:

> *... as a result of falling interest rates, the GARs began to exceed current annuity rates and GARs held real value. It also became apparent that the increased costs of reserving for these increased GAR benefits could add a significant financial burden on this mutual. As things stood it would also be the case that one set of members would be getting a larger slice of the assets of the mutual than another.*

FSA explain that, in these circumstances, Equitable had introduced their differential terminal bonus policy, which the House of Lords had now ruled against. FSA add that Equitable have possessed no estate and so were unable to absorb the costs of paying GAR policyholders *'unadulterated bonuses'*, as well as their GAR. As a result, Equitable put themselves up for sale.

FSA suggest that the cost to the industry as a whole of reserving for annuity guarantees, in the light of the ruling, was in the region of £10bn. FSA explain that they had issued guidance broadly requiring companies to reserve on the basis that virtually all policyholders would exercise their guaranteed option, if the guaranteed rate were higher than that available on the open market. FSA accept that, in practice:

> *... many policyholders will not fully exercise the GAO because it provides a form of annuity that is unattractive to them (eg because perhaps it only covers a single life, is not index linked, or is paid annually in arrears) and they usually take part of the benefits in the form of a tax free cash sum.*

FSA explain that they have surveyed companies on their assessment of the implications of the ruling (see 27/07/2000) and were considering producing some further guidance.

FSA acknowledge that the case has:

> *... added to concerns already raised about the lack of transparency of with profit policies. Typically a large amount of policy proceeds (as much as 60%) are determined by Directors and are not guaranteed.*

FSA explain that thought is now being given to re-designing this type of policy to make it more consumer friendly.

14/11/2000 [entry 1] FSA's Line Manager E writes to the Head of Life Insurance, copied to others, including officials in GAD. The Line Manager discusses in detail FSA's role in the bidding process for Equitable. He states that FSA should ensure best protection for policyholders in whichever of several scenarios develops. He notes that prospective purchasers had *'serious concerns'* about the *'seemingly unlimited exposure of Equitable to certain liabilities'*.

Line Manager E discusses possible options at the end of the process, including what might happen if no bid to purchase Equitable was made. The Line Manager suggests that FSA:

> *... would need to consider carefully whether we would wish to exercise any powers of intervention (if indeed the powers for us to do so exist in particular circumstances).*

The Line Manager concludes:

> *At this stage, there do not seem to be any grounds for considering action on the basis of insolvency since Equitable is able to meet its contractual obligations.*

The Line Manager adds that, if the position changes, it would be necessary to consider if it was best to leave the company *'self-standing'* or transfer the business to another, with support. However, these would be matters for the Policyholder Protection Board or, in due course, for the Financial Services Compensation Scheme.

14/11/2000 [entry 2] FSA explain to PIA that they have confirmed with Equitable that they are dropping the advertisements which had generated complaints (see 08/11/2000), although Equitable were not stopping advertising altogether. FSA say that they had told Equitable that FSA had taken a *'fairly robust line'* to people who had approached them, namely that Equitable were solvent and continuing to trade, and so it was not a matter for FSA to be concerned about. FSA conclude, however, that they hoped that any future campaign would recognise the sensitivities and be presented with more tact.

15/11/2000 [entry 1] FSA and GAD meet Prospective Bidder B to discuss their financing of the possible acquisition. The company raise queries about Equitable's future profits implicit item, their approach to reserving and their use of the old resilience test. The company ask if FSA/PIA anticipated any further issues with Equitable. FSA explain that they were looking at Equitable, and that this might or might not lead to conduct of business issues.

FSA provide Prospective Bidder C with some requested information following the meeting on 06/11/2000.

15/11/2000 [entry 2] FSA's Managing Director of Financial Supervision explains to the Director of Insurance that Prospective Bidder C have indicated that they do not consider it worth buying Equitable '*at any price. Even if all of any purchase price were paid in to help cover the present hole in Equitable's funds, there would be a great many disgruntled policyholders at the end of the day. This would make it impossible to continue selling to them or to new policyholders under the Equitable banner*'.

The Managing Director says that the company have also said that some of the Society's current policyholders were expecting a restoration of foregone bonuses and perhaps a demutualisation bonus, expectations it would be quite impossible to meet. The Managing Director says that the company had offered to take FSA through the actuarial assumptions they had made in their assessment of a purchase.

FSA's Chairman, in a manuscript addition to the note, states that he thinks it would be helpful to understand Prospective Bidder C's view. The Chairman comments that the prospects for a sale *'look dimmer by the day'* and that FSA needed to address their minds to what they should do if no buyer were forthcoming or one was, but only on terms which were difficult for FSA to accept.

16/11/2000 [entry 1] GAD's Directing Actuary B writes to FSA in response to Line Manager E's note of 14/11/2000 and the scenario that there were no bidders for the Society's business. The Directing Actuary comments that:

> *If all the potential bidders fall away for one reason or another, then the Equitable will be in a very difficult position. They have announced publicly that they believe they need to find a partner with capital if they are to continue as a viable organisation. It would be very difficult for them now to turn round and say "well actually we think we can still succeed on our own"...*
>
> *Moreover, from a regulatory perspective, we know that* [their] *financial position remains very close to the edge of not covering their margin of solvency, there are a number of uncertainties (eg in the viability of their financial reinsurance, and resilience to changes in financial markets – they are unable at present to satisfy one of the recommended resilience tests which they argue is quite strong and they point to a known anomaly in Regulation 69), and we would then also know that it would be difficult to arrange a "rescue" by another insurer in the event of technical insolvency arising.*

Directing Actuary B suggests that, in such a situation, FSA should require Equitable *'to commission an independent investigation of their viability to write new business'*. He explains that this would help to demonstrate to all concerned whether Equitable should, indeed, be allowed to continue writing new business.

16/11/2000 [entry 2] Equitable write to GAD to follow up the meeting on 03/11/2000. Equitable explain that:

> *The reserves held in form 52* [of the returns] *for contracts incorporating GAOs are 95.7% of the reserves that would be held if a 100% take up of GAOs were assumed. The reduced reserves are equivalent to assuming that 85% of benefits are taken up in GAO form. The justification for the 15% rate of 'non-take-up' is the attraction of cash commutation, the availability of more attractive form of annuity than permitted under the GAO, the desire of some clients to transfer to a personal pension to enable benefits to be taken before age 60 and, as at 31 December 1999, the fact that the Society's final bonus system reduced the attractiveness of the GAO.*

In response to FSA's request of 03/11/2000, Equitable provide GAD with copies of three reports prepared by their actuarial consultants for the purposes of a possible demutualisation and sale, which they understood was so that GAD can *'get an overall appreciation of the position as it would appear to a purchaser'*.

The first, dated 25 August 2000, is an actuarial appraisal of Equitable as at 31 December 1999. In their appraisal, Equitable's consultants explain that, for recurrent single premium contracts, it has been Equitable's policy since 1996 to rebate part of the administration charge to policyholders to reflect the low expenses of the office. The consultants state that this amount is added to the fund or given in the form of a premium discount.

Equitable's consultants also explain that, on certain non-contractual claims such as surrenders or switches, Equitable are currently applying a financial adjustment which reduces final bonus by 20%.

The second, dated 23 October 2000, sets out financial projections for Equitable, to illustrate the realistic and statutory financial strength of their business under different investment scenarios. Equitable's consultants note that, for with-profits recurrent single premium business, in the resilience valuation, *'0.5% pa of the benefit has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses'*. They state that the impact of removing the 0.5% deduction *'is to increase liabilities by £950m'*.

The third, dated 8 November 2000, sets out stochastic financial projections for Equitable. Equitable's consultants explain that their stochastic model shows:

> *... that in any one year the fund is solvent on a statutory basis in approximately 90-95% of scenarios. If the assumption is made that the Government Actuary would suspend the requirements to establish a resilience reserve after particularly adverse scenarios then in any one year the fund is solvent on a statutory basis in approximately 96-99% of scenarios.*
>
> *Assuming a resilience reserve is always required then on average 2½% of the scenarios generate new insolvencies in each of the next 20 years. At first sight this seems high but the results are consistent with previous published work which shows that the statutory solvency basis is very prudent and most well capitalised offices would fail this test in very adverse conditions. On further investigation we found that 40% of insolvencies lasted only 12 months or less. Excluding these short term insolvencies reduces the average annual rate of new insolvency to just under 1½%. Alternatively, assuming that the requirement for a resilience reserve is waived, the annual rate of new insolvency reduces to an average of less than 1.0%, or less than 0.5% excluding insolvencies of 12 months or less.*

Equitable's consultants also explain that GAR take-up rates vary *'according to how deep in the money the options are at the time of retirement'*. For the purposes of their modelling, they assume the following take-up rates:

0% if the GAR is "out of the money";

25% if the value of the GAR is between 100% and 125% of policy value;

50% if the value of the GAR is between 125% and 175% of policy value;

75% if the value of the GAR is between 175% and 200% of policy value;

100% if the value of the GAR is greater than 200% of policy value.

Equitable discuss in detail their approach *'to reserving in the conditions of the resilience test'*, as this was an issue that had arisen with prospective purchasers. They say that the recurrent single premium contract had never fitted the valuation regulations particularly well, as these were based on a net premium valuation of level premium contracts. As such, *'over the years, a certain amount of interpretation has been needed to determine minimum reserving requirements, particularly in resilience test conditions'*.

Equitable explain that, in particular, they have included *'an allowance for unrecouped acquisition costs, consistent with the spirit of regulation 68* [of ICR 1994], *which necessarily takes the form of a reduction in benefits'*. Directing Actuary B annotates the letter at this point with *'Zillmer'*.

Equitable explain that they had understood that this approach had been discussed with GAD when the Society's then Appointed Actuary had introduced the practice *'in the early 1990s'*. Equitable say that they cannot find specific correspondence on the matter, but note that the *'detailed discussion of the approach to resilience testing'* had been a major item on the agendas of the meetings held on 15/09/1992 and 30/11/1993. Equitable say that they described the approach in Schedule 4 of the returns from 1996 onwards, following the new regulations requiring greater disclosure about resilience testing. They confirm that the approach *'is only taken on contracts where future premiums are payable'*.

Equitable explain that, as their approach is *'non-standard'*, prospective purchasers were seeking explicit confirmation that GAD considered it reasonable. Equitable set out a number of technical justifications regarding what they have done and ask GAD to comment.

Finally, Equitable state that some prospective purchasers had queried if the future profits implicit item would be available to a new entity. Equitable point out the significance of the item to their statutory solvency position and state that any difficulty here would have a material impact on a prospective sale. They seek GAD's views.

FSA's Head of Life Insurance updates Managing Director A on the sale of Equitable. He explains that Prospective Bidder C have withdrawn, and that the first and second remain genuinely interested. However, each has reservations.

The Head of Life Insurance explains that Prospective Bidder A were primarily concerned about the open-ended nature of the guaranteed annuity liability, given that policyholders were entitled to the guaranteed rate on additional premiums. He explains that Prospective Bidder B had sought clarification of any ongoing regulatory action and of FSA's willingness to grant routine concessions to them as successor company, comparable to those granted to Equitable. The Head of Life Insurance notes that Prospective Bidder B *'gave no indications of particular issues that would be critical to their decision to go ahead'*. He says *'they appeared fairly determined'* and discussions had focused on matters which might affect the price and whether proposals would be acceptable to FSA.

16/11/2000 [entry 3]	FSA's Managing Director A presents his Monthly Report to FSA's Board. He reports that the due diligence process has revealed concerns about how far any liability for guarantees could be capped, since the guarantees appeared also to apply to some future premiums. The Managing Director adds that FSA were exploring with Equitable the implications of this for the sale prospects and for the expectations of future policyholders. The Managing Director also reported that the informal seminar, held on 01/11/2000, had reached a *'general consensus'* that the House of Lords' judgment should be interpreted narrowly and that FSA are reviewing the guidance that it might be possible to give to the industry, with emphasis on the process companies should follow to determine how that judgment affected them.
17/11/2000 [entry 1]	FSA's Managing Director A writes to the Head of Life Insurance in response to his note of 16/11/2000. The Managing Director comments that the bid from Prospective Bidder A *'looks fraught with difficulty for us'*. The Managing Director says the bid from Prospective Bidder B looks more promising, although he did not understand how they *'make the sums add up'*.
17/11/2000 [entry 2]	FSA write to PIA to seek a view on Prospective Bidder A's concern regarding the entitlement of GAR policyholders to pay additional premiums which attract the guaranteed rate. FSA note that, due to the relationship between the profile of many GAR policyholders and the structure of tax legislation, this was an attractive option for many. It is expected to have the effect of shifting the GAR liability *'significantly upwards'*. FSA explain that, as things stand, these additional costs would have to be met from any additional premiums of non-GAR policyholders (about 80% of Equitable's clients) who would, in effect, be subsidising the GAR policyholders. FSA explain that Prospective Bidder A had asked if FSA would take the view that, in those circumstances, this amounted to mis-selling to non-GAR policyholders.
17/11/2000 [entry 3]	FSA advise Prospective Bidder B's representatives that FSA would be prepared to consider granting them a section 68 Order for a future profits implicit item, subject to any request being considered on a case by case basis and being referred to HMT for a decision (but see 12/09/2000).
20/11/2000 [entry 1]	FSA's Line Manager E writes to the Head of Life Insurance following the letter of 17/11/2000 to Prospective Bidder B. The Line Manager suggests that FSA need to be clearer on the issue of future profits implicit items. The Line Manager asks whether FSA ever recommended to HMT that they should not grant a section 68 Order, and for comments on when an Order could be transferred to a successor company. The Line Manager copies his note to other officials. In response, Legal Adviser A explains that he was not aware that FSA have ever refused to grant an Order, although there have been disagreements as to the figure. The Head of Life Insurance also responds with his preliminary view that FSA have as a matter of practice tended to grant section 68 Orders for implicit items, provided the terms of the regulations are met as regards the calculation.
20/11/2000 [entry 2]	PIA write to FSA in response to their note of 17/11/2000. PIA emphasise that *'we are in very difficult territory (Chinese walls and all that)'*. PIA say that the minimum reasonable expectation of existing policyholders from new sales would be asset share. If asset share could not be promised, then the warning that a buyer could get back less must be disclosed; this could make it impossible to sell top ups to non-GAR policyholders. PIA conclude: *'In other words, if it is that bad, "the closed fund" option may be the only option'*.
20/11/2000[entry 3]	Prospective Bidder B's representatives write to FSA to clarify details of how they proposed to deal with the issue of goodwill.

21/11/2000 [entry 1]	FSA's Head of Life Insurance advises his Chairman on whether Prospective Bidder A could use a deadline for bids to put pressure on FSA to reach agreement over one outstanding aspect of the sale. The Head of Life Insurance explains that the current deadline for bids is 27 November 2000, but that this had slipped once and might slip again. The Head of Life Insurance does not consider that Prospective Bidder A could reasonably expect agreement by the deadline. However, he warns that the bidder might present FSA as frustrating the prospect of a satisfactory solution for Equitable's policyholders.
21/11/2000 [entry 2]	GAD's Directing Actuary B suggests to Scrutinising Actuary F that he should ask Equitable if they had considered how they could meet test 2 of the recommended resilience scenarios.
21/11/2000 [entry 3]	GAD and FSA comment on Prospective Bidder B's proposals for dealing with the issue of goodwill.
21/11/2000 [entry 4]	GAD advise FSA that, in their view, it would be possible for a section 68 Order to be granted to a successor company.
22/11/2000 [entry 1]	Equitable provide FSA with an update on their solvency position. The estimated solvency position at 31 October 2000 is disclosed as being:

		£m
Value of non-linked assets		*30,150*
Future profits implicit item		*1,000*
		31,150
Mathematical reserves		
- Basic (including GAR)	*26,885*	
- resilience	*1,970*	
		28,855
		2,295
Required minimum margin		*1,215*
Excess assets		*1,080*

22/11/2000 [entry 2] FSA and GAD meet Prospective Bidder A.

The bidder queries FSA's views on reserving. GAD confirm that there should be a full reserve based on what policyholders are guaranteed. FSA explain that agreeing to any flexibility on reserving could be a problem, in that it could set a precedent. The bidder expresses concern that the assumed 95% take-up rate of GARs was excessively conservative. FSA point out that solvency must be calculated on a statutory, not realistic, basis.

The bidder seek more information about Equitable's compliance issues. They explain that their main concern is *'reputational damage from past wrong doing by a predecessor firm'*.

FSA's Line Manager E writes to the Director of Insurance and other officials, including at GAD. The Line Manager considers the extent to which FSA's powers to discipline and obtain redress for consumers in respect of potential past mis-selling by Equitable would survive a sale.

The Line Manager writes again to the officials. The Line Manager notes that, if a successor company had unlimited ability to scale back the benefits under GAR policies, this would mean that insolvency was always avoided and thus that there was never a trigger for compensation arrangements to kick in. This could potentially put policyholders in a worse position than if the transfer to the new company did not go ahead. Line Manager E considers two ways in which FSA might be able to accept the proposal, in spite of the problem he identifies.

22/11/2000 [entry 3] FSA's Chairman's Committee meet to discuss the guidance on the House of Lords' ruling. The Committee decide to undertake six actions:

> a) [FSA] *to draw up a statement withdrawing the previous guidance and saying that companies should reach their own view on the acceptability of their past and future practice.*
>
> b) [FSA] *to draft a statement of the criteria that supervisors would use in assessing the acceptability of firms' actions that might be issued alongside this statement.*
>
> c) [FSA] *to set down the sorts of supervisory judgements that would have to be made in relation to interpretation of the judgement in order to inform* [the Chairman's Committee's] *decision making on the issue.*
>
> d) [FSA] *to review the current version of the guidance and to make an assessment of the risk of each element being contradicted by the courts.*
>
> e) [FSA] *to bring the current version of the guidance (once assessed as described in (d)) and the draft statements to be prepared under (a) and (b) back to* [the Chairman's Committee] *for discussion.*
>
> f) [FSA] *to consult Counsel on his view of what were the reasonable courses of action available to FSA or related questions about the risks of FSA pursuing particular courses of action.*

23/11/2000 [entry 1] GAD write to Equitable in response to their letter of 16/11/2000. GAD explain that, as well as developing some of the topics under discussion, they were raising some points from the 1999 returns.

GAD raise a number of issues including:

<u>Reserving for annuity guarantees</u> – GAD ask Equitable to explain how their assumption of an 85% take-up rate for annuity guarantees was consistent with the Government Actuary's guidance contained in DAA13 (see 22/12/1999 [**entry 2**]). They ask Equitable to explain their approach to assessing the annuity guarantee liability on future premiums and to justify their use of a 20% decrement in the statutory valuation.

<u>Accumulating with-profits business</u> – GAD ask Equitable to explain why they have assumed in the 1999 returns that personal pension contracts would be taken at age 55, rather than age 60, as assumed in the 1998 returns. They seek confirmation of Equitable's guarantees for personal pension contracts and the extent to which policyholders could take benefits at any time between 50 and 75, without Equitable applying a market value adjustment.

<u>Resilience</u> – GAD seek clarification of Equitable's approach to resilience and the impact of applying a particular approach to the new resilience test 2.

<u>Zillmer adjustments</u> – GAD refer to Equitable's statement in their 1999 returns that for the resilience test for accumulating with-profits pensions business, *'½% pa of the benefit value has been deducted for each year up to the date it is assumed that the benefits will be taken as a charge for expenses'*. GAD explain that:

> *At first sight this seems to be an additional allowance for renewal expenses, but it now appears to be a Zillmer adjustment in respect of unrecouped acquisition costs.*

GAD seek clarification of Equitable's approach and ask in particular:

> *... which margins (not already anticipated or required by the valuation regulations) are available from future premiums or elsewhere to provide the ½% pa allowance? We note from* [the report provided by Equitable's actuarial consultants on 25/08/2000 and passed to GAD on 16/11/2000] *that part of the administration charge on this business is already being rebated to policyholders.*

GAD query if Equitable's approach is consistent with PRE.

Finally, GAD say that they have asked FSA to respond directly to Equitable's query about the availability of a future profits implicit item to a new entity.

23/11/2000 [entry 2] GAD speak to the consulting actuary who complained about Equitable's advertising (01/11/2000). GAD explain that they could not comment on any advice they provided, and that, in any event, they do not advise PIA.

23/11/2000 [entry 3] FSA's Director of Insurance writes to Managing Director A about the latest position on Prospective Bidder A's bid.

The Director explains that, in addition to two specific outstanding issues, the company had concerns about the *'ongoing Enforcement case with the Equitable concerning income drawdown'*. He notes that the company saw this as a *'potential showstopper'* because of the possible damage to their reputation and the cost of changes to compliance arrangements. The Director says that FSA have made clear to the company that they could not discuss the affairs of another company. He suggests a meeting between FSA and PIA to ensure there is a clear understanding of all the issues involved.

23/11/2000 [entry 4] FSA's Director of Insurance advises the Head of Life Insurance of a telephone call from Equitable updating him on the progress towards a sale.

The Director of Insurance notes that Equitable see Prospective Bidder A as very keen and the leading contender, notwithstanding a number of outstanding issues. He explains that Equitable:

> *... expressed some concern that regulatory considerations might make it difficult for* [Prospective Bidder A] *to put forward a firm bid very quickly. I said we were naturally very seized of the need for urgency given the obvious fact that the goodwill in Equitable was effectively a wasting asset but that we could not guarantee to resolve all outstanding problems overnight.*

23/11/2000 [entry 5] FSA's Line Manager E says, following further exchanges in response to his note of 20/11/2000, that he was growing in confidence that HMT could, legally, grant a section 68 Order to a successor company.

23/11/2000 [entry 6] A PIA manager copies a note to FSA's Line Supervisor C, in which the manager explains that PIA would be writing to Equitable to ask if there were other policyholders who had similar claims (he doubts that there would be many). The PIA manager adds:

> *Other* [Equitable] *issues that we have our eyes on ...*
>
> *1) GAO ruling impact*
> *2) GAO selection of annuity type review*
> *3)* [Pension fund withdrawal] *disciplinary action*
> *4) PIA report Aug 2000 response*
> *5) Advertising issues re past performance and poor present.*

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24/11/2000 [entry 1] **GAD provide FSA with their detailed scrutiny report on the Society's 1999 regulatory returns**. (A copy of this scrutiny report is reproduced in full within Part 4 of this report.) The report uses a detailed format similar to that adopted for the 1993, 1994, 1995, 1996 and 1997/1998 returns (see 15/11/1994 [**entry 1**], 23/01/1996 [**entry 1**], 01/11/1996 [**entry 1**], 16/12/1997 and 20/05/1999).

In the heading to the report, GAD state that Equitable's priority rating is 2. FSA's copy of the report contains an annotation against this statement: *'Surely 1!'*.

The body of the report comprises 15 sections as follows:

(1) Key features
GAD set out some key statistics for both 1998 and 1999, including:

- Equitable had available assets of £2.5bn in 1998 and £3.9bn in 1999;
- they used an implicit item of £850m in 1998 and £925m in 1999; and
- they had a subordinated loan of £346m.

GAD set out Equitable's required minimum margin. They note that the last visit to Equitable had been in December 1999.

(2) Action points
GAD explain that there were no direct action points for FSA arising from the scrutiny, but that they have written to Equitable *'to raise a number of questions as a result of the scrutiny and other recent discussions'*. GAD attach a copy of their letter of 23/11/2000.

(3) Executive summary
GAD summarise the background to the Court case and its outcome. They explain that, following the ruling, Equitable had had to reduce the level of benefits to all policyholders and make substantial changes to their investment policy (switching from equities to fixed interest securities). GAD note that Equitable had concluded that members' interests would best be served by selling the business, and that there were three companies expected to make final bids. They say that, at the meeting on 03/11/2000, Equitable had explained that, if a sale did not take place, they would stop writing new business and rearrange their investment portfolio to a *'more defensive position'*.

GAD set out five risks to which Equitable are exposed:

Capital risk – GAD note that Equitable's cover for the required minimum margin is 3.46. However, the available assets included the future profits implicit item, disregarded the liability to repay the subordinated loan, and benefited from a reduction of almost £1.1bn in the reserves as a result of the reinsurance arrangement. Without these items, Equitable's cover falls to 1.36 – *'a less satisfactory picture for this large fund'*.

GAD note that Equitable's aggregate asset shares were close to the value of the fund, as they had no estate. As a result, *'lower free asset margins exist than might have been expected for such an institution'*.

Reserve risk – GAD note that it is unclear if Equitable's reserves provided fully for the flexibility of their policies; that they appeared to be using a zillmer adjustment; and that the 2000 Regulations were likely to lead to increased reserves. GAD explain that they have pursued these points with Equitable (see 23/11/2000 [**entry 1**]).

GAD explain that the reinsurance treaty provided Equitable with protection *'should more than 60% (formerly 25%) of the benefits in any calendar year on the contracts which incorporate guaranteed annuity options be taken in guaranteed form. This is not wholly satisfactory from*

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a regulatory perspective, as it relies on regulatory arbitrage to achieve the desired result, and would not be available in the event of insolvency. It removes over £1bn. of liabilities from Equitable's balance sheet'.

GAD state that Equitable assumed that 85% of benefits were taken in guaranteed form and that this was *'a weaker assumption than that specified in the guidance ...'*.

Asset risk – GAD note that Equitable are exposed to falls in the equity market and that they would be unable to cover their required minimum margin if the FTSE 100 Index fell to around 5,750.

Strategy risk – GAD note that, without capital support, Equitable would be unable to reinstate the seven months' bonus foregone in 2000 (see 26/07/2000 [**entry 2**]). They state:

> *There are PRE issues here for both GAR and non-GAR policyholders. Indeed, the related question of whether the Society should be continuing to sell non-GAR policies in the same fund as that where the GAR policies reside could be considered to be an environment risk.*

Control risk – GAD state their understanding that PIA are considering enforcement action over the sale of income drawdown policies.

(Note: this was the first time that GAD had used risk assessment as part of their scrutiny.)

(4) Background
GAD reiterate information included in the Background section of their reports on the 1993, 1994, 1995, 1996 and 1997/1998 returns, namely that Equitable are the oldest mutual life assurance society in the world, and that they never pay commission to third parties. As in their report on the 1997/1998 returns, GAD explain:

> *This background is typified by a determination to provide fair bonuses to policyholders, with no deliberate holding back of profits from one generation to another, by unit linked products which often have discretionary surrender values, and by using a gross premium bonus reserve valuation method. (However, the returns also show the results of a net premium valuation on a minimum basis – and the free asset position shown is identical.)*

GAD repeat that Equitable gained a controlling interest in Permanent Insurance in June 1997.

GAD reiterate that Equitable have increased their overseas activity in recent years (in the Republic of Ireland, Germany and Guernsey) and that these branches were producing increasing amounts of new business; they note, however, that Equitable had expressed dissatisfaction with the cost effectiveness of the German branch. GAD note again that, since August 1998, Equitable had provided insurance in Greece. GAD state, as in their reports on the 1993, 1994, 1995, 1996 and 1997/1998 returns, that Equitable regard overseas activity as *'missionary work'*.

GAD note that Equitable have provided systems support to other companies. They provide details of Equitable's subordinated loan.

GAD provide details of the four section 68 Orders in force at the end of 1997:

- to allow Equitable to use a future profits implicit item not exceeding £700m (see 14/10/1997);
- to allow Equitable to exclude recurrent single premium figures from the *'annual premium'* figures in the returns (see 13/06/1997);
- to allow Equitable to aggregate the details of their total personalised funds (see 31/01/1997); and
- to allow Equitable to make use of the subordinated loan (see 20/08/1997).

GAD note that Equitable had obtained new future profits implicit items in 1998 and 1999 (see 30/12/1998 and 09/11/1999), using £850m and £925m of these amounts respectively.

GAD again report that, following the Chief Executive and Appointed Actuary's retirement on 31 July 1997, those positions are now held by different employees. GAD say that a non-executive director chairs the Board.

Business developments during the year

(5) New business
GAD set out the new products Equitable have developed and the sources of their business. They explain again that Equitable target *'high net worth individuals'*. GAD explain that they have corresponded with Equitable about their income drawdown policies (see 07/09/1999, 06/12/1999, 10/03/2000, 20/03/2000 and 22/03/2000). GAD state that they accept Equitable's explanation for the cuts in the maximum income that could be withdrawn, but note again that PIA were now considering enforcement action.

GAD explain that with-profits annuities issued since 1 July 1996 were subject to a maximum permitted rate of decrease of 8.5% and that the actual maximum at 31 December 1999 was 5.5%, up from 5.0% at 31 December 1998.

GAD produce tables showing recent history of new regular premiums and new single premiums and a new business index. GAD note that, in 1997, Equitable were reported as the largest writer of pensions business in the UK.

(6) Changes in business in force
GAD produce a table showing *'Recent history of regular premiums received'*. GAD note the section 68 Order granted on 13/06/1997 permitted Equitable to exclude recurrent single premiums from the annual premium figures. They explain that, in their 1999 returns, Equitable have stated:

> *... that most policyholders take advantage of the flexibility under recurrent single premium contracts to change/cease the level of premium, and consequently there is no precisely identifiable annual premium on these contracts.* [In the returns] *the annual premiums now include recurrent single premiums to the extent that they are not specifically identified as single premiums. Annual premiums brought forward from 1998 have been restated accordingly.*

GAD produce tables showing: *'Claims experience'*; *'Persistency experience'*; and *'Recent history of combined surrender, lapse & paid-up conversion rates'*.

GAD note that, although pensions is the major class of Equitable's business, persistency data is not available, due to the flexible nature of the contracts written.

GAD reiterate their comment in their report on the 1997/1998 returns: *'These are excellent results, reflecting the fact that business is largely bought rather than sold!'*.

(7) Expenses
GAD produce a table showing the history of expenses from 1995 to 1999. They comment that Equitable's reported expense ratios have again reached *'astonishingly low levels'* and are the lowest in the industry. GAD repeat that Equitable's low expense ratio is a positive marketing image which helped to explain the strong sales figures and was thus *'part of a virtuous circle'*.

GAD again note, as an exceptional item, that Equitable claim to have invested some £70m in redeveloping all their operating systems over recent years.

Situation at year end

(8) Non-linked assets
GAD produce tables showing Equitable's: *'Recent history of asset mix'*; *'Recent history of asset mix attributable to UK with-profits business (%)'* (taken from Equitable's 1999 With-Profits Guide); *'Movement in asset values during the year'*; and *'Investment performance in 1998'*.

The latter shows a return of 14.0%. GAD comment:

> *The achieved rate of return of 14.0% over 1999 is encouraging — exceeding an expected return for the year of 12.8%. This follows achieved returns of 13.8% in 1998 and 19.1% in 1997.*

(9) Assets held to match linked liabilities
GAD provide details of internal linked funds, other assets matching property-linked liabilities, mismatching to property-linked liabilities, assets matching index-linked liabilities and policyholders' reasonable expectations (issues on linked funds). On the latter, GAD note:

> *Where a fund invests in an Equitable Unit Trust, the annual management charge is reduced by ½%, and charges are also adjusted where a fund invests in units of another fund to ensure that only one levy is made.*

GAD observe no particular problems.

(10) Valuation basis
Overall strength – GAD explain that Equitable produce their published returns:

> *... on the basis of a gross premium valuation for non linked business, with some modest allowance for future bonuses, but the resilience reserve included is determined such that the total liability is identical with the results of a net premium valuation — that is shown as an Appendix to the Returns, and is largely the basis on which the strength of the reserves is monitored by GAD.*

GAD explain that they have a number of concerns about Equitable's reserving bases, as set out in the Executive summary (see (3) above).

Accumulating with-profits business – GAD explain that reserves for this business are substantial. They dispute a recent report that the industry would need to increase reserves on this business by 10% as a result of the Insurance Companies (Amendment) Regulations 2000. GAD say that, on 03/11/2000, Equitable had explained that the Regulations would lead to an increase in reserves of £300m (less than 2.0%). They note that Equitable consider that the flexibility offered by revisions to GN8 and their *'inherent facility to apply market/policy value adjusters'* give them *'the valuation "freedom" they need'*. GAD explain that, nevertheless, they have asked Equitable *'to confirm the position'* (see 23/11/2000 [**entry 1**]).

GAD explain that many of Equitable's pensions contracts contained a guaranteed rate of accumulation of 3.5%, and that this business *'is in general valued at 4% in the NPV, which results in only modest discounting, and valuation reserves of the order of 95% of face value'*. GAD state that they are asking Equitable to explain why age 55 had been assumed for personal pensions business (see 23/11/2000 [**entry 1**]).

Interest – GAD produce a table showing the interest rates used in the net premium valuation for major classes. GAD explain that the rates are unchanged from 1998, although annuities have been valued at higher rates in response to the higher yields available from fixed interest securities.

GAD state:

> *In the case of accumulating with profits business ... a significant proportion of the backing assets are equities, and this contributes to our concern regarding whether the reserves are adequate to provide fully for the flexibility policyholders have to take benefits at a range of ages, as raised in our letter to* [Equitable].

Mortality – GAD explain that the bases used are reasonably conservative. They note that life annuities have been valued on 'a rather weak basis', although *'the Appointed Actuary states in his report that the mortality tables contain sufficient allowance for future reductions in rates of mortality'*. However, GAD state that, as the liabilities for this class are fairly minor, they would not pursue the point with Equitable at this time.

GAD note that the mortality assumptions for pension annuities and annuity guarantees look *'satisfactory'*.

Expenses – GAD state that the total provisions seemed to be more than adequate, and note the Appointed Actuary's contention that no additional provisions were needed to cover the continued sale of new business or to cover closure. GAD state that they *'see no reason to question his conclusions'*.

Mismatching & Resilience – GAD explain:

> *A resilience reserve requirement under the net premium valuation method is reported as £2,142m in 1999 (£1,236m in 1998). For the gross premium bonus reserve (GPBR) valuation a resilience reserve in 1999 is shown of £1,350m (£600m in 1998). The modified resilience reserve figures shown in the published GPBR valuation are designed to ensure that the amount of free assets disclosed is the same as would be shown by the Net Premium Valuation!*
>
> *It may be noted that the most adverse scenario at the end of 1999 involved a 3% rise in fixed interest yields with a 25% fall in equity values, whereas at end 1998 it had been the combination of a reduction of 10% in fixed interest yields combined with a 25% fall in equity values.*

GAD state that they presume that the *'GPBR resilience reserve is included in the Actuary's certificate provision ...'*.

GAD note that Equitable have used the old resilience test 2 in their demonstrations to FSA of their solvency position following the House of Lords' ruling. GAD explain that Equitable were considering whether to justify this formally *'which may give rise to some adverse comment'* or to seek a section 68 Order to enable them to adopt a *'"synthetic bond"* [a financial instrument whose combined features are comparable to a bond] *concept'*. GAD explain that a number of other companies did this already. However, were Equitable to choose this option:

> *... we would expect them to adopt a common approach in both the base and resilience scenarios, and to be consistent in approach as between one valuation and the next (ie not "picking and choosing" according to which method was the more favourable at the time).*

GAD note that they have asked Equitable for an update on this issue.

GAD also note that Equitable appear to be using a zillmer adjustment, and that they are querying this also (see 23/11/2000 [**entry 1**]).

Other factors – GAD note that Equitable have included a reserve of £132m for pensions mis-selling. They state that Equitable established a capital gains tax reserve of £100m at the end of 1998, increased to £150m at the end of 1999, reducing to £53m in the most onerous resilience scenario.

Options and guarantees – GAD summarise Equitable's approach to reserving for annuity guarantees. They explain that, in their 1998 returns, Equitable assumed a take-up rate of guaranteed annuities of between 70% and 82.5%, which they sought to justify in their letter of 25/06/1999. GAD say that Equitable have not repeated these percentages in their 1999 returns but have explained that *'the combined effect of the allowances made is that of those policies which survive to retirement date the gross reserves are reduced by less than 5%.'*

GAD explain that Equitable have said separately that the underlying assumption is that 85% of benefits would be taken in guaranteed form. As this is '*weaker than the guidance'* of 22/12/1999, GAD have raised this issue in their letter of 23/11/2000.

GAD provide details of Equitable's reinsurance treaty in its original form and as renegotiated after the House of Lords' ruling. They explain that, in the 1999 valuation, this treaty had reduced the liability in the net premium valuation from £1,630m to £551m, and the liability in the bonus reserve valuation from £1,663m to £565m.

GAD note that, in assessing the reserve needed in respect of benefits bought by future premiums, Equitable assume that the premiums reduce by 20% per annum. GAD comment that this *'does not appear to be prudent'* and that they have queried it in their letter of 23/11/2000.

GAD note that the cost of the rectification scheme for policyholders who have retired since 1994 could be up to £200m, and that currently about 44% of retiring policyholders were exercising the GAR.

(11) Financial results
GAD provide an overview. They note that Equitable's cover for their required minimum margin is 3.46 and that, at first sight, this *'looks reasonable'*. However, for the reasons set out in the Executive summary (see (3) above), the picture was less satisfactory.

GAD state that, at the meeting on 03/11/2000, Equitable confirmed that *'aggregate asset shares are close to the value of the fund (ie there is no "estate")'*. GAD explain that, because of this:

> *The £1.5 bn "saved" from the cut in roll-up rates on* [unitised with-profits] *business since the* [House of Lords] *judgement has been re-allocated to finance future GAO support and the likely costs of the rectification scheme.*

GAD note that Equitable's solvency matrix provided on 09/10/2000 showed that the Society would be unable to cover its required minimum margin if the FTSE 100 Index fell by 15% from its end August levels. GAD note that, at the meeting on 03/11/2000, Equitable had said that they had little alternative to a sale if they were to remain open to new business.

Under *'Summary of results for main classes'*, GAD produce three tables, showing liabilities for non-linked and linked business and a valuation summary, for the years 1995 to 1999. The valuation summary shows, under the bonus reserve valuation, that Equitable's cover for the required minimum margin in 1999 is 3.46 (compared with 2.51 in 1997 and 1998). There is no figure for cover under the net premium valuation. The table shows Equitable's free asset ratio rose from 2.36% in 1998 to 5.50% in 1999. (The figure for Equitable's free asset ratio in 1998 was incorrectly reported in GAD's scrutiny report on the 1997/1998 returns – see 20/05/1999.)

GAD comment:

> *Although the Net Premium Valuation showed a lower non-linked liability of £23,057m (£761m less than in the* [bonus reserve valuation]*) and a lower reserve for declared bonuses of £392m (£31m less than in the* [bonus reserve valuation]*), it was shown to require a resilience reserve £792m higher than the* [gross premium bonus reserve] *valuation. Thus, as intended, the total of Long Term liabilities ... for the* [net premium valuation] *is identical with the result shown above.*

GAD produce a further table showing composition and distribution of surplus. They make no comments on this.

(12) Bonuses
GAD produce tables showing the cost of bonuses declared and the recent history of key bonus rates. They reiterate that Equitable's:

> *... method of annual bonus declarations for unitised type contracts is unusual. As well as a declared guaranteed annual bonus, based on a proportion of accrued income and capital appreciation, a further annual bonus is quoted, which is not guaranteed (in that it may be withdrawn and/or reduced in future), but which makes up the total quoted accrued policy value at the valuation date. This non-guaranteed final bonus is declared in a similar way to reversionary bonuses, as a percentage of benefit, and the amount payable at maturity is the sum of these total annual "declarations", subject to the proviso that the final non-guaranteed bonus can be withdrawn.*

GAD reproduce Equitable's table from their 1999 With-Profits Guide showing gross investment returns at market value and the rate allocated in fixing bonuses, updated to include 1999:

	1995	*1996*	*1997*	*1998*	***1999***
Earned	*16.6%*	*10.7%*	*17.2%*	*13.3%*	***16.0%****
Allocated	*10.0%*	*10.0%*	*13.0%*	*10.0%*	***12.0%****
Guaranteed	*7.5%*	*7.5%*	*6.5%*	*5.0%*	***5.0%****

'taken from [Equitable's] *1999 Annual Report'*

GAD produce tables showing final bonuses for traditional life contracts and deferred annuities, according to duration of the contract.

Under *'PRE (issues on with-profit business)'*, GAD reiterate that Equitable:

> *... reserves the right to penalise early surrenders, even in relation to guaranteed bonuses added under unitised contracts, and it might be desirable for this possibility to receive greater prominence in the literature distributed. Further, with such a large proportion of unitised business and with the level of guaranteed bonuses declared taking account of some asset appreciation, it would seem to be desirable that policyholders were given some greater warning about the possible implications for future bonuses of a substantial market setback.*

(Note: this same point was made in the scrutiny reports on the 1996 and 1997/1998 returns – see 16/12/1997 and 20/05/1999.)

GAD note that *'unfortunately'* the House of Lords had ruled conclusively against Equitable's practice of reducing terminal bonuses to meet the cost of guaranteed options, with the consequences set out in the Executive summary (see (3) above). GAD note that the reinstatement of the bonuses foregone in the first seven months of 2000 depended on Equitable being able to find a buyer.

Under *'Recent history of maturity payouts'*, GAD produce a table of Equitable's payouts from 1995 to 1999, set against the industry average. GAD comment:

> *It is clear that, while Equitable strives to be fair to all its policyholders, and pays more generous surrender values than most other offices, its maturity payouts fall well short of the best in the market, particularly for conventional life contracts.*

(13) Reassurance and financing
GAD reiterate that Equitable made little use of traditional reassurance *'other than for very large sums assured (retention being £400,000 for UK life risks and DM250,000 for German risks), and for supplementary disability and accident risks'*.

GAD reiterate details of the reinsurance treaty entered into to cover costs arising from the exercise of annuity guarantees and note that this allowed Equitable to reduce the reserves they held for these policies.

(14) Compliance
GAD state that they have observed no problems.

Under *'PIA and other compliance problems'* GAD note that a reserve of £132m had been included for pension mis-selling, increased from £70m at the end of 1998.

(15) Professional requirements
GAD certify that their report conforms to the requirements of the Institute and Faculty of Actuaries, as set out in their Memorandum of Professional Conduct and Advice on Professional Conduct. GAD also certify that the report has been prepared in accordance with the Service Level Agreement between HMT and GAD, reached in November 1998, as that had been continued between FSA and GAD following an exchange of letters in December 1998.

GAD's scrutiny report runs to 28 pages.

24/11/2000 [entry 2] Legal representatives of Prospective Bidder A write to FSA following the meeting on 22/11/2000. The representatives provide further details of how they intend to approach the reserving issue.

24/11/2000 [entry 3] FSA's Firms and Markets Committee discuss the progress of Equitable's sale which was *'becoming increasingly complex'*. The Committee also note that Equitable were to meet PIA on 27/11/2000 to discuss the Enforcement Department's findings in respect of the sale of income drawdown policies.

27/11/2000 [entry 1] FSA write to Equitable in reply to their letter of 16/11/2000 to GAD. FSA explain that, in their view, it was likely that they would be able to grant a section 68 Order to allow a successor company to take advantage of an implicit item relating to the transferred business. FSA say that the power to make an Order was discretionary, and each case was considered on its merits, but generally Orders had been granted where the relevant requirements had been met. FSA add:

> *... at this stage, I cannot see that we would wish to apply different substantive tests when considering an application from a successor company for a section 68 order in relation to an implicit item for future profits, or that the Treasury would object to our recommendation.*

27/11/2000 [entry 2] An FSA official advises the Director of Insurance of a further meeting with Prospective Bidder A to discuss marketing issues arising from their proposals. The official says that he considered the meeting to have been productive. The official notes, in summary, that, in PIA marketing terms, the company's proposals were workable but would require some 'rule waivers' to deal with an interim situation before the company and Equitable were fully merged. These would need to be approved by the PIA Board. The official notes that the company will now make a case for the waivers, and that a decision by the PIA Board not to approve them would be a *'potential show stopper'*.

27/11/2000 [entry 3] Equitable meet PIA to discuss the position on income drawdown policies. FSA's Line Manager E sits in on the meeting. The Line Manager writes to FSA's Head of Life Insurance to set out what happens. The Line Manager explains that, prior to the meeting, he spoke to PIA's Enforcement Department:

> *... to alert them to our concerns 1. that regulatory action, and in particular punitive fines, would be detrimental to the interests of policyholders, and 2. the potential for regulatory action to disrupt – or even destroy – the sales process. The points were taken but they seemed uncomfortable with the idea that they should take such factors into account.*

The Line Manager says that, at the meeting, there was discussion about whether or not Equitable's representatives fully assessed investors' attitude to risk before recommending an income drawdown policy. Equitable claim they did; the Line Manager considers that the evidence to support this was weak.

The Line Manager explains that for the future, PIA were looking to Equitable to modify their procedures, which they were willing to do. He says PIA were also seeking a review of existing cases. This Equitable were not prepared to do, as they did not consider there had been any mis-selling. Line Manager E notes that the meeting did not really progress this issue, and that there was no mention, privately or in the meeting, of a possible fine (see 27/10/2000).

The Head of Life Insurance thanks him for his note. The Head of Life Insurance comments that Equitable now know FSA's latest thinking and could inform the bidders *'but I'm sure they will put the best gloss on it'*.

27/11/2000 [entry 4] GAD advise FSA on some outstanding issues in Prospective Bidder A's proposals. GAD discuss *'the position of the Equitable and PRE'*. GAD explain that the company intend to scale down or limit the benefits of with-profits policies. GAD question if this could be in accordance with policyholders' reasonable expectations and warn that '[a] *highly adverse reaction is likely from policyholders if the term is given the prominence it deserves'* which could place FSA in an awkward position.

GAD discuss the company's reserving standards. GAD say that policyholders should be sure which guaranteed benefits would not be touched, and such benefits should attract reserving at the usual industry standards. However, GAD observe that the company propose to run Equitable *'in just such a way as is being complained of about its current management – ie over reliance on things turning out for the best'*.

27/11/2000 [entry 5] FSA write to Prospective Bidder B, following the letter of 17/11/2000. FSA confirm their view that it is likely that, legally, a section 68 Order could be granted to a successor company. FSA say that the power to grant such an Order is discretionary and each case is considered on its merits.

28/11/2000 [entry 1] Equitable send FSA a copy of Article 4 of their Articles of Association. This reads:

> *Every policy shall be granted by the Society on the terms that the Society shall only be liable thereunder to the extent of its assets and property from time to time existing, and that no Member of the Society, and no other person who is at any time in any way interested in any policy, shall be liable to any call or contribution, whether in any liquidation of the Society or otherwise howsoever, for satisfying any claim or demand under or in respect of the policy so granted, whether by the grantee thereof or by any other person for the time interested therein.*

Line Manager E writes to officials in FSA and GAD about Article 4. The Line Manager says that he understands from GAD that similar wording appears in Equitable's policies. The Line Manager suggests that, as a result of the wording, Equitable's policyholders were not protected under the Policyholders Protection Act 1975.

28/11/2000 [entry 2] GAD write to FSA with a note on the options facing Equitable should they achieve no sale. The note is set out under three headings – *'Closing to new Business'*, *'Means to improve Statutory Financial Position'*, and *'Means to improve Realistic Financial Position'*. The note states, among other things, that Equitable are *'almost certainly too vulnerable to continue writing business if sale falls through'*. GAD also note that Equitable were known to be vulnerable to any significant fall in equity values, and that they were also reliant on financial reinsurance and an implicit item for future profits.

28/11/2000 [entry 3] FSA write to Prospective Bidder B, in response to their letter of 20/11/2000, indicating that they did not yet have adequate information to form a judgment about their proposals. FSA ask for a specific document and certain information in relation to their approach to goodwill.

29/11/2000 [entry 1] Equitable write to GAD in response to the points raised in their letter of 23/11/2000.

Reserving for annuity guarantees — Equitable state that the advice in the letter of 22/12/1999 was that the effect of assuming a less than 100% take-up rate of annuity guarantees should not reduce the reserves by more than 5%, and that their approach was consistent with this. Equitable acknowledge that the letter indicates that *'at most a 5% rate of non-take-up should be assumed on account of cash commutation'*, but say that it is not clear if this is the only reason that can be taken into account.

Equitable state that, if GAD were saying that the letter of 22/12/1999 should be interpreted as requiring a minimum assumed take-up of 95%, they would reflect this in the 2000 returns. They also query why, if this was the right interpretation, the letter did not say so explicitly, *'rather than using the somewhat complicated formulation referring to total reserves'*.

Equitable explain their approach to assessing their liability to annuity guarantees on future premiums.

Accumulating with-profits business – Equitable explain that they have assumed a retirement age of 55 for personal pension contracts to reflect recent experience and introduce an additional degree of prudence. Equitable confirm that there are no adjustments to guaranteed benefits *'on retirement between 60 and 75, or 50 and 75 respectively'*. They state that the last three returns (1997, 1998 and 1999) have shown the full guaranteed value in the reserves.

Resilience – Equitable explain that applying a particular approach to the new resilience test 2 would reduce the reserve by £300m. Applying a more sophisticated approach to asset hypothecation could reduce the reserve by £750m.

Zillmer adjustments – Equitable state that, in their view, it was possible to calculate a zillmer adjustment in the net premium reserve. They set out the source of the 0.5% margin. Equitable state their view that their practice is consistent with PRE.

On GAD's files, there are nine pages of undated manuscript notes by Scrutinising Actuary F discussing current and outstanding issues involving Equitable.

On the issue of resilience, the Actuary notes:

- *9/92 & 11/93* [see 17/09/1992 and 30/11/1993] *documents on file no help.*
- *28.3.94 letter from GAD to* [Equitable] *they said £462m* [resilience reserve] o*n NPV basis. GAD accepted this.*
- *15.11.94 letter (on 93 Returns) they said £236m* [resilience reserve] *NPV basis* [correspondence] *on using average* [valuation interest] rate.
- *20.12.94 = Interaction* [resilience] *test & implicit item.*
- *01.96 =* [resilience reserve] *@ 12.94? £171m.*
- *11.96 = 12/95 Scrutiny Action Points.*

Sustainability of present contract structure (no notes about this) & reaction to asset value falls? Discuss [meeting].

Recurrent [single premiums] *= valued assuming no more* [unclear] — *extremely strong* [because] *margins in future* [unclear] *could allow lower reserves.*

On the issue of the zillmer adjustment, Scrutinising Actuary F notes:

... [the Appointed Actuary] *says discussed with GAD in early 90 (file note* [Directing Actuary B] *9/91 =* [net premium valuation] *notionally charge expenses on ¾% pa* [deduction] *from bonus)*

- *appears to be a Zillmer* [adjustment in respect of] *unrecouped* [acquisition] *costs ...*

On the second report by Equitable's actuarial consultants (see 16/11/2000 [**entry 2**]) Scrutinising Actuary F notes:

- *explanation of +½ % pa in* [resilience scenario] *(worth £950m!) (Conceptual problem – this ½% pa* [presumably] *comes off future bonus which isn't being explicitly assumed in NPV.)*

29/11/2000 [entry 2] FSA write to Equitable to seek a meeting to discuss various issues raised by prospective purchasers, including the application of Article 4, reserving issues, interim arrangements following announcement of a preferred bidder, and the state of play on compliance issues.

29/11/2000 [entry 3] GAD write to FSA with some thoughts on the prospects for Equitable. GAD suggest that, as Equitable's with-profits policies contain a clause which appears to allow benefits to be reduced in the event of a shortfall of assets to cover liabilities, '*... it looks as if a "solvent" run-off would be easier to achieve, even without any additional capital support being available*'.

GAD consider that Equitable needed an investment return on their closed fund, over the next 30 years, of around 3.5%-4% per annum in order to cover guaranteed benefits. This would rise to around 5% if equities fell by, say, 25%. GAD comment that this analysis allows:

... some rather healthier debate about the prospects for this fund than the more cataclysmic view that might prevail if as a result of a fall in equity markets, [Equitable] *become unable to meet the statutory solvency test. (Some may argue that our test is therefore too tough, but we do have to meet international standards for the protection of consumers, and moreover, the absence of an acceptable takeover offer, even after around 15 expressions of interest, would show that the market too considers the prospects to be too risky for an external investor to consider offering their support.)*

GAD accept that, unless Equitable could earn high rates of future investment returns, there would have to be further cuts in bonus rates of up to 10%. GAD suggest that this might be a reason for the reluctance of bidders to become too closely involved.

29/11/2000 [entry 4] FSA's Head of Life Insurance writes to his Chairman and Managing Director A about the main regulatory issues arising from discussions with Equitable and the potential bidders, particularly Prospective Bidder A. The Head of Life Insurance identifies five matters:

- The company are seeking a condition that '*the sale of the goodwill and the salesforce must be irrevocable at the time of any announcement, irrespective of whether the scheme is ultimately approved*'. The Head of Life Insurance comments that this would be difficult to present to policyholders and that much would depend on whether the company's bid was sufficiently better than any others to justify such a pre-emptive condition.
- How the company's proposals could be compared with the existing closed fund option. He comments:

  > *A peculiar feature of Equitable's constitution is that benefits can be adjusted downwards so that assets can never exceed liabilities; hence the fund can never become insolvent. The affect of this appears to be that the provisions of the Policyholder Protection Act (which would normally pay policyholders 90% of their guaranteed benefits in the event of insolvency) is never triggered.*

  He queries whether the compensation scheme under the Financial Services and Markets Act 2000 (FSMA 2000) replicates the Policyholders Protection Act 1975 in this respect.
- The company is *'nervous'* about the potential effect of a number of outstanding compliance issues.
- The need for PIA to approve the company's sale of Equitable's products.
- The company's queries about FSA's approach to reserving standards.

30/11/2000 [entry 1] FSA's Line Manager E suggests to other officials at FSA and GAD issues to raise with Equitable at a meeting the following day. The Line Manager highlights Equitable's views on the bidding process (including the question: *'are they confident of securing a deal?'*), their contingency plans, their interpretation of Article 4, their response of 29/11/2000 to GAD's letter, PIA issues (including income drawdown policies and ongoing sales of with-profits policies) and the rectification scheme.

The Head of Life Insurance responds that the key issue for him is Equitable's contingency plans in the event of there being no bid.

30/11/2000 [entry 2] Line Manager E writes to the Director of Insurance, following a meeting on 28 November 2000 with Prospective Bidder A. The Line Manager notes that one of the issues raised was whether all the necessary information about current PIA Enforcement cases had been disclosed. FSA noted that it was their understanding that Equitable were keeping bidders up to date but recommended that Prospective Bidder A should seek an update from Equitable on their view of the current position. The Line Manager notes the Director's comments at the meeting that *'it would arguably be odd for PIA to be considering imposing fines in the current circumstances, but that if a reprimand was considered appropriate, it would almost certainly be made public*'.

30/11/2000 [entry 3] FSA's Legal Adviser A writes to Line Manager E in response to his note of 28/11/2000 about the Policyholders Protection Act 1975. The Legal Adviser suggests that the matter might not be as clear cut as the Manager had indicated. The Legal Adviser comments that Article 4 was designed to ensure that Equitable members were not subject to calls, by ensuring that policyholders' claims could only be paid out to the extent that the company had sufficient assets. Legal Adviser A says that he is '*not convinced that it must follow that the* *policyholders' entitlement to benefits are reduced or expunged so that the company has no liability in respect of them'.* He goes on: *'It is merely that they will not be paid – or paid in full – because the company does not have sufficient assets to pay them and no recourse can be had to the members'.* The Legal Adviser notes that drawing firm conclusions without seeing Article 4 in context was not easy.

30/11/2000 [entry 4] GAD's Directing Actuary B advises Scrutinising Actuary F on how to respond to Equitable's comments on their zillmer adjustment in their letter of 29/11/2000.

30/11/2000 [entry 5] FSA (Head of Life Insurance and another official) prepare a note for FSA's Chairman's Committee and Directors' Committee, outlining the options for further action following the House of Lords' ruling. They explain that, on 27/07/2000, FSA had asked companies for an assessment of the implications of the ruling. In responding, a number of companies had called for guidance from FSA on their obligations towards policyholders with GARs, *'due to concerns that a consistent approach should be adopted across the industry and concerns about what the FSA's own approach would be ...'*.

FSA set out the advantages and disadvantages of various courses of action, including taking no action, issuing minimal or fuller guidance, and taking a test case to court. FSA observe that they needed *'to come to a view on how to assess whether insurers are acting in a way consistent with PRE'* and that not to be transparent on this point would expose them to criticism.

FSA suggest that issuing fuller guidance offered the greatest potential benefit of reducing uncertainty, but also carried the highest risk of a successful legal challenge. The note explains that FSA were seeking Counsel's view on the way forward. FSA note that all the options contained an element of risk; however, the extra risk in issuing fuller guidance is, in their view, outweighed by the potential benefits.

01/12/2000 [entry 1] FSA and GAD meet Equitable and their advisers to discuss the sale process and their letter of 29/11/2000.

Prior to the meeting, GAD write to FSA. GAD explain that they have prepared a note on Equitable's letter of 29/11/2000, which they would forward in due course. GAD summarise the *'implications'* of their assessment as follows:

- GAD are looking for *'an increase from 85% to say 90% in the assumed GAR take-up rate'*. However, this would have no effect on the net level of reserves whilst the reinsurance treaty remains in place.
- GAD are unhappy with the 20% rate of decrement in future premiums when assessing the 'future premiums' part of the reserve for annuity guarantees. They estimate, on the basis of information provided by Equitable's actuarial consultants, that if no such decrement were assumed, Equitable's net liabilities would increase by up to £360m.
- GAD believe Regulation 72(3) might require Equitable to assume in future valuations that personal pensions benefits were all taken at age 50. They estimate, on the basis of information provided by Equitable's actuarial consultants, that the effect on Equitable's liabilities would be up to £200m.
- GAD believe the new resilience test 2 would lead to increased reserves of £600m, or £300m if the *'synthetic bond'* concept were used.
- GAD believe that more sophisticated hypothecation of assets in the resilience scenario could reduce the resilience reserve by up to £750m (or less, if a synthetic bond were used).
- GAD explain that they did not accept the use of a 0.5% pa allowance for expenses in the resilience scenario. They state that *'the resilience reserve is therefore weak and not*

in accordance with the guidance. [Equitable's actuarial consultants] s*ay that reserves are £950m lower than they otherwise would have been because of this'.*

GAD note that Equitable's letter of 22/11/2000 showed that, at the end of October 2000, Equitable had assets of £1,080m in excess of the required minimum margin of £1,215m. (Note: this gave Equitable cover for the required minimum margin of 1.89.) Equitable explain that adjusting to take account of the above points increased Equitable's liabilities by £1,010m and thus reduced their excess assets to £70m. (Note: this gave Equitable cover for the required minimum margin of 1.06.) GAD conclude:

> *In other words we estimate that the Society are currently very close to not covering their* [required minimum margin].
>
> *If the GAO Reassurance treaty were terminated, liabilities would increase by about a further £1000m.*

GAD's Chief Actuary C annotates the note to show that the increase in Equitable's liabilities was, in fact, £1,060m, and that thus the excess of assets over the required minimum margin fell to £20m. (Note: this gave them cover for the required minimum margin of 1.02.) The Chief Actuary also points out that, given the 60% threshold, Equitable's liabilities would increase by about £500m if the reinsurance treaty were terminated.

FSA prepare a note of the meeting. FSA record that Prospective Bidder A was now the only potentially realistic bidder, and that there were doubts as to whether this option could proceed because the effect of the Board accepting the bid would be an agreement to sell off the sales force and infrastructure without the prior approval of the membership.

Equitable explain that they are awaiting further guidance from PIA on income drawdown policies and that this was one of the matters concerning the company. FSA's Head of Life Insurance agrees to *'facilitate an open dialogue with Enforcement on this issue'*. FSA thought it would be best to have a proposal on the table before having a tripartite meeting (involving FSA, Equitable and Prospective Bidder A) to discuss prudential and conduct of business issues.

Equitable confirm that the Society had been established as an unlimited liability company and that thus each member could be liable for its liabilities. Equitable's solicitors suggest, therefore, that it was not possible for Equitable to become insolvent under the terms of the Policyholders Protection Act 1975 and that thus they could not claim any assistance under the Act.

GAD and Equitable fail to agree an interpretation of the letter of 22/12/1999. GAD agree to write to Equitable. Equitable state that the take-up of GARs *'was still below 50%'*.

Equitable agree that the use of a 20% *'decrement'* in assessing future premiums that secure GAR benefits needed to be reviewed.

GAD welcome the strengthening of the with-profits reserves. GAD point out that the regulations would shortly, or had recently, required reserves to be set up on the basis of an assumed retirement at the earliest possible date, in Equitable's case at age 50, and so reserves would need to be strengthened further.

GAD note that Equitable might be able to save £750m in the resilience reserve, *'from a more sophisticated approach to asset hypothecation'*, but that further work needed to be done.

GAD argue that the 0.5% zillmer adjustment:

> *... was not in accordance with the regulations. This reduction equated to a c£950m saving in this reserve.* [The Appointed Actuary] *confirmed that this approach had been used since the early 1990's. (This was disclosed in the 1998 and 1999 returns). GAD thought that from conversations with* [the then Appointed Actuary] *at that time it had been agreed that such an approach was not going to be taken.*

Equitable explain that the rectification scheme had been signed off, that it would be put before the Board on 7 December 2000 and that affected policyholders would be contacted shortly thereafter.

FSA note that Equitable *'did not appear to be unduly concerned about* [with-profits] *policyholders who joined the Society after the House of Lords judgement'*, although they accept that they would shortly need to make a decision on whether to carry on writing this business, depending on the outcome of the sale process. Equitable explain that they *'had not considered whether post 20 July* [with-profits] *policyholders could be excessively disadvantaged in a closed fund. This is because after this date the preferential treatment of GAR policyholders was known'*.

FSA note that, if GAR policyholders were more likely to top up their benefits than previously, this would be to the detriment of non-GAR policyholders. Equitable's solicitors consider that *'it might in these circumstances be possible for these policyholders to get a preferential bonus treatment'*.

Equitable confirm that their sales force were adequately briefed and instructed to advise potential with-profits policyholders on Equitable's particular circumstances prior to sale, and that their Board had taken legal advice on the matter.

01/12/2000 [entry 2] GAD provide further comments on Equitable's letter of 29/11/2000, reflecting the points made in their note to FSA, above.

FSA's Line Manager D (who no longer has regulatory responsibility for Equitable) provides comments to the Head of Life Insurance on a draft note by him on the latest position. The former Line Manager asks:

> *Why look at changing* [the Financial Services and Markets Act 2000] *if the conditions of the Equitable Fund take it outside the* [Financial Services Compensation Scheme]*? Why not change the terms of the fund so that if guaranteed benefit levels cannot be maintained the fund has to be wound up and it then does fall within the* [Financial Services Compensation Scheme]*? The change would appear to me to increase the protection afforded to policyholders so be unobjectionable.*

The former Line Manager queries how Equitable might seek a view from policyholders on how to proceed, and if the projected cash injection would be enough to ensure payouts of at least asset share.

01/12/2000 [entry 3] FSA's Firms and Markets Committee note that FSA were to meet with the Takeover Panel (a non-statutory body established to issue and administer the City Code on Takeovers and Mergers) to discuss one aspect of the potential bid for Equitable by Prospective Bidder A.

04/12/2000 [entry 1] GAD write to Equitable following their letter of 29/11/2000 and the meeting on 01/12/2000.

GAD accept that Equitable have met the requirements of the letter of 22/12/1999, in that their reserves have not been reduced by more than 5%. But GAD say that, in their view, to be consistent with the letter of 22/12/1999 it would not be prudent to assume that more than 10% of GAR policyholders would take cash or alternative benefits. GAD accept that this had no effect on the level of reserving while the current reinsurance agreement remained in place.

GAD question Equitable's *'rate of decrement'* on recurrent single premium business and suggest that there should be *'a somewhat stronger assumption'* in the 2000 returns. GAD confirm that, in accordance with new regulations, the valuation should be increased to reflect an assumed age of retirement of 50. GAD acknowledge that Equitable's method of determining the resilience reserve satisfies current guidance.

GAD say that the use of a zillmer adjustment causes them *'particular concern'*. GAD say:

> *In terms of the regulations as they existed before the 2000 amendments, we are doubtful that this ½% p.a. allowance would be wholly consistent with either regulation 67(3) or 72.*

GAD explain that, following amendments to the regulations in 2000, the position *'will become rather clearer'* and that the adjustment would not be acceptable in the 2000 returns.

GAD ask Equitable to explain why, in the resilience scenario, they release a significant part of their reserving basis for expenses.

04/12/2000 [entry 2] FSA's Line Manager E advises the Head of Life Insurance, following a conversation with Prospective Bidder B, that the bidder had withdrawn from the sales process. The Line Manager copies his note to other officials, including the Director of Insurance. The Line Manager reports that Prospective Bidder B had indicated that, since their last meeting (held on 15/11/2000), their due diligence had identified material risks for their shareholders and that, unusually, that risk could not be factored into the purchase price because a lower price simply increased the risks.

04/12/2000 [entry 3] FSA's Line Manager E writes to the Director of Insurance, following a meeting on 29/11/2000 with Prospective Bidder A. The main items discussed are the implication of Prospective Bidder A's proposals for the entitlements of policyholders and associated reserving issues. The Line Manager notes that Equitable's advisers take the view that Article 4 of Equitable's Articles of Association *'had the effect of automatically reducing the company's liability to with-profits policyholders'*. This means that Equitable could never be in debt to policyholders, and so could never be insolvent. As a result, there was no trigger for compensation under the Policyholders Protection Act 1975.

In response, the Director of Insurance queries whether the same applied to non with-profits policyholders. Line Manager E explains:

> *Non-*[with-profits] *policyholders are not members and so are not bound by article 4. It is not clear, though, whether their policies also contain a similar provision. The effect of* [Article] *4 seems to be that the company did not have powers to offer policies that did not have the relevant provision – though that* [would] *not, I think, affect the validity of the policy. We would have to investigate.*

The Director asks: *'Is nothing to do with the* [Equitable] *ever clear?!?'*.

In his note, Line Manager E also explains that Prospective Bidder A was seeking *'comfort or information'* on compliance issues. The Line Manager says that, in addition to action on income drawdown policies, the company wished to know if there were any issues arising out of a PIA monitoring visit in June 2000 and *'whether any action might be contemplated in connection with sales since the House of Lords judgment'*.

04/12/2000 [entry 4] Subsequently, the Director of Insurance advises Line Manager E of a telephone call received that day from Prospective Bidder A. The Director explains that the company had alerted him to some further concerns about a possible bid and that they now might not proceed. Those concerns included the company's analysis that running the business on the *'charges less expenses basis'* currently used by Equitable would produce a negative cash flow for a substantial period. The impact of this would be to depress the purchase price Prospective Bidder A was prepared to pay from around the £1bn previously discussed to around £500m - £600m. This would make the bid look unattractive to Equitable's policyholders and, along with the pre-emptive nature of the deal, could reduce the goodwill associated with the deal. The Director of Insurance records that: *'These factors combined could easily turn the deal into one where the amount of future business that was achievable could be insufficient to justify any bid at all'*.

The Director comments that he was not sure whether the telephone call was a genuine signal that Prospective Bidder A might not make an offer or whether it was intended to *'soften us up'* for a lower bid than had been anticipated. The Director notes, following the earlier news about Prospective Bidder B, that:

> *... we may face a position, as early as* [8 December 2000] *where it is clear that no bid will be made by either party. We (and the Equitable) will need to be ready to respond quickly to that. My preference in that situation would be a very early announcement by the Company that they are closing to new business. In this case we would need to be ready to explain:*
>
> > *a) The regulatory implications*
> >
> > *b) Why we had not closed the company immediately after the House of Lords' judgement (or possibly even before that).*
>
> *... We should also liaise with the* [Association of British Insurers] *since they are likely to get questions about why the industry had not been prepared to "rescue" the Equitable.*

The Director of Insurance copies his note to other officials, including FSA's Chairman. The Chairman comments in response:

> *This matches the impression given to me by* [an Equitable Director]*, and my own instinct all along.*

04/12/2000 [entry 5] In a further note, the Director of Insurance warns Line Manager E that, if a bid were made for Equitable, there would be considerable difficulty in obtaining a decision within FSA to allow Equitable to make an announcement within their preferred timescale.

The Director sketches out some of the considerations that would apply in reaching a decision, in the context of the relevant FSA objectives of protection of consumers and market confidence.

04/12/2000 [entry 6] FSA's Legal Adviser A advises the Director of Insurance on the issue of possible compensation for Equitable policyholders. The Legal Adviser explains that he had asked Counsel to assume that Article 4 of Equitable's Articles of Association meant that, in the event of insolvency, Equitable's liability to their policyholders would never be greater than their assets, and that if their assets were nil, benefits payable under policies would be nil. The Legal Adviser further asked Counsel to advise if, in those circumstances, the draft rules for the compensation scheme replacing the Policyholders Protection Act 1975 would enable compensation to be paid to the Society's policyholders.

Counsel's advice is that the scheme does not enable compensation to be paid. She suggests a way in which the rules could be amended to encompass claims that would otherwise fail.

Legal Adviser A notes that, although Counsel was not asked to advise on the interpretation of Article 4, her reaction, like his, was that it did not have the meaning set out above.

04/12/2000 [entry 7] PIA write to Equitable about their investigation into the sale of income drawdown policies. PIA say that they have considered the proposals in Equitable's letter of 24 November 2000. (Note: I have not seen this letter) and their further comments at the meeting on 27/11/2000.

PIA explain that Equitable's proposed amendments to their sales process were not adequate to meet PIA's concerns, and give reasons why. PIA ask Equitable to resubmit their proposed amendments, taking account of PIA's comments, and in the meantime suspend sales of income drawdown products.

PIA do not accept Equitable's arguments that a review of past income drawdown business was unreasonable. They ask Equitable to submit a project plan for a review of past business.

PIA seek a response by 15 December 2000.

05/12/2000 [entry 1] FSA meet GAD to discuss the latest position. GAD make brief manuscript notes of the meeting. GAD record that Equitable's solvency position under the statutory returns was now '[very] *borderline*'. GAD agree to prepare a note for a meeting of the Tripartite Standing Committee. FSA agree to prepare a fact sheet. FSA agree to research the history of companies which have closed. In this context, GAD note *'What does it mean to run off a closed fund? PRE?'*.

05/12/2000 [entry 2] GAD, in their subsequent draft note for the Tripartite Standing Committee, set out Equitable's current position. GAD explain that, following 15 expressions of interest, only 3 companies had pursued possible bids. But *'after studying the dynamics of the operation, and some reports commissioned from* [Equitable's actuarial consultants]', all were pulling out. GAD note that this meant *'that the Society has been considered by all these independent potential bidders not to be a viable prospect'*.

GAD also note that they are aware:

> *... following some recent discussions with the Society about their present finances that they are only just meeting their minimum capital requirement. While they do have around £2 billion free reserves in their Companies Act accounts, this would be exhausted in the event of equity markets falling by around 20-25%.*

GAD conclude that Equitable '*will have no choice but to close to new business*'.

GAD go on to discuss the implications of this for market confidence and policyholders. They anticipate the effects on policyholders to be:

> *1) The Society will not be able to accept any further business, but it is possible that they may be allowed to accept additional premiums on existing policies. An issue may though arise over whether they should be allowed to accept additional premiums on policies with Guaranteed Annuity Options since this would disadvantage other policyholders (who would have to meet the resulting cost).*
>
> *2) All claims on existing linked and non-participating policies can still be expected to be met in full as they arise.*
>
> *3) Similarly, all guaranteed benefits on with-profit policies will continue to be met in full.*
>
> *4) However, the Society is likely to levy a penalty on most early surrenders of non-linked policies where (as in most cases, we understand) this is allowed under the policy conditions.*
>
> *5) There are also likely to be some further cuts in bonus rates over the next few years as the present levels of discretionary final bonus are too high relative to available assets. In effect, the with-profit policyholders (and members) are sharing in the fortunes (and misfortunes) of the Society.*
>
> *6) Some redistribution of investments may take place over the next few years to reduce the exposure of the Society and its members to movements in equity and property values. (See below). In addition, some limited hedging protection may be available through reinsurance.*

7) There may be some reduction in the level of service offered to policyholders but their administrative operation is already fairly efficient and could in due course be outsourced to a third party if necessary.

8) In the event of unexpectedly adverse investment (or other) conditions arising, then even the guaranteed benefits might need to be reduced proportionately. However, there is an industry compensation scheme that could be expected to ensure that policyholders receive at least 90% of their guaranteed benefits (excluding discretionary bonuses).

In response to GAD's note, FSA's Managing Director A comments that there were three issues to be addressed:

- What FSA's powers were if *'push comes to shove (ie if* [the Society] *has no bidders left and won't voluntarily suspend business)'*. The Managing Director says that, if FSA were not sure how far their powers would go, the safest line to take would be to say that they would have to consider the use of their powers to protect potential policyholders.
- What FSA should say to policyholders about the implications of a cessation of new business. The Managing Director says that this would be primarily a matter for Equitable.
- What FSA should say in response to questions about which other companies might be affected. The Managing Director says that this is, in some way, the most difficult area and suggests:

... the best hope lies in citing the features that distinguish [Equitable] *(lean - has paid out its fat, anything one can say to show that they have proportionately more of the business causing the difficulty etc).*

FSA's Director of Insurance comments in turn:

On POWERS, discussion with GAD has clarified how thin and fragile the company's margin is. I think that we can be reasonably robust along the lines of "I am sure you recognise that, if the situation arises where there is no reasonably probable prospect of a sale you could not continue – and we could not allow you to continue – to write new business".

On what should be said to policyholders, the Director of Insurance agrees that Equitable (and the Association of British Insurers to whom FSA had already spoken) should *'so far as possible take the heat'*. The Director says that FSA should be calm and informative and ensure that there was proper transparency, for example for those considering whether or not to top up their policies. He says that FSA's initial but firm legal advice is that they had no power to interfere in contractual rights, such as the right to top up a policy.

On other companies, the Director of Insurance agrees:

... that we should major on the distinguishing features of the Equitable. In fact the combination of a deliberate avoidance of building up an inherited estate and the fact of being a mutual with consequent problems in raising capital does make the Equitable's case pretty much unique. (We may get some incidental, and much needed recognition that inherited estates are not all bad.)

05/12/2000 [entry 3] FSA's Head of Life Insurance writes to the Managing Director with details of a further review of Equitable's solvency position, in advance of a meeting with Equitable on 06/12/2000. He explains:

Our latest estimate is that the Equitable has free assets of £7m [this has been changed by hand to *'£70m'*] *above the required minimum margin of solvency. (This margin has built into it the "resilience test", which allows for a 25% fall in equities; but even so this margin is uncomfortably tight.) This estimate is £1010 billion* [this has been changed by hand to

2000

'*£1010 million*'] *less than the Equitable's own estimate; the reason for the difference is that GAD have made adjustments* [see 01/12/2000] *to a variety of assumptions in the reserving basis, to bring them into line with what they would normally expect.*

He comments that, on this basis, it was difficult to see how Equitable remained a going concern in the absence of a bid. He states that FSA would have grounds for closing the company to new business under ICA 1982 *'either for failing to meet its required minimum margin of solvency, or because of the risk that PRE would not be met'*.

The Head of Life Insurance outlines some alternatives to closure to new business (seeking renewed interest in a takeover of Equitable or allowing limited forms of new business) but says neither was very promising. He says that the main item for the meeting on 06/12/2000 should be to seek Equitable's own assessment of their financial position and of the situation should no bid emerge.

05/12/2000 [entry 4] FSA's Chairman's Committee consider Equitable's financial position in the event that there is no bid. The Committee note that Equitable would need to close to new business and that it would be preferable that they did so voluntarily. If they did not, *'FSA would need to assess its financial viability. It was considered that FSA would have powers to close the company under section 45 of the Insurance Companies Act 1982'*.

The Chairman's Committee consider the Head of Life Insurance's paper of 30/11/2000, on possible guidance following the House of Lords' ruling. In accordance with the advice received from Counsel, the Committee favour the issue of the shorter form guidance. The Committee note that guidance would generate renewed interest in the ruling, and hence Equitable, and so the timing of its release was an issue. They agree that the paper should be discussed by the Directors' Committee.

05/12/2000 [entry 5] FSA's Line Manager E writes to a policyholder who has asked FSA to investigate the way Equitable have valued their liabilities. The Line Manager concludes:

In our opinion, the Society and its auditors acted in accordance with the prevailing legal opinion at the time when preparing and reviewing the annual accounts. As your letter notes, the management of the Society immediately acknowledged the significant financial implications of the House of Lords judgment when it was handed down. Given that these events are well documented, we do not consider that an investigation would uncover any new information.

06/12/2000 [entry 1] FSA's Chief Counsel A writes to the Director of Insurance in response to his note of 05/12/2000. She explains, that under ICA 1982, FSA could suspend authorisation in urgent cases (section 12A) on the grounds that any of the criteria of sound and prudent management have not been, or may not be, fulfilled, or that an obligation under ICA 1982 has not been satisfied (for example, where the cover for the required minimum margin had been breached).

The Chief Counsel adds:

Although to use the intervention power under section 45(1) ICA [the residual power to protect policyholders] *would otherwise be of doubtful vires in the face of s.12A, if the Company agrees (and it will generally wish to avoid the use of s.12A due to the two month limit and to take advantage of the greater flexibility generally of s.45), s.45 can be used instead to suspend (a "stop order") on the same grounds.*

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06/12/2000 [entry 2] FSA and GAD meet Equitable and their advisers.

According to FSA's note of the meeting, Equitable explain that Prospective Bidder A had indicated they were unlikely to make an offer; they would make a formal decision on 7 December 2000. Equitable say that, in the event of there being no bid, they would close the with-profits fund and, probably, the unit-linked business.

FSA's Director of Insurance explains *'the problem we would have'* in allowing Equitable to continue to write unit-linked business because it appeared that those contracts contained provisions by which the value of the policies could be reduced to pay for the wider liabilities of the Society. In the light of this, Equitable agree that they would close to all new business in the event that Prospective Bidder A confirmed their withdrawal. Equitable and FSA discuss arrangements for the announcement of this and for dealing with press enquiries.

Equitable confirm that if there were no sale, no bonus would be declared for this year and the company's investment strategy would gradually move to a more conservative position.

Equitable's solicitors confirm that the subordinated loan is '*safe*', provided FSA did not withdraw authorisation. According to the note, it is also confirmed (it is not clear by whom) that the reinsurance treaty still held good if Equitable stopped writing new business.

Equitable ask if they could be granted any leeway in relation to the PIA's plan to require a review of the sale of income drawdown policies. FSA *'could give no comfort on this but added that it may in the circumstances be possible to review the time scales for any possible review'*.

06/12/2000 [entry 3] FSA's Director of GCD writes to Legal Adviser A. The Director of GCD explains that FSA should be ready by the following morning to exercise formal powers under section 11 or section 45 of ICA 1982 to prevent Equitable from taking on new business.

The Director says that Chief Counsel A has explained that FSA's practice in the past *'has been to threaten to use section 11 but then to proceed by way of section 45. This has been done on the basis that we regard section 45 as more appropriate, but are worried that we could be subject to criticism for using the lesser power in a circumstance that could justify using the more stringent power, with the stronger safeguards, in terms of representations, which would then apply'*.

Chief Counsel A refers the Director to her earlier note that day to the Director of Insurance.

Line Manager E later explains that, following the meeting with Equitable earlier that day, FSA are *'most unlikely to need to use powers (other than with the full consent of* [Equitable]*'*.

06/12/2000 [entry 4] The Director of GCD copies his note to Line Manager E and then writes directly to him. The Director sets out the grounds on which FSA *'could, if need be, exercise formal intervention powers against the Equitable on* [7 December 2000]'. He suggests that there were four grounds:

- that Equitable were unable to meet their liabilities to policyholders. He suggests this was potentially problematic, given the argument that Article 4 of Equitable's Articles of Association *'limits the company's liabilities to policyholders to the amount of its assets'*;
- that action was needed to protect the interests of policyholders and potential policyholders. He notes that closure to new business would protect potential policyholders. However, FSA would need to consider if this were a proportionate response, or whether adequate disclosure of the risks to them in sharing in the cost of annuity guarantees or ring fencing might be available. On the latter option he notes that the Director of Insurance does not consider this to be *'a runner'*;

- that Equitable have not maintained sound and prudent management. He states: *'This must be exercisable, but it would be useful to know exactly what criteria we would say Equitable had failed to meet in this area'*; and
- that Equitable have failed to fulfil the reasonable expectations of long term business policyholders. The Director of GCD states: *'This seems highly likely to be exercisable, but again would be useful to identify and the category of policyholders whose reasonable expectations the company is likely to be unable to meet'*.

The Director of GCD emphasises that the purpose of his note was to enable FSA to *'focus our decision taking on the statutory criteria'*. He says that he was not suggesting that FSA should hesitate from exercising their powers if they believed that to be necessary.

06/12/2000 [entry 5] FSA learn that Prospective Bidder A have confirmed that they would not be bidding for Equitable.

06/12/2000 [entry 6] FSA's Line Manager E prepares a summary of the results of the survey of companies which sold with-profits policies with annuity guarantees (see 04/02/2000), in preparation for the meeting of the Tripartite Standing Committee later that day. Of the 49 companies surveyed, 8 had reduced the terminal bonus, 5 of these following Equitable's approach.

The Line Manager notes that there were a number of special factors that apply to Equitable – they are a mutual with no estate and had a high volume of business containing annuity guarantees, offering generous and flexible terms. The Line Manager says that some, but not all, of these factors apply in other cases.

06/12/2000 [entry 7] FSA and GAD attend the meeting of the Tripartite Standing Committee, called to discuss the emerging situation with regard to Equitable.

In their note of the meeting, HMT observe that '[a] *unique combination of factors contributed to the Equitable's position being different to that of other firms'*. HMT note, in particular, that:

- *It was a mutual, so (in the absence of a buyer) had limited access to capital.*
- *It did not have an estate of surplus assets.*
- *The terms of its guarantees were unusually generous and flexible.*

HMT note that confirmation that there was to be no buyer would mean that Equitable could no longer write new business. HMT state:

> *If the Equitable had not reached that conclusion itself, the FSA would have been looking to step in and prevent them taking new business following any withdrawal by* [Prospective Bidder A]. *But, on the other hand, earlier closure to new business would have destroyed any prospect of a sale.*

06/12/2000 [entry 8] HMT brief the Economic Secretary to the Treasury on the latest position.

HMT explain that an announcement was due soon that Equitable were closing to new business. HMT assessment is that this would pose no threat to market stability but might cause *'a ripple on the gilts market'*. HMT caution that the announcement would feature widely in the press.

HMT set out the need for a sale following the House of Lords' judgment. They explain that *'until the last few days the prospect of a sale on reasonable terms seemed likely'*. They note that Prospective Bidder A was now likely to decide against bidding. HMT explain:

The main reason for the lack of a buyer is that it is impossible to cap the cost of some of the Equitable's guaranteed annuity business, thus raising questions over the proper value of the business.

HMT explain that FSA were encouraging Equitable to put in place a robust process to help meet policyholder needs. HMT state that FSA were cautious about what they could say to policyholders, but recognise the importance of ensuring that policyholders '*are not misled into throwing good money after bad*'. HMT estimate that policyholders were likely to see returns which were about 10% lower than expected before the House of Lords' judgment, but that this would still compare well with many of their competitors.

HMT discuss the role of the regulators, saying:

Should the regulator have taken early action to stop the Equitable writing new business? Maybe. But until a few days ago there was every sign that a successful sale could be achieved and this would have been in the best interests of policyholders. The regulators were just as surprised as the markets at this news that no buyer was to be found.

Does this event show up a deep-seated oversight on the part of the regulator? Probably. But this oversight (failing to ensure that proper risk management processes were in place at the Equitable) was not life threatening until the House of Lords judgment in July. The scope of the judgment was quite unexpected, and the FSA took steps after the judgment to work with affected companies to address the issue.

06/12/2000 [entry 9] FSA's Directors' Committee consider possible guidance on the House of Lords' judgment, following the discussion by the Chairman's Committee (see 05/12/2000 [**entry 4**]). The Committee agrees that a revised version of the shorter form of guidance should be submitted to the Board. Some disappointment was expressed that FSA were only prepared to issue guidance that *'said virtually nothing'*. It was thought that the merits of making guidance available should be comprehensively assessed against the risks to the FSA objectives, rather than just against the legal risk of challenge.

06/12/2000 [entry 10] FSA's Managing Director A provides the Chairman with a 'Supervision Update' following the meeting with Equitable. The Managing Director reports that Equitable had voluntarily recognised the need to stop writing new business. He outlines how Equitable planned to handle the announcement and its timing. The Managing Director says that, where Equitable could not give answers to questions (such as *'what is your bonus for this year'*) he had urged them to *'commit to a clear process and rapid timetable for delivering an answer'*. The Managing Director lists four key issues for FSA:

- that they would have to vet the scripts used by Equitable to check that they were not misleading;
- that they could calm market fears by making a statement that, as Equitable remain solvent, FSA saw no reason for them to hurry to make the necessary shift in assets (reducing equities and increasing gilts). He adds that GAD agreed with this conclusion. The Managing Director proposes to make such a statement, provided further checks show that it would be reasonable on all known facts;
- that they consider the extent to which it would be true to say that no other firms were known to be in the same extreme position; and
- that they are prepared to face the media, which is something he plans to do himself initially.

06/12/2000 [entry 11]	Equitable write to PIA in response to their letter of 04/12/2000. Equitable set out further proposed changes to their procedures for the sale of income drawdown policies. They seek confirmation from PIA by 8 December 2000 that these meet their requirements in full and that, therefore, they would not pursue the suspension of sales of income drawdown policies. Equitable explain they would respond separately on the requested review of past business.
07/12/2000 [entry 1]	Equitable's solicitors advise FSA that they understand the terms of the subordinated loan agreement to mean that the ceasing of new business by Equitable could not trigger a demand to repay the loan. The solicitors state that, if FSA withdrew Equitable's authorisation to write new business, exercising their powers under sections 11 or 13 of ICA 1982, this could trigger a demand for repayment. They note that a demand would have *'a considerable financial impact'* on Equitable. FSA's Head of Life Insurance sends a copy of the advice to Line Manager E and comments: *'Am I missing something? Ceasing of new business must be different from surrendering authorisation'*.
07/12/2000 [entry 2]	FSA's Director of Insurance advises the Head of Life Insurance of a discussion with the Association of British Insurers on how they intend to handle possible reactions to an announcement that Equitable are closing to new business. The Director explains that the Association would emphasise that this development did not indicate a company failure or insolvency, and that Equitable's position appeared to be unique. The Director comments that the Association of British Insurer's line *'looks OK – if pretty thin'*.

Closure of the Society to new business

08/12/2000 [entry 1] **Equitable announce that they will stop writing new business with immediate effect**. Equitable say that they remain solvent and would continue to pay out benefits and accept premiums on existing policies. Equitable announce that they have increased the market value adjustment made on surrenders or transfers of with-profits policies from 5% to 10%.

FSA receive a copy of Equitable's '*Media Q&As*', which sets out answers to questions that might be asked by the press. The document includes this answer to the question: '*Why couldn't you find a buyer for Equitable*':

> *We believe that a combination of the size of Equitable, the intractable nature of the differences in the interests of GAR and non-GAR policyholders, uncertainty over the value of Equitable's client base given what has happened to the Society and general concern from buyers as to the scope to earn adequate returns on pension business as the UK moves into a stakeholder pension world, all made a full acquisition ultimately too difficult.*

In answer to the question: '*Can Equitable afford to pay* [the] *redundancy terms* [of their employees]*?*', Equitable's response is:

> *Yes, statutory reserves always have to cover the cost of possible closure of new business. No immediate redundancies are planned.*

Equitable send FSA a copy of notes Equitable had given to their representatives following the House of Lords' ruling and Equitable's announcement that they were up for sale, to assist those representatives in dealing with questions from policyholders. Equitable apologise for the delay in locating and forwarding this document (the content of which, Equitable say, had been overtaken by events by the time it was sent to FSA). The first section of the notes deals with '*sale issues and addressing client concerns*'. Under the heading '*Concerns*', and subheading '*Security*', Equitable state:

> *Concern: Is the Equitable secure?*
>
> *Response: If the client is sincerely concerned that the Society "might go broke" and be unable to meet a claim the following simple statement may suffice:*
>
> *"All UK insurance companies are subject to strict supervision by the regulatory authorities. They would not allow any company to continue accepting new business if they were not satisfied that it could meet its liabilities."*

The response adds that, in the last resort, the Policyholders Protection Act 1975 protects policyholders.

08/12/2000 [entry 2] An unsigned note sets out the '*line to take*' in response to possible questions to HMT about the closure. This includes the following statements:

- *FSA maintains a watching brief and will not hesitate to step in if need be*; and
- *FSA do not believe Equitable Life's problems go right across the insurance industry. The underlying cause is specific to Equitable's own circumstances*.

08/12/2000 [entry 3] FSA prepare a more detailed note for internal use when briefing journalists. This sets out some of the background to Equitable's present position. FSA's note deals specifically with '*Regulatory Issues*', setting out possible questions and suggested responses.

In response to the question: '*Why didn't the FSA take action sooner — how could you let them keep taking new business?*', FSA answer:

The Company remained solvent and there was a realistic prospect of a sale which would have been in the long term interests of policyholders. So there was no clear reason or basis for taking action.

In response to the question: '*How do you judge policyholders' reasonable expectations (PRE)? How can Equitable have been meeting them in recent months?*', FSA answer:

PRE can not be precisely defined but it is important to remember that this company is owned by its members and With Profit policyholders share in the fortunes of mutuals for good or ill. Generally speaking policyholders have received benefits from this arrangement either through improved investment returns or windfall benefits after demutualisations but it is a two way street.

In response to the question: '*On what grounds would someone launch a legal action against FSA for its action or inaction, or are you just a law unto yourself?*', FSA answer:

Not clear to us that a person could have grounds to bring a case. FSA has acted in good faith and with integrity throughout. No statutory immunity for those functions of the FSA delegated by the Treasury under the Insurance Companies Act 1982. But FSA does have the protection of the common law which would make successful challenge very unlikely.

In response to the question: '*Why didn't you at least require Equitable to explain to prospective policyholders its precarious position?*', FSA say:

We understand that prior to the House of Lords judgement the position as reported to potential policyholders would have been in line with the current understanding of the law — where a differential approach to GARs was justified. Post the [House of Lords] *judgement it is our understanding that potential policyholders were advised about the circumstances surrounding the proposed sale of the company.*

In response to the question: '*Would you like to have more or different powers over insurers?*', FSA say:

It is not clear that there is any deficiency in the regulatory powers available.

08/12/2000 [entry 4] FSA write to GAD. FSA note that, in their '*Media Q&As*', Equitable state that they have reserved to cover closure costs. FSA ask if this is correct.

In response, GAD explain that Schedule 4 of Equitable's 1999 returns shows that their reserves for expenses included costs for redundancy payments and rent due on properties, but no additional sum for costs arising from a closure to new business. GAD note that, generally, Equitable's reserving basis for expenses is strong, but also that a significant part of this was released in the resilience scenario (note: this was a point taken up in GAD's letter of 04/12/2000).

GAD conclude:

We need to be sure that they are indeed covering closure costs in both the main valuation and in the resilience scenario.

08/12/2000 [entry 5] FSA's Chief Counsel Investment Business (Chief Counsel B) advises the Director of GCD on the position of policyholders who bought policies after the House of Lords' ruling on 20/07/2000.

Chief Counsel B sets out the responsibility of those selling Equitable's policies to advise potential policyholders of relevant information. The Chief Counsel considers that there is '*a very strong argument to say that the Equitable was under a duty*' to explain that, as a result of the House of Lords' ruling, there was a risk that Equitable could not sustain their investment returns and performance. In the event of a failure to explain this risk, a policyholder would have the right to take action against Equitable. If Equitable became aware of such a failure, they had a duty to remedy the failure and provide appropriate redress.

Chief Counsel B considers whether FSA could have stipulated to Equitable that it should only sell policies in circumstances where the risk has been explained. He comments:

> *In one sense this would have been unnecessary since, if I am correct, that obligation already existed. It would clearly, however, have been open to the regulators to have pointed out to the Equitable the obligations to which they were subject and to say that action would be taken to prevent further sales unless those obligations were complied with.*

08/12/2000 [entry 6] FSA's Line Supervisor C writes to the Director of Insurance and others. The Line Supervisor refers to complaints from a consulting actuary (see 01/11/2000 [**entry 2**] and 23/11/2000 [**entry 2**]) and one other person about Equitable's recent advertising campaign. The Line Supervisor explains that the complaints had been directed at PIA, who had felt that they did not fall to be investigated by them and so had passed the complaints to FSA. The Line Supervisor explains that FSA's standard response was that Equitable were authorised and solvent, and so should not be stopped from advertising.

Line Supervisor C notes that the advertisements had been placed at a time when there had been a reasonable expectation of a sale, and that they had served as '*hooks*' to prompt a subsequent dialogue with sales staff. The Line Supervisor explains that he was asking Equitable for details of the '*crib sheet*' sales staff had used after 20 July 2000, which would disclose what had been said at this stage.

Line Supervisor C copies his note to PIA. In response, PIA say that the complaints had gone beyond issues of advertising and raised questions about Equitable's right to write new business and what the Society was doing with its with-profits fund. PIA say that they had understood that FSA could provide a '*party line*'. PIA explain that they had no final view on the post-20 July 2000 advertisements, but that, if they needed to assess them, '*we would have to consider whether it was fair to promote the Society's wonderful history and past performance without tempering that with information about the current position. That is a specific point of detail and will need an assessment of the actual words and presentation*'.

08/12/2000 [entry 7] FSA's Head of Life Insurance writes to Managing Director A and others about the possible cancellation of policies bought after 20 July 2000. The Head of Life Insurance says Equitable have concluded they should not offer this to policyholders for two reasons. First, the pension contract was governed by pensions legislation which did not entitle a policyholder to any money back, other than at death or the vesting date. Secondly, if a concession were given for policies taken out after 20 July 2000, there would be pressure for this to extend to policies taken out after the Court of Appeal judgment or earlier.

The Head of Life Insurance concludes that '*the first of these arguments in particular is a powerful one against the FSA seeking to require that the Equitable should make a concession of this kind*'.

08/12/2000 [entry 8] An FSA official provides Equitable's supervisors with advice on policyholders' right to pay top up premiums and on how GARs apply to this. The official concludes that Equitable were right to assert both that policyholders have a contractual entitlement to pay additional premiums (although this would terminate if they failed to pay a due premium) and that GAR provisions would apply to any top up annuities. Equitable were wrong, however, to claim that they could unilaterally terminate the entitlement to pay top up premiums.

08/12/2000 [entry 9]	FSA's Firms and Markets Committee discuss Equitable's closure to new business. The Committee note that Equitable '*would go into solvent run-off and there would be a need to calm any panic reaction by policyholders*'. The Committee query whether there had been proper disclosure by Equitable of their position following the House of Lords' judgment and, if there had not, there might be a need for FSA to consider disciplinary action. They note that the disciplinary case in relation to income drawdown policies was still ongoing and that it could cost Equitable a further £30m.
09/12/2000 [18:35]	Further to discussions on 8 December 2000, Equitable's solicitors send FSA (ahead of their conference with Counsel on 11/12/2000 [**16:00**]) the current version of a note on the various legal issues discussed recently, in particular regarding the application of the Policyholders Protection Act 1975 to Equitable in the light of Article 4 of Equitable's Articles of Association. Equitable's solicitors' note reads: *In the course of our recent discussions with the FSA and, in particular, in the context of our discontinued discussions with* [Prospective Bidder A]*, three specific legal issues have arisen:* *(a) the propriety of the Society's Board of Directors irrevocably approving significant disposals of the Society's business or assets without the sanction of a resolution of its members;* *(b) the legal significance of Regulation 4 of the Society's Articles of Association ("Regulation 4"); and* *(c) the application to the Society of the Policyholders Protection Act 1975 (the "PPA") in the light of the interpretation of Regulation 4.*
10/12/2000 [17:53]	FSA thank Equitable's solicitors for their note and say that, unless they had any immediate questions, they would get back to them after their conference with Counsel. [**17:54**] FSA's Chief Counsel A asks Legal Adviser A to forward the note to Counsel.
10/12/2000 [18:26]	FSA's Chief Counsel A tells Legal Adviser A that the Director of Insurance was content for him to contact Equitable's solicitors to request more information and their analysis on 'top-up' rights of policyholders (i.e. the right of Equitable policyholders to have the guarantees, including any annuity rate guarantees, in their policies apply in respect of any further premiums paid).
10/12/2000 [19:18]	FSA's Director of Insurance says to Line Manager E that the press coverage that he had seen was '*no worse than we might have expected – and perhaps in some respects not as bad*'. However, the Director of Insurance adds that there were three points which caused him some concern, those being: *a) it is suggested that mortgage endowment type policies may not be made paid up but must either be continued in payment or surrendered. Is this really true? Could you check with the company as a matter of urgency please?* *b) a number of advisers are quoted as saying that policyholders are likely to be better off surrendering their policies (and accepting the 10% hit) rather than leaving funds locked in. The argument appears to be that moving funds to another company to avert the effect of the projected ½% to 1% fall in bonus rates consequent on adjustments to the investment mix will pay off for all except those close to maturity. Have we any feel for whether this is reasonable (particularly allowing for commission payments)? It seems inconsistent with the view we have been taking (although quite consistent with the "Don't panic" message which is all we have said publicly).*

c) some are suggesting (as expected) that policies sold after the [House of Lords] *judgment have necessarily been "missold". Can we put any sort of figure on the inflow of funds during this period and the likely net cost of returning premiums + interest and cancelling the relevant liabilities.*

The Director of Insurance says that FSA should give some thought as to how they could assess '*what could we have done better?*' to ensure the relevant lessons are learned.

11/12/2000 [entry 1] Equitable apply to renew the section 68 Order allowing them to raise the limit on the admissibility of shareholdings in certain companies.

11/12/2000 [12:09] FSA's Director of GCD advises the Head of Life Insurance that FSA: '*need to be clear whether early cancellation of a pension cannot be done, because of tax legislation, or whether it can be done, at the cost of losing the tax relief. If it can be, this might be the right course for some policyholders*'.

The Director of GCD also says that FSA: '*should explore whether the* [Inland Revenue] *would be prepared to grant an extra-statutory concession allowing transfers to another provider. There seems no reason why they should not, if the investor remains unable to access the funds*'.

[**13:14**] The Head of Life Insurance agrees to follow up both points. He says that Equitable's preliminary view was that, subject to the Inland Revenue being agreeable, cancellation should not be impossible, although they thought this would be very complex.

The Head of Life Insurance says: '*Even if it is do-able, we need to be clear that it is justifiable to give such an option to policyholders who took out their policy after 20 July, but not to others*'.

[**15:46**] The Director says that, if transfers were possible, such transfers could in principle be open to all annuitants, not just those who had taken their annuity after 20 July 2000.

[**16:05**] Chief Counsel B asks the Head of Life Insurance whether a cost-free transfer to another pension provider should be the alternative, if cancellation were not possible.

11/12/2000 [12:11] The Director of GCD advises Chief Counsel A that, having obtained Equitable's analysis, FSA should obtain Counsel's opinion on whether Equitable could remove the rights of GAR policyholders to receive their guaranteed rate on top ups.

11/12/2000 [12:34] FSA's Chief Counsel B provides advice to Managing Director A on PIA's regulatory approach to advertising. The advice is also sent to other FSA officials. Chief Counsel B advises:

(a) Correct, the regulators have never operated pre-vetting, although the monitoring staff may, and in practice on occasions do, offer views on draft material prior to issue but on the basis that this is without prejudice to the ability of the regulator subsequently to take action.

(b) For others to say, but my experience is that the PIA does engage in active monitoring of advertising. It does so through responding to complaints and allegations from the public and regulated firms and by some more systematic surveys of what is published (for example, at one stage Lautro/PIA subscribed to a service by which it was provided with samples of most direct-mail advertisements sent by postal mail-shot). In practice those "monitoring" advertising may, if the case appears to be sufficiently serious, engage with the regulated firm with a view to (i) the withdrawal or amendment of an advertisement (ii) contacting clients who have purchased. So in practice I do not think (historically) we have merely relied on the rules as a ground for compensation (your point (c)).

11/12/2000 [13:23] Equitable send FSA a copy of a letter that is to be sent to policyholders about closure to new business. The letter includes a copy of Equitable's press notice (of 08/12/2000) about the decision to close to new business and their '*Most Frequently Asked Questions and Answers*'.

FSA send the letter to PIA, having discussed it first, saying that Equitable would like any comments on it as soon as possible, as they hoped to send the letter to their printers that day.

11/12/2000 [15:44] FSA's Line Supervisor C replies to the Director of Insurance's questions of 10/12/2000 [**19:18**] that:

> *a)* [Equitable's Appointed Actuary] *has confirmed that mortgage endowments can be made "paid up" and he will send something to us confirming this. Although this possibly contradicts part of the crib notes to staff that we received on* [08/12/2000] *so we need to double check this.*
>
> *b) Could not really pin him down on this but the surrender rate is being closely monitored.* [The Appointed Actuary] *said* [the] *penalty could increase further if required. A colleague of* [the Appointed Actuary's] *I spoke to said that many other providers have a higher expense charge than the Equitable's which could actually offset the potential 0.5 to 1% reduction in investment return likely to be experienced at* [Equitable].
>
> *c)* [Further information] *to come from* [Equitable as soon as possible] *but the 15,000 policies referred to post 20 July contain both* [with profits] *and non profit policies.*

The Line Supervisor adds: '*It is worth noting that PIA have their wish list of matters they wish to discuss with* [Equitable], *they have held off for the time being but if we are to meet the Society soon perhaps they could also attend the meeting?*'.

Line Supervisor C later [**16:16**] provides an update, having spoken again to Equitable. The Line Supervisor says that Equitable have confirmed that the particular endowments that Equitable sell could not be made paid up. He says that a written explanation is to follow.

[**16:27**] FSA's Director of Insurance thanks the Line Supervisor and says '*I hope the explanation will follow quickly!*'. The Director of Insurance also asks:

> *Do we have/could you put together a very quick outline chronology covering:*
>
> *a) when did* [Equitable] *start including GARs in their policies*
>
> *b) when did they stop*
>
> *c) when did we/GAD first look at the issue of reserving for GARs*
>
> *d) when did we issue guidance on this*
>
> *Do we have/could we get more information on what instructions the sales force were given post* [House of Lords] *judgment on the risks implicit in* [Equitable] *policies given the inevitable shift in investment strategy that would be needed if no sale could be negotiated.*

The Director of Insurance sends a copy of his note to PIA and, on the last point, says that any information or advice that PIA could provide would be welcome.

11/12/2000 [16:00] FSA meet Counsel to discuss the meaning of Article 4 of Equitable's Articles of Association. FSA's note (which was subsequently approved by Counsel) records:

> *Counsel said that he had considered whether it was possible in law for a company to limit its liabilities to the amount of its assets. However, he had not found any authority*

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for saying that it was not possible so was advising on the basis that such provision would not be inherently illegal.

Counsel was of the view that there were three possible constructions to be placed on the example article (a relatively common provision in the articles of association of mutuals) which is reproduced in the insurance contracts.

The first meaning was that the company's liabilities were reduced to the amount of the available assets in the way mentioned in paragraph 3.8 of the instructions. If this was the correct interpretation then the [Policyholders Protection Act 1975] *compensation scheme could not apply as there would be no liabilities on which it could bite. The liability of the company was restricted to its assets so if the company was bankrupt there were no legal rights on which the policyholder could claim.*

The second meaning was the one put forward in the instructions, namely that the article dealt with the limitation of the liability of members and did not affect the liability of the company.

The third meaning depended on how "assets" should be construed: construing assets as gross assets rather than net assets.

Counsel advises that the first interpretation is '*alarming and novel*' and takes the view that a court would be unlikely to accept it.

FSA note:

<u>The Second Meaning</u>
Counsel advised that this interpretation made sense in its context. The section in which the article was located was headed "Members". It also made sense in the context of section 74 of the Insolvency Act 1986 which provides:

> *Nothing in the Companies Act or this Act invalidates any provision contained in any policy of insurance or other contract whereby the liability of individual members on the policy or contract is restricted, or whereby the funds of the company are alone made liable in respect of the policy or contract.*

Counsel, however, had a linguistic difficulty with this interpretation because the construction did not appear to give effect to the first three lines which clearly limited the liability of the Society, and not the liability of the Members.

<u>The Third Meaning</u>

Counsel stated that the article referred to "assets and property from time to time existing". It had been assumed that "assets" referred to net assets but it could reasonably be argued that the reference to "assets" here was a reference to "gross" assets. So in the case of a company having gross assets of £100 million and liabilities of £150 million the liability of the company would be restricted to the assets of £100 million.

In Counsel's view this interpretation made sense of the first three lines of the article and would probably not expunge any (or at least all) liability so as to present a problem with the Policyholders Protection Act.

Counsel said that the third meaning was his preferred construction. However, both the second and third meaning could be argued as alternatives so we were not driven to choosing between them. He could not say that the first meaning was not arguable on the wording but that he considered it the least likely construction.

11/12/2000 [16:26]	FSA's Managing Director's Office send senior officials some email enquiries about Equitable that had been sent to FSA's consumer helpline. The Managing Director's Office suggest that FSA should meet the following day to discuss how they were to co-ordinate formulating responses.
12/12/2000 [08:53]	Following a discussion the previous evening with Equitable's supervisors, FSA's press office and PIA, FSA decide to put together a series of questions and answers for consumers which would be posted on their website, used by their helpline, and printed for those who did not have access to the internet. FSA say that, in discussion with PIA, it had been suggested that FSA also needed to consider '*getting messages*' to Independent Financial Advisers as '*there are rich pickings to be had from Equitable policyholders with large funds in the run up to Christmas*'. FSA suggest that a PIA 'Regulatory Update' would be the most effective means to do this but that this would need to be put together '*very quickly and promoted widely*'.
12/12/2000 [09:10]	FSA's Director of Insurance writes to the Head of Life Insurance because '*In the rush last night I did not retain a copy of the briefing I gave to* [Managing Director A]'. The Director of Insurance sets out what he thought was agreed as being: *Q Availability of Compensation* *A The company remains solvent and the possibility of insolvency is remote. However the present compensation scheme, and its successor the Financial Services Compensation Scheme, are designed to provide protection in cases where such a situation does arise* *Q How much?* *A The immediate objective of the scheme would be to arrange for contracts to be transferred to another company to ensure continuity of cover or of payments as the case might be. Where this is not possible the schemes provide for compensation to be paid, generally of 90% of the guaranteed amounts.* [**10:45**] The Director of GCD notes for the record that FSA are able to give this briefing on the advice received from Counsel. He does, however, also note that FSA still needed to check the original purpose of Article 4 of Equitable's Articles of Association to ensure that that would not undermine FSA's position.
12/12/2000 [12:11]	FSA send PIA a copy of Equitable's latest guidance to their sales staff about the position following the House of Lords' judgment, which FSA had received earlier that week. FSA note '*this guidance does not appear to outline the consequences of there not being a sale – it seems to concentrate more on the distribution of windfall benefits*'.
12/12/2000 [12:53]	FSA's Head of Life Insurance prepares a possible FSA statement for policyholders which is to be discussed at a Chairman's Committee meeting that afternoon. The statement includes: *<u>Key Points</u>* *1. The Equitable is not bust. It remains solvent but is not accepting any new business.* *2. Don't panic. Consider your options carefully. But if you have bought a policy since 24th November you have until 22nd December to decide whether to exercise your right to cancel it.* *3. The Equitable's funds remain in place but the returns on with profits policies are likely to be lower because following closure to new business the company will need to make a gradual shift out of equities into lower risk investments.*

<u>Detail</u>
When a life fund closes to new business existing policies are still valid and the company continues to pay out benefits as they fall due. "Closure" just means that the company will not take on new customers. There is a margin of solvency above the level of assets needed to meet funds liabilities. In the case of Equitable, it has assets of some £34 billion to meet its liabilities, which are estimated on a cautious basis.

The Head of Life Insurance seeks comments on it, including from GAD.

[**13:00**] An official suggests that it would be helpful for him to set out to the Chairman's Committee the reasons for making such a statement.

[**13:35**] FSA's Head of Life Insurance writes to GAD's Directing Actuary B, saying: '*We spoke. We need to work up some more substantive material on the implications for the fund, and different categories of policyholder. But the immediate priority is to help policyholders*'.

[**14:03**] The Directing Actuary says that the '*Detail*' paragraph needs to refer to guaranteed liabilities '*since there is no provision in the balance sheet for potential final bonus (including amounts shown as allocated to policies but not guaranteed)*'.

[**14:41**] The Head of Life Insurance sends members of the Chairman's Committee a draft statement as a basis for discussion at a meeting that afternoon, explaining that: '*The background to this is that, despite the public statements so far made by both the Equitable and FSA, we are getting a clear message that policyholders and others feel that they do not have enough information. In the first instance it is for the Equitable to provide more detailed information; but it is consistent with FSA's statutory objectives to ourselves to remind policyholders of the main factors which they need to take into account, and to warn them of the importance of taking advice before acting*'.

After the statement is sent to members of the Chairman's Committee, [**14:59**] an IMRO manager suggests that a paragraph on unit trusts should be added following comment in the press that such investors should move their funds elsewhere.

The IMRO manager also says: '*This particular e-mail may not be the best forum for raising this particular issue, but one of my team members ... was contacted by a friend who has an Equitable personal pension plan and who is coming up for retirement in the next 6 months or so. He is quite concerned about the problems at Equitable and contacted 2* [Indepenadent Financial Advisers] *(as our proposed guidance also advises). It appears that he was informed by both that he should transfer out of the fund. It was also suggested by the* [Indepenadent Financial Advisers] *that policyholders with guaranteed annuities would be the first in the pecking order for payouts.* [The team member's] *information is not complete on this issue and she has spoken to* [two PIA officials] *on this and is trying to get further details of the matter and the* [Indepenadent Financial Advisers] *concerned. It looks like some badly informed/unscrupulous* [Indepenadent Financial Advisers] *may be trying to exploit the situation. Should we also not be doing a guidance for use by* [Indepenadent Financial Advisers] *about the sort of situations in which it would be unwise to advise a transfer?*'.

12/12/2000 [13:41] A member of FSA's Insurance Supervisory Committee sends Committee Members a paper on the impact of the merger of two large pharmaceutical companies on insurance companies who have, or would apply for, section 68 Orders on the admissibility limits of shareholdings. The Committee member notes that the merger was due to be sanctioned in the United Kingdom on 20 December, with share dealing commencing on 27 December 2000.

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The Committee member explains:

> *This clearly leaves us with a problem over existing Section 68 orders and year end positions. Existing concessions in respect of* [shares held for two companies] *will become void as the two companies will no longer exist, and to restore at least part of the position (any new concession can only offer 5% for the combined company rather than potentially 5% for each of the current two constituent parts) will require an amendment under S68(3) to add* [shares in the merged company]. *Even if there was sufficient cover in Treasury (and here) over the Xmas period to handle such amendments, there is realistically not enough time to receive and process requests within 2 working days.*
>
> *On anticipatory orders the* [Insurance Supervisory Committee], *at its meeting on 4 December, has already agreed that it would not recommend a S68 concession for the combined stock before the merger happens, but an application post-merger would not need to go back to the Committee. This leaves, I think, two options:*
>
> > *(a) We adopt a fairly hard-hearted, but consistent, approach which offers no company an anticipatory or amending order, which will leave all those with concessions at the moment of having to drop back to only being able to count 2.5% of the combined stock at the year end (this would also leave them in no different a position as companies holding no concession). Although not finalised, current responses from supervisors suggest 15 companies will be so affected. FTSE concessions have basically been sought for* [free assets ratio] *reasons, and so this approach ought not to raise solvency concerns - although an awkwardness, of course, is that all the concessions issued during the year for* [the two companies who are to merge] *will have been pointless.*
> >
> > *(b) We consider the option of offering, post-year end, a reporting concession. This would, of course, require overturning the now long-standing* [Insurance Supervisory Committee] *policy not to consider such requests. I think to follow this option would require some very compelling reasons, which I am not at all sure flow from* [this] *situation. It may also, unhelpfully, trigger other requests for FTSE concessions that did not quite get to us before the year end.*

The Committee member concludes:

> *Personally I favour option (a) as probably the fairest, if not the most popular, but no doubt others will have views. Obviously* [the Insurance Supervisory Committee] *need to consider and agree an approach, and despite being already over-burdened I suggest we add it to Monday's agenda.*

12/12/2000 [15:48] Equitable send FSA some generic advice for policyholders on whether or not they should continue to pay premiums. The advice states: '*You should be aware that the following sections contain information which may assist you in your decision as to whether to continue paying premiums. These are guidelines only – for advice regarding your individual circumstances you should refer to your financial adviser*'. For recurrent single premium contracts (which, at that time, formed approximately 70% of Equitable's business), the advice states:

> *Under these types of contract, the client can pay premiums of any amount and at any time.*
>
> *(i) With profits retirement annuities, with profits individual pension plans written before July 1988 (both types have GARs)*
>
> > *These policies have guaranteed annuity rates which provide a minimum income irrespective of prevailing annuity rates. In order to preserve those terms for future contributions, the terms of the policy require a payment to be made each year. For policies with a monthly premium there is an additional condition such that if a*

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premium is unpaid on the due date the policy will be made paid up and no future contributions would be allowed. The Society has not imposed these conditions to date, although they may be applied in the future. Consequently the general advice must be to continue making contributions. However it must be borne in mind that the more cautious investment approach, which the with profits fund will now follow, may lead to lower investment returns. In addition, the actual cost of the guaranteed annuity liability could be more or less depending upon a number of factors, most importantly future interest rates. If the final liability exceeds the current best estimate then policy values would be lower than would other wise be the case.

It may also be the case that these contracts have features that are not available under alternative arrangements (e.g. personal pension plan) due to changes in Inland Revenue practice e.g. the ability to accept greater contributions.

Transfers under such contracts are not guaranteed.

(ii) Personal Pension Plans/post July 1988 individual pension plans/Free Standing AVC plans/2000 Personal Pension Plan ...

(a) With profits

Pre July 1996 plans

Benefits purchased on a with-profits basis contain a guarantee such that each contribution (after a charge to cover expenses), receives a guaranteed rate of interest of 3½% per annum.

Post July 1996 plans

The guaranteed rate of interest is not included in these plans.

For all plans, you should bear in mind that, as a result of the need for the Society to make provision for the guaranteed annuity rates available under certain older pension contracts, the more cautious investment approach, which the with profits fund will now follow, may lead to lower investment returns. In addition, the actual cost of the guaranteed annuity liability could be more or less depending upon a number of factors, most importantly future interest rates. If the final liability exceeds the current best estimate then policy values would be lower than would otherwise be the case.

Transfers of all with-profit benefits are not guaranteed.

FSA's Line Manager E provides some comments about the format of the headings and the method of distribution. The Line Manager also suggests that they should amend the explanation in relation to GARs, so that it is easier to understand.

Equitable write to FSA with details of the very limited circumstances where they feel they should continue to write new business. Equitable also enclose a further copy of their advice to policyholders on whether or not to continue to pay premiums.

12/12/2000 [17:51] FSA's Consumer Relations Department inform the Director of Insurance that the OFT had telephoned asking for help from FSA on complaints that they had received about Equitable's application of a market value adjuster. FSA note that their contact is timely, in view of an FSA Director's Committee meeting the following day at which a paper on FSA taking on unfair contract terms powers was to be discussed.

12/12/2000 [18:00] FSA send Equitable's solicitors a copy of their instructions to Counsel and a note of the subsequent conference.

12/12/2000 [entry 9] The OFT write to FSA, explaining:

> *We are considering whether we need to take enforcement action in relation to reports that Equitable Life has imposed a new charge of 10% on transfers of assets out of the Society. We are beginning to receive complaints and enquiries about this charge. The relevant terms and conditions could be unfair if they give the Society discretion to make new charges or to vary existing ones.*
>
> *The Director General of Fair Trading has powers to prevent the use of unfair terms, by seeking an injunction in the High Court. The Office is prepared to move swiftly on the matter to protect the interests of consumers. However, we know insufficient about the basis on which Equitable is making the charge to justify formal action at this stage.*
>
> *Whatever light you can throw on the question would therefore be most welcome.*

12/12/2000 [entry 10] In advance of a meeting that afternoon, the Director of GCD provides FSA's Chairman with a note of legal issues in relation to Equitable. These issues include:

- *confirmation by Counsel that compensation would be available, subject to checking original purpose of Equitable's article 4;*
- *transferability to new providers: Inland Revenue difficulties likely to be surmountable by extra statutory concession;*
- *validity of "market value adjuster" may need to be considered to ensure used for proper purpose and not invalid as an unfair contract term;*
- *scope for closing down rights to take out additional guaranteed policy: advice that this cannot generally be done: possibility in some special cases (eg where new staff members join a pension scheme) to be explored;*
- *scope for action by way of redress or discipline for misselling: note by* [Chief Counsel B] *attached;*
- *risk that Equitable's subordinated loans could be triggered by decision to close the doors to new business.*

Attached to the note are briefing notes on various types of inquiry that might be commissioned to review the role of the regulators and on the options for seeking redress for mis-selling.

13/12/2000 [entry 1] The German regulatory authority writes to FSA, further to FSA's letter of 07/08/2000.

13/12/2000 [entry 2] FSA prepare a paper for their Insurance Supervisory Committee advising that the Committee should recommend to HMT that they agree Equitable's requested section 68 Order to raise the limit on the admissibility of shareholdings in certain companies.

FSA's analysis notes that Equitable's request '*follows the pattern of many other requests for this concession from companies based on the argument that adequate market weightings of certain equities can not be held (as admissible) because of the AVR restrictions*'.

13/12/2000 [09:46] PIA thank FSA for the information sent the previous day. PIA suggest that both regulators meet the following day to discuss their '*information wish lists*' and to see what of the information they already had could be shared.

[**10:12**] FSA's Line Manager E says that it would be useful to meet '*not least so that we can prioritise and coordinate what we are doing*'. The Line Manager explains to PIA that:

2000

Equitable currently have a number of things to deal with and we must be careful not to distract them too much from dealing with priority matters, such as getting information to policyholders and looking after the funds.

I do not wish to imply that reviews, enforcement, redress etc are not important but we have to be realistic about what the company can do at any one time. I think in terms of [conduct of business] *issues, our senior management will consider looking into sales post 20 July as the absolute priority. But we also need to ensure that we prioritise information requests. We have asked the company to establish a working level contact (I will act in that capacity here) through whom we will channel requests.*

13/12/2000 [10:05] FSA's Head of Press Office provides Managing Director A, the Director of Insurance and the Head of Life Insurance with a summary of press coverage about Equitable, under the heading '*Today's pasting and strategy going forward*'.

The Head of Press Office says that, when asked about wider systemic issues in relation to annuity guarantees, FSA have said that '*the other 50* [companies] *writing GARs have been able to take the hit*'. The head of Press Office asks the Director of Insurance for his views on this.

Under '*Strategy*', the head of Press Office says: '*The sooner we can say something one way or another about an inquiry the better. Otherwise things will carry on in dribs and drabs with no real prospect of our being able to draw a line under things or put up a case that knocks them down. The reserving point issue is a classic example. Our line so far has been "too early to talk about it at this stage", but clearly the pressure will intensify. It will also allow us to stop being drawn into "on the hoof defensive mode" on things to which we don't have the full answers*'.

[**10:31**] The Head of Life Insurance replies:

Our line on the other 50 or so companies which wrote GAR policies is that the Equitable's position is different because of a unique combination of circumstances which do not apply more generally. In particular:

- *it does not have an estate of surplus assets;*
- *the terms of its guarantees were unusually generous;*
- *pensions are a major element of its business.*

[**11:02**] FSA forward the summary of the press coverage to GAD and say that it would be helpful for them to put together a factual account of the position that FSA have taken on Equitable's reserving for annuity guarantees. FSA suggest that this might set out:

- *when and how we became aware of the extent of the problem from the industry review conducted in early 98;*
- *the reserving standards that we insisted on and the Equitable's reluctance to accept these;*
- *the particular arrangements which Equitable adopted to address the problem, including in the reinsurance cover and the implicit item;*
- *our view of these both at the time and now. (I think we need to be clearer than we have been able to be so far about the extent to which the reinsurance arrangement provided genuine protection, at least against the circumstances then envisaged);* [and]
- *our view on the Equitable's position now, both in steady state, and faced with significant lapses. In particular any assessment on the extent and the timing of the necessary rebalancing towards fixed interest securities would be very helpful.*

[**13:08**] GAD say that they would give priority to producing the factual account requested. GAD also say that, subject to FSA's agreement, a GAD staff member would be situated permanently at FSA during the Equitable crisis, and that Directing Actuary B would be that person in the run-up to Christmas.

[**14:03**] GAD provide FSA with a seven-page draft document entitled '*Equitable Life Assurance Society: timetable of GAD involvement since 1996*'.

[**15:00**] FSA's Director of Insurance circulates a copy of GAD's chronology.

13/12/2000 [10:51] FSA's Line Manager E circulates the OFT's letter of 12/12/2000 and asks if others have any views on whether Equitable's practice might be in breach of the Unfair Terms in Consumer Contracts Regulations 1999. The Line Manager says: '*The approach is a fairly standard one adopted in the industry for transfer values, even if it* [is] *usually not made quite so explicit*'.

13/12/2000 [12:29] HMT prepare a response to a tabled question in the House of Lords, which asked whether FSA had taken adequate action to safeguard the interests of Equitable's policyholders. HMT send FSA a copy of the reply, saying that it had only been finalised late the previous night and had been revised by special advisers. However, HMT hoped that it was acceptable to FSA and '*there is nothing nasty in it*'.

The text of the suggested answer was: '*The FSA is working with The Equitable Life Assurance Society to look after the interests of its policyholders*'.

The following drafting is recorded on the answer as having been removed:

> *The Equitable Life is seeking to act prudently in closing to new business in order to allow the best opportunity to stabilise the business in the interests of existing policyholders. The FSA will maintain a watching brief and will not hesitate to step in if necessary.*

In their background note to the proposed answer, HMT write:

> *The Society's difficulties stem from with profit guaranteed annuity rate policies (GARs) which it wrote up until the late 1980s. These pension policies gave policyholders the contractual right to an annuity at a specific percentage rate when the policyholder retired, which although appropriate for the time in which the policies were offered, can be seen in today's low inflation environment as generous.*
>
> *During the 1990s, when interest rates fell, the GARs began to exceed current annuity rates. Reserving standards were increased to reflect the revised expectations of investment performance in a low inflation environment, but it became apparent to the Society that the increased costs of reserving for these increased GAR benefits would add a significant financial burden on the company, with one set of members getting a larger slice of the assets of the mutual than another.*

The note continues:

> *The Directors of the Society took the view that it would be inappropriate for one set of members to disproportionately benefit in this way and they put in place a bonus policy that differentiated between GAR and non-GAR policyholders on maturity of the investment.*
>
> *This policy caused resentment amongst some GAR policyholders who felt that they were being deprived of their full entitlement. The Equitable responded by funding a representative action in Court to decide the issue.*

After setting out the result of the litigation up to the House of Lords' judgment, the background note concludes:

> *The result of the judgment meant that, although the solvency of the Equitable was unaffected, the cost of the GAR liability would curtail its investment freedom and so a decision was made by the Board that it would be in the best interests of policyholders to*

seek a buyer for the Society. When this option failed to materialise, the Society took the decision to close to new business in order to concentrate on safeguarding the interests of its existing policyholders.

HMT then set out possible supplementary questions and suggested replies. In response to the question: '*Why didn't the FSA require the Equitable to honour its guarantees and to hold adequate reserves against them in the first place?*', HMT state:

> *The Society was fully reserved for all of the guarantees it made based on its differential bonus policy. Prior to the House of Lords' judgment this was deemed to be in line with the then understanding of the law where it could be justified.*

In response to the question: '*Has there been a failure of regulation in allowing this to happen?*', HMT say:

> *It is not possible for regulation to remove all risk and possible failure from the financial system. FSA as regulator takes a risk-based approach, operating its regulatory techniques in partnership with the proper responsibilities of consumers themselves and with firms' own management to realise realistic aims and performance.*

In answer to the question: '*What is the point of regulation if it does not prevent this sort of problem occurring?*', HMT explain:

> *The regulations have ensured that the Society has maintained a strong reserving basis. It is because of this that the Society should be able to enter a period of solvent run-off and meet its liabilities as they fall due.*

In answer to the question: '*Why didn't the FSA take action sooner – how could they allow the Equitable to keep taking new business?*', HMT say:

> *The Company remained solvent and able to meet its obligations. Although the long-term investment freedom was curtailed by the judgment, there was a realistic prospect of a sale which would have brought a new injection of funds to safeguard the long term interests of policyholders. The prospect of a sale seemed likely until recently, so the decision was taken to allow the Company to seek a buyer.*

In response to the question: '*What about policyholders reasonable expectations (PRE) and bonuses?*', HMT explain:

> *PRE cannot be precisely defined.*
>
> *The company has long maintained a policy of paying out bonuses as fully as possible to policyholders and not holding back reserves well in excess of those needed to match liabilities. This means that the company did not have the resources needed to fund the large unexpected costs that stemmed from the Judgment.*
>
> *The Equitable must now seek a more prudent investment strategy in order to provide greater security for its policyholders. PRE and bonus performance is never guaranteed, being based on the performance of the company during the term of the policy. It is likely that bonus levels will be reduced, but this is both a symptom of the weaker fund and also of the low interest rate environment. Bonus rates are reducing across the industry.*

13/12/2000 [13:19] The then Department of Social Security ask FSA for information in order to brief their Secretary of State, including: general briefing on Equitable; the number of policyholders affected; details of any occupational pension and AVC schemes run by Equitable; and any information on likely policyholder losses. FSA record that they supplied a copy of their press office briefing.

13/12/2000 [15:34] GAD's Chief Actuary C provides FSA with an explanation of Equitable's reinsurance arrangement. The Chief Actuary explains:

> *The following is, hopefully, a simple explanation of the Equitable reinsurance arrangement. Any explanation needs to be prefaced by some background on the reserving requirements.*
>
> *Insurance companies are required to set aside reserves sufficient to cover their liabilities based upon prudent assumptions. Where a company has GAR liabilities, a prudent assumption would be that policyholders would be expected to exercise their GAR option if it is likely to be the most expensive option for the insurer. In practice, policyholders may choose to take a less financially attractive option for personal reasons, for example to take a tax free lump sum rather than the guaranteed pension.*
>
> *A reinsurer takes a commercial view of the situation reflecting, for example, the fact that policyholders might prefer to receive lump sum and take a reduced pension or to take their pension in a more convenient form than that offered under the GAR. The reinsurance is an effective and legitimate way of taking liabilities off the balance sheet of the Equitable by transferring the top slice of the liability on GARs to the reinsurer. In other words, the Equitable ends up setting up a liability on its balance sheet calculated on the commercial basis (reflecting a GAR take-up rate of 60% in the Equitable case) and the reinsurer bears the risk and cost if more than 60% of policyholders take the GAR.*
>
> *The initial reinsurance treaty entered into by the Equitable was based on a 25% take-up rate but was made conditional on the Equitable being able to continue to operate its then bonus policy. The 25% rate reflected the low take-up rate then being experienced by the Equitable as a consequence of that bonus policy.*

[**15:48**] FSA's Director of Insurance thanks him for the '*very helpful*' explanation, suggests that the Head of FSA's Press Office pursue directly with the Chief Actuary any follow-up questions he might have and asks that they put together something similar on the section 68 Orders for future profits implicit items which had been granted to Equitable.

The Director of Insurance says: '*The point again, I think, that this is a relatively routine arrangement, for which provision is made in the European legislation, which recognises that profits on in force business, prudently calculated, represent an asset for which credit can be taken. There was nothing novel or unusual in the* [Equitable] *case which would have made it inappropriate to allow this*'.

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

[**16:29**] GAD's Chief Actuary C says:

> *There appears to be little more that we can add to our explanation of the treaty.*
>
> *GAD and FSA reviewed the treaty and were eventually satisfied that it was reasonable for the actuary to take credit for the cover provided by the reinsurer. We were aware of the cancellation clause that gave the reinsurer the right to cancel the treaty. We pointed out to the company that professional actuarial guidance to the Appointed Actuary required him to consider whether he should make any additional provision for the contingency that the reinsurance might cease. At the time the company were confident that they would win their Court case and believed that they need make no provision for the risk. This subsequently proved to be a false expectation and they renegotiated the treaty. The revised treaty is satisfactory.*

Placing a value on future profits (the implicit item) is permitted by the EC directives and UK legislation. Equitable have been granted an order which allows it to count this item for at least four years. The amount that the Equitable value is determined strictly in accordance with the legislation. A number of other insurance companies place a value on future profits in their statutory returns that demonstrate solvency and the Equitable were treated consistently with those insurers. Those returns show the amount of future profits in a clear manner.

13/12/2000 [15:52] FSA's Director of Insurance asks Legal Adviser A for some brief and simple guidance on FSA's 'fit and proper' powers, as FSA's Press Office were coming under some pressure from the Press on the standing of Equitable's Board members.

[**15:56**] The Head of Press Office explains that: '*It also needs to cover any obligations the directors have in relation to the selling of products – so, in other words, what could we "get them" for under the FS Act 86 and/or the Insurance Companies Act*'.

[**17:13**] Legal Adviser A explains that most breaches of ICA 1982 were criminal by virtue of section 71: '*So if a breach has been proved, then prosecution possible but Secretary of State/Treasury consent required i.e. not contracted out to FSA*'. The Legal Adviser says:

> *What follows is largely theoretical in this case*
>
> *The powers under the ICA are aimed at companies not directors. So if a director is not fit and proper to hold the position, proceedings would be taken under section 11 to withdraw authorisation of the company to effect contracts of insurance. Technically the grounds are a combination of 11(1)(b) (there exists a ground on which* [The Treasury] *would be prohibited from issuing an authorisation) and section 7(3) which says an authorisation cannot be granted if any director is not fit and proper. Alternative ground is that the criteria of sound and prudent management is not/may not/will not be fulfilled. The criteria of sound and prudent management also require directors* [to] *be fit and proper.*
>
> *Obviously, a company normally will sack its director if it is likely to have its authorisation withdrawn but it is not much of a threat if the company is not effecting any new contracts anyway.*
>
> *Conceivably we could direct a company under section 45 to remove a director for the purposes of ensuring the criteria of sound and prudent management be fulfilled but that is uncharted territory.*
>
> *There are powers under section 54 of the Act to present a petition to wind up in the public interest which could possibly be used in the case of a board of dishonest/incompetent directors.*

[**18:01**] Chief Counsel B advises on the relevant conduct of business powers, saying: '*There is a power in section 59* [of the FS Act] *1986 to prohibit individuals from being employed in connection with investment business if it appears that an individual is not fit and proper. This is a high hurdle and has been used very infrequently – I doubt whether it would be applicable here*'.

13/12/2000 [16:13] FSA's Legal Adviser A sends the Director of GCD a draft note of his meeting with Counsel on 11/12/2000 [**16:00**]. The Legal Adviser says that, while the note had not yet been formally approved by Counsel, it had been discussed with his junior and Legal Adviser A did not anticipate any material changes. The Legal Adviser highlights that the view that Article 4 reduces Equitable's liabilities to the amount of their available assets, while not unarguable, was the one least likely to find favour with the courts. The Legal Adviser notes that the other two meanings discussed '*will not have the effect of expunging the liability of the Society such as to cause difficulties under the* [Policyholders Protection Act 1975] *and compensation scheme under* [FSMA 2000]'.

[**16:56**] The Director of GCD says: '*I am happy to follow this advice, but am not really convinced by it – hopefully the full Opinion will be more convincing*'.

[**19:12**] Chief Counsel A adds that FSA might also receive a '*sanity check*', via work being undertaken by Equitable's solicitors.

13/12/2000 [16:30] HMT and FSA hold their eighth quarterly meeting on insurance regulation issues. HMT give an outline of the discussion following the answer given to a parliamentary question that had just taken place in the House of Lords.

FSA's Director of Insurance explains that it is hoped that the advice posted on their website would prove useful in providing policyholders with guidance and reassurance.

In response to HMT asking if there were to be an internal FSA inquiry, the Director states that: '*a paper was being prepared to be put before the FSA Board on options available for the company, and whether there are any lessons to be learned in hindsight, but that any decision-making that would have contributed to the problems of the Equitable would have been the responsibility of DTI and pre-*[Securities and Investments Board]'.

HMT's note then records:

> *Discussion turned to questions about the events leading to the closure of Equitable; why the company and the FSA did not realise sooner the potential problems caused by the uncapped liability of GAR options, and why a sale could not be arranged. Turning to the sale first,* [the Director of Insurance] *explained that there had been three heavyweight bidders at the outset, but* [Prospective Bidder A] *was the most realistic and likely option. However, discussions about ring-fencing the GAR liability by buying out the options would have cost* [Prospective Bidder A] *over £1bn and the company could not afford to do this in addition to the launch of stakeholder funding.* [The Director of Insurance] *then explained that neither the Equitable nor the FSA realised the extent of the GAR liability. The company had thought the liability capped, and the FSA had not appreciated the scale of the problem ...* [The Director of Insurance] *assured* [HMT's Head of Home Financial Services] *that this has served as a "wake-up call" for the FSA and the industry to review their structure and their strategies.*
>
> *Broadening the discussion,* [HMT's Head of Home Financial Services] *asked about whether the* [Policyholders Protection Act 1975] *would be effective.* [FSA's Head of Life Insurance] *explained that the company was not insolvent and so policyholders would not be eligible for the scheme.*
>
> [HMT's Head of Home Financial Services] *mentioned that there may be allegations of mis-selling following the House of Lords' Judgement.* [FSA's Head of Life Insurance] *explained that although the script provided to the salesforce did not deal with the problems, it would have been unreasonable to stop the company from continuing as a going-concern while a sale was anticipated.*

13/12/2000 [16:42] FSA send Equitable a '*PIA wish list*' ahead of their meeting the following day. The list sets out a number of questions, including how Equitable were dealing with telephone enquiries, what new business activities had ceased and how Equitable were dealing with requests for the transfer of funds to other providers and for switches of funds to unit-linked policies.

13/12/2000 [19:41] FSA's Director of GCD says to the Head of Press Office that, while he had not seen the note prepared by FSA on whether they could require Equitable directors '*to go*':

... I should have thought the press line should be "If a director were not fit and proper to be involved in [investment business] *we have powers to ban him. If a director loses the confidence of those to whom he is accountable, they have their own remedies."*

13/12/2000 [21:43] FSA's Chief Counsel A reports that she had had a very long conversation with Equitable's solicitors that evening, which had mostly concerned the compensation scheme but also GAR top up rights.

Chief Counsel A records: '*He explained the Equitable's policy wording which led in his view pretty inexorably to the conclusion that the company can stop top-ups extending to GARs only where a policyholder has missed a top up and so given up the right to top-ups in future. The policies make clear that the company can exercise its discretion nevertheless to allow top-ups in future, but can exercise this discretion on the basis that top-ups will not extend to GARs. The Equitable proposes to notify policyholders that in future it will exercise its discretion in this way. That should mean that the only argument which might be raised against this is one of estoppel (due to the Equitable's history of exercising its discretion so as to allow top-ups to extend to GARs)*'.

The Chief Counsel concludes that Equitable's solicitors' reasoning seemed persuasive and seeks the view of other FSA lawyers.

13/12/2000 [20:00] In response to Line Manager E circulating the OFT's letter that morning [**10:51**], Chief Counsel A says that Legal Adviser A would have to take forward the legal work, but notes that the Director of Insurance had agreed at an update meeting that morning that FSA would need to do some further work on this issue.

13/12/2000 [entry 16] The Consumers' Association write to FSA, asking whether FSA were planning to hold an inquiry into what had happened to Equitable. The Consumers' Association raise a number of detailed questions about the actions of Equitable, including: why they had not adopted an incremental approach to managing their exposure to guaranteed annuities; why a sale had not happened and whether Equitable were unwilling to accept an offer; whether FSA could have influenced Equitable to accept a deal in the consumer interest; and whether there had been any attempt to put together an industry rescue. The Consumers' Association ask if FSA would be updating their advice to consumers and the industry on guaranteed annuities. The Association explain that there was a real fear that Equitable would increase the size of their market value adjustment to dissuade policyholders from taking their funds elsewhere.

14/12/2000 [entry 1] Equitable notify FSA that their Chief Executive had resigned on 7 December 2000 and that they proposed to appoint their current Appointed Actuary as Chief Executive.

14/12/2000 [entry 2] An official sends an FSA Director a note for a Heads of Department briefing meeting, arranged for the following day. Under '*Other Issues*' and '*Equitable Life*', the note reads:

Invite [FSA's Head of Life Insurance] *or* [the Director of Insurance] *(depending on which of them is there) to talk about the situation and FSA's stance*

Invite [FSA's Director of Consumer Relations] *(who is a trustee) to talk about the implications for the FSA Pension Scheme.*

14/12/2000 [entry 3] FSA provide a statement for BBC *Watchdog*. FSA say that they had always acted in what they had considered were the best interests of policyholders since they had taken over prudential regulation in January 1999. FSA explain that Equitable were a '*special case*', being a mutual with no inherited estate and a higher proportion of guaranteed annuity business than other insurers, with Equitable also offering more generous and flexible benefits than was usual. FSA say that their current priorities were to do all they could to protect policyholders' interests by ensuring Equitable provided relevant information to those policyholders as quickly as possible. FSA state:

> *Equitable Life has closed to new business, but continues to run its business for existing policyholders. Equitable remains solvent – it has enough assets to meet its projected future pay-outs, even after allowing a cushion for likely market movements.*

FSA say that they were warning Independent Financial Advisers that FSA would be protecting policyholders by monitoring any advice provided and that FSA would highlight to policyholders that: '*It is essential that no adviser seeks to take advantage of your situation by panicking you into unwise decisions*'.

On compensation schemes, FSA state: '*As the Equitable remains solvent, the need for any back-stop arrangements in the event of insolvency are remote. However, should the need ever arise, there is a scheme designed to provide compensation. The immediate objective of the scheme would be to arrange for your contract to be transferred to another provider to ensure continuity of cover – or pay-out – as the case may be. If that were not possible, the scheme provides for you to be paid compensation, generally of 90% of the guaranteed amount, up to an unlimited amount for pensions and life insurance*'.

14/12/2000 [09:53] FSA's Public Affairs and Accountability Department send Line Manager E the transcript of an answer in the House of Lords about Equitable from the previous day.

[**10:19**] Line Manager E comments that the response did not look too bad '*– it balances reassurance and realism*'.

14/12/2000 [10:34] FSA ask GAD for comments on a note for use in dealing with policyholder queries about the market value adjuster. FSA explain that, before it is used, they also want to send the note to Equitable for their comments.

[**11:53**] GAD suggest some amendments.

14/12/2000 [10:36] GAD's Chief Actuary C forwards the discussion on Equitable's reinsurance treaty (see 13/12/2000 [**15:34**]) to Directing Actuary B.

[**12:10**] The Directing Actuary replies (copied to FSA):

> *Our understanding from the meeting with* [Equitable's Appointed Actuary] *is that the reinsurance cover should remain in place even after the society closes to new business. If the reinsurer is now seeking to terminate this agreement, then I would expect the Equitable to challenge this (possibly even in Court), but FSA might wish to verify developments on this front with the society in due course.*
>
> *For the implicit item on future profits, there is also the 1984 DTI Guidance Note which we believe to have been followed by Equitable. Incidentally, we could add that they should only need to earn an additional investment return of around 1% per annum in excess of the valuation rate of interest on with profit funds (ie probably around 4.5% p.a. in total) in order to justify the present £900 million implicit item.*

14/12/2000 [c12:00] FSA post information on their website for Equitable policyholders. In relation to their role, FSA explain:

The FSA is:

- *monitoring the Equitable's position closely;*
- *making sure that policyholders are given timely and comprehensive information so that they can consider their options fully;*
- *requiring the Equitable to have effective arrangements for dealing with any complaints they receive; and*
- *the Equitable has, with the encouragement of the FSA, established a process for helping policyholders to decide whether they should take any immediate action.*

Since current Equitable policyholders may be asking other firms for advice, the regulators will shortly be reminding all firms of their obligations to give suitable advice, taking properly into account the personal circumstances and aspirations of their customers.

14/12/2000 [14:36] GAD's Directing Actuary B comments to Chief Actuary C and FSA's Director of Insurance (in reply to 13/12/2000 [**13:08**]), on the issue of Equitable's asset mix, that:

If they are seeking to ensure to a high degree of probability that all guaranteed benefits can be met in full, and are no longer willing to incur additional investment risk to be spread across all with-profit policyholders, then I would expect to see them switch progressively towards a portfolio where some 80-90% of their with-profit liabilities are covered by fixed interest securities of appropriately matched duration. This will though of course lock them into some fairly low bonus declarations in future years.

The Directing Actuary also says that he had seen '*a reference recently to their Deed of Settlement which apparently contains a provision that allows a rateable reduction of benefits in the event of the society incurring any unexpected losses. It would be interesting to know more about this provision*'.

14/12/2000 [16:22] FSA's Line Manager E advises the Head of Life Insurance and the Director of Insurance that Prospective Bidder B have indicated that they might still wish to make a bid for Equitable. The Line Manager explains that Equitable were unaware of this.

[**16:50**] Managing Director A suggests that this was potentially good news and that FSA should consider how the different types of policyholder would be treated by such a proposal.

14/12/2000 [16:38] FSA's Chief Counsel B sends Managing Director A, the Director of Insurance and the Head of Life Insurance a copy of advice that he had given to PIA, concerning advice given by trustees of group schemes in response to a query from the National Association of Pension Funds.

14/12/2000 [before 18:51] FSA and PIA meet Equitable. Equitable agree to provide FSA with regular updates on the service provided to policyholders (numbers of telephone calls answered, access to advice and requests for transfers and surrenders).

[**18:51**] Following the meeting, Equitable provide FSA with copies of information Equitable had provided to policyholders on their closure to new business.

14/12/2000 [18:08] FSA's Managing Director A sends the Chairman and two Directors a draft paper for FSA's Board which seeks to: bring the Board up to date with events; identify the work currently in hand; note the main issues to be resolved; and set out the options for review of what had happened and how best FSA might identify lessons for the future.

14/12/2000 [18:11]	GAD advise FSA that a particular condition of the subordinated loan might be interpreted to mean that loan holders could require full repayment plus interest if Equitable ceased to write new business and could petition for winding up if this were not paid. GAD say: '*While they clearly have the resources to make this payment (the usual concern of banking regulators) this would almost certainly mean that they would be unable to meet the full resilience test that we would normally require in the FSA returns. However, they should still be solvent at the present time in Company Act terms*'.
14/12/2000 [18:18]	GAD send FSA a copy of Equitable's leaflet setting out their approach to transfers, which they had initially provided on 14/12/1995. GAD say that they expected that Equitable were applying the same principles now, with one exception. GAD suggest that Equitable's statement in the leaflet: *The financial adjustment is not a "penalty" in the normal sense of the word. The current value based on the value of the underlying assets is being paid, and there is no attempt at recouping initial acquisition expenses that have not as yet been met.* might no longer be relevant for a closed fund '*where all expenses do have to be recovered from existing policyholders, and also the GAO cost has to be taken into account*'.
14/12/2000 [18:46]	FSA's Head of Life Insurance provides Managing Director A with a note for use by FSA's helpdesk and correspondence units, explaining Equitable's announcement that they are increasing the '*exit charge*' (i.e. the market value adjuster) for policyholders surrendering a with-profits policy, from 5% to 10%. In the note, FSA accept that, in current market conditions, this charge was not excessive. FSA say they '*will continue to monitor the Equitable's practice*' and explain that they '*have the powers to intervene at any time, if we consider the figure to be excessive*'. FSA's note also draws policyholders' attention to the fact that: *... there may be one or more points in your policy, such as contractual review dates, when a withdrawal can be made without such a deduction. You can check this in your contract and if in doubt refer to the Equitable.* and that policyholders: *... should consider very carefully the implications before deciding to make a withdrawal. This is explained in more detail in our information material available on the* [FSA's] *website or on request.* The note reflects comments by GAD and Equitable. An earlier version included the statement that Equitable would consult FSA if they needed to raise the rate further. This was removed at the request of Equitable. The Head of Life Insurance comments: *We could take up* [this point] *with* [Equitable]. *But it is not vital, and in the interests of speed I recommend you approve this version for use by helpdesk and correspondence units. Any improvements can be incorporated in a Mark II version later.*
14/12/2000 [entry 16]	FSA attend a meeting of the Tripartite Standing Committee. FSA report to HMT and the Bank of England on developments since the last meeting on 06/12/2000. HMT ask FSA to produce a paper for the next meeting of the Committee in January 2001, which would set out the issues and priorities arising from the Equitable case.

15/12/2000 [08:10]	FSA's Managing Director A agrees with the Head of Life Insurance's recommendation to approve the note on Equitable's use of a market value adjuster (see 14/12/2000 [**18:46**]), but warns that he would leave Equitable in no doubt that if they raised their rates again without consulting FSA this would be '*at their peril*'.
15/12/2000 [10:21]	HMT ask FSA for help with a response to a Parliamentary question, which asked the Chancellor of the Exchequer to make a statement on the performance of FSA in regulating the insurance sector, with particular reference to Equitable.
15/12/2000 [13:32]	Equitable's solicitors respond to the note of FSA's conference with Counsel, sent to them on 12/12/2000 [**18:00**]. The solicitors say that they were due to speak with Equitable about this on 18 December 2000 and could not really say much before then. The solicitors do, however, confirm, as had already been indicated to FSA on 13 December 2000, that: '*I find it difficult to square* [Counsel's] *"Second Meaning" with the express wording of Regulation 4. Also I cannot follow the logic of the "Third Meaning", on which his conclusion relies*'.
15/12/2000 [17:23]	Equitable provide FSA with details of calls to Equitable's helpline over the last three days and the value of transfers, surrenders and switches on the previous day. This did not include information about contact with branch offices. Equitable also provide policyholder and membership data as follows: *i.* *Number of individual policyholders (includes members of 2400* [group pension plan policies]*)* — *700,000* *ii.* *Number of Group Schemes (excluding* [group pension plan policies]*; including AVC)* — *6,000* *iii.* *Number of members within group schemes (remember that our contract is with the Trustees, not the members)* — *760,000* *iv.* *Membership of the Society* — *528,000*
15/12/2000 [18:51]	Equitable write to FSA about the '*exit charge*'. Equitable say that the fact that the full value was not guaranteed had been built into the terms of each contract. Equitable explain that they would provide a copy of the relevant extract from the policy booklet, with other information on '*the MVA justification*' that they were preparing for FSA.
15/12/2000 [19:06]	FSA's Director of Insurance provides FSA's Head of Consumer Education with a note, setting out an explanation of the figure of £1.5bn given for Equitable's reserve for annuity guarantees. The Director of Insurance says that, in their 1998 and 1999 returns, Equitable had set up provision of the order of £1.5bn '*at our insistence*'. The Director explains that this sum had been calculated on an extremely prudent view of the percentage of policyholders who would choose the guaranteed annuity option, as '*statutory reserving requires a worst case assumption about liabilities*'. The Director of Insurance notes that, in their 1998 Companies Act accounts, Equitable had showed a provision of £50m. (Note: Equitable had in fact made a provision of £200m.) The Director of Insurance explains that such accounts were prepared on a '*"true and fair" (ie realistic) basis*' and so the '*extreme prudence*' in the returns was not required. He explains that Equitable's figure of £50m – which had been accepted as reasonable by their auditors – was their best estimate, based on their experience to date and on their advice about the probability of success in the court proceedings. The Director of Insurance notes that take-up of GAOs had been relatively light and that this was:

... not surprising since bonuses of those doing so were reduced to fund the GAR cost so that there was no advantage in doing so, and in many cases some disadvantage.

The Director of Insurance explains that, after success in the High Court and an adverse, but not particularly damaging, decision in the Court of Appeal, the House of Lords' ruling '*was devastating and entirely overturned the assumptions underlying the Companies Act figure*'. In addition, the ruling had meant that more policyholders would probably exercise their rights to take guaranteed annuities and invest more funds in the '*in the money*' options.

The Director of Insurance notes that there would be additional costs in identifying policyholders who had chosen not to exercise the right to a guaranteed annuity because their bonus had been cut, and in compensating them.

The Director of Insurance explains that:

The Equitable estimated that the effect of the [House of Lords] *judgment would cost them a* <u>*further*</u> [£]*1.5bn. They met this by cutting bonuses. But to remain commercially viable they needed to find additional capital to reverse this and to maintain bonuses at competitive rates going forward. Hence the search for a purchaser*.

The Director adds that, during negotiations with prospective purchasers:

... things got still worse. Equity markets fell and their solvency cover (in worst case statutory terms) became very thin. This made them even more vulnerable to fluctuations in the equity market which could leave their statutory capital requirement uncovered. This in turn meant that they would need to move progressively out of equities and into gilts (which would both reduce their exposure to volatility in their asset values and also – because of the way in which the liability valuation rules work – reduce the value of their liabilities). But this would also reduce probable investment returns to policyholders (probable because a stock market crash could in theory wipe out the investment advantage in equity holdings). This reduced return made it commercially impossible for them to remain in business.

The Director of Insurance explains that, in addition, Equitable's '*very thin capital cover*' meant they did not have the working capital to continue, or the capacity to finance '*new business strain*' (i.e. the difference between the amount that has to be reserved when a new policy is put on the books and the income received, which in the initial stages is generally negative).

The Director of Insurance expresses the hope that his analysis is helpful, although he suspects '*it will give actuarial colleagues a fit*'. He copies his email to GAD and invites them to correct any errors.

15/12/2000 [entry 7] PIA issue a '*Regulatory Update*' on Equitable to remind financial advisers of the need to follow the standards that were expected by PIA, when advising customers in the wake of Equitable's closure to new business.

15/12/2000 [entry 8] PIA write to FSA about the implications of Equitable's problems for the pensions review. PIA note that policyholders may not want any redress they received as a result of the review to be paid into their existing with-profits policy.

PIA explain that they are minded to encourage Equitable to allow policyholders to apply the redress to a fund other than the with-profits fund, or to the fund of a new provider. PIA ask if FSA see any difficulties with this approach.

PIA explain that, under their guidance, redress could be calculated in one of two ways, either: '*The amount available for transfer to another contract*'; or: '*Where this amount does not reflect the ongoing value of the contract, an adjusted amount which takes account of the* [Securities and Investments Board's] *assumptions as to future interest rates*'.

PIA say that Equitable were considering switching from one approach to the other, and say that this could significantly increase Equitable's costs and therefore their required reserves. PIA also explain that, under Equitable's new approach, the redress is increased to reflect the transfer penalty and thus more policyholders might be encouraged to transfer out.

15/12/2000 [entry 9] FSA issue a statement in '*rebuttal*' of an article in a national newspaper criticising their actions over Equitable. FSA do not accept that: '*rivals pressed regulators to do something about the fact that by industry standards, Equitable was hugely under provisioned*'; or that FSA: '*treated the Society in any special way. All life insurers including ELAS have been and continue to be subject to the same valuation rules*'.

FSA explain that they could not demand that companies hold reserves beyond the legal requirements. FSA say that, following FSA/GAD guidance to the industry, Equitable had increased their reserves by around £1.5bn and had entered into a reinsurance agreement, but that the adverse House of Lords' ruling then had led to increased financial costs.

FSA explain that companies' use of future profits when determining their solvency: '*is a standard practice and adopted by many UK life insurers. The basis for attributing this item is laid down in the EC Insurance Directives and UK legislation and reflects only part of the embedded value of the business. This accounting treatment is perfectly normal, we require companies to project forward the liabilities arising under the policies written by them, so it is only right that they should be entitled to take into account part of the profits that will be earned on these policies*'.

18/12/2000 [entry 1] Equitable write to FSA about a number of issues recently discussed on the telephone. Equitable explain that, between 20 July and 8 December 2000, they had enlisted about 18,900 new policyholders, of which about 46% had taken out with-profits policies. Equitable say that, because of the tax implications for policyholders, they did not offer the option of converting a with-profits policy to a paid-up policy.

18/12/2000 [08:58] FSA's Director of Insurance suggests to Managing Director A that FSA may need to clarify the position on the availability of compensation following a newspaper article which reported that a law firm had expressed doubts that the Compensation Scheme would pay out on all of Equitable's products. The Director of Insurance suggest that FSA should be prepared to add the following to their public statements on this:

> *We recognise that this is an unprecedented situation. We are looking urgently at the implications but, in the light of the advice we have taken, we believe that the Compensation Scheme would deliver the protection it is designed to provide.*

The Director of Insurance says that FSA should talk to Equitable and HMT with a view to also saying:

> *If, on examination, there is any doubt about whether the scheme would operate as it is designed to do this doubt will be removed. But bear in mind that the company is solvent and that the prospect of insolvency is very remote.*

However, the Director emphasises that this line should definitely not be used at this stage and explains the possible ways in which he believed that the relevant doubt might be removed.

	[**10:19**] Line Manager E reports that he had spoken to HMT, who were aware that this might be an issue. The Line Manager says that he had explained the position and FSA's legal advice in more detail and '[the Economic Secretary to the Treasury] *may be more inclined to support the idea that if necessary the Government would look to amend the law to ensure that all policyholders are protected in the way we had ... assumed they were.* [HMT's Head of Home Financial Services] *however seems to think that it is enough just to remind people that Equitable is solvent*'. [**12:50**] The Director of GCD believes that FSA should be more cautious and instead say: '*We recognise that this is an unprecedented situation. We are looking urgently at the implications but the advice we have received is that the Compensation Scheme would deliver the protection it is designed to provide*'.
18/12/2000 [09:49]	FSA's Director of GCD replies to the note of 11/12/2000 [**16:26**]. The Director of GCD suggests possible guidance that FSA could provide: • *if I withdraw now, would this weaken my case for compensation. Answer "no"* • *should I exercise rights under my policy to change from with-profits to unit linked ("yes")* • *could Equitable impede this by imposing an MVA (doubt it)* • *could non-GAR policyholders challenge any specific decision by the Equitable as to meeting costs of GARs in court, (and possibly get more clarity as to the impact of the case)? – yes* • *are there any advantages in keeping with Equitable? (There may be tax advantages, and costs of moving, but these need to be weighed against the uncertainty of its current position)* • *how is an Equitable annuity in payment affected? (only at risk if becomes insolvent?)* • *if I have a right to take an annuity now, or postpone doing so, would it be sensible to take the annuity now rather than wait (yes, but you should consider exercising your "open market option"?)* • *if I have a right to withdraw a with profits investment at any time (eg because it is paid up?) Should I do so ("yes" – its profitability will be reduced)* [**11:12**] PIA say that they would not disagree with what the Director has '*hazarded as* [essential] *advice for the average Joe. But our information for consumers so far has kept just this side of giving advice at all. Some big issues involved, I suggest, in stepping over that line*'. [**20:11**] Chief Counsel A says to Legal Adviser A that she perceives that the Director of GCD was attempting to push FSA into an adviser role '*which is potentially highly risky*'. The Chief Counsel asks to discuss the issue.
18/12/2000 [10:27]	FSA's Legal Adviser A informs the Director of GCD that FSA's Insurance Supervisory Committee are to consider that afternoon Equitable's application for a section 68 Order to increase the admissibility limits for shareholdings in certain companies, as while this is a '*perfectly standard concession ... anything we do will be under scrutiny; I* [therefore] *thought I should tell you*'. [**11:55**] The Director of GCD thanks the Legal Adviser for keeping him informed.
18/12/2000 [10:40]	FSA's Director of GCD suggests to Managing Director A that FSA should have a short '*brainstorm*' to look at the possible proposals put forward by Prospective Bidder B on 14/12/2000 [**16:22**].

18/12/2000 [10:44]	Further to FSA's note on section 68 Orders on admissibility limits for shareholdings (see 12/12/2000 [**13:41**]), GAD ask FSA whether Equitable had significant holdings in the two companies who were expected to merge before the year-end. GAD say: '*It would be unfortunate if they end up with a large amount of inadmissible assets at this year end*'.

18/12/2000 [10:51] Equitable apply to FSA for a section 68 Order to allow them to calculate the valuation interest rates for fixed interest securities in an aggregate form. The Society explains that:

> *The purpose of the Order would be to enable the rates of interest to be used in calculating the present value of future payments under fixed interest securities to be calculated on an aggregate yield basis. That rate of interest would, therefore, be the rate which equates the discounted value of the aggregate cash flows on the fixed interest portfolio with the total market value of that portfolio. The yield used to justify the valuation rate of interest would be adjusted for risk in the usual way.*

Equitable ask FSA to confirm that the use of such an Order would only be compulsory once it had first been used. On FSA's file behind this letter are manuscript notes, including: '*need to know why help should be given*'; and: '*Doesn't help Equitable*'.

18/12/2000 [12:41] Equitable provide PIA with their draft briefing for company representatives and sales staff on issues arising following their closure to new business. Equitable seek PIA's urgent comments.

(Note: this correspondence was held on FSA's regulatory file with other items around this date, although it is not clear when PIA passed it to them.)

18/12/2000 [12:42] FSA's Line Manager E prepares a response to the OFT's letter of 12/12/2000, which draws on the 'line to take' already agreed by FSA. The Line Manager checks that others were happy that it could be sent.

[**12:52**] GAD say that the letter looked fine and point to the correspondence with Equitable in 1995 which had explained that a similar 10% charge had been applied at that time (a copy of which was sent to FSA on 14/12/2000 [**18:18**]).

GAD also advise:

> *Incidentally, we also need to bear in mind that the Equitable would very likely become insolvent if they were to remove this adjustment at the present time and experienced a large number of surrenders. This is a result of the combination of GAO costs, a negative investment return in the present year, the final bonus additions for which no provision is required under the regulations, and unrecovered "deferred acquisition costs".*
>
> *I hope that FSA will therefore not insist on them removing or reducing this adjustment factor on surrenders without considering the impact on their solvency.*

[**13:13**] The Line Manager replies:

> *Yes, I have seen the material that you sent to* [the Head of Life Insurance]. *I did wonder about including copies with the letter but then decided it might look like we thought that OFT had a basis for taking action. I agree that solvency is a concern if they are not applying the MVA and have made the point on the phone to OFT. Naturally GAD would be consulted if we in* [FSA] *thought the MVA were going too far.*

[**13:22**] The Director of GCD says that he had asked a colleague (Legal Adviser C), as FSA's expert on unfair contract terms, to look at the issue and the draft letter to the OFT. The Director of GCD asks that the Legal Adviser is supplied with the relevant Equitable documents.

[**13:25**] Line Manager E says that he does not have the relevant documentation, but understands that Equitable were going to provide it. The Line Manager explains that the sentence in the draft letter, '*I understand that the fact that the full value of a policy is not guaranteed other than on contractual dates is built into the contract terms and explained in various documents issued to relevant policyholders, such as the Key Features documents, annual statements and the Society's with-profits guide*', is so worded because his contact at Equitable had assured him that this was the case.

18/12/2000 [13:08] PIA inform FSA that Equitable have told them that they planned to stop offering advice, as from that evening, and that their sales force would instead concentrate on giving information only.

PIA list a number of their thoughts on this so far, including: '*We should try to resist* [Equitable] *abandoning clients in this way*'; '[Equitable] *should consider offering more constructive directions than just "contact an* [Independent Financial Adviser]"'; and: '*The Client Information Sheet needs more clarity on when the MVA is applied*'.

[**13:16**] FSA's Managing Director A agrees that this sounded like a worrying development that PIA should discourage. The Managing Director says that PIA needed to check that there were no regulatory reasons for Equitable to stop giving advice. If the answer was no, then PIA should try and talk Equitable out of taking the proposed action and PIA should also establish whether they could force Equitable not to do so.

[**15:53**] PIA inform the Managing Director that PIA could not intervene to force Equitable to provide advice. PIA say that there was no reason why Equitable should stop giving advice and that it was not clear why the Society proposed to take this line now.

[**16:18**] FSA's Head of Consumer Education notes that Equitable's plan was likely to be bad news for FSA, who had stated publicly that '*the Equitable has, with the encouragement of the FSA, established a process for helping policyholders to decide whether they should take any immediate action*'. She says that '*While it doesn't state that this includes giving customers advice, the natural assumption is that Equitable's advisers can advise their clients, and we will be seen as being ineffectual for not being able to ensure this happens*'.

[**16:27**] The Director of Insurance says that the Managing Director was going to speak with Equitable to express concern about their proposed approach, to ask them to explain their reasons and to ask how they could reconcile their proposed approach with their responsibilities under the criteria of sound and prudent management.

[**16:31**] PIA report that Equitable had said that the briefing note withdrawing advice would not now go out that evening.

18/12/2000 [14:30] FSA's Insurance Supervisory Committee approve, without discussion, the recommendations put forward in 22 papers on various issues (as modified in correspondence), in relation to different companies. These include the paper recommending approval of Equitable's application for a section 68 Order to increase the admissibility limits for shareholdings in certain companies (see 13/12/2000 [**entry 2**]).

The Committee also discuss, at length, the matter of the expected merger of two companies as they expected a number of insurance companies would request section 68 Orders on the admissibility limits for shareholdings for the new merged company. The minutes of the Committee meeting record:

... the committee agreed our policy line. This differs somewhat from that originally set out in [the Committee member's] *earlier e-mail* [12/12/2000 [**13:41**]], *and supervisors should take note of the following. Supervisors will also need to inform their companies of the position.*

As before, we will not offer anticipatory Orders for the new [merged company] *stock. However once the merger has been effected and the shares in the new company are trading, with a market capitalisation available (expected to be 27 December 2000) then either of the following scenarios will apply:*

a) For companies currently holding a substantive concession(s)
... we will be prepared to recommend to Treasury that a reporting concession be given to allow the insurance company to take credit in its year end returns for the holding it will have in [the merged company] *from 27 December 2000.*

... Companies will obviously need to inform supervisors that they would like such a concession, but they do not need to go back to the [Insurance Supervisory Committee] *for approval.*

b) For companies that do not currently have a substantive concession, but do hold [shares in the companies that plan to merge]
... We will similarly be prepared to recommend to Treasury that a reporting concession be issued to such firms ...

Applications for these concessions do need to go to the [Insurance Supervisory Committee] *...*

It should be noted that the above does not change our general policy that "cosmetic" reporting concessions should not be considered.

18/12/2000 [17:19] Equitable provide FSA with a breakdown of calls to Equitable's helpline over the previous three days. Equitable offer to supply this information on a daily basis. Equitable explain that no company representatives had resigned since 8 December 2000.

18/12/2000 [18:06] FSA's Managing Director A informs the Director of Insurance of a telephone conversation that he had had with Equitable, in which he had expressed FSA's concerns about their plans to stop offering advice to policyholders. The Managing Director records that: '*they're clearly worried about the accusation subsequently that they overrepresented the merits of staying with* [Equitable]. *They also can't say anything about where else to put the money*'. The Managing Director notes that he had told Equitable that they must attend a meeting to discuss their plans with PIA and FSA.

18/12/2000 [22:10] FSA's Director of Insurance writes to HMT, following a meeting that evening with the Economic Secretary to the Treasury, to update HMT on the possibility of a new approach to Equitable.

The Director of Insurance says that he had spoken to Equitable's Chief Executive that evening and it was clear that an approach from the interested company had not yet happened. However, '*the* [Chief Executive] *was very bullish about other, more piecemeal, approaches reporting ('though have you heard this before?) "keen interest"*'.

The Director of Insurance also reports that Equitable were to meet with a policyholder action group the following day to look at the possibility of an arrangement or reconstruction under the Companies Act.

18/12/2000 [entry 15] A policyholder action group write to FSA. The action group ask:

... whether the FSA have at any times over the last 3 years or so had any concerns about either the conduct, or the performance of The Equitable Life Assurance Society, and whether these concerns were raised with the Society, and what their response was.

19/12/2000 [10:18]	FSA's Line Manager E sends the Director of GCD and Legal Adviser C the latest draft of the reply to the OFT's letter of 12/12/2000 which took account of comments which had been provided the previous day. The Line Manager says that Equitable would send over some further information later that day.
19/12/2000 [12:34]	FSA's Consumer Relations Department prepare a note on policyholder protection and the availability of compensation, along with a list of defensive questions and answers. [**15:57**] The Director of Insurance says: '*This all looks good stuff. But I am slightly nervous about referring callers to the* [Policyholders Protection Board]. *We have not consulted with them over the "unprecedented" nature of the* [Equitable] *situation or over the legal issues concerning the operation of the scheme. In any case the prospect of an insolvency is so remote that the prospect of the* [Policyholders Protection Board] *having to act rather than the new scheme is surely infinitesimal*'. [**22:04**] Chief Counsel A comments that there were some tricky legal issues involved and asks whether anyone had obtained legal advice on the note, as she did not have time to assist. Chief Counsel A sends the note, and discussion of it, to the Director of GCD and Legal Adviser A.
19/12/2000 [13:49]	FSA's Line Manager E reports to the Director of Insurance (in response to 18/12/2000 [**22:10**]) that he had not been able to contact representatives of the company who had told FSA that they would be putting a proposal to Equitable for the purchase of some of their business.
19/12/2000 [16:08]	Equitable send FSA a note entitled '*Application of financial adjuster by Equitable Life*'. [**18:41**] FSA's Director of Insurance replies to Equitable's solicitors, having spoken to them, stating: *I am concerned that the penultimate part appears problematic for the reasons we discussed. If so the company is clearly exposed. I should be grateful for your urgent views. As I said, we have not yet considered whether there are any other issues raised by the note which we would wish to take up.* The Director highlights the following excerpt of the note: '*The move away from a percentage of final bonus to a percentage of policy value (where the value could therefore be lower than the accumulated guaranteed fund that would be available on contractual termination) was for reasons of fairness*'.
19/12/2000 [16:29]	Equitable provide FSA with copies of the information sent to policyholders about the rectification scheme and their briefing for staff on frequently asked questions.
19/12/2000 [entry 6]	FSA ask GAD to look at a draft paper on Equitable's application for a section 68 Order of 18/12/2000 [**10:51**], for submission to the Insurance Supervisory Committee. Line Manager E also asks Legal Adviser A for his thoughts, explaining: *We want to give ELAS the chance to decide whether to take advantage of this concession for the 2000* [year-end] *returns. But once it has done so, it would be required to continue on the same valuation basis. To achieve that it seems to me that the <u>conditions</u> in para 5* [should] *be <u>requirements</u> (are they enforceable?) and that the condition should be that the company has confirmed it is going to act in accordance with the order by [30/6/01].*

19/12/2000 [16:32] FSA's Legal Adviser A advises Line Manager E on Equitable's application for a section 68 Order (18/12/2000 [**10:51**]). The Legal Adviser notes that both Equitable and GAD consider Equitable's proposed method to be more accurate than that prescribed by the regulations, that two other companies had been granted similar concessions and that it was estimated that the Order would improve Equitable's financial position by around £300m. Legal Adviser A says:

> *You have ... asked for advice on two points only. First, if it is granted, can it be drafted in such a way that the Company cannot thereafter choose to change the valuation basis back to that provided for in the 1994 Regulations. Secondly, because the* [Appointed Actuary]/[Managing Director] *wishes to re-check his figures before deciding whether or not they want the Order, can it be drafted in such a way that the Company can take advantage of the Order, or not, provided it tells us before an agreed date.*

Legal Adviser A considers that the Order could be drafted in such a way that Equitable could not '*be relieved from using it if some time in the future it results in a more onerous reserving requirement*'. The Legal Adviser says that the second point was more difficult and advises that:

> *... it does seem to me that it would have the effect of "changing" the financial position of the Company as at the year-end. As such, if it is to be effective, it must be in force at the year-end.*

The Legal Adviser advises that he is '*uncomfortable*' with the prospect of granting an Order now, on the basis that it would become effective at the end of 2000, according to a post-year-end decision by Equitable:

> *i.e. they should not (effectively) be allowed to pick and choose the method of valuation they prefer some time after the date to which the valuation refers.*

Legal Adviser A adds:

> *Should the Order be granted some time after the year-end then it will be effective <u>going forward</u>. If it is granted before the 2000 returns are required to be deposited, then the granting of the Order could be mentioned in those returns as a post balance sheet event. There is nothing in the regulations to stop companies adding extra information in the returns.*

[**16:48**] Line Manager E tells Line Supervisor C and the Head of Life Insurance that, in the light of Legal Adviser A's advice, '*it would cause real problems if we were to proceed on the basis* [Equitable] *want us to*'. The Line Manager suggests that FSA might be able to offer some comfort to Equitable:

> *... while it is not very clear from* [Legal Adviser A's] *minute, we can in fact express the order in terms that would enable them to present the returns using the valuation method they decide on, with a footnote explaining that the concession has been granted and the returns have been produced on a basis consistent with the current requirements.*

Line Manager E adds that Equitable have asked what had happened to their application for a section 68 Order to allow them to raise the limit on the admissibility of shareholdings in certain companies (see 11/12/2000 [**entry 1**], 13/12/2000 [**entry 2**] and 18/12/2000 [**14:30**]).

[**22:07**] The Director of Insurance comments to Chief Counsel A: '*All this has a faintly unreal air. While we clearly must consider any application put to us on its merits we need to be careful that we do not get sucked into facilitating ingenious ways of presenting the* [Equitable] *in a more favourable light*'.

[**22:18**] Chief Counsel A passes the comments to Legal Adviser A.

19/12/2000 [17:43] GAD (Scrutinising Actuary F) send FSA (Director of Insurance, the Head of Life Insurance and Line Manager E) a 13-page report (dated 20 December 2000) that they had prepared in response to FSA's request of 13/12/2000 [**11:02**]. The report, entitled '*Reserving and related issues*', states that it has been prepared in order to '*demonstrate the substantial dialogue that has been held between FSA (previously HMT), GAD, and the Society over recent years in respect of their reserving practices*'.

GAD deal with the following:

<u>Guaranteed Annuity Options: the 1998 Industry Review</u>
GAD summarise events in 1998 following the survey (see 20/06/1998). They explain:

> *In GAD's Detailed Scrutinies of the 1998 Returns, particular attention was paid to the presence of, and reserves held in respect of,* [GAOs]. *To place the cost of GAOs in context, long term interest yields were 7.6% at end 1996 but had slipped to 6.4% by end 1997, and crashed to 4.4% by end 1998. The situation eased slightly over 1999, but by end November 2000 the same yield was back to 4.5%.*

<u>Equitable's reserving approach</u>
GAD summarise Equitable's approach to reserving, noting that, up until the end of 1997, Equitable had made no addition to their reserves for annuity guarantees. GAD explain that, in the 1996 and 1997 returns, Equitable had stated that '*it was considered unnecessary in current conditions*' to reserve for annuity guarantees. GAD state:

> *GAO reserves were not a point of discussion at this time, as by the above statement it appeared the guarantees were not at that time biting.*

GAD further explain that Equitable's '*exceptional position*' (compared with the practice of most companies) of not reserving had become apparent following the Society's response to the survey, and that HMT and GAD had considered, at the time, that that was unacceptable. (Note: it has been suggested to me that GAD's view that the Society took an '*exceptional position*' does not fairly reflect the findings of the actuarial profession's Annuity Guarantees Working Party.)

GAD set out the correspondence and dialogue which had ensued (from September 1998 to May 1999). GAD explain that further consideration was then deferred, pending the outcome of the court case, but that GAD had returned to the issue in their scrutiny of the 1999 returns (see 24/11/2000 [**entry 1**]) and in subsequent correspondence with Equitable. GAD note that Equitable were yet to reply to the letter of 04/12/2000.

GAD explain that, since June 2000, they had monitored Equitable's solvency position on a monthly basis.

<u>The development of the GAO Reinsurance Arrangement</u>
GAD describe the treaty in general terms, noting that the '*most controversial*' aspect is that it could be cancelled in the event of Equitable's affairs being wound up. GAD summarise the discussions that had taken place between Equitable and HMT/FSA and GAD from the end of 1998 onwards. GAD note HMT's willingness to consider the arrangement as being in place from the end of 1998 (see 07/12/1998). GAD explain that FSA and GAD had reviewed the treaty in the early part of 1999 and '*were eventually satisfied that it was reasonable for the actuary to take credit for the cover provided*'. GAD state:

> *We were aware of the cancellation clause that gave the reinsurer the right to cancel the treaty in certain conditions. We pointed out to the company that professional actuarial guidance to the Appointed Actuary required him to consider whether he should make any additional provision for the contingency that the reinsurance might cease. At the time the*

company were confident that they would win their Court case and believed that they need make no provision for this risk. This subsequently proved to be a false expectation.

GAD continue:

> *Such treaties continue to depend on regulatory arbitrage to achieve the desired result. (It is unlikely that the reassurer, Irish European, will currently be setting up compensating reserves to those removed from the balance sheet of the Equitable.) ...*
>
> *The reliance on an offshore reassurer, and the cancellation clause leave the treaty as a more controversial device by the Society, but the treaty has been accepted as satisfactory in statutory reserving terms up until now.*

GAD explain that, following the House of Lords' ruling, Equitable had renegotiated the treaty. GAD say that Equitable had said that the take-up rate of GARs, following the ruling, was 44%, compared with their statement on 30/10/1998 that no policyholders were choosing this option. GAD conclude:

> *An important aspect of the treaty is that should claims fall upon* [the reinsurer] *under the treaty, they would seek to recover the cost in future years from Equitable's future profits. This has implications for Equitable's implicit items ...*

Implicit Items
GAD set out in tabular form Equitable's applications for future profits implicit items from 1994 onwards. GAD note that, while Equitable were not required to state the assumptions they used in calculating future profits, the 1984 DTI Guidance Note (which was still current) had stated that these should be '*cautious* [and] *in many respects similar to those required for the minimum basis for calculating mathematical reserves*'. GAD say that they:

> *... will normally only question the detail of the future profits implicit item calculation where they have reason to doubt whether the Actuary's calculations satisfy the 1984 Guidance. We believe that Equitable to date have been following this Guidance.*

GAD explain that, when reviewing Equitable's applications, they were not always satisfied with the company's calculation of past profits, but did always feel that a correct calculation would have produced an amount at least as large. GAD say they never had cause to question the calculation of future profits.

GAD reiterate that the calculation of future profits now needed to take account of the reinsurance treaty. GAD say that the subordinated loan would also be repayable from future profits.

Resilience Reserves
GAD set out Equitable's practice of reporting their net premium valuation as an appendix to their returns. GAD explain that:

> *... in recent years, the resilience reserve reported by the Society in their bonus reserve valuation has been such that the free asset position in the net premium valuations and the bonus reserve valuations has been the same. This means that the resilience reserve in the* [bonus reserve valuation] *is simply a balancing item, and so the robustness of the* [bonus reserve valuation] *is somewhat dubious. However ... GAD do not use the* [bonus reserve valuation] *to monitor solvency*.

GAD note that, in the early 1990s, the Society '*took advantage of its use of a bonus reserve valuation in the statutory returns to hide its resilience reserve*'. They say that Equitable's disclosure improved following the implementation of the ICAS Regulations 1996. GAD quote the statement in the 1996 returns:

For accumulating with profits pensions business, ½% pa of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses.

GAD explain that this:

... was never questioned by GAD; it appeared to be a part of the Society's overall provision for renewal expenses. However, in our Scrutiny of the 1999 Returns – in October/November 2000 – and in discussion with potential purchasers of the Society, this was identified as an unusual statement. [Equitable] *confirmed to GAD in* [their] *letter of 16 November 2000 that this was an allowance, not for renewal expenses, as we had understood, but a mechanism to recover as yet unrecouped acquisition expenses. GAD view this as totally unsatisfactory, since it anticipates that future premiums will be paid on the recurrent single premium pensions contracts, when there is no obligation on the policyholder to do so, and furthermore the Society is taking credit in advance for expense margins in those premiums, to reduce the accrued liability*.

GAD set out how they had pursued the matter at the end of 2000. They conclude that '*there has been a history of unsatisfactory disclosure regarding the Society's approach to resilience*' and that the statement in the 1996 returns '*is particularly opaque*'. (Note: see also 30/06/1997.)

Other Reserving Issues
GAD state that, in their scrutiny of the 1995 returns (see 01/11/1996 [**entry 1**]), they had noted that Equitable had taken the view that their interests were best served by using a weak valuation basis in order to show as strong a free asset position as possible. GAD say that Equitable had made the same point at the visit on 09/12/1994. However, GAD note that, as Equitable had built up very little by way of an estate, their free asset position had also been relatively weak.

GAD refer to the concerns identified in the scrutiny of the 1995 returns about the sustainability of Equitable's present contract structures (see 01/11/1996 [**entry 1**]). GAD explain that they had not written to Equitable about these matters, but had taken them up at the meeting on 08/11/1996. GAD set out Equitable's comments at the meeting and conclude:

GAD were left with the firm opinion that the Society had to be very careful that customers were not misled about their eventual benefits.

Equitable's current position
GAD explain that Equitable had not followed the more onerous resilience test set out in the Government Actuary's letter (DAA14) of 15/05/2000. Had they done so, an increase in the reserve of £600m would be needed. GAD say that Equitable would now reserve on this basis, but would offset half of the increased reserve by use of a section 68 Order. This would allow them to show a higher rate of interest on their fixed interest securities by calculating the valuation interest rate in an aggregate form (see 18/12/2000). GAD confirm that other companies adopted this approach.

GAD explain that information attached to Equitable's letter of 09/10/2000, and in their auditor's reports (see 16/11/2000 [**entry 2**]), showed that they were vulnerable to unfavourable market movements. GAD also explain that Equitable reported that, as at 31 October 2000, they had free assets of £1.08bn above a required minimum margin of £1.22bn. However, GAD consider the true position was '*less favourable*' than those figures indicated. GAD refer to the adjustments they had advised Equitable about on 01/12/2000 and say that the net effect of these:

... is to increase reserves by £1,060m, and reduce the Society's free assets at 31.10.00 from £1,080m to £20m. This demonstrates that, despite what the Society say, GAD believe they are very close to not covering their solvency margin.

GAD note that, if the reinsurance treaty were terminated, Equitable's liabilities would increase by a further £500m.

GAD refer to the 10% '*penalty*' that Equitable were applying to non-contractual withdrawals. GAD say that, without further information from Equitable, they could not say what the correct level of penalty should be. GAD note:

> *However, we understand from figures supplied* [by Equitable's auditors to Prospective Bidder A] *last month, that Equitable are overpaying (on monies leaving the fund) at 30.09.00 at the rate of £2.3bn (across the whole portfolio) and this suggests that some correction to the level of payouts is overdue. In the normal course, the Society would seek to recover this overpayment in future years, but in the situation they now find themselves in, this would be to the particular detriment of the remaining policyholders.*

GAD conclude:

> *The Insurance Companies' Regulations and the actuarial guidance do not require companies to reserve for Terminal Bonus in statutory valuations, and most companies/societies take advantage of this exemption. When Terminal Bonus is paid on a claim, the cost is met from the Society's free assets. However, as shown ... above, we do not believe the Equitable have any free assets of any size. There is therefore a danger that if the Equitable allow out-going policyholders to leave the fund on terms which are too generous, there could then be insufficient assets available to meet the guaranteed benefits of the remaining policyholders. The whole situation is very delicate, and needs to be handled carefully.*

19/12/2000 [17:48] GAD's Directing Actuary B thanks Scrutinising Actuary F for his paper and says:

> *I gather that* [the Economic Secretary to the Treasury] *has now announced that FSA will be conducting its own internal inquiry into the FSA's role in dealing with the Equitable.*
>
> *This is likely to be conducted by a group of auditors so we need to ensure that all our files are ready for inspection, and in the meantime to ensure that we keep them locked away overnight.*

19/12/2000 [18:06] FSA thank GAD for their report and tell them that FSA were not now going ahead with Equitable's application for a section 68 Order in respect of the valuation rates of interest for fixed interest securities at this stage, as:

> *Lawyers have advised that it causes problems to give directors powers to decide whether the law applies to them! (A fair point, perhaps.)*

As a result, GAD are now asked to ignore the paper prepared for the Insurance Supervisory Committee relating to Equitable's application for a section 68 Order copied to them earlier that day (see 19/12/2000 [**entry 6**]).

19/12/2000 [18:52] FSA's Managing Director A reports to the Director of Insurance that:

> *I saw the OFT tonight ... they said they have had complaints about the Equitable's MVA and were considering it as a possible Unfair Contract Term issue. I offered our input which was flatly refused – along the lines of "we'll analyse the position and tell you when we've decided".*

[**19:06**] FSA's Consumer Relations Department say that FSA had good links with the OFT.

[**20:09**] The Director of GCD informs officials that Line Manager E had been consulted by the OFT and had circulated a draft reply to their letter.

19/12/2000 [21:56]	FSA's Director of Insurance writes to GAD's Directing Actuary B having just read GAD's report. The Director of Insurance says: *I think this raises, particularly in its final paragraphs, some very difficult issues on which we need to take very clear and measured views. I am concerned particularly that, if the OFT – to whom complaints have been made – were to take the view that the mva as currently operated (or perhaps a matter of principle) amounted to an unfair contract term, the position could become highly problematic.* *Perhaps we might have a word on the telephone fairly early tomorrow (Wednesday). I will need to brief senior management here, and we will together need to devise a strategy for handling all this. But I am concerned that I should understand the position better than I currently do.*
19/12/2000 [entry 13]	HMT's Deputy Director of Finance Regulation and Industry prepares a note entitled '*Secret Warning on Equitable*' for the Chancellor of the Exchequer, following the leak to the press of HMT's note to FSA of 05/11/1998. The Deputy Director attaches a copy of the note, on which Line Manager E writes: '*We were subsequently satisfied that* [Equitable] *was solvent and it remains solvent today*'. The Deputy Director explains that, following the note, FSA's Head of Life Insurance and others had begun meetings with Equitable which had clarified the position and had led to adequate reserving; FSA then had issued new guidance on reserving (see 13/01/1999 [**entry 1**]). The Deputy Director points out that Equitable had also complained that HMT/FSA were being too tough (see 30/04/1999).
20/12/2000 [entry 1]	An FSA legal adviser provides Legal Adviser A with a draft note on whether the Unfair Terms in Consumer Contracts Regulations 1999 apply to Article 4 of Equitable's Articles of Association. The draft note concludes that the terms of the Article were not unfair.
20/12/2000 [morning]	FSA's Managing Director A advises his Chairman that Prospective Bidder B's current proposals were very unlikely to be successful unless they dropped their demand for exclusive negotiations, which he considered unlikely. The Managing Director says that Equitable, supported by their advisers for the sale, had decided not to enter into exclusive talks because: • [Prospective Bidder B's] *bid before* [Prospective Bidder A] *dropped out was flaky in a number of ways. In particular, it was unclear whether the Southern European members of* [the company] *were persuaded of the case for buying Equitable even before the latter had stopped writing business.* • *The business model proposed by* [Prospective Bidder B] *for the purchase had been changed without warning at the last minute (27 November) and made a number of untested/implausible assumptions about how the business could be taken forward. Equitable had concluded that – even if* [Prospective Bidder B] *were serious – the chance of a viable bid coming forward was low.* • *The money being offered by* [Prospective Bidder B] *was not sufficiently great to justify taking the chance of losing the more attainable targets of the sale of viable parts of the company. The pre-closure offer had involved only £300mn for goodwill upfront; the offer now appeared to be nothing upfront, with a maximum of £300mn if everything went as well as it possibly could. Equitable judge that a month's exclusivity would seriously jeopardise their current discussions with* [a friendly society] *and others for parts of the group.*

20/12/2000 [entry 3] FSA's Director of Insurance writes to Managing Director A, having reflected on Equitable's situation now that they knew that Prospective Bidder B would not, after all, be making a bid '*and (more seriously) the possibility that OFT will find that Equitable's MVA constitutes an unfair contract term*'.

The Director of Insurance says that FSA '*know that the Equitable is very thinly capitalised. On prudent assumptions it only covers its required margin by a whisker*'.

The Director of Insurance notes that Equitable's recent bonuses had been higher than justified by their investment performance. He expresses concern that, if Equitable were not allowed to use a market value adjustment for those transferring or surrendering, this would be at the expense of policyholders who remained. He speculates that this could reach a point where Equitable could not meet contractual obligations.

The Director of Insurance proposes a '*proactive approach*' of convening a meeting of major life companies to consider an industry-led rescue. He explains:

> *What I have in mind is a demutualisation of the Equitable into a proprietary company to be owned jointly by a number of the major players. The* [new company] *would run on 90:10 lines and the court sanctioned Schedule 2c transfer would provide that where policyholders had accumulated funds under GAR policies those funds would convert to annuities at the guaranteed rate but that "top ups" would not attract GARs. It might be possible too to provide that existing GAR funds had access only to new money injected into the fund so that the "piranhas" could not eat the "goldfish". While this would probably not have been acceptable to the policyholders 2 weeks ago it might well be so now.*

20/12/2000 [entry 4] FSA meet the Association of British Insurers to discuss the possibility of an industry-led buy out of Equitable. The Association report that leading life companies were unenthusiastic because they saw Equitable's situation as unique and not likely to lead to wider problems. The Association consider the situation had arisen due to a conflict between policyholders at Equitable, and question why money from other policyholders and shareholders should be used to resolve this. FSA explain that:

> *... while an orderly run off of the Equitable might be tolerable we believed anything worse would have wider reputational implications. This was not a impossible scenario. Falling equity prices would put the Equitable under severe pressure. It would almost certainly trigger an increase in the mva. The mva was already subject to review by the OFT following complaints to it. Even if the mva was not struck down by the* [OFT] *it was not certain that it would prevent a run.*

FSA record that they had said that, if a run on the fund were to happen, then Equitable would have to make a greater change to their asset mix than expected, away from equities and into gilts, which, due to a current shortage of gilts, would not provide as much relief as would normally be expected. FSA continue:

> *The key to the problem, as they recognised, was to find some way of securing an accommodation between the groups of policyholders. This might, in theory be achieved:*
>
> > *Through a Schedule 2c transfer into a* [new company]*, with the court endorsing a majority decision to give up some GAR right (perhaps the right to "top up" with full GAR protection*

Through a Companies Act reconstruction/arrangement promoted by the company

Through a "just and equitable" winding up by the FSA/HMT which (if the [Policyholders Protection Act 1975] *applied (they were already aware of the legal doubts surrounding this), might allow the* [Policyholders Protection Board] *to provide funds to facilitate a transfer (the funds in question being raised by a levy on the industry)*

Of these the first was what we thought stood most chance of success. It would offer all policyholders some benefit, and this might be the key to securing the necessary degree of consent. But it would clearly need to offer commercial benefits to the purchasers. These might be, the prospect of future business (the Equitable sales force was efficient and productive, and if the business were operated through a new 90/10 fund the initial strain would be less). The reduction of reputational damage to the industry and greater market stability would be beneficial too. The second was a serious contender and was being pursued by the Company with our encouragement. However it might be less likely to be achievable with no upfront benefit to all policyholders. The third was presentationally awful, legally uncertain and would involve the costs falling on the industry. But it could not be excluded.

The Association of British Insurers agree to consider the matter further.

20/12/2000 [entry 5]	FSA meet to discuss Equitable. The note of the meeting (dated 2 January 2001) records the actions agreed in relation to producing a '*Report on lessons to be learned*' (i.e. what became the Baird Report).
20/12/2000 [10:02]	FSA's Public Affairs and Accountability Department distribute copies of an adjournment debate held in the House of Commons the previous day about the situation at Equitable.
20/12/2000 [10:14]	In response to being informed that FSA were not now going to accept Equitable's application for a section 68 Order (see 19/12/2000 [**18:06**]), GAD's Scrutinising Actuary F says:

Presumably this means that [Equitable's Appointed Actuary] *will be less enthusiastic about recognising the new resilience test 2. We understand that the artificial bond approach would have led to reserves £300m. lower than otherwise in this scenario.*

The adjustments which we believe need to be made to the Society's liabilities (see §8.6 of the Report sent yesterday) become an increase of £1,360m. (instead of £1,060m.), when there are only £1,080m. of assets available (at end-October 2000).

It is all very tight, to say the least.

[**10:20**] Directing Actuary B comments:

I think therefore that it is very likely that Equitable will publish their 2000 returns with a less demanding resilience test than that recommended by the Government Actuary. It will be difficult to do much about this as our advice to companies is not mandatory and they are already closed to new business. However, it will highlight their vulnerability to adverse movements in the financial markets.

[**11:08**] FSA's Line Manager E replies:

I am well aware of the possible difficulties, at least in presentational terms. However, to a degree the issue is academic in that no new liability is being created and no money is disappearing. Arguably the effect is simply that they would end up over-reserving for a *period. We will have to consider the question of the annual returns once they have decided about the valuation method.*

Separately, [**10:24**] a GAD actuary queries why the Order had been refused, as two similar Orders, which had required the companies to always use the aggregate yield, had been granted that year.

[**10:28**] Scrutinising Actuary F explains that Equitable had been seeking an Order which gave them the choice as to when they first wanted to use it.

20/12/2000 [12:32]	GAD advise FSA that, subject to a query about transfers into policies with GARs, Equitable's approach to writing further business (see 12/12/2000) '*seems reasonable*'. GAD suggest that FSA should take up with Equitable an outstanding point about whether transfers could be made from another provider into policies that had guaranteed annuity rates.
20/12/2000 [15:21]	PIA hold a liaison meeting with Equitable. PIA advise FSA that Equitable would delay implementing their proposal to prevent company representatives giving advice until the New Year. PIA say that they would liaise further with FSA about their briefing to sales staff and their plans to handle the '*public message*'.
20/12/2000 [15:44]	As part of giving comments to an FSA actuary concerning draft rules on the valuation of liabilities for eventual inclusion in the new FSA handbook, GAD's Directing Actuary B writes: '*One particular omission is the present Regulation 64(f). This is an important aspect of PRE that may also effect reserving (as may become apparent shortly in the context of Equitable)*'.
20/12/2000 [16:20]	FSA's Friendly Societies Division inform Equitable's supervisors and GAD that Liverpool Victoria Friendly Society had informed them that they proposed to purchase Permanent Insurance for £150m (being £120m for the in-force business and £30m for goodwill).
20/12/2000 [18:03]	Equitable provide Line Manager E with updated information from the previous day on the value of payments made on surrenders, transfers and switches and calls to Equitable's helpline.
21/12/2000 [entry 1]	Equitable's Appointed Actuary writes to GAD in response to their letter of 04/12/2000 about their 1999 returns. Equitable express surprise that GAD considered the letter of 22/12/1999 led to a minimum assumed take-up rate of 90%. Equitable point out that, at 31 December 1999, the pre-House of Lords bonus structure applied, the actual take-up rate at that time had been below 4%, and that an assumed rate of 85% was therefore extremely conservative. Equitable say that they would take GAD's comments into account when considering reserving levels following the House of Lords' judgment and the consequential change in bonus structure. Equitable accept that there should be a stronger basis for the rate of decrement on recurrent single premium business. Equitable dispute that the new regulations required an assumed retirement age of 50 on the basis that the draft guidance in GN8 would seem to require prudent allowance for proportions of policyholders likely to exercise the option if more valuable, rather than that all policyholders did so. Equitable say that they consider that that assumption of retirement age of 55 was sufficiently prudent, on the basis that the average retirement age for this business was still well over 60. Equitable note GAD's comments on the resilience reserve:

... but feel that such an interpretation of the current regulations raises serious issues about the future of with profits business. Views have been expressed by the industry and professional bodies that the effect of current regulation and guidance leads to layers of prudency which make with-profits business unattractive to write compared to other categories of business ...

A change to the way in which the return on equities is assessed for the purpose of the regulations, which was the subject of earlier consultation, would have been helpful in that regard. Because those proposals have not been pursued we seem currently to have a particularly onerous combination of requirements.

Equitable also note, however, GAD's expectation that reserves in the 2000 returns would be established in accordance with these comments. Equitable say they intended to introduce a more sophisticated hypothecation of assets to liabilities in the resilience test and this would be fully presented in the 2000 returns.

Equitable explain that they reduced the reserves for expenses in the resilience scenario to a level closer to that experienced in 1999, in order to avoid holding unnecessary margins. Equitable explain that they were currently assessing the expenses that would be reserved for in the 2000 returns, following their closure to new business.

21/12/2000 [entry 2] Equitable send FSA information about Equitable Investment Fund Managers Limited to help FSA consider whether the company could continue to take on investment-only business.

21/12/2000 [entry 3] FSA write to Equitable in response to their letters of 12/12/2000 and 18/12/2000.

FSA seek clarification on the basis of advice from GAD of Equitable's proposals concerning transfers into existing policies with GARs (see entry at 20/12/2000). FSA also state that they were '*uncomfortable*' with Equitable's proposal to allow new members to join existing group schemes. Finally, FSA ask for a more precise estimate of new policies written between 20 July and 8 December 2000.

21/12/2000 [08:56] Equitable's solicitors send FSA a copy of a note to Equitable (dated 20 December 2000), along with draft instructions to Counsel about the general interpretation of Article 4 and its specific interpretation in the context of the application of the Policyholders Protection Act 1975. The solicitors seek comments from FSA on the draft instructions.

21/12/2000 [10:01] FSA's Legal Adviser C advises the Director of GCD that a proposed response to the OFT's letter of 12/12/2000 about market value adjustments was accurate, in light of his review of a bundle of documents received from Equitable, upon FSA's request. The Legal Adviser suggests, however, that the point in the draft that companies' considerations when applying an adjuster include:

The need to prevent sales of the fund's assets at disadvantageous prices, meaning a poorer deal for policyholders staying in the fund

could be amended to reflect more closely Equitable's point that the adjuster was to '*protect the future solvency and investment freedom of the fund*'.

Legal Adviser C advises:

The Unfair Terms in Consumer Contracts Regulations 1999 are not restricted in their application: they are capable of applying to insurance contracts. So the question arises whether the provision in [Equitable] *documents, which in theory would allow them to pay nothing in relation to a with-profits policy which is surrendered or transferred would be an "unfair term" for the provisions of these regulations.*

The definition of "unfair term" in Regulation 5 is one which:

> *(i) has not been individually negotiated; and*
>
> *(ii) contrary to the requirement of good faith, causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer.*

By Regulation 5(2), a term [is] *not individually negotiated where it has been drafted in advance and has therefore been unable to be influenced by the consumer. I take it as read that this condition is satisfied.*

I also take it as read that a term which would allow [Equitable] *to pay nothing if a policy were surrendered after (say) 24 years of a 25 year term would cause a significant imbalance in the parties' rights and obligations, and one which would lead to obvious detriment to the consumer.*

However, under Regulation 6(2):

> *"In so far as it is in plain intelligible language, the assessment of the fairness of a term shall not relate –*
>
> *(a) to the definition of the main subject of the contract, or*
>
> *(b) to the adequacy of the price or remuneration, as against the goods or services supplied in exchange."*

Legal Adviser C continues:

The analysis at paragraphs 5-6 above indicates, I think, that the language used by [Equitable] *is both clear and intelligible. And I also think that it could plausibly be argued that Regulation 6(2)(b) is relevant here. The effect of that regulation is to make it impossible for a consumer to argue that he has paid too much for what he has actually acquired, provided that the "price" is spelt out in plain intelligible language. Applying the regulation to the* [Equitable] *case, the* [Equitable] *"defence" to a claim by an investor that a term allowing a reduction in the value of the with profits policy potentially to zero was unfair would be that, in effect, that term concerned the price that the investor had agreed to pay for the contract. It might indeed be that in certain circumstances the price paid would be very heavy, since the investor might receive nothing for 20 years of contributions. However, as that point had been made clear to the investor in plain intelligible language, it was not open to the investor to argue that the term was unfair. As I say, I find this argument plausible.*

If this interpretation of Regulation 6(2) is not correct, then the key issue becomes whether the term is "contrary to the requirement of good faith" under Regulation 5.

This I think would be difficult to prove, and I think we would not be able to make it out. Those who transfer or surrender the policy may not - indeed, almost certainly will not in any circumstances - receive the full "value" of the policy as at the date of transfer or surrender.

Legal Adviser C continues:

Given that:

- *the issues concerned do not involve the person transferring/surrendering the policy and the* [Equitable] *alone, but also impact on the position of other policyholders who remain with* [Equitable] *(for the reasons explained in* [Line Manager E's] *draft letter);*

- *other life offices operate a similar policy (which means, as* [the] *letter points out, that even after the increase in charges to 10%,* [Equitable's] *surrender values are not out of line with those elsewhere in the industry); and*
- *the regulators under the Financial Services Act have since 1988 been content for life offices (including* [Equitable]*) to market their products on this basis,*

it would seem to be odd were we to be taking action against [Equitable] *on the grounds that the 10% deduction was contrary to the Unfair Terms in Consumer Contracts Regulations (particularly where similar reductions appear to have been imposed in the past by* [Equitable] *without adverse regulator comment). I would also think that it would be odd, given the above considerations, for the OFT to consider taking action under those regulations against* [Equitable]*, thought that of course is a matter for the OFT.*

I therefore conclude that the "exit charge" imposed by [Equitable] *is unlikely to be contrary to the Unfair Terms in Consumer Contracts regulations.*

[**10:32**] The Director of GCD requests a meeting to discuss this.

21/12/2000 [10:39] FSA's Director of GCD replies to discussion on 19/12/2000 [**12:34**] about the note that FSA had prepared on policyholder protection and the availability of compensation. The Director of GCD says that he expected to go back to Counsel in the new year '*for him to confirm that nothing we have found about the history of such clauses undermines his advice*'.

21/12/2000 [11:38] FSA's Director of GCD writes to Legal Adviser A about the advice that FSA are to seek from Counsel on compensation that might be available to Equitable policyholders. The Director of GCD comments:

The case you found ... seemed to be very helpful to reaching the conclusion that compensation should be available. As you described it to me, it involved a mutual with a clause of the kind concerned which was wound up as insolvent due to debts due to policyholders, and where the court was asked to use its powers to order reduction of liabilities to policyholders, so that the company could continue as solvent.

As we discussed, it would also be worthwhile discussing in further instructions the possibility that the clause might be invalid under the unfair contract terms regulations, or, for inadequate disclosure, under the "utmost good faith" principle which applies each way in insurance contracts. [See 20/12/2000.] *...*

Finally, I think it would be useful to focus the debate on how the courts would interpret the scope of the policyholders Protection Act. There seems to me to be some force in the argument that references to "liability" in that Act should be construed as references to the full amount of any current liability of the company even if, in a private law context, the liability of the company, and so the members should be limited to the amount of the available assets.

21/12/2000 [11:39] FSA's Director of GCD writes to the Director of Insurance, who had mentioned that it might be possible to achieve a '*desirable outcome*' by winding up Equitable on just and equitable grounds and seeking to transfer the business through the policyholder protection scheme.

The Director of GCD says that, although the issue had been raised with Counsel on 11/12/2000 [**16:00**], FSA had not yet pursued this '*given the reluctance to go down this route, and the advice from Counsel that the better view was that article 4 did not prevent payment of compensation*'. The Director of GCD asks whether there were any specific legal issues that they would like to be addressed with Counsel, as they were about to go back to seek confirmation on the advice already given.

[**11:46**] Managing Director A says that just and equitable grounds had to be a possible way forward and any related legal issues should be explored.

[**11:55**] The Director of Insurance replies to the Director of GCD:

> *I don't see it as a runner to avoid potential* [Policyholders Protection Act 1975] *problems. I see it, instead, as a way in which* [Policyholders Protection Act 1975] *action to facilitate (ie partly fund) a transfer, through which a court blessed accommodation between the various policyholder interests (including some giving up of extreme GAR rights), might be made possible. In other words it would be another way of achieving a Companies Act type arrangement, but with the advantage of a cash injection to sweeten the deal and improve the fund. It would, of course, require a willing transferee, and the* [Policyholders Protection Board] *contribution would be a necessary part of that.*
>
> *I think it is not a very likely runner (and it may be completely flawed legally). It is presentationally awful and there may well be no willing transferee. But I am reluctant at this stage to rule out any possible options, however remote, and think we should be prepared to think the unthinkable.*
>
> *I leave it to you to decide whether it is worth asking Counsel to consider. It may be that in-house legal advice will shoot it down sufficiently comprehensively to make counsel's advice unnecessary.*

21/12/2000 [12:12] FSA's Director of Insurance reports to Managing Director A on a further conversation that he had had with the Association of British Insurers where, as agreed, he had said that FSA did not think it appropriate that they engage advisers to work up their proposition but might meet Equitable's advisers for the sale to explain their thinking and to see if they thought it merited further work.

The Director of Insurance says that the Association of British Insurers were comfortable with this '*but stressed that his members were very sensitive about all this. There should be no suggestion that they were in any way involved in this or would be likely to look with favour on any proposals that might emerge*'.

21/12/2000 [13:12] An FSA official informs Equitable's FSA supervisors that a named company had called FSA's Chairman about their interest in Equitable and were looking at '*picking up the whole package*'. The official reports:

> [The company] *would not do this out of the goodness of their heart but would also not be looking to make a killing out of it. They had not met Equitable yet and were still trying to get hold of* [Equitable's President]. [The company] *had met* [Equitable's Appointed Actuary] *last week but that meeting had not really been effective hence the move to pitching this at Chairman level.*

The official says that it had been agreed that the company would keep in touch with FSA.

21/12/2000 [13:34] FSA's Director of Insurance advises Managing Director A that Equitable's auditors had said, in confidence, that Equitable have been referred to the Financial Reporting Review Panel over their last accounts. (Note: the Panel was one of the Financial Reporting Council's two operational bodies – see 24/08/2000.)

21/12/2000 [14:01] FSA's Director of GCD thanks the Director of Insurance for sending him a copy of Equitable's solicitor's note and instructions to Counsel (see 21/12/2000 [**08:56**]). The Director of GCD says he did not think that Equitable's solicitors should attend the planned meeting with Counsel and recommends that if FSA were to go jointly to Counsel, it should be with HMT and/or the Policyholders Protection Board. The Director explains:

This is because the key question is whether, in the light of article 4, the Equitable has liabilities to its policyholders within the meaning of that expression in the Policyholders Protection Act or, subsequently, our own compensation scheme. The views of the Equitable on this are, in one sense, neither here nor there.

The Director of GCD says that he shared Equitable's solicitor's uncertainty about Counsel's 'third meaning'.

21/12/2000 [14:01] FSA's Director of GCD thanks Legal Adviser C for his note of that day [**10:01**] about Equitable's use of the market value adjuster and the Unfair Terms in Consumer Contracts Regulations 1999. The Director says that he found the analysis convincing and:

While it may not be sufficiently strong to be clear that there is no problem, it is in my view sufficiently strong for us to regard there as being no prima facie problem which would make us wish to change our own approach now.

The Director of GCD asks Legal Adviser C to consider whether his analysis needed to distinguish between the validity of the term and the validity of the level of the adjuster. The Director says that he would be happy for the draft reply to be sent to the OFT.

[**14:31**] Line Manager E agrees that Legal Adviser C's analysis was convincing but adds:

I had also wondered about whether there was a distinction between an MVA applied in the anticipated way – as explained in my draft letter – and an MVA applied on terms that are designed to meet the company's objectives by imposing an irrational charge on the policyholder. My personal view is that there probably is a difference, and that in those circumstances there would be an unfair term (whether or not it is contrary to the Regulations).

[**14:49**] Legal Adviser C says that he is content for the reply to be sent and that their further work may throw up further points to make to the OFT, but that this could be done when such points arose.

21/12/2000 [15:00] GAD send FSA a copy of a reply to FSA's Friendly Societies Division about the value of Permanent Insurance, where GAD state that they were unable, without further information, to comment on the reasonableness of the amount that Liverpool Victoria were prepared to pay for Permanent Insurance.

21/12/2000 [15:09] FSA respond to the OFT's letter of 12/12/2000. FSA explain the background to exit charges, clarifying that they only applied to surrenders or transfers at non-contractual dates.
FSA conclude:

Equitable announced last week that its "exit charge" would be increased to 10% from its previous level of charges which averaged around 5%. On the basis of information available to the Government Actuary's Department, we understand that, even following this increase, surrender values of Equitable policies are not out of line with the industry average. The FSA will be monitoring the adjustments made by Equitable and we have powers to intervene at any time, if we consider the figure to be excessive.

21/12/2000 [17:06] FSA's Line Manager E seeks comments on some standard lines to take that had been prepared in response to '*the more difficult*' enquiries that FSA had received.

21/12/2000 [17:15] FSA's Line Manager E circulates a draft agenda for '*the urgently needed supervisory meeting with Equitable*'. The Line Manager says that FSA should try to arrange the meeting for the first week in January 2001. (Note: the meeting actually took place on 16/01/2001.)

The Line Manager's suggestions include: a progress report on disposals of Permanent Insurance and other subsidiaries; an update on customer handling issues and consumer trends (rate of surrenders and transfers); discussion of their reserving and future strategy (including: the way Equitable envisage going forward; their solvency position; any further reserving issues; and issues arising from taking on new obligations and new contracts with existing customers and group schemes); an update on requested section 68 Orders for admissible assets and the valuation interest rates for fixed interest securities; a review of sales after 20 July 2000; the rectification scheme; and the position on both income drawdown policies and pensions review issues.

[**18:44**] In response, GAD's Scrutinising Actuary F suggests additional items:

- *Details of the actual/anticipated year-end bonus declaration: what this is & impact on reserves.*
- *Further details on the current level of payouts, i.e. how do payouts on retirement & non-contractual exits compare with aggregate asset shares. Is the 10% MVA a true penalty, or just a mechanism to restore payouts to a "fair" level? How is Terminal Bonus being managed currently? Can they explain why, according to* [Equitable's auditor's] *figures, the "deficit on the smoothing account to recover in future" stood at £2.3bn. at 30.09.2000. This suggests that the underlying amounts payable on termination are currently too high. Answers to these questions will help us to understand the dynamics of the business and the ramifications of those leaving the fund on the continuing policyholders.*
- *GAO reserves: what level of statutory reserves (before & after reassurance) do they envisage holding as at 31.12.2000?*

21/12/2000 [18:10] FSA's Line Manager E sends Managing Director A a draft letter to Equitable on the market value adjuster.

[**18:51**] The Managing Director says that he was happy with it, as far as it went, but queries one point.

Behind this correspondence on FSA's file is a copy of a letter from the OFT to Equitable, requesting an explanation as to why the market value adjuster had been increased to 10% and copies of standard contracts which contained the term on which Equitable had relied to increase the adjuster.

21/12/2000 [18:45] FSA's Consumer Relations Department circulates the final draft of FSA's defensive briefing note on policyholder protection and the availability of compensation (see 19/12/2000 [**12:34**] and 21/12/2000 [**10:39**]).

[**20:13**] The Director of GCD expresses reluctance about including the first question.

21/12/2000 [19:03] Equitable provide FSA with updated information from the previous day on the value of payments made on surrenders, transfers and switches and calls to Equitable's helpline.

This information is accompanied by a copy of a press release and an open letter, in which Equitable's President updates policyholders about the sale process. Equitable say that this letter is to be placed as an advert in newspapers the following day.

22/12/2000 [entry 1] Equitable's advisers for the sale send FSA a summary of their discussions with Prospective Bidder B.

22/12/2000 [entry 2]	The President of the Institute of Actuaries writes to FSA's Director of Insurance, following a discussion earlier in the week. The President encloses a copy of '*With Profits Without Mystery*' and comments: *As you will see it was presented in 1989. Indeed, you might well have been in the audience for the discussion!*
22/12/2000 [entry 3]	FSA reply to The Consumers' Association's letter of 13/12/2000. FSA explain that they intend to report on events from January 1999 (when they took over the prudential regulation of insurance companies). The report would also cover the exercise of PIA's functions under the FS Act 1986. FSA set out the action they have taken to assist policyholders following the closure to new business. They explain that '*we are monitoring the size of the Market valuation adjustment being imposed by Equitable and would not hesitate to use our powers if we judged it excessive*'. FSA also state, for the avoidance of doubt, that: *... there never was a formal offer lodged by any of those who expressed an interest in buying Equitable after it had put itself up for sale. What the last of the interested parties did on 7 December was to notify the Equitable that it did not wish to move to making a formal offer.*
22/12/2000 [entry 4]	GAD send FSA's Head of Life Insurance a copy of the completed '*Expenses*' section of their 1999 annual report on the life insurance industry.
22/12/2000 [09:42]	FSA's Line Manager E writes to the Director of Insurance (copied to the Head of Life Insurance) following the correspondence the previous day on the Financial Reporting Review Panel. The Line Manager says that he had remembered that, at some point, he had received a call from the Secretary to the Panel asking about FSA's conflicts of interest policy, as some of their accounting advisers had Equitable policies.
22/12/2000 [10:13]	FSA's Director of GCD asks Legal Adviser A to provide legal advice on FSA's '*Most Frequently Asked Questions*' (see 21/12/2000 [**17:06**]).
22/12/2000 [10:22]	Liverpool Victoria Friendly Society announce that they have entered into a binding agreement for the purchase from Equitable of Permanent Insurance.
22/12/2000 [10:24]	FSA's Line Manager E advises the Chairman and others of a banking group's possible interest in a rescue plan for Equitable.
22/12/2000 [10:26]	In reply to 21/12/2000 [**11:55**], the Director of GCD asks the Director of Insurance if he was right to assume that FSA did not require any further legal advice over the Christmas period on the issue of a possible just and equitable winding up of Equitable.
22/12/2000 [10:42]	FSA's Line Manager E asks whether anyone wanted copies of the information regularly supplied by Equitable on calls to their helpline and on requests for transfers and switches. The Line Manager also asks if they would like a summary of this information.
22/12/2000 [13:33]	FSA's Legal Adviser A invites comments from Chief Counsel A, Chief Counsel B and Legal Adviser C on draft instructions to Counsel. [**16:06**] FSA seek formal advice from Counsel on:

Counsel will recall that at the consultation of 11 December 2000 it was agreed that Instructing Solicitor would do some further research before Counsel prepared a formal written advice. The results of this research is set out in paragraphs 2.1 to 2.5 below. The further advice of Counsel is sought on the point raised in the earlier instructions in the light of the additional research.

In addition, at the consultation Instructing Solicitor mentioned 3 further matters although Counsel was not specifically asked to advise on them. These were (i) the possibility that the Society could change its articles and offer to amend its policies (ii) the Society being put into liquidation on a petition in the public interest (iii) the application of the Unfair Terms in Consumer Contracts Regulations 1999.

Counsel is now asked to advise additionally on the possible application of the Unfair Terms in Consumer Contracts Regulations (although this would only be relevant if the "First Meaning" was correct). This is dealt with in paragraphs 5.1 to 5.6 of these Instructions.

22/12/2000 [18:20] FSA's Director of Insurance says that Line Manager E's list of topics (see 21/12/2000 [**17:15**]) to be discussed with Equitable:

Looks ok. But I think we will also have to discuss with them how they think they can manage their bonus problem in February.

27/12/2000 [entry 1] FSA's Line Supervisor C, in response to a query from Line Manager E, explains that he had told Equitable what FSA's conclusion had been on their application for a section 68 Order in respect of the calculation of the rates of interest on fixed interest assets (see 18/12/2000). (Note: it is not clear when he did this. Also see 23/03/2001 (and 06/03/2001).)

27/12/2000 [11:05] FSA's Line Manager E seeks approval from the Director of GCD, Legal Adviser C and the Head of Life Insurance on a revised draft letter to be sent by Managing Director A to Equitable on the market value adjuster.

[**12:51**] Legal Adviser C questions whether it was '*really the case that what Equitable have done "could (and in some cases should) reduce surrender levels to <u>below contractual levels</u>" [my emphasis]?*'.

[**13:09**] Line Manager E agrees with Legal Adviser C, noting: '*The distinction being drawn is, as I understood it, between the value of the policy at the time of surrender and a share of any accrued bonus since the last declaration or any expectation of a share of a future terminal bonus. As you say, the words "at first glance" aim to deal with the point, but not very successfully I will try and make this clearer in the letter*'.

27/12/2000 [13:35] PIA send FSA a copy of a letter to Equitable, sent that day, about their pensions review. In their letter, PIA had encouraged Equitable to allow policyholders to pay any redress into a unit-linked fund or to a policy with a different provider. PIA also had asked Equitable to let them know what they had decided.

27/12/2000 [14:19] FSA ask Equitable, following a query raised by an FSA employee who is an Equitable policyholder, whether members of group schemes would receive the same information as individual policyholders.

27/12/2000 [14:27] Equitable write to FSA's Line Manager E with two queries relating to how the Society is to handle policyholder complaints connected with its GAR rectification scheme.

27/12/2000 [16:02]	An FSA official circulates a revised version of FSA's '*Most Frequently Asked Questions*' and seeks comments.
27/12/2000 [17:24]	Equitable provide FSA with updated information from the previous day on the value of payments made on surrenders, transfers and switches, and calls to Equitable's helpline.
28/12/2000 [09:06]	FSA's General Counsel's Division prepare a chronology of the legal advice provided in relation to Equitable.
28/12/2000 [10:23]	FSA's Line Manager E sends Legal Adviser A a copy of Equitable's deed of settlement and says: *I have only skimmed through it (which may not be wise for a legal document of this vintage) but in so doing I was struck by clause 68 – with the side heading "call, when to be made". It may be (if I have understood it correctly) that the effect is not out of line with Counsel's idea that Article 4 was referring to the availability of assets to pay claims at any point in time. In short, the clause seems to require all members to meet a call in the event the society is unable to meet claims arising from the death of assured members and that such calls are to be treated as deposits which would be repaid with interest when the society has enough money.*
28/12/2000 [11:42]	FSA send GAD a copy of Equitable's letter of 21/12/2000 about Equitable Investment Fund Managers Limited, along with a copy of their 1999 report and accounts.
28/12/2000 [12:38]	An insurance company (not one of the three which had originally expressed an interest in bidding for Equitable) provide FSA with copies of recent letters to Equitable, which set out proposals which involved the transfer of Equitable's sales force, business infrastructure and investment operations. FSA's Head of Life Insurance comments to the Director of Insurance that the correspondence shows that '*at least one interested party has put to* [Equitable] *rather fuller ideas than we had been made aware of by Equitable themselves*'.
28/12/2000 [17:40]	Equitable's solicitors write to FSA about the market value adjuster (in response to 19/12/2000 [**18:41**]). The Society's solicitors say: *I am responding somewhat belatedly to your fax of Tuesday evening, 19 December, with which you enclosed a copy of* [Equitable's Appointed Actuary's] *fax to* [FSA's Managing Director A] *of the same day.* [The Appointed Actuary] *had enclosed a note on the Society's application of the "financial adjuster". You were concerned as to any possible legal implications of the application of a financial adjuster that would reduce the amount paid on a surrender (or other non-contractual termination) to an amount that would be "lower than the accumulated guaranteed fund that would be available on contractual termination". I think you were concerned as to whether any such move might in some way be contrary to the House of Lords' decision.* *I think this concern is misconceived. The main point is that the House of Lords' decision was specifically about the principles of contractual interpretation, and possible implied limits on the exercise of the discretion granted by a contract. One of the key statements in Lord Steyn's judgment (which I have to say has been roundly ignored by one or two commentators) was that any attempt to imply terms into a contract should be "sparingly and cautiously used and may never be employed to imply a term in conflict with the expressed terms of the text. The legal test for the implication of such a term is a standard of strict necessity."*

The solicitors continue:

> *The Society refers to such events as surrenders and premature withdrawals as "non-contractual", and does so for a very good reason – these are occasions when the policyholder generally has no contractual right to make a withdrawal from the policy. Any withdrawal depends on reaching an agreement with the Society outside the terms of any existing contract. As a result, the Society has always made it clear that such withdrawals will only be permitted on terms that are agreed by the Society itself. These terms are at the discretion of the Society – and, indeed, could in many cases amount to a complete refusal to entertain a request for early termination. This is not a question of the exercise of a discretion that is available to the Society under a contract (as was the case in the House of Lords' decision). Rather, it is a case where the policyholder wishes to do something entirely outside the terms of the contract, and the Society is contemplating whether or not to agree to such terms.*
>
> *In these circumstances, the fact that the financial adjuster may result in the policyholder receiving less than the accumulated guaranteed fund that would be available on contractual termination is legally of no significance.*
>
> *Obviously the FSA has other discretions (most notably under sections 37 to 45 of the Insurance Companies Act) that may in theory be brought into play to protect policyholders in these circumstances. However, given the fact that the Equitable is clearly acting even-handedly towards all policyholders, and the balance that the Equitable is very properly seeking to maintain between the interests of departing and remaining policyholders, when contemplating any request for a non-contractual policy termination, I would find it difficult to believe that any of these powers of intervention would be properly exercisable in the present case.*

28/12/2000 [17:44] FSA's Chief Counsel B suggests to the Director of GCD that:

> *I think it would be helpful if you were to commission some advice on the benefits/disbenefits of the FSA seeking to wind up the Equitable on just and equitable grounds with particular emphasis on the differences this might make on the payouts to policyholders with or without the addition of the benefit of the* [Policyholders Protection Act 1975]. *I see this as something which will be needed going forward. It is probably a piece of advice on which we would need external advice after we have sorted out an internal legal line and also something which we could get on and do without waiting for instructions from an internal client*.

28/12/2000 [18:18] Equitable provide FSA with updated information from the previous day on calls to Equitable's helpline. The usual data on the value of payments made on surrenders, transfers and switches is '*not available yet*'.

29/12/2000 [entry 1] HMT write to Equitable to explain that, on FSA's advice, they had agreed the application for a section 68 Order to raise the limit on the admissibility of shareholdings in certain companies (see 11/12/2000 [**entry 1**]). HMT enclose the Order.

29/12/2000 [entry 2] FSA write to Equitable about Equitable Investment Fund Managers Limited (see 21/12/2000 [**entry 2**]). FSA say that they would like to take up the offer of a meeting. FSA state that, at this time, they were inclined to take the view that Equitable Investment Fund Managers Limited should be allowed to continue to take on investment business but that FSA wanted a clearer understanding of the arrangements proposed.

29/12/2000 [11:56]	FSA discuss the proposed letter to be sent by Managing Director A to Equitable (see 27/12/2000 [**11:05**]).

[**14:56**] Line Manager E circulates to colleagues and to GAD a slightly extended version of the draft letter, in which FSA accepted that an adjustment of 10% was not unreasonable. This asks Equitable to discuss any further increase in advance, wherever practicable, as the level had the potential to raise prudential concerns by having the opposite effect to that intended, that is:

> *... rather than encouraging people to stay, an increase could cause people to panic into surrendering.*

FSA point out that Equitable should not have extended the adjustment to Republic of Ireland policies without informing FSA. FSA also query Equitable's decision to change the calculation from a proportion of bonus to a proportion of market value, in order to allow an adjustment greater than the total amount of the bonus. FSA state:

> *At first glance, this might appear to amount to the exercise of the discretion provided by the MVA clause in such a way as to avoid the bargain originally struck between the parties. On this basis, we should need to see very persuasive arguments that this represents a legitimate use of the MVA.*

[**16:43**] Legal Adviser C comments:

> *Having raised the question of whether it was sensible to speak of "contractual levels", I am very happy that this draft simply speaks of "bonus amounts".*
>
> *You will have seen* [the Director of GCD's] *earlier e-mail which asked me to look at the issue of "contractual entitlement" in more depth. I am about to go on leave for a fortnight, and* [Chief Counsel B] *has kindly agreed to take over in my absence – including considering whether we need to instruct Counsel on this point.*
>
> *For what it is worth, I think that although we can all identify quite easily circumstances where the MVA could be used in an obviously inequitable way – such as reducing the value of a 25 year policy to zero when the holder wished to transfer it, or surrender it, in the 24th year – we are much more likely to be faced with circumstances which are not clear-cut. For instance, if (as I assume we do) we are content that 10% is "fair" (or at least "not unfair"), where on the scale should we place 12%? Or 15%? Or 20%? It seems to me to be very difficult to come up with a simple formula that will supply an answer in each case. The issue appears to boil down to defining what would be reasonable (or unreasonable) conduct – and this will surely depend to a large extent upon the facts: the economic position that the life office faces being one of them I also suspect that this will in essence be the view that Counsel will take – or indeed a court, were matters to go that far.*
>
> *It may well be, as* [Chief Counsel B] *suggested to me, that the House of Lords in considering the Equitable guaranteed annuities touched on these issues, and we can certainly look into that.*

29/12/2000 [11:57]	FSA's Director of GCD informs Chief Counsel B that he agreed with the suggestion that FSA should undertake some work on the benefits/disbenefits of seeking to wind up Equitable.
29/12/2000 [15:30]	Equitable's solicitors send FSA a copy of revised instructions to Counsel (see 21/12/2000 [**08:56**]). The solicitors ask for comments by 4 January 2001, ahead of conference with Counsel on 9 January 2001.

29/12/2000 [16:21]	An FSA official distributes the latest version of FSA's '*Most Frequently Asked Questions*', which incorporates comments made on the draft of 27/12/2000 [**16:02**].
29/12/2000 [16:52]	Equitable provide FSA with updated information from the previous day on the value of payments made on surrenders, transfers and switches, and calls to Equitable's helpline.
29/12/2000 [17:15]	Equitable reply to FSA's query of 27/12/2000, concerning how members of group schemes were being provided with information. Equitable also respond to the request of the previous day for a meeting, suggesting the week commencing 8 January 2001, and to a query about their application of the market value adjuster, saying they would respond in due course.

January 2001

02/01/2001 [entry 1] FSA and PIA meet to discuss Equitable. FSA's note of the meeting records the conclusions and action points agreed on the issues related to '*Media*', '*MVA*' and '*Policyholder Information*'.

In relation to the market value adjuster, the note records that:

> *No information about OFT timetable available; FSA wrote to OFT* [week ending] *22/12 and OFT requested information from Equitable – Equitable have not responded to date.*
>
> [FSA's Director of Insurance] *wrote to* [Equitable's solicitors] *on 19 December about any possible legal implications of the application of the MVA that would reduce the amount paid on a surrender (or other non-contractual termination) to an amount that would be "lower than the accumulated guaranteed fund that would be available on contractual termination" and in particular whether any such move might in some way be contrary to the House of Lords' decision. Equitable's response appeared robust but required further work on presentation.*

FSA's note continues, stating that:

> *Attendees were concerned about potential implications of any further increase in MVA.* [The Director of Insurance] *explained FSA's responsibilities and powers in this area and the complications caused by the competing interests of different groups of policyholders. FSA's powers were separate to any consideration under Unfair Contract Terms (currently within OFT's responsibility but soon to move to FSA).*

It is agreed that Managing Director A would draft a letter to Equitable's Appointed Actuary, informing him that FSA would be concerned if the market value adjuster were increased from its current level without '*significant justification*'.

FSA's note goes on to record that FSA's Chairman has requested more information to verify that the market value adjuster was in line with other insurers. Attendees confirm that GAD had provided an oral briefing to FSA, which had said that Equitable's application of the market value adjuster was more transparent than others in the industry.

It is agreed that Line Manager E would request a briefing note from GAD on industry comparisons.

[**15:50**] Line Manager E requests the briefing note from GAD, comparing Equitable's surrender values with the rest of the industry.

02/01/2001 [entry 2] The Government Actuary writes to an Equitable policyholder in response to a complaint about the regulation of Equitable. After noting that GAD had never been responsible for insurance regulation, the Government Actuary says:

> *The Government Actuary's Department has provided actuarial advice to each of these regulatory bodies but it would not be appropriate for us to disclose details of the professional advice given to our clients.*

The Government Actuary continues:

> *I would emphasise that ELAS has always met the statutory solvency margin requirements, which are substantially more stringent than a normal test of insolvency. UK insurance legislation, based on the requirements of EU directives, but in common with insurance legislation in many countries, envisages intervention by the supervisory authorities if and only if the solvency margins are breached.*

> *ELAS has prudently decided ... that they should cease to accept new business. However, they expect to be able to meet all their liabilities as they fall due.*

The Government Actuary had sought advice from Chief Actuary C on a draft of the letter, asking whether the draft was appropriate or '*should I be even less forthcoming*'. The following drafting was removed from the final sentence quoted above: '*so there is no question of insolvency, the approach of which would have triggered regulatory intervention*'.

Reference to the continuing ability of Equitable to meet their solvency requirements was also omitted.

(Note: I am told that the statement was omitted from the final version in line with established policy and practice at GAD not to say anything about a company's solvency position that was not in the public domain.)

02/01/2001 [08:31] FSA's Director of Insurance asks Legal Adviser A to consider Equitable's draft instructions to Counsel, received on 28/12/2000 [**15:30**], as he was very anxious that FSA and Equitable should keep closely in step over this issue.

02/01/2001 [12:45] FSA's Line Manager E circulates draft '*lines to take*' for dealing with enquiries from members of the public.

02/01/2001 [13:15] GAD's Directing Actuary B writes to Scrutinising Actuary F about Equitable's letter on their 1999 returns (see 21/12/2001 [**entry 1**]). The Directing Actuary says that the Scrutinising Actuary needed to suggest to FSA that they should take legal advice on the interpretation of Regulation 72(3). The Directing Actuary gives his view that the regulation did require that the actuary should look at whether the payment could be covered by existing resources, should the option be exercised, and that there was no indication that the actuary would be allowed to assume that only a small percentage of clients would exercise that option. He believes that the relevant paragraph of a draft revision to Guidance Note 8, which was currently being consulted on, relates to Regulation 72(1), not to Regulation 72(3) directly – and that GAD's interpretation was in line with the recommendations in the professional working party paper. The Directing Actuary concludes that, if GAD's interpretation were not correct:

> *... actuaries would be able to circumvent their basic premise that the reserve should be at least equal to the PRE surrender value on mass discontinuance (the reference here to "mass" being largely at the insistence of Equitable!)*

02/01/2001 [15:38] FSA's Head of Press Office informs senior officials and Equitable's supervisors that Equitable's press office were stressing that the market value adjuster applied to the projected final bonus as well as to the guaranteed element, and had said that they were only being criticised about this as other insurance companies were less transparent about the final benefits of their policies. The Head of Press Office gives, as an example of Equitable's more transparent approach, the fact that '*Equitable send a statement each year identifying the guaranteed bonuses and a projection of the final bonus*'.

The Head of Press Office also reports that Equitable have also conducted an analysis of final surrender values which had confirmed that, even with the adjuster, they compared '*pretty well*' with the market. However, he says that '*that is not a message they are keen to peddle at this stage since their main priority is to encourage people to stay rather than leave*'.

The Head of Press Office concludes by saying that: '*The main focus for* [Equitable] ... *is the OFT and getting a powerful response to them on the MVA*'.

02/01/2001 [16:42] FSA's Line Manager E provides FSA's Press Office (and others) with a summary of the information supplied by Equitable on the levels of policy surrenders, transfers to another company, and switches to unit-linked policies. The Line Manager also provides a summary of Equitable's handling of calls to their customer enquiry line.

02/01/2001 [17:39] In response to his suggestion of 28/12/2000 [**17:44**] that FSA should look at the benefits or disbenefits of seeking to wind up Equitable on just and equitable grounds, Chief Counsel A suggests to Chief Counsel B that he should initially undertake a broad brush overview about which they could then take stock and discuss next steps. She explains that: '*Anything more thorough would require to be worked up with supervisors and GAD*'.

03/01/2001 [entry 1] FSA meet Equitable and their advisers to discuss progress on the sale of the business.

Equitable's advisers provide an overview of the position of discussions with the key interested parties ('Prospective Bidder D', 'Prospective Bidder E', 'Prospective Bidder F' and Halifax) and say that they expect to receive indicative proposals the following week. The advisers say that each party was working on slightly different proposals, with Prospective Bidder E's bid appearing to be the most comprehensive. This envisaged acquisition of Equitable's infrastructure first, and later looking to achieve an '*accommodation*' with GAR policyholders, followed by a transfer of the ongoing business pursuant to Schedule 2C of ICA 1982. The bidder hoped to continue both with-profit and unit-linked business.

Equitable's advisers say that discussions with Prospective Bidder B were facing difficulties, as the bidder desired exclusive negotiations. The advisers confirm that, nevertheless, all the other bidders:

> *... were looking to buy the infrastructure and leave a closed Equitable fund. However, they were also looking at ways of enabling the existing policyholders to transfer from Equitable into new funds within the purchaser's group on favourable terms. He thought that none were looking to inject large amounts of shareholders funds but all the proposals involved some form of capital support to the ongoing fund.*

FSA's Chairman says that FSA's interest in the discussions was to ascertain what input potential bidders might seek from them, and:

> [FSA's Chairman] *noted that it was likely that if there was to be a transfer or accommodation subject to court approval, the court could place considerable reliance on any views expressed by us. He noted that we were willing to be involved and would make ourselves available when required ...* [The Director of Insurance] *said that there was a limit to how far we could commit ourselves in advance, but we would do our best to give an indicative view. He added that it would be useful to have early discussions so we could better understand the proposals, and that not all the regulatory hurdles would necessarily be easy to overcome.*

After discussion about the effects of various sale scenarios on the sales force, FSA's Chairman asks whether the market value adjuster had been raised. In response:

> [Equitable's adviser] *said he believed most were expecting it to remain. There were essentially three options under all the proposals: a policyholder could stay in the closed fund, leave the fund and suffer the mva, or they could transfer to the acquirer, who would look to enhance the value of the transferred funds (eg on the basis of low acquisition costs).*

Equitable's advisers continue: '*The level of surrenders had remained fairly stable, running at about four times the usual rate*'.

Equitable's Appointed Actuary says that there were no plans to increase the level '*which continued to operate marginally in favour of those remaining in the fund, but* [he] *noted that the current value of shares meant the margin was very thin*'. Equitable say that they were yet to respond to the OFT, who had asked about the justification for the adjuster.

Equitable's President informs FSA that Equitable had sold a substantial quantity of equities and that their equities to fixed interest ratio was now 55:45 (from 60:40).

The potential benefits of some form of compromise between the different policyholder groups are discussed. FSA's note records that:

> *... even in isolation there were potential benefits ... whether by a s.425 scheme, a Schedule 2C transfer or even a contractual buying out of GAR rights. The latter would not be a complete solution, compared with a court solution, as some GAR policyholders would almost certainly not sign up. It was not, however, ruled out.*

FSA ask about whether Equitable's sales force might stop giving advice. FSA later receive revised proposals, which clarify to staff the extent to which they could provide advice and when those staff should refer policyholders to an independent financial adviser.

Under the heading '*Post 20 July sales*', FSA's note records: '[FSA's Managing Director A] *asked if there had been any developments on the post 20 July 2000 sales.* [Equitable's Appointed Actuary] *said that there had not, since there was no real indication from the behaviour of policyholders that there was a particular issue about the most recent sales.* [The Director of Insurance] *said that it would be useful to develop a general approach to complaints handling, and that it might be helpful to discuss that at an early stage with the* [Financial Ombudsman]'.

Following the meeting, FSA's Chairman talks to Equitable's President about Equitable's Board and, in particular, about the position of their Appointed Actuary. The President explains that the charges being incurred, as part of the search for '*headhunters*' to assist with finding new non-executives, were, in his view, '*hugely inflated*'. FSA's Chairman says that he had advised Equitable's President:

> *... to point out to them that, in present circumstances, the costs of the assignment would be highly likely to become known, and they would need to watch out for their reputation if it looked as if they were picking over a corpse too extravagantly.*

FSA's Chairman records that he had expressed surprise when informed that Equitable's Appointed Actuary would sit on Equitable's Nomination Committee that would vet applications for non-executives, as it was '*highly unusual for executives to be involved in choosing the non-executives on the Board*'.

(Note: it has been explained to me that, historically, Equitable's Nominations Committee had been comprised wholly of non-executive directors. In the unusual situation of early 2001, when all the non-executive directors had announced their intention of resigning as soon as replacements could be found, those non-executive directors had felt that it would be inappropriate for them alone to decide on new director appointments and had asked the Society's Chief Executive to join the Committee to provide some continuity. When FSA's Chairman raised his concern, Equitable's Chief Executive had relinquished his membership of the Committee and the Society had reverted to the historical norm.)

FSA's Chairman says that FSA did not want the individual to remain in the Chief Executive and Appointed Actuary roles concurrently for any longer than was necessary, to which Equitable's President agreed. The Chairman also says that '[the Appointed Actuary] *had been associated with some propositions in relation to reserving for GARs which were particularly extreme, and any review of regulation in the past would be bound to draw attention to that*'. Equitable's President again apologises for the position that the Society had got itself into, adding that he did not know what it could have done in the last two or three years to avoid it. FSA's Chairman suggests that '[there] *were policy holders, of course, who thought they should have* [attempted] *to do a deal earlier, rather than take the case all the way to the Lords*' to which the President replied that Equitable: '*had thought about that, but had been strongly advised that the only way to get certainty was to take a case. But that was now all water under the bridge*'.

On the following day, FSA's Chairman informs the Director of Insurance, Managing Director A, the Head of Life Insurance and Line Manager E of this discussion.

03/01/2001 [10:57] FSA's Managing Director A seeks confirmation from the Director of GCD that there are no legal objections with a draft letter to Equitable about their use of the market value adjuster. [**14:21**] Chief Counsel B later sends Line Manager E and Legal Adviser A some drafting points. (The letter is sent the following day.)

03/01/2001 [12:53] FSA send Equitable's solicitors a copy of their further instructions to Counsel to advise on the application of the Unfair Terms in Consumer Contracts Regulations 1999.

03/01/2001 [16:31] FSA's Director of Insurance writes to Managing Director A about a meeting with the action group planned for 5 February 2001. The Director of Insurance suggests that, while the exact nature of any statement depended on the outcome of the meeting, a possible public line to take might be:

> *FSA is keeping closely in touch with all interested parties. Much of our effort has been directed to ensuring that policyholders are given the fullest possible information (both by the Company and via our helpline/website etc). Moreover policyholders, both as policyholders and owners of the company, are likely to have an important role to play in future developments – particularly in any which might involve some resolution of conflicting interests between different categories of policyholders. It is therefore right that we should* [hear] *what policyholders think both of the adequacy of the information etc which has been made available and on possible future developments.*

03/01/2001 [16:41] Equitable let FSA know when they hope to provide information on briefing for sales staff, client serving information and their availability for a meeting with FSA. Equitable ask whether FSA have any comments on the content of the Society's website and invite Equitable's views on a proposal that their representatives should telephone policyholders to see if they had any questions.

03/01/2001 [18:31] Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

04/01/2001 [entry 1] FSA meet Halifax's Chief Executive, who wanted to inform Equitable of the possibility that they might make an offer for parts of Equitable. The Chief Executive explains that Halifax had been interested in acquiring Equitable prior to closure to new business '*but had not pursued it previously because they were concerned about the balance sheet implications for the group and were not sure that they would be in a position to support the business going forward*'. The Chief Executive says that they had revisited this in the light of Equitable's closure to new business. The Chief Executive outlines their two stage proposition where they, first, buy Equitable's infrastructure (with Equitable then contracting out those services to Halifax) and, secondly, seek to reach an accommodation between different groups of policyholders. He explains that the second stage was key to realising the value of their investment in the sales force. He says that Halifax were also looking at the possibility of buying Equitable's unit-linked business.

FSA's Managing Director A notes that:

... the FSA was not there to be involved in the commercial considerations behind a possible deal. However, he said that we would be willing to help to deal quickly with regulatory issues. He also noted the FSA's potential involvement in any court based procedures, where [the case of another company] *had demonstrated that a judge might attach considerable weight to any evidence submitted by the FSA.* [FSA's Director of Insurance] *added that a court based procedure would be necessary both for a section 425 reconstruction or a Schedule 2C transfer.* [The Managing Director] *also pointed out that it was important not to overlook any banking regulatory issues.*

FSA's note records:

[Halifax's Chief Executive] *said that the condition of the closed fund was a matter of concern. Part of the problem was the GARs, which was widely acknowledged, but he thought also that the general inadequacy of capital in the fund was a real problem. He asked about our position on the concessions that had already been granted to Equitable, to which we replied that we saw no reason for our attitude to change following any deal.* [Halifax's Chief Executive] *also asked our view if the statutory solvency requirements were breached. Halifax were concerned that if they were, they would wish to be able to continue to make bonus allocations while working on a longer term plan for the restoration of the financial position. If bonuses could not be paid in such circumstances until after the solvency position had been corrected, that could seriously damage the goodwill of the customers they were seeking to attract.* [FSA's Director of Insurance] *expressed sympathy over the problem but said it would be difficult to give assurances on this point since it might depend on wider market conditions that could not be predicted with certainty.*

Halifax's Chief Executive also asks: '*if it was consistent with the closure to new business for Equitable to continue to take on further funds and premiums. We confirmed that this was acceptable where the policies, or rights to a further policy, existed before the closure announcement*'.

04/01/2001 [entry 2] FSA write to Equitable, following discussions '*on a number of occasions*' about the market value adjuster. FSA explain that they had sought to make clear that:

- *the level of the MVA for <u>any</u> insurance company is of legitimate concern for the FSA because of its implications for policyholders' reasonable expectations and for directors responsibilities under the "criterion of sound and prudent management".*
- *in the circumstances in which the Equitable currently finds itself, there are particular prudential risks of any further rise in your present MVA – namely that it might cause the obverse of what is intended, by leading people to panic into early surrender.*

FSA say that they had indicated that FSA expected to be consulted on any plans to raise the market value adjuster applied to policies, and that consulting would:

... reduce the risk that might otherwise arise (and which would be of no benefit to either the Society or to policyholders) that if you were to raise MVAs the FSA might then find it appropriate to take formal action, on PRE or "sound or prudent management" grounds to secure a reduction in them.

FSA continue:

I understand the point you have made to me in response, namely that there are circumstances in which you might wish to move very quickly – most obviously in the event of a sharp sudden fall in asset prices. In such an event, the FSA recognises that adjustment of the MVA can be one way of seeking to ensure a balance between the legitimate interests of policy-holders that stay with the company and those that wish to *terminate their policies. Let us hope that such circumstances do not arise. If, however, they do I should be grateful if we could discuss the issue urgently before any decision is taken.*

FSA note:

Obviously, while the circumstances currently facing the Equitable are specific to your Society, MVAs are a topic of general interest to the life assurance industry. Recent circumstances suggest that there may be a case for the FSA to consider providing general guidance on how it views this topic and the main circumstances it would take into account in deciding at any point in time whether to exercise its powers.

04/01/2001 [11:21] FSA's Director of Insurance writes to Line Manager E about restrictions on distributions by a holding company with an insurance subsidiary with a life fund in deficit. The Director sets out his understanding of the issue with discussion of the relevant sections of ICA 1982, as well as FSMA 2000. The Director of Insurance notes that:

- section 29(7) of ICA 1982 would prevent any company from declaring a dividend where the long term fund or funds of a subsidiary insurance company were in deficit on the regulatory basis;
- a section 68 Order could in theory disapply section 29(7), but only where the company was an insurance company – it was '*not immediately clear that it is available in respect of non-insurance companies*'; and
- the position would change when FSMA 2000 and associated rules and regulations came into effect.

In the light of the above, the Director of Insurance sets out the following options:

- It was arguable that, due to Article 4 of Equitable's constitution, their long term fund could never be in deficit. FSA were sceptical of this view and it was inconsistent with initial advice received from Counsel.
- It might be that HMT could make a section 68 Order to disapply section 29(7), which could raise policy problems said to be '*difficult*' but '*in the circumstances probably not insuperable*' for FSA. The Order would have limited use, as such an order would have no effect once ICA 1982 was replaced by FSMA 2000.
- There was no provision within FSMA 2000 similar to section 68 in ICA 1982 which would allow HMT to waive any requirement under the regulations due to come into force. A '*generic, but suitably restricted*' draft of the regulation was suggested, so as to prevent other companies in a similar position to Equitable exploiting a possible loophole which could be created by that regulation. It was said, however, that this option '*looks fraught with difficulty*'.
- HMT regulations could not be waived but an exemption could be provided in respect of the FSA rule. If granted, no breach would occur and the HMT regulation would not be triggered. The Director of Insurance says:

  This seems a much more promising way forward – not least because it would keep the issue under our own control and would not be subject to the vagaries of HMT drafting and Parliamentary process. To be acceptable it might well be necessary to accompany the exemption by a bespoke requirement on the Equitable (perhaps restraining the Equitable from moving assets out of the long term fund except in certain defined circumstances).

FSA's Director of Insurance concludes that the last option appeared to be the only '*serious contender*'.

[**12:59**] Line Manager E says:

I think there is a fundamental policy issue we need to address here before we can work out the detail. However, it does seem that even if there are short term difficulties, there may be scope for overcoming them from N2 – it really depends what restrictions we think are necessary across the board.

The Line Manager notes further that:

The provisions in section 142 [of FSMA 2000] *were included because of an (ie my) understanding at the Treasury that the general prohibitions on making distributions or charges would be continued in FSA rules.*

Your account of the proposals for funds in deficit suggest that the de facto prohibition on paying dividends will not apply (although a dim view will presumably be taken in the event a company whose fund is in deficit makes distributions at a time that it can ill afford to do so). However, this change of approach is significant, and not something I had appreciated. The power of the Treasury was intended to back onto the requirements that would be imposed on the insurance companies themselves. However, if the primary requirements are not to be imposed on the insurance companies themselves, I am not sure I (if I were still in my previous [incarnation]*) would see the grounds for imposing secondary restrictions on the parents of insurance companies. It is even arguable whether the lack of corresponding "asset identification rules" might even have the effect of narrowing the Treasury's discretion to make the Regulations we had talked about.*

Before we can produce an analysis of the future impact of the regime, I think we need to work out quite what the restrictions are that we would be looking to impose on parent companies, and then explain our position to the Treasury ...

Perhaps [the Insurance Division's Head of Policy (the Head of Insurance Policy)] *and I could discuss?*

[**13:22**] FSA's Director of Insurance thanks him for his comments and asks Line Manager E to discuss this urgently with the Head of Insurance Policy.

[**14:08**] The Head of Insurance Policy writes:

Happy to discuss. But you might like to note that [the Director of Insurance's] *memo is not quite right in one important respect which I think might be the key driver of the concern you express.*

FSA rules, not HMT [Regulations]*, prohibit the insurer from paying a dividend when its long-term insurance fund is in deficit – see rule 3.2(6) in Consultation Paper 41a. The HMT* [Regulations] *(will, when drafted) merely reinforce this by also prohibiting the holding company from paying a dividend.*

[**15:50**] The Director of GCD gives some comments, following '*useful discussions*', including:

Under the existing law, the legal position would be straightforward, I believe, if the company wishing to pay the dividend were a UK authorised insurer. In that case, a section 68 order could in my view lift the section 29(7) requirement from it both as an insurer and as a holding company. Since the section 68 powers are for HMT to exercise, it would need to be HMT lawyers who advise on this, but it is in my view the correct position.

However, the position under the existing law would be more difficult if the holding company were not an insurer. This is because section 68 powers allows us to lift requirements only for insurers. I have not yet found a way to resolve this issue. (I have not researched the idea that section 29(7) applies only to holding companies within the UK jurisdiction, but this seems to me pretty improbable.)

I am, however, more optimistic about the prospect for dealing with the problem under the new legislation ...

As I understand it, the existing outright ban on distribution by holding companies creates many anomalies. We could therefore modify the rules we have currently proposed, not only to extend them to holding companies who are authorised, but also to avoid these anomalies, for example, by creating a group derogation. This could allow distribution by a holding company where the assets of the group are such that the group could have made the distribution if it had been a single insurer, or where the insurer with the life fund has been required by a group on terms designed to ringfence its funds (and their liabilities).

[**17:44**] Legal Adviser A notes that:

... the starting point is Article 21(2). In general, we cannot restrict the free disposal of assets. I agree with your comment on Article 24(3) which is reflected in section 32 and 45(2) and 37(3)(d). The only obligation to restrict seems to be in [the] *second paragraph of Article 26. I can find nothing to suggest that we must impose a restriction on the holding company.*

[**18:05**] The Director of GCD asks: '*does this mean that the existing s29(7) is inconsistent with the directive and could be repealed under* [the European Communities Act 1972] *S 2(2)?*'.

04/01/2001 [11:28] FSA thank Equitable for the information supplied on 03/01/2001 [**16:41**], including that on call handling and surrenders, transfers and switches [**18:31**]. FSA say that they have no comments on Equitable's website, as it had since been updated and that the suggestion to proactively contact policyholders would be welcomed. FSA say that the subject matter of a forthcoming meeting with Equitable would be '*primarily about prudential issues involving actuaries (eg reserving and solvency)*'.

04/01/2001 [16:13] GAD provide FSA with a short note '*prepared to give some background information on the relative level of surrender values offered by Equitable*', in response to their request on 02/01/2001 [**15:50**].

GAD's note reproduces the results of a Money Management survey carried out in February 2000 (and published in April 2000). GAD explain that the survey showed that Equitable's maturity payouts were slightly below average in February 2000 '*(and indeed they have been in the third quartile on their 20 and 25 year policies since around 1990)*', but that their surrender values at most durations (and original terms) were above average in February 2000 (except for policies approaching maturity).

GAD go on to explain that the application of a 10% market value adjuster would reduce these payments on surrender but that they would still be close to the average for endowment policies at most terms and durations, and indeed higher than average for short duration policies.

GAD also point out that other companies were also likely to have reduced their surrender values to reflect the negative investment returns of around -2% to -7% that most companies were likely to have experienced on their with-profits funds during the year 2000. Accordingly, '*we would expect to find that surrender values on with-profit endowments offered by Equitable Life are still likely to be fairly close to the average for all companies, even after the application of the 10% MVA factor*'.

GAD explain that Equitable had only a relatively small portfolio of with-profits endowment policies (which was the main type of contract on which published surrender value surveys were carried out) and that: '*We do not have any corresponding survey figures for the transfer values available on accumulating with-profit pension policies (the Equitable's main product line) but we would expect the pattern to be similar ie close to average surrender values.*

(Maturity values on pension policies were though shown to be around 5 to 10% below the market average in a March 2000 survey.)'

05/01/2001 [09:55]	FSA's Director of GCD queries how the market value adjuster was deducted from the guaranteed amount of a policy (see 02/01/2001 [**15:38**]). The Director of GCD asks: '*Does this mean that if a policy has a guaranteed value of £10,000, and a projected final bonus of £5,000, the MVA is £1,500 and this is deducted from the £15,000 so that the policyholder gets back £13,500?*'. Line Manager E confirms that FSA's understanding was that this was done on that basis, clarifying that the final bonus would '*only be the share of the terminal bonus earned after x years, not the amount that would have been earned had the policy run its course*'.
05/01/2001 [10:33]	FSA send GAD a copy of the information Equitable had sent to them on 19/12/2000 [**16:08**] about their application of market value adjusters.
05/01/2001 [12:23]	An FSA Legal Adviser writes to the Director of GCD about restriction on dividends and makes the following observations regarding whether section 29(7) is inconsistent with the First Life Directive: *I ... conclude that the inconsistency exists. The payment of a dividend is a form of disposal of assets. The existence of a deficit on the long term business does not justify restricting, under the Life Insurance Directives, the payment of a dividend. Section 29(7) could therefore be repealed under section 2(2) of the* [European Communities Act 1972], *since in effecting the repeal we would be implementing a Community obligation not to restrict the free disposal of free assets.* *I should imagine that if we were to remove the inconsistency we would wish (how urgently I can only speculate) to do so by replacing it with a provision that goes at least some way towards achieving the same policy objective (for instance requiring the insurance company to notify FSA if a dividend were declared where the deficit existed). That would then raise the question whether the replacement provision itself could be effected under section 2(2) and whether, if not, we could make use of other powers.* [**14:32**] The Director of GCD agrees with this view, saying: *... we will not be in a position to replicate such a provision in our rules, as currently proposed ...* *This does not necessarily provide a complete answer before N2. Assuming HMT agree with our view, they could repeal the existing current Insurance Companies Act requirement by regulations under the European Communities Act. We will need to give further thought to whether the* [provision] *has any legal effect in the interim.*
05/01/2001 [13:51]	GAD's Scrutinising Actuary F declines an invitation from FSA's Head of Life Insurance to a meeting with Equitable Investment Fund Managers Limited. The Scrutinising Actuary explains that he would be happy to attend but that, in view of his heavy workload, it might be preferable for him not to do so on this occasion. He advises that GAD believe that the company could continue to take investment-only business, subject to their marketing expenses being met by the margins generated by the company, and there being no cross-subsidy between it and the Society. An official subsequently notes that Equitable Investment Fund Managers Limited had no marketing expenses.

05/01/2001 [13:56] Equitable send FSA a draft briefing note that they planned to send to their representatives, which included information sheets for issuing to clients. Equitable ask for FSA's and PIA's comments.

Equitable also send FSA two communications that have '*come my way*' which showed the advice being given to policyholders by two Independent Financial Advisers. In one of the two Independent Financial Adviser communications, it says, in response to the question, '*Is our money safe?*':

> *Yes – the Society has closed to new business. It remains solvent and will continue to meet its contractual obligations under existing policies. Should this position alter 90% of investors' funds will be met under the Policyholder's Protection Act.*

The advice given also states:

- that future returns were likely to be poor;
- that, as a closed fund, the Society was forced to be more cautious by investing in gilts rather than equities. This would also impact on future returns;
- that Equitable were likely to increase future charges;
- that anyone with unit trusts was advised to sell and reinvest, as these funds had historically under-performed and there would be no penalty for selling;
- that investors with with-profit bonds should surrender at the first penalty-free opportunity;
- that those with endowment plans should generally surrender their plan if they were still in the early years. Otherwise, they should continue with the premium but arrange to fund any shortfalls from the Equitable Life plan. It was recommended that investors '*Please seek our advice before surrendering your plan, as there may be tax implications*';
- that holders of with-profits pensions were most affected. Those with less than five years to normal retirement should remain invested, as Equitable would impose an exit penalty. Those with more than five years to retirement should consider transferring, as the exit penalty would be made up by better growth elsewhere. Investors who had GAR policies should seek individual advice as: '*The value of the "guarantee" lost on transfer needs to be weighed against the inevitable loss of growth in remaining invested. We would strongly recommend that anyone with this type of plan bring us their policy document in order that we can fully assess the implications*'.

The advice also noted that the exit penalty was currently 10%, but that this might change. It concluded by informing policyholders that:

> *It is essential that all Equitable Policyholders review their contract in light of the current circumstances and we would suggest that you contact one of our advisers as soon as possible.*

FSA's Line Manager E notes that Equitable had planned not to make a public comment about this type of advice. However, he says that Equitable '*were considering if they could privately raise it with the media as a way of alerting policyholders to the need for care when taking independent advice, and to rubbish scare stories*'.

05/01/2001 [17:54] FSA's Chief Counsel B informs the Director of GCD that he had had a '*satisfactory* [conference]' with Counsel that morning in relation to advice on the operation of the Policyholders Protection Act 1975, in the light of Article 4 of Equitable's Articles of Association. Chief Counsel B reports:

[Counsel] *has firmed up on his advice as to the preferred meaning which is the "Third meaning" identified at the previous* [conference] *that the reference to "assets" in* [Article] *4 should be taken as referring to the gross assets of the Society – this means that a policyholders rights under a policy would only fall to be scaled down (by the operation of the Article) where the liabilities under that policy exceeded the total gross assets of the Society – what you don't do is net off all policy liabilities and then assess whether there is a deficiency and if so scale down.*

05/01/2001 [19:26] Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

08/01/2001 [entry 1] Equitable write to FSA in response to their letter of 21/12/2000 on new sales following Equitable's closure to new business. Equitable set out their position on group schemes and explain that, on transfers, they had sought confirmation of the exact position from their solicitors. Equitable also set out figures regarding new policyholders who had joined after 20 July 2000. Total new policies effected were 17,832 – of those, 8,841 had been with-profits contracts. Of this total, 10,500 were new clients and, of these, less than 6,000 had effected a with-profits contract.

08/01/2001 [entry 2] FSA's Director of GCD provides Managing Director A with advice on how to deal with concerns that had been expressed about FSA's regulatory approach to Equitable's advertising in the period after the House of Lords' ruling. The Director of GCD suggests that the following questions might need to be addressed by FSA and should be considered:

Was it in fact your view, after the House of Lords judgement, that failure to sell the company would lead to closure to new business?

along with the following '*other*' questions:

a) whether, short of acquiring a disclosure along these lines, we were concerned about the scale of advertising on the part of the Equitable in this period, whether we took any action to express that concern to the company, or ask it to reduce the scale of that advertising;

b) whether we formed any view on the accuracy of the statements made in that advertising or of the company's ability to meet the policyholder expectations it was creating;

c) whether we believe that the scale of the advertising during that period was normal for the company concerned, or whether we believe that it was specifically designed with a view to a possible sale;

d) whether we are happy with the response which we gave when concern was expressed to us about the Equitable's ongoing advertising or whether, with the benefit of hindsight, we believe that that could have been better handled;

e) whether we undertook any particular enhanced monitoring of Equitable's advertising during the period concerned;

f) how far we think that the split accountability for prudential regulation, to HMT, and conduct of business regulation, to PIA, may have affected our response;

g) how the move to the new regulatory structure might make a difference, either in strengthening or reducing our powers.

The Director of GCD suggests producing a briefing regarding FSA's approach to investment advertising in the context of consideration of the European Directive on misleading advertising.

08/01/2001 [entry 3] FSA (Head of Life Insurance and Line Supervisor C) and IMRO meet Equitable to discuss new business issues for Equitable Investment Fund Managers Limited, following Equitable's closure to new business. According to FSA's note of the meeting, the following points are considered:

- that Equitable Investment Fund Managers Limited had not actively marketed themselves or sought business since Equitable's closure to new business;
- that Individual Savings Account (ISA) business would roll forward into the following tax year, unless an investor wished to cancel. Equitable Investment Fund Managers Limited wished to continue offering ISAs to existing clients; and
- that Equitable Investment Fund Managers Limited also sought clarification on whether it would be appropriate for them to invest money in, for example, an Open Ended Investment Company, if approached by a client to do so.

FSA and IMRO confirm that the continuation by Equitable Investment Fund Managers Limited of business in this passive manner should not pose problems in the light of the current situation, but that this would need to be revisited should there be a sale and/or restructuring, as '*there could be an issue regarding viability of* [Equitable Investment Fund Managers Limited] *on a stand alone basis*'.

It is noted that IMRO had seen the financial information provided by Equitable Investment Fund Managers Limited prior to the meeting and that it had been thought that any potential problems would be human resource-based rather than financial.

FSA's note records that Equitable Investment Fund Managers Limited had provided IMRO with some financial information prior to the meeting. FSA record that in this information, Equitable Investment Fund Managers Limited acknowledged that they faced a heavy administrative workload, having to deal with queries and surrenders. The information noted that there appeared to be a fair amount of uncertainty in investors' minds, however, those investors did not appreciate that Equitable Investment Fund Managers Limited investors were not affected by the GAR uncertainty which affected the Society's with-profits fund. Equitable Investment Fund Managers Limited were considering writing to investors to clarify the difference between an investment between Equitable Investment Fund Managers Limited and the Society.

08/01/2001 [entry 4] FSA's Director of GCD establishes an 'Equitable Life Lawyers Group' whose purpose it was: '*to review legal points already raised in connection with the Equitable case and confirm that they have been adequately dealt with; to deal with any outstanding legal points; to address legal issues as they arise; to consider other legal issues that may arise; to provide legal advice to our colleagues where necessary*'.

08/01/2001 [09:53] In response to Chief Counsel B's note of the clarification from Counsel (see 05/01/2001 [**17:54**]), the Director of Insurance says:

> *This advice is clearly helpful. I am concerned however about the possibility that* [Equitable] *may take a contrary view – particularly if this leads them to take action which might be unhelpful to policyholders and which (a fortiori) we would consider unnecessary. That said I am not* [clear] *what that action might be. But, if for example they came to the view that the* [Equitable] *couldn't become insolvent in* [Policyholders Protection Act 1975] *terms they might* [feel] *it appropriate to warn policyholders about this. It would clearly be relevant to any policyholder in deciding whether to surrender a policy. But such a warning, if inaccurate, could produce the "wrong" decision. If we do end up taking different views we will presumably need to provide rather clearer guidance to policyholders and to the Equitable on the availability of compensation in the event of insolvency. Are we comfortable that unequivocal guidance be given?*

Against this background I have been one of those who have thought ([in] *my simple non-lawyer sort of way) that it might be a good idea if we and the* [Equitable] *could contrive to get the best, most reliable and most consistent advice so that we could ensure that policyholders are, in turn, best advised and protected. Happy to discuss.* [There] *are clearly issues here which I do not understand!*

[**10:58**] The Director of GCD comments:

I would be concerned in this event that the [Policyholders Protection Board] *might take the narrower view, or at least be reluctant to agree* [with] *the advice we have received, because of concern to protect their fund. We need to guard against this – hence my desire to get support from* [government] *lawyers*. [Chief Counsel B] *has suggested that this needs to be done on the back of scenario planning as to how the issue might arise*. *Could* [Legal Adviser A] *prepare this, discussing with* [Chief Counsel B] *what he has in mind?*

[**16:41**] Chief Counsel B replies that he had discussed the matter with Legal Adviser A and they had agreed to start work on the scenario planning.

09/01/2001 [entry 1] GAD write to Equitable in response to their letter of 21/12/2000 about their 1999 returns. GAD:

- note that Equitable were considering what reserving basis for GARs was appropriate following the House of Lords' decision;
- note that Equitable intend to strengthen their assumptions in respect of payments of future GAR premiums;
- note the comments made on the assumed retirement age for personal pension business. However, GAD '*take the view at present that Regulation 72 (3) overrides Regulation 72 (1) and requires the actuary to set up a liability sufficient to cover the cash payments that would result from an exercising of the vesting option, at any time that that option may be exercised. In our opinion, the revised GN8, in paragraph 3.8.2, is referring to Regulation 72 (1), and not Regulation 72 (3)*';
- in relation to the quasi-zillmer adjustment used in the resilience test, assume that Equitable have accepted GAD's interpretation of the Regulations and note that Equitable would be applying a more sophisticated hypothecation of assets; and
- note that Equitable were reviewing the level of provision required for expenses in the resilience scenario.

GAD send a copy of their letter to FSA, explaining that there remained disagreement over the retirement age assumptions used (that is, over the interpretation of Regulation 72) and suggest that the matter is referred to FSA's lawyers for a definitive view.

By way of background, GAD explain:

... that in his valuation, [Equitable's Appointed Actuary] *assumes that benefits are taken at age 60 on retirement annuities, and at age 55 on personal pension contracts. On the retirement annuities, benefits may in practice be taken at full value (i.e. without applying an MVA) at any time between the ages 60 and 75. In his letter of 29 November,* [the Appointed Actuary] *said that the actual average age of retirement is closer to 65 [than 60] on these contracts, but a reasonable proportion of clients retire at 60 or shortly thereafter, and so age 60 was chosen as a prudent assumption in the valuation. Indeed, this is the strongest age assumption he could be expected to make.*

On the personal pensions, benefits may be taken at any time after age 50 at full value. [The Appointed Actuary] *told us in his 29 November letter that the average retirement age on these contracts is still well over 60, but since retirement in the late 50's is more* *popular than previously,* [he] *felt it appropriate to "introduce an extra degree of prudence into the valuation" by using an assumed retirement age of 55. (In previous valuations, he assumed a retirement age of 60 on this business also.)*

Because the valuation discounts the guaranteed retirement benefits from the assumed retirement age to the valuation date, the sooner the benefits are assumed to be taken, the stronger the reserving basis becomes. Indeed, the strongest reserving basis would be to assume that all personal pensions policyholders take their benefits at age 50. We advised [the Appointed Actuary] *in our letter of 04 December 2000 that the Regulations required this.*

[Equitable's Appointed Actuary] *appears to be arguing that Regulation 72(1) requires a prudent assumption to be made on when the vesting option may be exercised. He cites the actuarial guidance GN8 in support of this (presumably referring to 3.8.1 and 3.8.2 – attached.) He then considers that Regulation 72(3) allows him to take account of the assumed vesting dates when assessing the liability, i.e. he considers that the words in the Regulations "if the assumptions adopted for the valuation of the contract are fulfilled in practice" includes the assumption as to the date when the option will be exercised.*

However, we take the view that Regulation 72(3) overrides that Regulation 72(1) and requires the actuary to set up a liability sufficient to cover the cash payment that would result from an exercising of the vesting option, at anytime that that option may be exercised.

Regulation 64(3)(c) requires the amount of the long term liabilities to take into account "all options available to the policyholder under the terms of the contract".

09/01/2001 [09:11] Prospective Bidder B sends FSA a copy of a letter to Equitable dated 8 January 2001, which stated, in the light of events, a revised interest in purchasing parts of the business. This was on a revised basis from that prior to closure, due to:

... the need to restructure our initial first round proposal in order to limit the risk of deteriorating investment markets as well as a fall in interest rates. We also concluded that it would not be possible to pay a bonus in 2000 and that by not paying bonuses, persistency and new business could suffer significantly. Finally, we felt that we could not write new with-profits pensions business in the long term fund of Equitable without a capital commitment far larger than we could economically justify.

The four key components of the revised proposals were:

a) a deferred purchase of the non-with-profits value of insurance in force;

b) contingent loan financing of the with-profits fund;

c) reduced payment for goodwill; and

d) an offer to transfer non-with-profits business to a '*New Equitable*' at a reduced market value adjuster.

09/01/2001 [13:57] FSA's Director of GCD provides a note to the Director of Insurance confirming the advice that the Director of GCD had given at a meeting on 8 January 2001 on the issue of the restriction on dividends. The Director of GCD advises:

There is more than one view about the extent of the impact of Community Law on this situation. But all are agreed about one point. This is that it would in our view be contrary to Community Law for the restriction on declaration of dividends by a holding company to be applied to a holding company which was itself an insurer which was home state regulated in another member state.

... It is not necessarily a complete answer to the issue. This would depend on HMT taking the same view.

This is for two reasons. The first is that HMT will need to decide whether to continue the existing restrictions in their current form, or in a modified form, when the Insurance Companies Act provisions are repealed. It will be desirable to ensure that HMT do not continue the existing restrictions. Second, in the interim, if action were required to bring UK legislation in line with Community Law, it would need to be HMT which took this action.

There is also a wider, policy question, about whether it makes sense to apply controls on holding companies to insurers, but not to other firms we regulate.

09/01/2001 [15:06] Further to discussion on 08/01/2001 [**09:53**], Legal Adviser A informs the Director of GCD that Counsel had advised Equitable's solicitors that he was '*sure the* [Policyholders Protection Act 1975] *provisions will apply and that the court will interpret regulation 4 and that the policy condition in such a way that the liabilities to policyholders will not be extinguished*'.

09/01/2001 [18:37] Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

09/01/2001 [20:11] FSA's Director of Insurance provides the Financial Services Compensation Scheme with a briefing paper about Equitable and arranges to attend a briefing for the Scheme's Board on 20 February 2001. The briefing note provides background about the Society and its closure to new business. It also deals with a number of current issues, including:

- Solvency and compensation arrangements.
- Review of FSA regulation.
- Future performance.
- Help for policyholders.
- Other FSA activity.
- Adjustments to policy values.

In relation to solvency, FSA say that '*the Equitable continues to be solvent in Companies Act terms, as well as satisfying the more onerous requirements under the Insurance Companies Act 1982. The compensation arrangements under the Policyholders Protection Act 1975 and in future under the Financial Services and Markets Act 2000 are not, therefore, of immediate relevance*'.

10/01/2001 [entry 1] Equitable provide FSA with their briefing notes for representatives, some of which had been provided to policyholders on 18 December 2000.

10/01/2001 [morning] FSA meet with Prospective Bidder D. The purpose of the meeting was to keep FSA informed so that any regulatory issues could be spotted in advance. The Bidder outlines its proposals and gives FSA a copy of a letter, dated 8 January 2001, to Equitable setting out those proposals. These are summarised as follows:

- Prospective Bidder D strongly supports Equitable's approach to business. The bidder intends to build a company which mirrored the characteristics of Equitable's strategy and infrastructure.
- The bidder intends to make a substantial payment into Equitable's closed fund in consideration for all of Equitable's ongoing business.

- Part of the consideration would be deferred to reflect the success of the ongoing business.
- Equitable's closed fund would be managed by a service company operated by Prospective Bidder D.

The proposals note that the potential buyer '*intends to enter into immediate discussions regarding partial demutualisation of The Equitable to achieve a substantive resolution of its current capitalisation problems. This is expected to provide significant benefits for existing policyholders of The Equitable*'.

FSA's note of the meeting states that the potential buyer:

> *... thought that a resolution of the problem between GAR and non GAR policyholders was required for the* [Prospective Bidder D] *proposal to work. Some thought had been given as to what the form of compromise could be and this largely appeared to be some form of cash settlement to all GAR policyholders, but this needed further work. The final settlement of this issue would lead to a c£1bn "estate" from the release of regulatory capital which could then be used to buy the GAR policyholders out.*
>
> *At the next stage policyholders of both camps would have the option of transferring to an* [Prospective Bidder D] *company (possibly a dormant subsidiary of* [an insurance company]*) this would be recapitalised with a further £1bn from* [Prospective Bidder D]. *This should help maintain investment freedom.*

10/01/2001 [11:49] An FSA official distributes a revised version of FSA's lines to take, which had received plain language comments. In response to a question, which asked whether Equitable were justified/legally entitled to withhold seven months' bonus/interest, it is stated that:

> *Life Insurance companies can only pay bonuses to their with-profits policyholders when they have surplus assets. Most of the Equitable's surplus funds have had to be earmarked to cover the costs of correcting the position of certain policyholders in line with the recent House of Lords judgment. It had been hoped that the sale of the business would have provided additional capital, so the bonus could be restored. However, as the Equitable were unable to find a buyer, it has announced that it is unlikely now to be able to restore the bonus.*

In response to a question, which asked whether '*previous accounts should have mentioned or taken account of these liabilities even though the legal position was still being considered*', it is stated that: '*The Companies Acts require a company to prepare its accounts, based on a "true and fair" valuation of its assets and liabilities, and for the auditors to give an opinion as to whether this has been done*'.

When asked '*What advice have you given* [Independent Financial Advisers?]', the FSA line is that: '*independent financial advisers are required to act in accordance with the rules made by the Personal Investment Authority. The PIA has recently issued a regulatory bulletin to remind* [Independent Financial Advisers] *of their duties and responsibilities*'.

In relation to the degree to which the GAR issue had wider implications, it is said that:

> *The practice of offering pension plans with guaranteed annuity options was fairly common some years ago. However, the circumstances leading to the Equitable's decision not to accept new business were specific to the Equitable. This arose from the combination of a number of factors, including the generous terms of the guarantees and the significant proportion of its business which had the benefit of such guarantees.*

It is also noted that: '*Unlike many companies, the Equitable did not maintain large levels of unallocated assets, often referred to as "orphan" or "inherited estates". Instead, the Equitable preferred to distribute surpluses to its fund to policyholders as and when they arose*'.

10/01/2001 [12:27]	FSA's Director of Insurance informs the Director of GCD about a conversation he had had with HMT about the issue of the restriction on dividends. The Director of Insurance reports that, while HMT understood the need for a common position, this could prove difficult if it were dependent on action needed to repeal/amend section 29(7) of ICA 1982 as: '*Action under s2(2) of the* [European Communities Act 1972] *required an affirmative resolution (and also the involvement of the Law Officers). Advice to HMT was that early implementation of the relevant part of* [FSMA 2000] *would "raise difficulties"*'.
10/01/2001 [13:57]	PIA send FSA the minutes of a meeting held on 8 January 2001 with the Association of Independent Financial Advisers about PIA's Free Standing Additional Voluntary Contributions review. The issues discussed included Equitable.
10/01/2001 [16:00]	FSA meet Equitable and their advisers to discuss their thinking on the indicative bids received. FSA's note records:

> [Equitable's adviser for the sale] *said that since* [indicative] *bids had been received,* [they] *had been trying to analyse them on a consistent basis (eg some attributed value to assets but on the basis that future intra-group charges would be on a cost or profit basis while others maintained existing charges but offered no consideration). They also needed to consider whether the bids carried any risks (in terms of delivery or price), the number of conditions and the timetables. He expressed some disappointment that the submissions were thin on detail and would need considerable further investigation.*
>
> [The advisers] *first outlined the* [Prospective Bidder E's] *proposition. They were looking at a two stage process. First they would acquire the parts of the company relevant to new business acquisition. The second stage was dependent on an accommodation between policyholders and would involve a Schedule 2C transfer of the business to a company in the* [Prospective Bidder E] *group. The administration platform would only be taken over at that stage.*
>
> *The offer included £100 million by way of consideration, £100m for goodwill and up to a further £300 million which was contingent on certain factors. Further capital would be generated on restructuring the fund and buying out the in-force business. They would be looking to transfer existing business into an open fund. The bid made certain assumptions about the adequacy of funds to maintain equity ratios, the sales force not leaving and litigation and publicity being under control.* [Equitable's advisers] *thought the key issues were whether the numbers would work generally and in particular whether the assumptions on the GAR/non-GAR were realistic.*
>
> *On Halifax,* [the advisers] *noted the similarities to other bids, but also the philosophical differences. In particular, Halifax were clear that they wished to leave the old closed fund as a self-standing entity for which they would have no responsibility. The offer was for £100m, with a further £400m (made up as a number of components) as a carrot for resolution of the GAR issues. They would also offer a further £250m by way of a loan, which would help demonstrate confidence. Equitable wanted to find out more about their "not-for-profit" proposals, to compensate policyholders for the mva when transferring from Equitable to a Halifax company with-profits fund. There could however be implications for the closed fund that would need to be considered. Fuller details are recorded on file in a draft proposal given to us by Halifax before it was submitted.*
>
> [Equitable's advisers] *noted that the* [Prospective Bidder D] *proposal was also broadly similar to the others although parts of it were unclear through lack of detail. Equitable would need to explore this further to understand it better. Again, fuller details of the proposal are on file (copy of the submission from* [Prospective Bidder D] *and a note of a*

meeting on 10 January 2001). [The advisers] *said he was particularly unclear about what would happen with in-force business – was it to transfer to* [a Prospective Bidder D] *company or remain mutual.* [FSA's Line Manager E] *explained what he had understood from the discussion with* [them] *that morning, and summarised in that meeting note. Broadly, the plan appeared to be to seek a resolution to Equitable's problems within the company, but then to propose a Schedule 2C transfer to* [a Prospective Bidder D] *group company, with policyholders having the option to remain in a closed Equitable fund.*

[Equitable's advisers] *said that the* [Prospective Bidder F] *bid was disappointing. A simple cash offer of £50m and a contingent loan of £1 billion. They had no interest in resolving the issues surrounding the closed fund.*

[The advisers] *said at this stage, they were not minded to proceed with the bid from* [Prospective Bidder F]. *Of the rest, they all had attractions but it was too early to say which would be the most favourable. They hoped to be in a position to select a preferred bidder before an Equitable board meeting on 17 January.* [FSA's Director of Insurance] *said we would make ourselves available if bidders wished to discuss any regulatory issues with us.*

11/01/2001 [08:51] An FSA official asks Legal Adviser A whether the Policyholders Protection Act 1975 applied to group policies such as a company's Group Money Purchase Pension Plan.

[**11:03**] Legal Adviser A says that he would look into it. The Legal Adviser also highlights that FSA's frequently asked questions stated categorically that the Policyholders Protection Act 1975 did not apply in respect of policies sold through Equitable's Guernsey branch. He says that he did not '*think it is that easy*' and would advise further.

On 15 January 2001 [**09:42**], the Director of GCD asks Legal Adviser A to ensure that their answer was amended and that '*no answer is given*' until Legal Adviser A had reviewed it.

11/01/2001 [09:57] Equitable send FSA a copy of the policyholder update that they had issued that day, by way of a press notice, which started by saying that '*the sale process is going well*'.

FSA send the Personal Investment Authority Ombudsman a copy of Equitable's policyholder update '*as it covers some of the issues we discussed the other day*'.

11/01/2001 [10:16] FSA's Line Manager E writes to GAD about an article in a national newspaper that day which concerned the reinsurance treaty. Line Manager E says: '*As I understand it, ... the journalist was trying to imply that there was something fishy about a reinsurance with an offshore company etc, perhaps that it was not really worth very much etc*'.

[**10:56**] GAD's Directing Actuary B replies that GAD were looking back through their file for more information. The Directing Actuary says he believed that there were '*a number of inaccuracies*' in the article and states:

1) *Irish European is currently AAA rated (*[Standard & Poor's]*) reinsurer.*
2) *Equitable Life is fully reserved to cover all guaranteed benefits including* [GAOs] *up to the threshold, and held reserves of close to £1 billion (including a resilience provision for adverse experience) as at 31 December 1999 for this purpose.*
3) *We accept though that bonuses would be reduced to meet GAO costs. This is a direct result of the House of Lords judgment last year which required these costs to be spread across all policyholders.*

[**12:20**] GAD's Scrutinising Actuary F sends Line Manager E a copy of his report of 19/12/2000 [**17:43**] and directs him to what he had said there.

11/01/2001 [14:46]	FSA's Line Manager E sends FSA's Press Office an updated summary of the information on Equitable's levels of policy surrenders, transfers to another company and switches to unit-linked policies and on their handling of calls to their customer enquiry line.
11/01/2001 [18:26]	Equitable send FSA further information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.
12/01/2001 [entry 1]	FSA's Head of Life Insurance circulates a copy of a letter from Equitable to Prospective Bidder B, dated 11 January 2001, saying they were not '*actively pursuing*' their proposals for the purchase of the asset management function of the Society, as it was Equitable's view that the '*value to members is likely to be maximised if substantially all of the Society's operations can be transferred in a single transaction*'. The Head of Life Insurance informs other officials that the bidder had told him that afternoon that Equitable's advisers had in fact subsequently asked them to put in a bid for the asset management part of the business.
12/01/2001 [entry 2]	Equitable apply to FSA for a section 68 Order in respect of the admissibility limits on shares held in the newly merged company, which had been the subject of discussion within FSA's Insurance Supervisory Committee during December 2000 (see 12/12/2000 [**13:41**] and 18/12/2000 [**14:30**]). Equitable say that: '*As discussed, I would be grateful if you could grant the order with effect from 31 December 2000*'.
12/01/2001 [entry 3]	FSA's Company Secretary writes to the Director of GCD about the latest position regarding any potential conflicts of interest among FSA's Board. Information is provided on personal Board conflicts, detailing the Equitable policies held by Board members or their partners. Four of the twelve members declared that they held an Equitable policy (all of which were for not insignificant sums), one member declared that their partner held a policy (again, for a not insignificant sum) and one member had not made a declaration, as they were currently abroad. The Company Secretary states that two members (who did not hold Equitable policies) have indicated that they would be conflicted if their company were interested in acquiring the sales force or other parts of Equitable's business. The Company Secretary goes on to say: *I have discussed the conflicts issue with* [FSA's Chairman] *and he agreed that this represents part of the study of risks faced by the Board in achieving its function, which I believe* [FSA's Director of Internal Audit] *is undertaking. In the meantime, the Articles currently provide for a materiality test, but I believe we need some advice on exactly how we can interpret this, whether we need to change the relevant Article for the future, and if so, how.*
12/01/2001 [12:45]	An FSA official distributes a revised version of the lines to take (version 3) and asks for any comments.
15/01/2001 [entry 1]	FSA and GAD meet Prospective Bidder E to discuss their indicative bid. Equitable and their advisers for the sale, their actuarial consultants and solicitors, also attend the meeting. Prospective Bidder E explain that they had been looking to expand their distribution and product range and had been interested in Equitable at an earlier stage but: '*at that time it was difficult to come up with a scheme that would work. He noted that in the changed circumstances, there was more scope to conduct a realistic deal which would enable them to restore confidence among Equitable policyholders*'. Prospective Bidder E explain their proposals and several issues are discussed. On regulatory issues, they say that one concern to them was the continuing availability of Equitable's implicit items and subordinated loan. GAD say that they had considered the implicit items and saw no reason in principle why this could

not continue. On the subordinated loan, FSA say that they would not intend to apply a different test to those normally adopted.

Equitable leave the meeting and Prospective Bidder E ask about FSA's approach to Equitable's reserving basis, noting that they had seen correspondence on the issue. Prospective Bidder E seeks comfort that FSA were not expecting to raise any new issues. GAD confirm that there had been a recent exchange on reserving but say that the disputed issues had largely been resolved.

15/01/2001 [entry 2] FSA and GAD meet Prospective Bidder D to discuss their indicative bid. Equitable and their advisers for the sale, their actuarial consultants and solicitors, also attend the meeting.

Prospective Bidder D takes FSA through a paper that they had prepared, setting out how their proposals would work – and several issues are discussed.

15/01/2001 [entry 3] Equitable write to FSA about Equitable Investment Fund Managers Limited to confirm the points that had been agreed at the meeting of 08/01/2001.

On 16 January 2001, FSA's Head of Life Insurance notes to Line Manager E that he believed the letter reflected the points agreed.

15/01/2001 [entry 4] FSA send Equitable a suggested agenda for the meeting to be held on 16/01/2001. The agenda items include: updates on customer handling issues, consumer trends and market value adjuster issues; reserving and future strategy; update on requests for section 68 Orders; and other issues (including PIA's review of sales after 20 July 2000, pension fund withdrawal contracts and Pensions Review issues). Line Manager E notes that '*The key issue for discussion is on the current financial position*'.

15/01/2001 [entry 5] FSA's Director of GCD asks Chief Counsel B (copied to FSA's Chairman and Company Secretary) to advise the Company Secretary on any conflicts regarding members of FSA's Board (see 12/01/2001 [**entry 3**]). The Director of GCD says:

> *At the last Board, I among others disclosed conflicts re* [Equitable]. *Those do not generally inhibit me advising on* [Equitable], *given the disclosure, but should inhibit me taking responsibility for advice on how conflicts themselves should be handled – or at least make it desirable that someone else should be involved.*

15/01/2001 [10:33] HMT write to FSA asking for information on Equitable's '*key numbers ... ie an official take on all the* [figures] *that are in the press*'.

[**10:36**] FSA's Line Manager E asks Line Supervisor C to deal with the request.

15/01/2001 [12:54] A Bank of England official writes to FSA's Managing Director A following a '[Managing Director A]/[the Bank of England's Executive Director of Financial Stability] *dinner*', at which the issue had arisen as to whether the Financial Law Panel should be asked to assist with the '*uncertainty*' following the House of Lords' decision. The official asks if FSA had followed up the issue.

FSA's Managing Director A suggests to the Director of GCD:

> *... my own feeling about this is that the* [Financial Law Panel] *is something of a red herring (though* [the Bank of England official] *would argue it does allow subjects to be raised informally with "the right people").*
>
> *We have 2 main options it seems to me:*
>
> > *a) we understand Equitable itself is seeking legal advice and we should not pre-empt that. Absent developments there, it might be worth the* [Financial Law Panel] *being involved but it would make much more sense for the* [Association of British Insurers]

> *or the Equitable or another firm to approach them rather than us, as so much seems to rest upon particular circumstances (about which we by definition are not best placed to speak).*
>
> *b) The other route is ... for us (or for us to ask* [the Bank of England] *to raise it for us) to raise the issue with the* [Financial Law Panel] *and see what bright ideas* [the Financial Law Panel] *come up with for going forward.*

The Director of GCD replies: '*A supervisory matter, but not sure what help this would be at this stage*'.

15/01/2001 [14:44] FSA's Director of GCD replies to the FSA official about FSA's lines to take (see 12/01/2001 [**12:45**]). The Director of GCD says:

> *... the essence of the* [House of Lords'] *judgment is that GAR liabilities are binding liabilities of the company. All company assets are available to satisfy them. Given this,* [it is] *not clear how the FSA "keeping a very close watch" could help.*
>
> *The answer to the second and third questions says that "there is no obvious statutory basis" for the regulators organising an accommodation among the different classes of policyholders/a rescue. This need not inhibit action of this kind. Organising rescues without public money falls to us under the Tripartite* [Memorandum of Understanding].
>
> *We could surely require the company to call an EGM under usual intervention powers – eg to secure PRE/sound and prudent management.*

[**17:21**] Line Manager E queries whether the use of section 45 of ICA 1982 to order an extraordinary general meeting would be an appropriate use of that power.

[**18:13**] Legal Adviser A advises further on this question.

16/01/2001 [09:30] FSA and GAD meet Equitable. Equitable's handling of customer enquiries is discussed, along with the level of requests from individuals for policy surrenders and transfers. Equitable say that cash reserves had already been built up to meet the demand of these withdrawals and no assets had to be sold for this specific purpose. FSA record that the position on withdrawals for group schemes was unclear, because moving such schemes took time to process and employers needed to research the alternatives. Equitable confirm that the market value adjuster for group schemes was negotiated with them. FSA's note also records that there had been a higher level of surrenders in the Republic of Ireland '*where there was less of an MVA because of a separate hypothecation of Irish assets*'.

Equitable report that they expected to show in the 2000 returns around £500m of free assets above their required minimum margin, subject to work by their new appointed actuary '*and to confirmation by* [FSA] *of some technical waivers to the valuation rules as intimated to us last year (and as given recently to some other companies)*'. Equitable say that this valuation included the various changes agreed in recent correspondence '*(other than the possible additional £250 million for personal pension policies on which we await legal advice), but does not include a contingent liability for any possible redress for pension fund withdrawal contracts that might be imposed by PIA (estimated by the PIA as £40m on a worse case scenario)*'.

FSA note that Equitable were expecting to fail to declare any bonus that year, as they did not have sufficient emerging surplus, and that they were currently reviewing the interim bonus of 9% that was applied to maturing policies, or on death. FSA note that Equitable would also need to review the bonus rate applied to with-profits annuities in payment that were held by '*a particularly sensitive group of policyholders (who have no ability to transfer their policies to another company)*'.

FSA record that Equitable:

> *... explained that the present 10% MVA is* [needed] *to cover the additional cost of* [guaranteed annuity options] *arising following the* [House of Lords'] *judgment (probably around 5%), along with the relatively poor investment return last year (around 2.5%), and the need to recover all initial expenses incurred (around 2.5%). They have made a robust response to the OFT on this topic.*
>
> *The MVA is applied of course to the full policy value which was increased on an interim basis by around 4% last year, as compared with an actual investment return on the fund of around 2-2.5%. Meanwhile, they are not keen to draw any further attention to the MVA and its link to investment conditions in view of the possible adverse publicity. They stressed to us that the MVA is not intended to act as a penalty; rather the objective is that payments on non-contractual termination should be fair to both outgoing and remaining policyholders.*

FSA's note of the meeting records the actions to be taken:

- FSA '*owed*' Equitable a note on new business issues.
- Equitable were to submit formal notification of their new Appointed Actuary.
- FSA were to liaise with Equitable on the treatment of the section 68 Order for the calculation of the valuation rates of interest for fixed interest securities.
- FSA were to consider whether they wished to see Equitable's submission to the OFT.
- FSA were to consider how Permanent Insurance should be valued in Equitable's 2000 returns, noting that Equitable would need to apply for a section 68 Order.

16/01/2001 [11:19] FSA's Director of GCD suggests to the Head of Life Insurance that FSA should formulate '*criteria for judging*' the proposals for purchasing Equitable's assets.

[**11:31**] Managing Director A says that he was '*not in favour of this*' as the '*commercial decision is for Equitable*' not FSA. The Managing Director says that FSA's role was to ensure that the offer Equitable decided to proceed with was sound in regulatory terms: '*(bidder can afford it, Equitable policy-holders fairly treated etc)*'.

16/01/2001 [11:30] FSA hold an '*Equitable Life Lawyers Group*' meeting. The minutes of that meeting include:

- Chief Counsel A informs the group that: '*a breach of PRE investigation had been on hold since the judgement of the Court of Appeal. The evidence gathered was consequently incomplete and the likely outcome of the investigation could now only be a matter of speculation*'.
- Legal Adviser A explains that, if Equitable were to have a deficit on the long term fund, then any holding company would be prevented by section 29(7) of ICA 1982 from paying a dividend.
- The group note: '*The internal view on the market value adjuster (MVA) was that the Insurance Regulations do not bite on MVAs ... A brief discussion on intervention powers (in relation to MVAs) was held. It was noted that judging when it was appropriate to intervene should MVAs be increased would be a difficult task. It was agreed that* [Line Manager E] *would be contacted to see what public statements had been made by Equitable on MVAs*'.
- The issues of compromising GAR rights and winding up are discussed and the group note that the Policyholders Protection Board would be involved where policyholders' rights were to be compromised, stating: '[The case of a named company] *was a good*

comparison for Equitable on this point as it slipped from solvency to insolvency during run-off. A scheme of Arrangement or analogous measures under a Schedule 2C Scheme may be more appropriate in circumstances where solvency was likely, and as it would cap all the uncapped GAR liabilities its relevance is unlikely to be limited to insolvency alone.'

It is agreed that the minutes of the group's meetings should be sent to Line Manager E, the Head of Life Insurance and the Director of Insurance and PIA.

16/01/2001 [16:06] GAD's Directing Actuary B sends FSA (Managing Director A, the Head of Life Insurance, Line Manager E and Line Supervisor C) and Scrutinising Actuary F his conclusions on the present financial position of Equitable, following their meeting with them that morning. Directing Actuary B reports:

At a meeting today with Equitable, they outlined to us their draft financial result for the year 2000. They expect to be able to show free reserves of some £500 million in excess of the required margin of solvency, subject of course to further work by the newly appointed actuary in examining the methodology and assumptions, and to confirmation by [FSA] *of some technical waivers to the valuation rules as intimated to us last year (and as given recently to some other companies).*

This result includes a provision of around £1.8 billion net of reinsurance for Guaranteed Annuity Options, and the various changes to the valuation basis as agreed in recent correspondence (other than the possible additional £250 million for personal pension policies on which we await legal advice), but does not include a contingent liability for any possible redress for pension fund withdrawal contracts that might be imposed by PIA.

The net provision for [guaranteed annuity options] *has therefore increased over the year by around £1.2 billion (in addition to a £200 million provision for redress to already retired policyholders), mainly as a result of the changes to the reinsurance cover (following the* [House of Lords'] *judgment), the lower interest rates assumed (both as a result of changing market conditions and the more conservative approach required by the changes to the regulations), and an increased allowance (following the* [House of Lords'] *judgment) for the payment of future premiums on GAO policies.*

Directing Actuary B's note continues:

They are not expecting to make any bonus declaration this year (as they do not have sufficient emerging surplus), and are reviewing the present 9% p.a interim bonus that is added for claims on maturity (or death). They will also need to review the bonus rate applied to the with-profit annuities in payment that are held by a particularly sensitive group of policyholders (who have no ability at present to transfer their policies to another company).

They explained that the present 10% MVA is need to cover the additional cost of [guaranteed annuity options] *arising following the* [House of Lords'] *judgment (probably around 5%), along with the relatively poor investment return last year (around 2.5%), and the need to recover all initial expenses incurred (around 2.5%). They have made a robust response to the OFT on this topic.*

The MVA is applied of course to the full policy value which was increased on an interim basis by around 4% last year, as compared with an actual investment return on the fund of around 2-2.5%. Meanwhile, they are not keen to draw any further attention to the MVA and its link to investment conditions in view of the possible adverse publicity. They stressed to us that the MVA is not intended to act as a penalty; rather the objective is that payments on non-contractual termination should be fair to both outgoing and remaining policyholders.

The Directing Actuary's note continues:

> *They sold around £740 million overseas equities last December, along with £530 million UK equities, and then held most of this in cash. In January, they have sold so far a further £375 million equities and £50 million investment trusts and are planning some further sales to reduce the equity proportion from around 72% last autumn to possibly 60%, depending of course also on the progress on the potential sale of the society. They have invested around £400 million this month in fixed-interest securities but are also mindful of the need to maintain liquidity.*
>
> *They are estimating at present cash outflow of up to £3 billion this year, based on an outflow of around £200 million over the last month (and a fairly steady rate of requests for surrender continuing at around 1,000 policies per day). Their investment manager is somewhat nervous though about the capacity of the market to absorb possible sales at this continuing level. They are not looking actively to sell properties at this stage but will take advantage of any such opportunities that may arise.*

Directing Actuary B concludes:

> *Generally, they remain of course quite vulnerable to adverse investment conditions, and meanwhile, the equity market will be aware that further significant sales by the society can be expected to continue. Their best prospect is a link to one of the potential bidders that allows a less defensive investment strategy to be implemented.*

16/01/2001 [19:02] Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

16/01/2001 [entry 6] FSA meet to discuss Equitable. FSA note that they next expected to hear from Equitable on potential bidders on 17 January 2001. They discuss a note that had been prepared by the Head of Life Insurance on FSA's criteria for assessing any bids. It is agreed that the Head of Life Insurance should amend his note. (Note: this was recorded in the note of the meeting, which was written up the following day, as having been done). FSA note that HMT had asked for early notice of any decisions that would have to be put to Ministers. Line Manager E says that there would be decisions for Ministers but '*all were of a technical nature and precedents existed, however they would need to be agreed quickly*'. It is agreed that the Head of Life Insurance should press PIA for an update on possible enforcement action. On Equitable's financial position, Managing Director A refers to GAD's note of 16/01/2001 [**16:06**] and asks for a further breakdown of the increase to net provisions. He says that he was concerned about the value of the future profits implicit item and the impact of any ruling by the OFT on Equitable's application of the market value adjuster.

16/01/2001 [entry 7] FSA's Head of Life Insurance informs Managing Director A of the '*considerations*' which FSA '*are taking into account in discussing with the Equitable and various interested parties the proposals to purchase some or all of the business*'. The Head of Life Insurance's note says:

> *Our basic approach is that it is for the directors of Equitable Life to decide which proposal, if any, to choose to put to policyholders. The FSA's primary aim is to ensure that any regulatory issues arising from these proposals are exposed in good time, so they can be either resolved or taken into account before decisions are taken. We are also offering our good offices to facilitate discussions between the parties to assist the prospect of a satisfactory agreement being reached.*
>
> *As regards to the proposals themselves, and the various bidders, we are taking the following factors into account:*

- *The fairness of the proposal to policyholders in general, and to each of the main classes of policyholder (GAR and non-GAR);*
- *Financial factors, notably the impact of the proposal on the strength of the Equitable fund or any replacement to it and the wider group of which Equitable may become a part;*
- *The commitment of the bidder to the deal, and to the longer term interests of the Equitable policyholders in the way the deal is followed through;*
- *How convincing the proposal is, in terms both of how well the proposal fits the strategic objectives of the bidder, and how attractive it is likely to be to policyholders;*
- *The strength of the management, and its ability to carry through the proposal;*
- *The regulatory standing of the bidder, both in the UK and (in the case of overseas bidders) in its own jurisdiction;*
- *Whether the bid is likely to produce a better outcome overall compared with a continuation of the closed fund.*

17/01/2001 [entry 1] Equitable send FSA a copy of a letter from them to the OFT, dated 8 January 2001, about their use of a market value adjuster. The letter contains information on the financial adjuster, as requested by the OFT. Equitable's letter concludes:

> *It will be worth your bearing in mind one overriding fact – a contract without a financial adjustment mechanism could not be fair to all with profits policyholders since it could at any point in time place on the fund and hence on continuing policyholders an unfair burden to finance continuing with profits policyholders. The timing of surrender is entirely at the discretion of the policyholders in question and therefore creates considerable scope for them to act to the disadvantage of other with profits policyholders.*

17/01/2001 [entry 2] Equitable send FSA a copy of an investment strategy paper which had been discussed at their Investment Committee meeting on 10 January 2001.

17/01/2001 [entry 3] FSA prepare a paper on the proposed appointment of a new Chief Executive of Equitable and Controller of Permanent Insurance. FSA's paper discusses the sections of ICA 1982 relevant to such appointments. It recommends that FSA do not object to the appointments, and concludes '*I do not believe we have any firm grounds for making an objection on the basis of the above. Furthermore Section 60 would not appear to confer the powers for us to attach conditions or restrictions on any approval*'.

17/01/2001 [entry 4] FSA's Head of Life Insurance seeks advice from Legal Adviser A on FSA's powers under ICA 1982 to object to or to approve the proposed appointment of a new Managing Director of Equitable. The Head of Life Insurance says:

> *From a policy point of view, we may not be happy with* [the person] *as* [Managing Director] *on a long term basis; but there are strong practical grounds for not objecting to him performing this role during the interim period while the future of the company is in doubt, and they are negotiating with third parties over a possible sale. The new owners (if any) may well have views on the future of the existing Equitable management.*
>
> *... I would like you to consider ... whether it would be possible to give, in effect, a qualified or conditional approval, for example giving approval for a limited period of say 6 months ...*

Whatever the legal position, we shall probably want to discuss the issue with [the proposed Managing Director] *and* [Equitable's President] *(or his successor, if appointed), before giving a formal response to the application. But before we do so, it would be helpful to be clear whether there is any flexibility in the statutory position.*

17/01/2001 [08:24] FSA's Managing Director A informs FSA's Chairman that a foreign regulatory authority had informed him that morning that they could see no obvious problem in principle as to why a deal with Prospective Bidder D should not go ahead. The Managing Director also informs him that Halifax had called that morning to let FSA know that they had pulled out. The Managing Director says: '*He says the main reason is that the more they looked at the prospects for the sales force (whose future performance he thought the City would regard as the key indicator of the success of any deal) the more they had worried. I asked whether he thought a foreign bidder would be likely to come to the same conclusion. He said not necessarily. There were some issues specific to Halifax – the City was doubtful about whether Halifax could do all it was currently doing, and people would see this as* [the Chief Executive's] *personal speculative foray. He also thought some foreign firms could get even more value out of aspects of Equitable than they could. He is frustrated by all this, as he still thinks there is real value in Equitable for someone's shareholders*'.

17/01/2001 [09:25] Prospective Bidder B send FSA a copy of a letter the bidder had sent to Equitable's advisers the previous day, giving the details of their preliminary proposal to purchase the investment management activities of Equitable.

17/01/2001 [13:28] GAD provide FSA with further information that had been requested by Managing Director A at the meeting on 16/01/2001 about Equitable's future profits implicit item. GAD say:

Under the present rules and guidance, this has to be substantiated both by a historical test against actual profits achieved, and also by a certificate from the actuary relating to the sustainability of these profits.

The application, accompanied by such a certificate, for an amount of £1.1 Bn for the year ending 31/12/00 was made by Equitable in June 2000, and I believe has now following perusal by GAD and FSA been granted by FSA/HMT.

The information provided with this application indicated that the formal historical test (as required by the EU Directives) would be satisfied even if all policies were assumed to run off over the next 3 years.

The actuary has not provided us with details of the calculations made for the purpose of his certification that future profits of the required amount will emerge. However, if we assume that they need to generate profits of around £450 million for the next 5 years in order to cover both the reinsurance offset of £800 million and the future profits item of £1100 million, then we believe that they would need to earn an average investment rate of return on their with-profit fund of around 5.5% each year.

The figure of 5.5% is circled by FSA's Chairman.

GAD explain that, if the market value adjuster remained in place, solvency should continue to be covered:

However, if the MVA has to be removed while the FTSE Index remains at present levels, then they will incur a loss on all their surrenders. This would not only invalidate the implicit item for future profits but would also mean that additional provisions would almost certainly need to be established in the balance sheet for potential surrenders. This would be likely to mean that the society would be declared technically insolvent.

GAD suggest that FSA should ask the new Appointed Actuary to recertify the item and provide details of his key assumptions before the 2000 returns were submitted.

GAD also provide figures for the increased cost of annuity guarantees. These provide an analysis of the increase in the reserve for annuity guarantees between 31 December 1999 and 31 December 2000 (based on the draft year-end 2000 figures so far available from Equitable). GAD highlight that the main sensitivities of this reserve were the interest rates and future premiums that might be payable. They explain:

> *The potential variability in this reserve is then one of the main reasons that Equitable are hoping to arrange some deal between the GAR and non-GAR policyholders that would buy out these GAOs.*

17/01/2001 [17:13] Equitable send FSA some policies data, which is presented as follows:

Data at 31/12/2001	*With profit*	*Unit linked*	*Total (see notes)*
Number of policies in force	*720,000*	*189,000*	*909,000*
Number of Group Schemes (excluding [group pension plan policies] *but including AVCs)*	*5,400*	*2,500*	*7,900*
Number of members within Group Schemes	*656,000*	*132,000*	*788,000*
Number of individual GAR policies	*110,000*	*N/A*	*110,000*

Please note the following points:

- *ULAS policies are included.*
- *Non Profit policies are excluded from the number of policies/schemes in force.*
- [Equitable Investment Fund Managers Limited] *business is excluded.*
- *Where a policy/scheme has both unit linked and with profit investments, they will be counted in both sets of data.*
- *For information, please note that the GAR figure of 90,000 which is frequently quoted relates to the approximate number of clients with an interest in GAR policies at the time of the court case.*

17/01/2001 [17:21] In response to a query from the press as to whether FSA would be providing more specific advice to policyholders, FSA's Line Manager E notes that he is:

> *... sure that we should* not *be giving information of that kind to policyholders. We have made it clear – and should continue to do so – that everyone's circumstances are different and people should take proper advice before taking action. It is all very well making generic assumptions about people's circumstances, but while that may be right for the majority, it will not be right for everyone. Eg someone in their late 20s or early 30s who has taken out an endowment with their home loan and a couple of years later is found to be suffering from a terminal illness should not surrender if they want their families to be protected.*

Other FSA officials agree with this '*cautious view*'.

17/01/2001 [17:30]	FSA's Head of Life Insurance relays to Managing Director A a summary of a '*more substantive*' conversation that the Director of Insurance had had with the foreign regulatory authority about Prospective Bidder D's proposals. The Head of Life Insurance reports that that Authority had had no concerns about the way that the company, which they regulated, had described themselves. He comments that: '*this gives us the comfort we were looking for as regards* [the foreign regulatory authority's] *attitude to* [Prospective Bidder D] *in general. It is for us to consider the details of the proposal as they emerge, and seek comfort on any aspects which appear not to be tied down, or which are unclear*'.
17/01/2001 [18:16]	FSA's Chief Counsel A asks the Head of Life Insurance and Line Manager E (copied to the Director of GCD and Line Manager D (who is now carrying out work connected to the Baird investigation)) whether FSA should request accelerated returns from Equitable '*or more realistically, part returns (not for publication but to give us better info than what we are getting now)*'.
18/01/2001 [entry 1]	Equitable send FSA a copy of a briefing note dated 17 January 2001 for managers on the subject of the supervision for conduct of business purposes of authorised representatives and the advice that they could give to clients following Equitable's closure to new business.
18/01/2001 [entry 2]	FSA reply to Equitable's letter of 12/12/2000 about new business and to record FSA's position in response to a number of discussions about the issue. FSA say that the explanation in Equitable's letter of 08/01/2001 was acceptable and '*provides sufficient comfort for the time being, but this is something we can perhaps review further when the future of the relevant group schemes is clearer*'. FSA also say that they would not object to Equitable issuing new policies for new directors, given that Equitable's '*constitution requires board members also to be members of the Society*'.
18/01/2001 [entry 3]	FSA's Chairman informs officials of a telephone conversation that he had had with Prospective Bidder A on 16 January 2001. The Chairman reports: *I first wanted to confirm with him that the message we had sent, via the* [Association of British Insurers]*, about our willingness to discuss a collective package for the Equitable had got through. He confirmed it had done so, and thought it had been reasonable of us to ask. But there was no interest among his colleagues in discussing a collective rescue. They were concerned about the moral hazard point, since they believed that Equitable had run with too little capital for a long time. And they could not see how the economics could be made to work. If there was any value in the Equitable which might justify an additional contribution to the with profits fund, then that depended on the goodwill and the access to the Equitable's customer base. It was hard to see how that value could be realised for the benefit of a group of firms, rather than one. So he simply did not think that any industry-wide deal was a runner.* FSA's Chairman's note continues: *As for the position of the Society itself, he confirmed his view that* [Equitable] *was simply short of capital, and had been for some time. There had apparently been some discussions with the Society a few years back about the possibility of a conversion and acquisition, at a time when it would have been possible to reconstruct the fund on a viable long term basis. But the management had not been interested. And he thought that, once the court case had begun, the die was cast. In his view, half the problem lay in the approach to reserving which the government actuary had taken in the past. Although he agreed that, for many insurance policyholders, had the Society been required to have*

larger reserves in the past, their current position would not be materially different from what it is now, since they would have had lower distributions along the way.

18/01/2001 [entry 4] FSA meet with PIA to discuss enforcement issues. FSA record the discussion under the following headings.

<u>Pension Fund Withdrawals</u>
PIA say that Equitable had '*agreed to do a past business review*' (note: said to be around 20,000 cases), although '*It was currently thought that the scope of the review was not fully acceptable to* [Enforcement]*, but Equitable were moving in the right direction*'. It is noted that Equitable did not accept that their sales process had been flawed. FSA record: '*It was thought that typically a mis-selling case of this nature might attract a fine of about £500,000. It was thought that on a worse case scenario the total cost of this to the Equitable could be £40m including compensation and expenses*'.

<u>Pensions review</u>
PIA say that the '*remedial action*' required from Equitable for failings with regard to PIA's Pension Review had been signed off by Enforcement. However: '*the issues that arose from this case following a June 2nd visit would normally lead to some form of penalty from* [Enforcement]*. A possible fine of £300,000-£500,000. It was not thought that there were any remaining additional costs to the Society in respect of the review*'.

<u>Discipline</u>
FSA record:

> [FSA's Head of Life Insurance] *was concerned that any disciplinary action could harm the delicate sales process and any goodwill payment which would be in the overall interest of policyholders.* [The Head of Life Insurance] *outlined the sensitivities and the proposed sales timetable.*
>
> [One of PIA's Enforcement Heads of Department] *was sympathetic to* [FSA's] *concerns and agreed to talk to the Chairman of the disciplinary committee that day to outline these. He thought that the committee should be able to take a decision in principle on this issue. But it was important not to sacrifice the principle that those that have lost out should be compensated – on this both* [FSA] *and* [PIA Enforcement] *were agreed.*

FSA's supervisory file includes a letter from PIA to Equitable, dated 18 January 2001, about their pension fund withdrawal contracts enforcement investigation. PIA seek clarification of a number of points concerning Equitable's proposed review.

18/01/2001 [09:37] FSA's Director of GCD says that Chief Counsel A's suggestion of requiring Equitable to provide accelerated returns: '*Sounds sensible to me!*'.

[**09:59**] The Head of Life Insurance comments:

> *We are in communication with the company on their current financial position. I am inclined to think that asking for returns as at end 2000 will not add to our knowledge; and since they won't be in the normal publishable form, they won't assist public disclosure either (which would be the strongest argument for early submission, but is outweighed by the need to avoid imposing distractions on the management from getting a deal).*

[**13:44**] The Director of GCD replies '*ok*'.

18/01/2001 [09:54] FSA send HMT the information about Equitable that FSA had received the previous day (see 17/01/2001 [**17:13**]).

[**20:20**] HMT ask FSA to contact the Department of Social Security, who were seeking some similar general information about Equitable.

18/01/2001 [10:20]	PIA write to FSA about the situations in which Equitable were writing new policies for existing group schemes and about the ability of personal pension policyholders aged over 50 to avoid the application of a market value adjuster by transferring to income drawdown policies and then transferring to another provider. FSA later (on 19 January 2001) confirm the situation in which new policies were being written and, on 22 January 2001, that they were aware of, and had spoken to Equitable about, policyholders being able to transfer out while avoiding the market value adjuster.
18/01/2001 [10:27]	Further to Line Manager E's comments about giving advice to policyholders (see 17/01/2001 [**16:29**]), the Director of GCD says: *I believe it would be possible to give generic advice of the kind* [suggested] *without any risk that we would be giving authorisable investment advice.* *This would be similar to the decision trees we are working on for a stakeholder pensions. But I can understand reluctance to give advice on these issues in the immediate future particularly if its effect could be destabilising on the Equitable and/or its sale prospects. This is a difficult balancing judgement.*
18/01/2001 [11:30]	Equitable's advisers for the sale send FSA a copy of letters of that day to Prospective Bidder E and Prospective Bidder D, seeking clarification of their proposals.
18/01/2001 [11:57]	FSA's Line Supervisor C tells other officials that FSA had received Equitable's formal notification of the appointment of their new Managing Director on 20 December 2000 and that, therefore, they would need to make any objection in early February to meet the three-month statutory deadline.
18/01/2001 [12:33]	FSA's Head of Life Insurance informs Managing Director A of a conversation that morning with Equitable about the outcome of a Board meeting the previous day, at which Equitable had decided to continue discussions with both Prospective Bidder E and Prospective Bidder D. The Head of Life Insurance records: '[Equitable's Chief Executive] *commented that, following Halifax's withdrawal, he had been nervous that the other parties may do likewise. But both had seemed genuinely enthusiastic, and relieved to find that they were still in the running*'.
18/01/2001 [12:49]	FSA's Head of Life Insurance forwards GAD's note of 17/01/2001 [**13:28**] to Managing Director A, commenting that, at first sight, this might seem alarming but that it was a '*hypothetical worst case scenario*'. The Head of Life Insurance says that if the market value adjuster did disappear, the effect on solvency would be severe, but this: '*is a highly unlikely scenario, and if it did arise, we as prudential regulator would have to consider intervention to protect policyholders (which might take the form of preventing the company from making any payouts on policies except those which were contractually required – ie even more severe in its effect than the MVA?*'. The Head of Life Insurance also writes: '*As regards the reserve for GAOs, the figure has increased partly as a result of discussions which we and GAD have had with the company over recent months about the appropriate prudent level*'. [**13:03**] The Managing Director sends GAD's note and the Head of Life Insurance's comments to FSA's Chairman, who later replies on 23 January 2001, saying: '*My worry (if I understand all this, which is not guaranteed!) is that the "future profits" figure appears to assume fund growth of 5.5% p.a., whereas I understand their Friday announcement as saying that the figure for last year was 2.7%*'.

18/01/2001 [17:40]	FSA's Legal Adviser A provides the Head of Life Insurance with advice on whether FSA's powers under ICA 1982 allowed them to give qualified conditional approval of a new managing director. The Legal Adviser advises that it was legally permissible for FSA to impose the condition that the appointment is limited to six months. This advice was based on the use of the sound and prudent management criteria set out in Schedule 2A of ICA 1982. The Legal Adviser says: *Paragraph 3 of Schedule 2D to the Act gives some flexibility. The position is as follows. If we are entitled to serve a notice of objection (effectively because we consider that the criteria of sound and prudent management may not be fulfilled or continue to be fulfilled in respect of the company if the appointment is made) but we consider the criteria will be fulfilled if certain conditions are complied with, we can impose conditions instead of objecting outright. Conditions can be imposed on the company or the managing director.* *Before serving such a notice, we have to go through a similar procedure to that involved in serving a notice of objection. That is, we have to serve a preliminary notice and allow one month for the making of written and oral representations.* *The preliminary notice will have to state the conditions we propose to impose and the criteria of sound and prudent management which we consider will not be fulfilled if we neither serve such a notice nor a notice of objection.* *It is necessary, therefore, to first identify the criteria of sound and prudent management that will not be fulfilled if the appointment is made. In this case, because we consider that "a controller" (*[the Managing Director]*) is not fit and proper to hold the position (the second criteria). We would then have to "consider" that if a condition was imposed the criteria would be fulfilled.* *The suggested condition is that the company should make the appointment only for a limited period of time. It seems to me legally permissible to form the view that a person is fit and proper to be managing director of a company, particularly one having difficulties, as an interim measure but not in the long term.* Legal Adviser A concludes by stating that his advice '*pre-supposes that you have good grounds for considering* [the Managing Director] *not to be fit and proper in the first place*'.
18/01/2001 [18:16]	Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches. They also say that none of their sales force have so far left.
18/01/2001 [18:48]	FSA's Head of Life Insurance informs the Director of GCD and Chief Counsel A that he has told Equitable that, in considering proposals for compromising GAR rights as part of a sale, one factor on which FSA would need to be satisfied is the '*fairness of the arrangement to relevant classes of policyholder*'. The Head of Life Insurance says that Equitable had agreed to send them a note on possible mechanisms tomorrow and that he planned to send them a note on the considerations against which FSA would judge the acceptability of any such proposals. The Head of Life Insurance also notes that Equitable's advisers would send a note regarding the Society's constitution. [**20:41**] The Director of GCD thanks the Head of Life Insurance and says that FSA should put the notes, when they received them, to Counsel.
18/01/2001 [entry 16]	FSA's Managing Director A presents to the FSA Board his '*Managing Director's Report: Financial Supervision*'. The report includes recent developments on Equitable. The report states: *Discussions continue between the Equitable and other parties interested in a variety of possible transactions. At the time of writing, the Equitable has sold only one subsidiary,*

Permanent Insurance Group. We are keeping in close touch with the Equitable on these discussions, and are participating in discussions with interested third parties, as almost any deal will require rather more than usual regulatory action. We are also meeting various action groups, and continue to work closely with the Equitable on handling representations from policyholders and members of the public. Dedicated units have been set up to deal with correspondence on this issue, and to prepare material for [the] *Treasury Select Committee (TSC) and for the FSA's internal enquiry.*

18/01/2001 [entry 17] FSA's supervisory file contains a note prepared by Line Manager E, entitled '*Impact of disciplinary and enforcement action*'. It is not clear what prompted him to prepare this, whether it was discussed with PIA or what use FSA put it to. A copy of the note is also held on the Head of Life Insurance's working papers. The note reads:

Following the High Court ruling and the subsequent decisions to seek a buyer for the business and then to close to new business, the prospect of any enforcement action has had the impact [of] *damaging the interests of the members of the Equitable and its other non-member policyholders. The impact needs to be looked at in three ways: a fine, public censure or rectification. It is also important that the value of securing a rescue is of benefit to all policyholders of the Equitable since it could restore its investment freedom and give greater confidence over its long term security.*

On the impact of imposing a fine, FSA say:

As it is a mutual, any fine imposed on the Society will impact directly on the members and other policyholders. This may well be the right outcome in normal circumstances since the same people could well benefit from the upside to any improper behaviour by the Society. However, given the difficult financial circumstances of the Equitable following the adverse ruling in the House of Lords, any financial penalty would simply erode the already thin cover that the Society has over its solvency margin and could lead it into statutory insolvency. As recent developments have shown, in realistic terms the business already has negative value in simple economic terms, and a further deterioration could destroy any "good will" value that a potential rescuer might see at this late stage and completely jeopardise the prospects of any kind of sale.

On the impact of public censure, FSA say:

A public censure would not of itself cause financial damage, but is not without difficulty. The terms of any statement would be highly material. As noted above, the current positive value of the Society is marginal and anything that would have the impact of further eroding confidence of the Equitable's client base in the company could tip the balance and scare off the possible rescuers. A statement that had the effect of identifying shortcomings but at the same time confirmed that the issue was a past issue and that it had been rectified already, or an indication that a sale of the business and allied changes in management arrangements address the issues, could mitigate the risk of damage, but the position is extremely sensitive.

On the impact of rectifying Equitable's mis-selling, FSA state:

Rectification raises some different issues. There can be no suggestion that we should permit a small number of policyholders to suffer disproportionately to the marginal benefit of the majority. However, it is important that proposals for review and appropriate compensation should be properly assessed. Action could have a number of impacts – the direct costs of compensation, the distraction of management from priorities and associated internal costs and the risk of reputational damage. These costs, if significant, could also have the effect of jeopardising a possible sale.

19/01/2001 [10:38]	FSA write to Equitable to set out the considerations that they were taking into account in relation to the sale. FSA state:

Our basic approach is that it is for the directors of Equitable Life to decide which proposal, if any, to choose to put to policyholders. The FSA's primary aim is to ensure that any regulatory issues arising from these proposals are exposed in good time, so they can be either resolved or taken into account before decisions are taken. We are also offering our good offices to facilitate discussions between the parties to assist the prospect of a satisfactory agreement being reached.

The letter continues:

As regards the proposals themselves, and the various bidders, we are taking the following factors into account:

- *The fairness of the proposal to Equitable policyholders in general, and to each relevant class of policyholder;*
- *Financial factors, notably the impact of the proposal on the strength of the Equitable fund or any replacement to it and the wider group of which Equitable may become a part;*
- *The commitment of the bidder to the deal;*
- *How credible the proposal is, in terms both of how well the proposal fits the strategic objectives of the bidder, and how attractive it is likely to be to policyholders;*
- *The strength of the on-going management, and its ability to carry through the proposal;*
- *The regulatory standing of the bidder, at group and solo level, both in the UK and (in the case of overseas bidders) in its own jurisdiction;*
- *Whether the bid is likely to produce a better outcome for the policyholders of the Equitable compared with a continuation of a stand alone fund;*
- *Whether the bid might have an adverse effect on the reasonable expectations of any relevant policyholders of a bidder;*
- *The fairness and thoroughness of the process by which the Equitable Board make the decision on what structure to propose to policyholders going forward.*

FSA copy the letter to Equitable's advisers for the sale and ask that they should forward copies to interested parties.

19/01/2001 [10:41]	FSA's Director of GCD responds to Legal Adviser A's advice of 18/01/2001 [**17:40**], saying that it had produced '*the right result*', but that he had three doubts about his analysis. These were:

... it looks as though conditions can be imposed where the doubt is about sound and prudent management, but not where it is about whether the individual is fit and proper.

It looks a bit odd to say that someone is fit for six months but ceased to be automatically one day later.

The ... conditions look like conditions requiring action by the company – not merely the [effluxion] *of time.*

The Director concludes by saying that '*we should consider (if you think it works) allowing him to remain as acting* [Chief Executive], *but on the basis that we do not for the time being wish to form a view on fitness to be* [Chief Executive]'.

19/01/2001 [10:58]	FSA's Director of GCD tells Line Manager E that, following an FSA Board meeting the previous day, at which '*One of the Board members mentioned that this could be vulnerable to a decision by* [the OFT] *that the MVA is contrary to the* [unfair] *contract terms legislation*', the Director of GCD had '*suggested privately to* [FSA's Chairman]*, and he agreed, that it would be sensible to find a way to make clear to the OFT that a considerable amount could depend on their decision*'. The Director of GCD asks the Line Manager to take this forward.
19/01/2001 [10:58]	FSA's Director of GCD asks Chief Counsel B to advise on the respective treatment of the rights of GAR and non-GAR policyholders in the event of a winding up. [**11:26**] Chief Counsel A says that she would ask Legal Adviser A and another legal adviser to look at this.
19/01/2001 [12:37]	FSA's Director of GCD queries with the Head of Life Insurance how Prospective Bidder D's proposals to allow with-profits policyholders to convert to unit-linked policies would help. [**12:51**] The Head of Life Insurance says that he was not sure that Equitable understood the proposal either and that was why they had sought clarification on it.
19/01/2001 [12:54]	FSA's Line Manager E speaks to an OFT case officer about their work on Equitable's use of the market value adjuster. The Line Manager records the OFT's provisional views as being that they accepted the '*explanation we gave them and the criteria that Equitable apply in calculating a suitable adjustment*', while not being in a position to form a view on whether the 10% level was a reasonable one. The Line Manager says '*the "bad" news*' is that the OFT took exception to the terms of the policies which said that Equitable had absolute discretion on making such adjustments. [**16:57**] The Director of GCD suggests to Line Manager E that '*This would be understandable, if the conclusion is reached that the unfair contract terms legislation applies*'. FSA show the OFT their legal advice, which suggested that the Unfair Terms in Consumer Contracts Regulations 1999 did not apply. [**17:34**] Line Manager E queries whether the legal advice had said that the regulations could be said to apply if the policy terms were being used in a way that was not justifiable. The Line Manager records that he had informed the OFT of FSA's powers to intervene under section 45 of ICA 1982, if FSA considered that the application of a market value adjuster was unfair to a group of policyholders. He notes that the OFT had found this '*reassuring*'.
19/01/2001 [13:39]	Equitable send FSA a paper that they had prepared entitled '*Buying out GAR options*', along with a note by their solicitors on the legal mechanisms that were available for achieving an accommodation between GAR and non-GAR policyholders.
19/01/2001 [14:10]	FSA's Legal Adviser A updates the '*Equitable Life Lawyers Group*' list of legal issues to include work on FSA's powers in relation to the proposed appointment of the new Managing Director of Equitable.
19/01/2001 [14:52]	Equitable send FSA a copy of a policyholder update notice to be published in the press the following day.
19/01/2001 [17:52]	FSA's Legal Adviser A writes to Line Manager E in response to his request for advice '*on the dispute between* [Equitable's previous Appointed Actuary] *and GAD relating to the interpretation of regulation 72*'. The Legal Adviser says that he could not give any definitive advice unless he received some input from GAD on the nuances of the regulations.

	[**18:01**] Line Manager E thanks Legal Adviser A for his comments and asks GAD for '*help with the detail ... asked for*'.
19/01/2001 [19:01]	FSA's Chief Counsel A speaks with Equitable's solicitors about the Society's compromise proposals (see 18/01/2001 [**11:30**]).
20/01/2001 [10:54]	FSA's Director of GCD writes to Chief Counsel A about various issues that might arise in relation to any compromise of the claims of GAR policyholders. In relation to identifying classes of policyholders for participation in such a scheme, the Director of GCD notes that: '*The papers seem optimistic in believing that it will be possible to limit the classes affected to two. Query the position of those with annuities in payment, those with unit-linked policies, and those of different ages within each class. There is an obscure reference to a legal difficulty ... that needs to be explored*'.
22/01/2001 [09:09]	FSA ask GAD to consider Equitable's proposal that they should apply for a concession '*so enhanced value can be given to the value of Permanent* [Insurance] *in the 31/12/00 returns*'. FSA note that the sale had been agreed in principle prior to the year-end, but would not be completed '*until later this year*'. FSA say that, therefore, '*I thought that this could only be treated as a post balance sheet event but you may have some other ideas*'. [**10:56**] GAD say that they would need to see the sale agreement before they could advise on how the value of Permanent Insurance ought to be treated. GAD suggest that FSA should ask Equitable how their auditors intended to treat Permanent Insurance in their Companies Act accounts. GAD also ask FSA if they wanted to request early submission of Equitable's 2000 returns. GAD say: '*Although we were given comfort about their solvency position at last week's meeting, the wider world would presumably benefit from such disclosure sooner than 30.06.01?*'. [**11:24**] FSA say that they will send GAD a copy of the sale agreement.
22/01/2001 [10:00]	FSA hold the second meeting of their Equitable Life Lawyers Group.
22/01/2001 [10:07]	FSA's Head of Life Insurance writes to the Head of Consumer Education about: *... whether we could put on to the FSA website some sort of decision tree similar to that published recently in the Financial Times ... I remain of the view that the difficulties and risks of the exercise outweigh any benefits. The average Equitable policyholder is fairly sophisticated and articulate, and is looking for quite specific assistance in relation to his or her policy. This is the best given by the company. As you know you have been encouraging the company to improve its own material for policyholders, and their own website now contains a lot of extremely useful material. I think we now need to concentrate on the efforts to find a* [compromise] *solution to take the company forward.*
22/01/2001 [10:42]	GAD's Directing Actuary B advises FSA's Head of Life Insurance and Director of Insurance: *I am concerned to see that some press reports are seemingly attempting to raise policyholder expectations about higher bonus rates this year. After a 2.7% investment return last year and equity values still close to end-2000 levels, it is very doubtful that the Equitable could afford to increase the 9% interim bonus rate applied last year, and smoothing surely implies that their figure should now be reduced.* *Similarly, I believe that it is very unlikely that they have the capacity at present to make any significant reduction in the present 10% MVA.*

22/01/2001 [11:06]	GAD respond to FSA's request for help of 19/01/2001, by suggesting a meeting to discuss the issue further. [**10:15**] Internally, GAD suggest sending FSA's Legal Adviser A a copy of the actuarial profession's Guidance Note 8.
22/01/2001 [11:29]	FSA's Director of GCD tells Line Manager E, in reply to 19/01/2001 [**17:34**] about the OFT and the market value adjuster, that Legal Adviser C would draft a letter to be sent to the OFT.
22/01/2001 [14:54]	A draft letter to be sent by FSA's Chairman to the Chancellor of the Exchequer is circulated to officials for comment. The Director of GCD comments that a proposed statement that FSA were '*tightening up the reserving requirements for GARs will be taken as acceptance that existing levels of reserving are too low, or defective. We must clearly tighten them up, if that is the case, but we should be wary, in the light of possible future litigation, of seeming to concede that the current approach is inadequate*'. Managing Director A agrees with the Director's concerns, adding '*One way to deal with this would be to talk instead about the prospective integrated source book and to say that we will before long be going out with consultation on ways of harmonising insurance and banking regulation*'.
22/01/2001 [15:46]	GAD write to FSA regarding possible policyholder classes for a compromise scheme. GAD note that: *... there are a number of potential sub-classes that could be identified. For example, among the GAR group, there would be those with an immediate right to retire, those with 3.5% annual bonus guarantees, and those with the right to pay future premiums. There will also be groups with different levels of GAR (ie the actual rate written into the contract), and groups with various levels of availability of GAR.*
22/01/2001 [16:41]	HMT ask FSA for a copy of an open letter from Equitable to policyholders that had appeared in a national newspaper.
22/01/2001 [entry 10]	FSA's Head of Life Insurance speaks on the telephone with Equitable's Chief Executive. The Head of Life Insurance's note of the call records: *... that the results of* [the] *weekend discussions looked promising on both fronts ...* *I mentioned our concern that FSA would have sufficient time to consider the bids against our own "hurdles" for acceptability, before the Equitable Board make a decision between the two on Friday.* [The Chief Executive] *said that, under pressure from both bidders, the Board was now hoping to reach a decision on Wednesday. I said that I thought this would be very difficult for FSA. We had already thought that the Friday deadline would be tight for the work we needed to do.* [The Chief Executive] *said that he would pass that consideration on to the bidders.* *... Meanwhile, we are preparing a short checklist of issues which we will need to consider under the various possible scenarios (e.g. rival bids on different basis; only one bid; or no bid at all).* FSA's Chairman notes that '[clearly] *we have to do a thorough job. But equally we don't want to hold things up if we can avoid it*'.

22/01/2001 [entry 11] FSA send the Department for Social Security some data on the numbers of policyholders. FSA inform the department that '[on] *solvency all we can state at the moment is that the Company remains solvent, I do not think we have a regulatory gateway to discuss the sensitivities of the position*'.

23/01/2001 [entry 1] FSA's Chairman writes to the Chancellor of the Exchequer to set out what FSA were doing in response to Equitable's closure to new business.

The Chairman says that FSA's '*immediate focus is on resolving the future status of the company, and attempting to create a more certain prospect for its policyholders, who continue to face great uncertainty*'.

FSA's Chairman writes:

> *There is no interest in the insurance industry in a collective rescue, but some individual companies have been interested in acquiring all or part of its operations. These offers would be likely to involve a restructuring of the with-profits fund, to cap the liabilities to policyholders with guaranteed annuities. So any deal in prospect would involve some cost for policyholders, both with and without guaranteed annuities. The upside might be a fund with a large company behind it in the future, and therefore able to hold a larger proportion of equities, and yield a higher return.*
>
> *Since the reconstruction proposals would depend on support from different groups of policyholders, we have also been in discussions with the associations representing policyholders, who generally understand the need for concessions on all sides.*

The Chairman explains that the negotiations with the prospective purchasers '*are at a delicate stage, and there is no guarantee of success*', and he notes in parentheses that: '*If no new purchaser is prepared to do a deal, then reconstruction of the fund will still be necessary. But without the associated benefit of strong future backing it would be more difficult to "sell" to policyholders*'.

FSA's Chairman goes on to explain the internal review of their regulation of Equitable in the period from 1 January 1999 to 8 December 2000 that FSA's Board had commissioned (the Baird Review). He notes that such a review could not address the full history of the case, but FSA aimed to learn what lessons they could from an assessment of their actions as regulator. The Chairman continues by stating:

> *We had already, in fact, reached one conclusion about the prudential regulation of insurance companies which is that, by comparison with other forms of financial regulation, it has been under-resourced in the past. And part of our reconstruction of the FSA as a single regulator will involve an increase in resources for insurance supervision, within a broadly flat overall total, therefore involving some reallocation of staff from elsewhere. That has been part of our planning for the last year. But there may be other lessons, too.*

The Chairman also outlines the longer term actions that FSA were to undertake, being:

- Setting rules under the new regulatory regime to come into force at 1 December 2001, requiring companies to include more information about their with-profits contracts within their returns.
- Conducting a review of with-profits policies, which would look particularly at the extent of discretion inherent in policies and at how to improve the transparency of policies.
- Giving consideration to whether discussions with companies over distribution of inherited estates could be done through a more transparent process.

23/01/2001 [entry 2] FSA and GAD meet Equitable's new Appointed Actuary. The main purpose of the meeting '*was to exchange views on the society's current position, and in particular its reserving position*'. According to FSA's note of the meeting:

> [The Appointed Actuary] *was clearly nervous about his professional responsibilities, especially that of being satisfied at all times that the company was meeting its solvency requirement. He stressed that he had only been in the job seven days, and could not with hand on heart* [confirm] *that the solvency requirement was currently being met (although he had no reason to suppose that it was not). He also wondered whether the FSA would look to the appointed actuary in place at the year end to certify the year end returns of the Equitable, as we had often done in the past when there was a change of appointed actuary between the year end and the time that the return had to be submitted.*

FSA's note records that they had told Equitable that:

> *... in this particular case, given the special circumstances of the Equitable, including widespread public concerns about the financial position, we would expect the new appointed actuary to form his own opinion of the financial position, and be prepared to certify to that opinion in the returns. We would regard this as a significant element of comfort, especially as he himself was a highly respected and senior member of the profession, and would be bringing a fresh mind to the position of the Equitable Life.*

FSA's note continues:

> [Equitable's Appointed Actuary] *speculated that it could turn out that the Equitable Life was clearly and comfortably solvent in Companies Act terms, but that there might be a period when it would be difficult or impossible to meet the margin of solvency required in the Insurance Companies Act. What would the FSA's attitude be to that situation? It could be in the interest of policyholders to accept a short period when the margin of solvency was breached, if in the long run that enabled the fund to recover and produce better returns for policyholders than going into insolvency. In the case of a closed fund, the arguments for maintaining the solvency margin were weaker than the case of a fund open to new business, not least because there were no competitive issues.*

FSA record that they told Equitable: '*that we would not wish to enforce the regulations in an unhelpfully restrictive way, if there were good arguments for flexibility; but any departure from the norm would have to be* [open] *and transparent, and capable of being justified*'.

The House of Lords' judgment is also mentioned, and: '[The Appointed Actuary] *repeated his well-known views that the judgement had rendered illegal practices which lay at the heart of the management of with-profits funds right across the industry. But he accepted that there was no realistic prospect of a challenge to that judgement*'.

The note recorded that no detailed discussion on the sale had taken place '*as the position was so fluid*'. However:

> *... we discussed possible ways of reaching an accommodation with the GAR and non-GAR policyholders.* [The Appointed Actuary] *shared my hope that the classes of policyholder who would need to vote separately on any proposal could be restricted to two (GAR and non-GAR); although it would be very easy to identify a number of categories, it was not clear that their interests were so special that they should be given a vote of their own; and the greater the number of policyholder classes, the less likely that any proposal would secure the necessary agreement.*

FSA's note continues that:

In the context of the Treasury Select Committee enquiry, [the Appointed Actuary] *was surprised that the Equitable's position had aroused public consternation. He contrasted this with the actual failure of a large number of other financial institutions which had not aroused the same public dismay; yet the Equitable was still solvent. I said that we had made that point ourselves, but it would not be an easy one to put across in the current climate.*

FSA's note concludes by recording that:

[Equitable's Appointed Actuary] *said that he had got the impression that we had had some difficulties and disagreements with his new colleagues. We said that the Equitable had a reputation in the market place as a company which was confident of the rightness of its position, and that we have found the same in our dealings. But our current relationship was very open and co-operative.* [His] *own comment was that the company had tended to rely on* [home] *grown talent for much longer than other life offices; and that the effects of this were still apparent.*

23/01/2001 [entry 3] Equitable send FSA a list of action points from the meeting on 16/01/2001 for them to check. The list records progress on those points.

23/01/2001 [entry 4] FSA receive Counsel's Opinion on Article 4 of Equitable's Articles of Association and on the potential impact of the Unfair Terms in Consumer Contracts Regulations 1994 and 1999 on related issues. In relation to the Regulations, the Opinion states that:

On any basis the impact of the Regulations on The Equitable Life's policies would be limited. These and the predecessor 1994 Regulations would only have potential effect on policies issued after 1st July 1995. This is likely to represent a modest proportion of the total number of policies issued by the Equitable Life.

The Opinion then goes on to offer some '*tentative*' conclusions. First, it is suggested that, on balance, Equitable's members and those holding investments who were not members '*would qualify as consumers*'. Secondly:

Taking a broad view of the matter, we would have thought that there was a plainly arguable case for saying that [Article 4] *was "unfair", in that its operation and effect could indeed cause a "significant imbalance in the parties' rights and obligations ... to the detriment of the* [policyholder]*".*

... it would be open to a policyholder to seek a declaration from the Court to this effect or to deploy the Regulations against The Equitable Life if and to the extent that the company sought to deny liability to the policyholder ...

23/01/2001 [entry 5] Equitable provide FSA with further information in support of their application for a section 68 Order on the admissibility limits of certain shares.

23/01/2001 [entry 6] FSA's Line Supervisor C submits a paper to FSA's Insurance Supervisory Committee, recommending that they should support Equitable's application for a section 68 Order on the admissibility limits of certain shares for the year-end 2000. (See 12/01/2001 [**entry 2**].)

The paper states that the request for the Order followed the guidance that had been issued by the Committee. (See 18/12/2000 [**14:30**].)

23/01/2001 [entry 7] FSA issue instructions to Counsel in relation to '*the regulatory functions of the FSA related to current and possible future bids for the Equitable ...* [and] *the deal which might be struck with the Equitable's policyholders so as to cap the company's liabilities to holders of policies containing a guaranteed annuity rate (GAR)*'.

23/01/2001 [11:58] PIA ask FSA for updated figures on Equitable's new business following the House of Lords' judgment.

[**12:01**] Line Manager E asks Line Supervisor C whether this had been covered in the information received '*the other day*', which they had been '*told not to disclose*'.

23/01/2001 [14:37] An FSA legal adviser writes to Chief Counsel A about the powers of a liquidator to compromise claims. The legal adviser says:

> *The answer is yes. The power to compromise claims is expressed in very wide terms in Schedule 4 of the Insolvency Act 1986.*
>
> *... This power is exercised with the sanction of an extraordinary resolution of the company in the case of members voluntary winding up, the sanction of the liquidation committee in the case of creditors' voluntary winding up and the sanction of the liquidation committee or the court in the case of a compulsory winding up.*
>
> *Section 55(1) of the Insurance Companies Act 1982 provides that long term insurance companies cannot be voluntarily wound up. Section 366 of* [FSMA 2000] *will allow such companies to be voluntarily wound up with the consent of FSA.*

23/01/2001 [15:27] An FSA official circulates version four of their public '*lines to take*'.

23/01/2001 [15:29] GAD provide FSA with their comments on Equitable's paper '*Buying out GAR options*' (see 19/01/2001 [**13:39**]). GAD say that they support the objectives of the proposal, although the relative emphasis given to each objective needed fine-tuning. GAD note that '*the GAR/non-GAR issue is rather more fundamental than the term "incidental" might suggest*'.

GAD note that, while '*Equitable would like to restrict the number of policyholder classes to 2*', there were at least 11 different ways of distinguishing between groups of policyholder. However:

> *There would seem to be three underlying categories:*
>
> 1. *Those with-profit policyholders who potentially benefit at the expense of others (e.g. the GAR policies);*
> 2. *Those with-profits policyholders who provide such benefit (e.g. the non-GAR with-profit policies);*
> 3. *Those who neither provide nor receive benefit (e.g. non-profit policyholders), but who ultimately benefit from a stronger solvency position.*

GAD continue:

> *Those in (or potentially in) category 1 are the GAR policyholders, those non-GAR policyholders with a minimum 3.5% bonus rate, and those with-profit policyholders who can terminate without penalty, either now or at some future date.*
>
> *In category 2 we have the with-profit policyholders without a minimum bonus rate and who can only leave subject to an MVA, and with-profit annuities in payment. Income drawdown may also be in this category, but the policy wording would need to be examined to understand the extent to which any MVA might be applied.*
>
> *In category 3 we have all the non-profit (including non-profit annuities in payment) and unit-linked policyholders.*

GAD continue:

> *However, the fundamental issue at stake, following the House of Lords judgement, is how to distribute the available funds between GAR and non-GAR policyholders such that both groups are satisfied that their share of the "cake" is in accordance with their expectations. Whilst, for example, some cross subsidy may arise separately between policyholders with a minimum roll-up of 3.5% and those without such a guarantee (indeed, investment returns during 2000, when the with-profits fund secured a growth of, we understand, about 2%, were such that cross subsidy may well have arisen over that year), there is no evidence of any dissatisfaction between these two "classes" of policyholders. However,* [Equitable's solicitors'] *note (§2.8) comments that "it may be that policyholders benefiting from a 3½% p.a. investment return guarantee would also need to be treated as a separate class".*
>
> [Equitable's solicitors] *also say (§2.9) that "it is in theory possible ... that policyholders with both GAR and non-GAR policies should be placed in a separate class" because of the impossibility of knowing that they might vote otherwise.*

GAD state that:

> [The] *distinction between those retired and those who have not yet retired could be reflected rather better in the terms of the "deal"; to seek to divide these into groups (according to duration to retirement, presumably), would involve some inevitably arbitrary divisions. However, so far as we can tell, there is no "tapering" of the proposed deal, and we think this is unsatisfactory. For example, if the GAR is currently worth 30% more than CAR, and the proposal were to give policyholders a 20% uplift, this does not look equitable to the policyholder 1 year away from retirement, but it may be quite acceptable to a policyholder 15 years away from retirement.*
>
> [Also, we] *believe that non-profit policyholders are in separate category. As noted above, they would ultimately benefit from a stronger solvency position (and certainty of outcome).* [Equitable's solicitors] *do not appear to comment on these, but it seems to us that they constitute a separate "policyholder class".*

GAD conclude that:

> *We therefore appear to have potentially 5 (or more) policyholder classes. This is unfortunate, since the higher the number, the more likely it is that one of the classes will not vote in favour. These five are:*
>
> - *GAR policyholders;*
> - *Non-GAR with-profit pension policyholders;*
> - *With-profit life policyholders;*
> - *Policyholders with policies that fall into more than one class;*
> - *Non-profit (including unit-linked) policyholders.*
>
> *... it is for the lawyers to decide on the appropriate number of classes.*

23/01/2001 [18:24]	Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.
24/01/2001 [09:00]	FSA and GAD meet Equitable's Chief Executive and advisers to discuss the latest position on potential bids for Equitable's business. Counsel for FSA is also present. FSA's note of the meeting records the current position of all bidders.

Equitable report that Prospective Bidder E had decided to withdraw from the process, but would not make this public knowledge yet. Equitable say that they had had concerns about the implications of the time it would take to transfer the business and had been advised that it would take longer than anticipated. Equitable say that, given that Prospective Bidder D were the only company left, they would continue exclusive negotiations with them for two weeks and attempt to improve on any offer.

FSA's note records: '*The latest proposal was disappointing and the chances of securing improvements would be better if* [Prospective Bidder D] *did not know they were the only party left*'.

The details of the proposals are discussed. FSA's Managing Director A expresses concern about the scale of the effective reduction in policy values envisaged by Prospective Bidder D's requirement that Equitable should establish an estate of £1bn and about the proposed increase in the level of the market value adjuster, pending adoption of a scheme of arrangement between GAR and non-GAR policyholders.

FSA's Director of Insurance states that it was important to consider realistic alternatives to a deal: '*For example, thought would need to be given to whether or not a section 425 scheme was likely to be achievable under a bid or closed fund option. The analysis would also need to compare the possible outcomes compared with a winding up of the Society*'.

In an '*aide memoire*' sent by the Director of GCD to Managing Director A in advance of the meeting, the Director notes, among other matters, that '*the proposal to increase the mva to avoid adverse selection in light of reduction in policy values arising from the offer*' was a '*critical issue for us, given our commitment to keep this under review and the OFT angle*'.

He notes further that all this '*suggests the deal* [is] *not* [very good] *for policyholders*'.

24/01/2001 [morning] FSA's Head of Life Insurance talks with Prospective Bidder E about the background to their decision to withdraw. Prospective Bidder E says that there had been a combination of factors that had led to their decision, including:

> <u>*Fund Strength*</u>
> [Prospective Bidder E] *had been keen to achieve an outcome which produced a fund which was both robust and seen to be robust; they attached importance to the realistic possibility of the fund reopening in due course, in a way which would engender policyholder confidence. In this context, he claimed that* [Prospective Bidder E] *thought this would be difficult to explain convincingly to policyholders, not least because of the impact on the Equitable of the new valuation regulations in respect of unitised with-profits business (these require companies to take more account in their reserving of terminal bonuses, which are not guaranteed). He said that this provision would be particularly hard on the Equitable, because of the unusually explicit reference in their sales material to the use of MVAs.*

Other factors noted by FSA were:

> *... the difficulty of selling any proposal to policyholders, in a way which would reduce the risk of challenge to acceptable proportions. These problems of timing also affected the value of the salesforce, which was a wasting asset.*

> *... a number of issues surrounding the salesforce. Equitable were keen for the salesforce to be able quickly to start selling with-profits policies again; but* [Prospective Bidder E] *had doubts about this. There were also concerns about problems arising from Equitable's past sales practices (though no suggestion that these were worse than other companies'); and about the ability to retain the salesforce – they had received a large retention payment already, and had been led to expect large redundancy payments; these factors made it less likely that they would stay on in the longer term.*

24/01/2001 [entry 3] Prospective Bidder E write to FSA to formally notify FSA of their decision to withdraw from negotiations on the purchase of part of Equitable.

Prospective Bidder E explains: '*Our decision to withdraw arose not from a single factor but from a combination of emerging concerns over the last few days – particularly on our ability to re-open, successfully, the Equitable Life With Profit Fund (given the required visibility of MVA and associated issues in the light of Equitable Life's reserving position) and the prospect of the transfer process becoming substantially more complex than we or our lawyers had initially anticipated (with the potential for the process to fail or, at least, the likelihood of there being lengthy delays in implementation)*'.

On 26 January 2001, FSA's Director of Insurance comments:

> *As expected. A bit thin – they could have reached this decision much more quickly – but we always doubted their commitment.*

24/01/2001 [12:40] FSA's Director of GCD sends the Head of Life Insurance a note of actions that FSA had agreed to take after the meeting with Equitable that morning, which reads:

> *You will prepare a letter to go to Equitable pretty rapidly asking them for more detail about the deal for policyholders. This is partly to ensure that their own Board has a proper understanding of what this might mean for policyholders, partly to enable us to give our assessment of it from this viewpoint; and partly to put them in a position where they can answer questions regarding this if and when this deal is agreed and announced. This material should compare the deal that is being offered to different classes of policyholders with what they would get without the deal, whether on winding up or otherwise.*
>
> *This is against the background of advice from* [Counsel] *that a schedule 2 scheme could not credibly be used to modify the rights of the GAR holders, and that a section 425 scheme would be long and difficult. Policyholders need to be put in a position where they can see an attractive outcome from the start if such a process is to have a chance of success. This meshes in with* [FSA's Managing Director A's] *concern that the action groups should be in a position where they can support the process.*
>
> *We also noted that part of the possible counter factual might be intervention action by FSA, depending on the financial situation, the safeguards for policyholders expectations, and what intervention could achieve. We should consider this in its own right as well as a counter factual to section 425 scheme.*

It concludes by stating:

> [Legal Adviser C] *is asked to advise rapidly on whether OFT's view that the width of the discretion is inconsistent with UCTA could call into question the validity of a reasonable MVA imposed under that discretion.*

24/01/2001 [14:47] FSA's Director of GCD writes to Chief Counsel A (copied to others in FSA and GAD and to Counsel) about GAD's paper of 23/01/2001, asking if GAD could suggest how a proposal for a compromise scheme could be put together to appeal to the groups in different positions in each policy class that GAD had identified.

24/01/2001 [15:08] An FSA official informs the Director of Insurance and the Head of Life Insurance that Managing Director A had just returned from meeting Equitable and had reported that their Board had decided to proceed with the offer from Prospective Bidder D.

24/01/2001 [entry 7] FSA's Chief Counsel A sends the Director of GCD and Counsel a copy of GAD's paper '*Reserving and related issues*' of 19/12/2000 [**17:43**].

25/01/2001 [entry 1] Equitable write to FSA about new business in Germany. Equitable ask for FSA's agreement to allow them to write new with-profits immediate annuity policies for existing with-profits policyholders whose policy terms only allowed for a non-profit annuity on retirement.

25/01/2001 [11:06] GAD's Directing Actuary B says that he was surprised by the comments about reserving requirements made by Prospective Bidder E on 24/01/2001, as FSA had been assured by Equitable that the new valuation regulations would not have a material impact on them: '*However, this did depend on the Society retaining a substantial amount of discretion on its surrender values, an issue that is known to be under review by OFT at present*'.

25/01/2001 [11:42] FSA's Line Manager E seeks advice from GAD's Scrutinising Actuary F. The Line Manager says:

> [Chief Counsel A] *just raised with me a question about the reinsurance treaty. Counsel has spotted that there is a provision that terminates the contract on insolvency. (I should point out here that we are not sure whether he was looking at the current treaty.) I know you are familiar with it and so wondered if you could confirm the position.*
>
> *As I understood it, the treaty simply provides cover for excessive take up of the GARs and so reduces the overall reserving requirements. If there were an insolvency, those people saving under pension plans including the GAR option would not be able to exercise their right to the guarantee – rather they would receive their share of the fund which they would have to switch to another provider with whom they had started a new pension scheme.*
>
> *If that is right, there would be no basis for a claim under the treaty in the event of actual insolvency in any event, so its automatic termination would not seem to be an issue.*
>
> *But do you know if the provision features in the existing reinsurance agreement and whether or not "insolvency" in this context means insolvency in the Companies Act sense or in the sense of failing to cover the ICA requirements?*

[**11:55**] Chief Counsel A clarifies to Line Manager E and GAD that: '*I do not think Counsel was talking about the reinsurance covering GAR take-up, but rather the contract which was replaced after the* [House of Lords'] *judgment. I would be grateful if GAD would check to see if present contracts can be voided on insolvency and, if any of them can, that does not matter*'.

25/01/2001 [12:57] Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

25/01/2001 [13:21] FSA seek comments internally and externally from PIA and GAD on a draft letter to the OFT about Equitable's use of a market value adjuster. FSA explain:

> *OFT's position is that* [they] *accept our arguments that the mva is necessary for prudential reasons, and given that its effect is to achieve fairness, it is not by definition unfair, in practice. However, they are unhappy about the absolute discretion reserved to the society to decide what if anything should be paid on surrender and are thinking of asking Equitable to change the wording so that it will clarify the circumstances in which adjustments would be made and the criteria that are used in calculating the adjustment.*
>
> *At the end of the day, we share the same underlying thought – the mva is necessary, but it should be used fairly. Where we differ is that OFT want to use their powers (which we are not clear they have in this context) to modify the terms of the contract. I think (and hope* [others] *will agree) that we need to be careful that we do not inadvertently prevent the mva being applied in circumstances where it is necessary, just because it is not spelt out in any modified terms. That points to us relying on our general intervention powers under the ICA 1982.*

FSA's Line Manager E suggests sending the draft letter to the OFT, pointing out the common ground between them, and suggests that they meet to '*explore the best method for achieving our common objective*'.

[**14:41**] GAD's Directing Actuary B notes the need '*to be careful that any imposed surrender value term takes reasonable account of the interests of both departing and continuing policyholders*' and suggests: '*As a possible way forward for further debate, this term might be phrased for example as being the latest "policy value" less an adjustment for any element of unrealised profits within that "policy value". These unrealised profits would include both profits not fully earned at the last balance sheet date (and the Society could be asked to disclose the relevant proportion publicly) together with any investment or other losses (relative to any interim bonus rate applied) sustained since then (which again could be disclosed at regular intervals)*'.

[**15:31**] FSA's Director of Insurance says that he is '*a little nervous*' about leading the OFT to the conclusion that the Unfair Terms in Consumer Contracts Regulations 1999 did not apply.

[**19:15**] PIA reply to FSA, saying that they agreed with earlier comments, and that:

> *More generally I do think it looks like (though I'm sure this isn't actually the case) we are taking* [Equitable's] *interpretation/advice pretty much without question and then drawing conclusions from it, which might be dangerous to this particular audience?*
>
> *My other issue though is that the interpretation itself looks ... not to be entirely consistent with that given to us recently by leading counsel in relation to mortgage endowments.* [Counsel] *has told us that in providing compensation for contractual "product flaws" breaches, we should be looking to firms to compensate people who have <u>surrendered</u> policies (even though the contractual promise is likely only to relate to <u>maturity</u> value), as policies should behave during their life in a way consistent with the eventual outcome, in terms of the relationship between costs and investment returns. That doesn't seem to me to support the pretty wide management discretion view expressed in the draft OFT letter.*

PIA ask that FSA's General Counsel's Division consider whether their concern was misplaced. (See 26/02/2001 [**11:37**])

25/01/2001 [entry 6] FSA write to Equitable, following their meeting the previous day. FSA say that they had no major issues regarding the Society's update on the negotiations for the sale. FSA say that the discussions had highlighted the importance of presenting as clear a picture as possible of the sale proposals and how any accommodation of annuity rate guarantees would work. FSA say that policyholders also needed to know that any accommodation would most likely require a scheme under section 425 of the Companies Act 1985 and that any such scheme '*stands the best chance of success if the scope and implications ... can be explained in broad terms to policyholders at the time the deal is announced*'. Given this, FSA ask Equitable to provide more detail as to how they would handle the issue, the key questions being: '*what classes of policyholders need to be separately identified for the purposes of voting under a Section 425 scheme*[?]*; and in what terms will the proposition be put to each separate class of policyholder – in other words, what is the selling point?*'.

FSA suggest that the minimum number of policyholder classes was two (GAR and non-GAR) and that the scheme was a '*"graded" proposal which addresses the main differences of interest between policyholders within any one class*'. FSA explain:

> *The FSA will need to assess any "deal" that might be offered to different classes of policyholder taking into account what they would get absent a "deal", whether on a winding up or otherwise. We should be grateful if, as your discussions with third parties*

proceed, you could keep us abreast of how the Equitable itself is assessing these alternatives.

This information will assist us in carrying out our responsibility to consider, for example, whether we should object to any proposal which may be put forward (you will recall that an important criterion for us in this regard is the fairness of any deal to relevant groups of policy holder). An important aspect of this is whether we are satisfied that the Equitable Board has itself addressed the issues in a proper and thorough way before reaching its own decision.

25/01/2001 [entry 7]	FSA write to alert HMT to their work on the application of the Policyholders Protection Act 1975 in relation to Equitable policyholders and to inform them of the legal advice received on the meaning and effect of Article 4 of the Society's Articles of Association.
25/01/2001 [entry 8]	FSA send HMT a copy of Equitable's open letter to policyholders, requested on 22/01/2001.
25/01/2001 [entry 9]	FSA attend a meeting of the All Party Insurance and Financial Services Group, as part of FSA's programme of keeping in touch with key parliamentary groups. FSA are questioned by Members of Parliament on Equitable, FSA's risk-based model, endowments and stakeholder pensions.
26/01/2001 [10:26]	FSA's Line Manager E circulates a further update, summarising the data received from Equitable, as at 23 January 2001, on the levels of surrenders and transfers and on the number of customer enquiries handled. The Line Manager says that the information showed that the situation seemed to have '*stabilised considerably*'. The Line Manager also explains that FSA's correspondence unit were receiving around 10-15 enquiries a day from members of the public (down from around 30 a day) and around 15 enquiries a week from Members of Parliament. The Line Manager says that these were normally being responded to within 48 hours of receipt by the correspondence unit, although FSA had discovered that there was a delay of about a week from when letters arrived in the building to when they reached the unit.
26/01/2001 [10:59]	FSA's Director of GCD informs Legal Adviser A that his division had been asked '*for some urgent advice*' as to whether policyholders or the FSA could call an emergency general meeting before Equitable took a decision on the sale of their assets. On the FSA element of the advice, the Director of GCD says: '*what powers FSA may have to require an* [emergency general meeting]*: I have so far prevented our briefing from saying that we have no powers for this purpose, on the basis that we might do so, if this were necessary to secure policyholders' reasonable expectations and we can see a sensible outcome arising from the exercise of the powers*'.
26/01/2001 [11:37]	FSA's Chief Counsel B provides comments on FSA's proposed letter to the OFT, in response to PIA's request of 25/02/2001 [**19:15**], including: *... the legal view which we have taken is one which has proceeded from our examination of the policy documents and the Regulations themselves.* *It is important to be clear that we have not advised that the Equitable has a complete unfettered discretion to apply whatever MVA it chooses. What we have said is that a Court approaching the policy terms which allow it to apply the MVA would be likely to construe those terms as involving an implied term that it should exercise the MVA on a reasonable basis.*

As [Line Manager E] *has pointed out, the FSA does have powers under ICA 1982 to intervene should it appear that the Equitable is exercising its powers in an unreasonable way.*

Turning to your reference to the work on endowment mortgages, I am unsure about the point you are seeking to make. The fact that someone who surrenders a policy might be entitled to some form of compensation as a result of losses attributable to the original misselling of policy does not it seems to me impact on whether the existence of the MVA clause in the policy is unfair for the purposes of the Regulations. The MVA is a factor which determines how much is paid to the policyholder on surrender.

26/01/2001 [13:14] FSA's Director of GCD provides comments on the draft letter to Equitable of 25/01/2001, after the final version is sent. The Director of GCD suggests that it would be useful to formally confirm the Director of Insurance's summing up of FSA's position at the end of the meeting on 24/01/2001, that being:

- *the Board must compare this offer with realistic alternatives;*
- *it will be necessary for them to be completely transparent about the genuine value of the offer to policyholders: we could not lend our support to anything which misleads them;*
- *it is highly desirable to segment the section 425 scheme aspects, so that the position can be no worse with them than without them;*
- *if it is possible to produce an overall package, this might be better than the section 425 scheme on its own, but the section 425 scheme on its own would constitute a benchmark against which an offer would need to be judged;*
- *it would be difficult for us to be able to conclude that the offer is reasonable and fair to policyholders if it involves the sort of reduction in policy values described in the paper, or the proposed uplift in the MVA.*

[**13:31**] The Head of Life Insurance says that the letter had already been sent and that he had understood that the Director of GCD did not have any comments on the draft.

[**13:44**] FSA's Director of Insurance believes that the last point '*overstates*' FSA's position and that FSA would need to look very carefully at any proposals that included reductions in policy values or increases to the level of the market value adjuster '*of the scale envisaged*'.

26/01/2001 [13:31] FSA's Director of GCD queries GAD's Directing Actuary B's comments about the meeting with Prospective Bidder E (see 25/01/2001 [**11:06**]), saying that it was less likely to be the OFT's role that was the cause, but Prospective Bidder E's assessment of the impact that the new regulations would have.

[**13:58**] Directing Actuary B clarifies that:

The new regulations do not refer to terminal bonus (though it is generally recognised within the actuarial profession that they have the effect of requiring a partial provision for possible terminal bonus).

However, the amended regulations do require that insurers should establish adequate provisions to cover the lower of the amount of cash payment that would reasonably be expected on surrender, and the amount of cash payment that would be expected disregarding all discretionary adjustments.

I suppose that there could be some ambiguity in the latter phrase, but we understand that Equitable would interpret this to mean the amount of the contractual liability (on death or maturity), excluding therefore the potential final bonus (which is discretionary).

If this interpretation were incorrect and instead the potential final bonus does have to be included, then they would indeed have a major reserving problem at the end of last year.

[A similar point could arise for other insurers though they would be able to say that they had not disclosed the level of potential terminal bonus to policyholders and therefore that any terminal bonus addition must clearly be a discretionary adjustment. Equitable have tried to be more open by showing the potential amount of this bonus in their annual bonus notices].

The Directing Actuary concludes:

Even if Equitable are right in their interpretation, there would also be an increased reserving requirement if the OFT concluded that they had no discretion on surrenders, and had then to pay out 10% more on surrenders than is being paid at present.

26/01/2001 [16:56] GAD provide the following advice to FSA in response to their request of 25/01/2001 [**11:42**]:

We confirm that the reinsurance treaty includes a provision that terminates the contract on insolvency. This is provided by Article X.2 which states that:

"Each party is entitled to terminate the treaty without giving prior notice if ...

2. The other party becomes insolvent or goes into liquidation or a Receiver/Administrator is appointed or has its licence to conduct insurance business revoked as defined in Section 13 of the Insurance Companies Act 1982".

The treaty goes on to say that "In the event of cancellation under part 2 ... of this clause the portfolio at the date of termination will be withdrawn and the Reinsured shall refund to the Reinsurer at the same point in time any Reinsurance Claims Amount and any outstanding cash balance in full, subject to the requirement that in the event of cancellation under part 2 of this clause such refund will be subordinate to the Reinsured's liabilities in liquidation towards its policyholders under the terms of its long term policies. However, the Reinsurer will retain the right of offset against future Recovery Amounts due."

The above extracts are as per the original treaty. They were not amended in any of the subsequent Addenda.

We suggest that the lawyers answer the part of your question as to what "type" of insolvency this is.

We would just add that it is not unusual for a financial reinsurance treaty to terminate on insolvency.

26/01/2001 [afternoon] FSA (Director of Insurance and Head of Life Insurance) meet the person who goes on to become Equitable's President to discuss his possible appointment. The meeting was held at the individual's request. According to FSA's note: '[He] *believed very strongly that the Equitable situation had to be "sorted out", that it was doing immense damage to confidence and that, while it looked to be a complex and difficult task it was one which he was prepared to take on "pro bono"*'.

26/01/2001 [entry 8] FSA's Head of Life Insurance provides Managing Director A with a paper on the options for FSA on whether or not to give their formal approval to Equitable's proposed Managing Director. The Head of Life Insurance sets out his view that FSA had three broad options, namely:

1. *Seek to arrange that he remains as acting* [Managing Director], *without the need for us to either approve or object at this stage. To achieve this, we would need to persuade the company voluntarily to withdraw the notice of proposed appointment. Normally we*

would not wish to do this, as leaving someone as an acting [Managing Director] *without submitting a notification can be used by a company as a device to put in place de facto someone whom they suspect we would not approve. But in the special circumstances of this case, it could be justifiable on an interim basis.*

2. We could approve the appointment, subject to the condition that the appointment was for a limited time (say 6 months) after which a fresh application would have to be made to us. The Insurance Companies Act provides a mechanism by which this could be done; but we would still need to issue a provisional notice, and we would still need to state the grounds on which we would object, if the conditions were not met. This would boil down to stating that we did not find him a fit and proper person, or that the criteria of sound and prudent management would not be met. This is a high test, and we would have to think very carefully indeed whether we judged it to be met.

3. We could approve the appointment (or simply let the time limit lapse without objection, which would have the same practical effect). Under this option, we would have to accept that in formal terms the appointment was open-ended. But we could nevertheless speak to the Chairman on an informal basis, to say that we saw merit in the appointment being made for a limited period in the first instance, until the situation clarified; and that we would expect to see the Managing Director supported by a particularly strong and independent Board, given his close involvement in the problems of the past.

FSA's Head of Life Insurance continues:

You may wish to discuss the options further. My view is that the second option would be difficult to justify. The other two options both involve informal persuasion rather than formal use of powers. One disadvantage of the first is that failure to confirm the appointment would eventually become public knowledge, and this could raise fresh public doubts about the soundness of the company. I therefore come down in favour of the third option. Although we take some risk in giving an approval which in formal terms is unconditional, in practice the risk is limited. The company is now in run-off, so that the job of Managing Director is less significant than in the case of a going concern; and if a bid is successful, the new owner of the business will have a major say in the composition of the Equitable's Board, and indeed the identity of the [Managing Director].

26/01/2001 [entry 9] FSA's Insurance Division's Policy Department prepare a paper (which is copied to Equitable's supervisory team) on how current banking regulation and supervision would have dealt with exposures such as Equitable's GAR issue. The paper includes the following description of how Equitable's policies work:

Equitable Life issued individual with profits annuity policies with Guaranteed Annuity Rates ("GARs"). (Annuity = pension). The GARs are applied to the pot of money in the policy at the selected retirement age to calculate the pension payable.

These policies also included an option whereby at the selected retirement age, rather than taking an annuity with [Equitable] *using the GARs, policyholders could either take an annuity with* [Equitable] *but without the GAR ie at current annuity rates, or take the fund they had built up with* [Equitable] *to the market and a different provider the open market option. In practice this is likely to happen (not exercising the GAR) if the market is offering better annuity rates than the GAR written into the GAR policies. Or perhaps if the policyholder wanted to structure their annuity in a way not allowed under the GAR policies eg to include a spouse's pension. The policyholder makes this decision once at the point of retirement.*

26/01/2001 [entry 10] GAD's files contain a paper prepared by Scrutinising Actuary F which further develops the implications of the policyholder classes which had been set out in the paper of 23/01/2001. (Note: this was presumably prepared in response to FSA's request of 24/01/2001. However, the paper is marked '*NOT SENT – not approved by* [Directing Actuary B]'.)

26/01/2001 [entry 11] PIA produce a paper on a project to review the conduct of Equitable from the Court of Appeal's decision of 21/01/2000 to the Society's closure to new business on 08/12/2000. The paper is distributed to FSA. PIA explain:

> *Throughout the period 21st January to 8th December 2000 the risk profile of the with profits fund was potentially different to that which applied before the* [Court of Appeal's] *decision against Equitable. It potentially changed after the* [Court of Appeal's] *ruling and again after the* [House of Lords'] *decision. The project needs to:*
>
> *1) Analyse whether appropriate disclosure and/or appropriate advice was given to investors by Equitable to fulfil its regulatory obligations under PIA and Adopted Lautro Rules...*
>
> *In the light of this analysis establish whether Equitable's post* [Court of Appeal] *and/or post* [House of Lords] *with profits investors have been disadvantaged and, if so, what action should be taken if problems are widespread. For example, should a wide scale review be required and redress be paid or would an approach more focused on individual clients be more appropriate?*
>
> *If a review is required we will establish which groups of clients are affected and what further action needs to be taken.*
>
> *2) Establish and assess the basis of Equitable's adjudication of complaints from investors advised into the with profits fund post* [Court of Appeal] *and/or post* [House of Lords'] *ruling [this element will extend to the period post closure to new business].*

Under the section '*How will this work be done?*', PIA list the questions they would be asking in order to assess Equitable's actions, which were as follows:

> *3) How did Equitable assess its regulatory obligations post* [Court of Appeal] *judgement? ...*
>
> *4) How did Equitable assess its regulatory obligations post* [House of Lords'] *decision? ...*
>
> *5) What it did to alter its marketing and advice positions in response to these obligations.*
>
> *6) Were Equitable's actions in compliance with their regulatory obligations in its marketing and advice to new with profits fund clients? How many clients were affected?*
>
> *7) How are Equitable dealing with complaints from clients who say they should have been told of the risks inherent in the potential future for the with profits fund.*
>
> *8) Should Equitable be undertaking a full or focused review of their sales of with profits business? If so, over what period?*
>
> *9) Have any clients entered into the with profits fund post closure to new business?*

28/01/2001 [entry 1] FSA's Director of GCD sends Managing Director A a copy of GAD's paper '*Reserving and related issues*' (see 19/12/2000 [**17:43**]). The Director of GCD says:

> *You should see this, if you have not seen it before. It suggests that the basis for taking the view that the Society is in compliance with solvency requirements is tenuous, and depends on various forms of special treatment agreed for the Society.*

28/01/2001 [10:15] Halifax's Chief Executive writes to FSA's Head of Life Insurance. The Chief Executive says:

> *You will no doubt recall the very helpful discussions I had with you and your colleagues earlier in the month. A number of your observations were then and still are today, material to the judgement we have had to make on this difficult transaction. Subsequently, on behalf of the FSA,* [an FSA official] *confirmed that you were comfortable with the way in which we had represented your position in an internal report.*
>
> *I'd like to give you the opportunity today of reviewing again the relevant parts of the paper (copy attached).*
>
> *In section 13 of the same paper we refer also to our need for a waiver of the marketing group rules so as to enable us to operate the* [Halifax Equitable] *and* [Halifax] *field forces alongside each other but with separate product portfolios. We would only require the waiver for a matter of months but without it we will be unable to put* [Equitable's] *field force back into action for months. It is therefore a matter of significant commercial importance and I would like your guidance on the FSA's position on this point.*
>
> *Finally, I would ideally like some "off the record" feedback on* [Equitable's] *compliance performance and standing. We know from our due diligence that* [the Society] *is currently reviewing its advice in relation to a substantial number of income drawdown cases. If this is, in the FSA's opinion, likely to result in a public reprimand it is an issue that would, at the very least, need to be taken very fully in account in our final judgement today.*

The relevant sections of the internal Halifax document are:

> *10. THE FSA*
>
> *<u>The FSA's attitude to any proposals we may make is of crucial importance</u>. A preliminary, and necessarily high level discussion on the basis of the proposition outlined in this paper revealed that:–*
>
> - *in principle (and subject to the detail) <u>they would be likely to approve of the structure;</u>*
> - *should they approve any final proposal <u>they would give public endorsement on announcement;</u>*
> - *they are prepared to commit unambiguously (again publicly) to the fact that <u>in no circumstances will they regard</u>* <u>[Halifax]</u> *<u>as standing behind the ultimate fortunes of the closed fund;</u>*
> - *<u>they are committed to move with pace, resource and considerable flexibility</u> to help put in place the detail of any proposals that may be agreed (as between all three parties).*
>
> *In practice we could not pursue any proposition that did not get this sort of response from the FSA*;

and:

> *<u>Resolution of the GAR/non GAR uncertainty will be seen by most audiences to have substantially resolved</u>* <u>[Equitable's]</u> *<u>financial problem</u>. Therefore, should the FSA respond to any short term technical insolvency by insisting on draconian action (for example, passing reversionary bonuses) this would bring the closed fund's financial position back into very sharp focus and damage both our reputation and any equity inherent in the acquisition. We cannot expect the FSA to stand back in all market circumstances (for example a 50% bear market in equities which materially impacted the whole with profits industry). However, we are optimistic that in most circumstances the closed fund would*

> *be allowed to pursue a planned recovery over a number of years. Although it would be for the Board of* [Equitable] *to oversee this process and they might well take a quite different approach.*
>
> *... the feasibility of transferring our existing bancassurance business on to* [Equitable's] *operating infrastructure ... we need to review* [Equitable's] *administration and systems capability, the timetable for any transfer, and its organisational and financial implications. Almost certainly we will need more help from the FSA as we will need a waiver to operate two product sets and marketing groups under* [Halifax Equitable] *and* [Halifax]*; for a period of up to a year.*

On 1 February 2001, the Head of Life Insurance passes the papers to Line Manager E, saying: '*Papers faxed to me at home last weekend + dealt with in subsequent discussion + correspondence*'.

28/01/2001 [21:52] FSA's Director of GCD advises Managing Director A on the legal considerations relevant to a decision on whether or not FSA should require Equitable to call an emergency general meeting or to consult policyholders in some other way. The Director of GCD says that FSA's relevant power was section 45 of ICA 1982, which '*is exercisable if the action required appears to be appropriate for the purpose of ensuring that the criteria of sound and prudent management are fulfilled*'. The Director of GCD advises:

> *A company is not to be regarded as conducting its business in a sound and prudent manner if it fails to conduct its business with due regard to the interests of policyholders and potential policyholders.*

The Director continues:

> *So to require consultation we would need to consider that without it the company would be failing to conduct its business with due regard to the interests of policyholders.*
>
> *The test allows us to form our own view about what is needed to have due regard to the interests of policyholders. We are not in my view limited to considering whether as a matter of process the company has considered the issue + reached a view on it. But to exercise the power we must conclude that the company is acting without due regard to those interests.*
>
> *In determining whether a company is having due regard to the interests of policyholders, we are entitled to look at the full range of policyholder interests, including both their interest in being consulted + their interest in getting the best deal. The company must pay due regard to the interests of all policyholders, not merely those of a particular group.*

The Director of GCD then asks:

> *Can we conclude that the company is not having due regard to the interests of policyholders if it goes ahead without consultation?*
>
> *In favour of consulting would be the possibility that the deal is not the best course for all classes of* [policyholders]*: though there are no other deals around, some may prefer to see the company liquidated: this would allow the GAR policyholders their rights, and probably stop these being increased by further top ups.*
>
> *This consideration might be less significant if the deal did not prejudice liquidation, or meant a clear net increase in value over that which would be likely to be obtained on a liquidation. This evaluation would need to take into account both the wasting asset of the sales force and the risk of increased liabilities through the top ups.*

The Director continues:

We should also bear in mind that consultation is the course favoured by the only director we expect to stay with the company long term.

In favour of the company going ahead with the deal without consultation would be any real reason to believe the deal would not be maintained for the time it would take to consult: this has been suggested so far but not explained. The bidder will presumably have given an indication of its approach and [Equitable's advisers] *should have advised on the prospects in practice.*

Consulting may not be as big a risk for the bidder as going ahead without policyholder support, if the value lies in the possibility of repeat business from customers with goodwill. It may be possible to keep the salesforce in position during the consultation phase if they are given the right incentives.

It would be extremely unattractive if any reluctance to consult were based on a view that the policyholders, properly advised, would not agree to the deal. (The need for an increased mva to prevent adverse policyholder selection suggests something of the kind for the s 425 scheme, though not as I understand it for the deal as a whole.) If this were the case it would be a strong reason to require consultation, since it would show disregard of their wishes if not their interests.

10% of policyholders can requisition an [extraordinary general meeting]. *If policyholders know all relevant facts this provides an alternative to action by FSA, but would still allow us to take action if it was needed sooner, and we believed their interests were not being paid due regard.*

The Director of GCD concludes that:

Possible next steps would be:

- *bring forward analysis of effect of liquidation;*
- *ask the* [company] *for its analysis of policyholders interests;*
- *ask to see what the bidder has said and the advice* [Equitable's advisers for the sale] *have given;*
- *consider whether the action groups should be consulted + if so who by + on what terms.*

29/01/2001 [09:03] FSA's Managing Director A calls for a meeting that morning (at 10:00) to discuss the '*key issues with the last bidder*'. The issues being:

- enforcement;
- extraordinary general meeting;
- whether FSA would be able to support the GAR/non-GAR deal;
- details of the draft contract;
- number of classes of policyholder;
- situation with Prospective Bidder D; and
- press handling.

The Managing Director distributes a draft letter to be sent to Equitable that he has prepared, which states FSA's view on whether Equitable had to put the bid to policyholders before the deal was agreed.

	Managing Director A also distributes Halifax's draft bid, which had been received by FSA on 28 January 2001.
29/01/2001 [10:10]	FSA's Director of GCD sends Managing Director A a note summarising advice on whether FSA had the power to require Equitable to consult their policyholders before accepting a bid. On a copy of this note, the Director of GCD has written: '*Advised at meeting 29.1 that: entitled to form own view about whether due regard being paid – not merely* [company] *has considered*'.
29/01/2001 [12:02]	FSA's Managing Director A informs the head of Press Office that he had just spoken to Equitable's Chief Executive, who had said that they were going to keep '*a low profile*' regarding the withdrawal of Prospective Bidder D from possible purchase negotiations. The Managing Director also says to FSA's Chairman and the Director of GCD that: '*I told him a letter would be on the way from us; it isn't as urgent as he was thinking yesterday so if it can't go today it isn't the end of the world*'. (Note: this appears to be regarding the draft letter distributed by the Managing Director earlier that day.)
29/01/2001 [12:55]	Equitable's solicitors send FSA a note of a conference that they had held with Counsel on 22 January 2001. The purpose of the conference had been to discuss the relative merits of achieving a GAR/non-GAR compromise and the transfer of Equitable's business to a potential purchaser.
29/01/2001 [15:06]	FSA's Line Manager E receives details of the amount of correspondence about Equitable that FSA had received since the Society's closure to new business. The figures supplied show:

Letters	*Received*	*Completed*
Public/Interested Parties	*253*	*150*
MPs (House of Commons)	*32*	*11*
MPs (Treasury)	*1*	*1*
Total	*286*	*162*
Emails	*180*	*130*

29/01/2001 [15:09]	FSA's Managing Director A informs the Chairman (copied to other senior officials) that he had received a telephone call from an Equitable Director about progress on finding a President. Managing Director A also records that: '*we discussed the need for an* [emergency general meeting]. [The Equitable Director] *has backed off a bit. If the legal advice is unquestionably that they have powers and if it really would be a deal breaker then he is prepared to back down and go ahead without calling an* [emergency general meeting]. *I outlined the kind of letter we were likely to be able to send to* [Equitable] *and he said that would be very helpful*'.
29/01/2001 [15:13]	FSA's Managing Director's office circulates a note of the telephone conversation with the Equitable Director. On the need to involve policyholders before a bid went ahead, they record: '[The Equitable Director] *reported the Equitable Board was divided on the issue.* [He] *himself was adamant that no decision could take place without policyholder approval – he considered that it would be improper use of the Board's powers given that all Board members had indicated their intention to resign.* [FSA's Managing Director A] *indicated that Equitable should take advice on this matter and needed to consider process for ensuring that policyholders interests were taken into account*'.

29/01/2001 [16:09]	FSA's Director of GCD sends Managing Director A a revised draft of the letter about the need to consult policyholders on a deal to be sent to Equitable that had been discussed that morning (see 29/01/2001 [**09:03**]).
29/01/2001 [17:00]	FSA hold an Equitable Life Lawyers Group meeting. The minutes of the meeting record that an update had been given on attempts to sell parts of Equitable. It was noted that two interested parties had dropped out. However, a new bidder had expressed '*serious interest*'. The minutes record '*that the combination of a short timescale and the likelihood that detailed information would not be available ... meant that the FSA would not be able to approve the purchase but at most say that it did not object*'.
29/01/2001 [17:18]	In response to FSA's Head of Life Insurance's paper of 26/01/2001 on approval of Equitable's managing director, FSA's Chairman says that FSA should avoid responding until they knew that a deal with a purchaser would be done. The Chairman says that Equitable's Chief Executive was unlikely to be a positive factor in any GAR/non-GAR accommodation and '*I cannot see why he should win a prize for having been so comprehensively wrong*'. [**19:56**] Managing Director A agrees that FSA should aim to see the Chief Executive depart but says that there needed to be '*due process to an objection*'. The Managing Director says that he would prefer FSA to encourage Equitable to put the application on hold, pending further information.
29/01/2001 [17:30]	FSA meet Halifax (at Halifax's request). FSA's note records that they had discussed three possible stumbling blocks to a deal taking place: *<u>Not waiting for an EGM.</u>* [Halifax's Chief Executive] *stressed that he couldn't take the risk of waiting.* [FSA's Chairman] *confirmed that we think the Equitable Board does have the power to take this decision itself provided that they satisfy themselves that it is in the best interests of policyholders. He added that we have the power to insist on a meeting but would not exercise this provided we were satisfied with Equitable's due process; rather, we would look for an exchange of letters with them over key issues.* *<u>The legal construction of phase 2 of the deal.</u>* [FSA's Chairman] *noted that we would have to say in due course whether the deal was a reasonable offer to put to policy-holders. Our view was that a Section 425 would be needed – Section 2c being "too fragile" for the purpose. We might – as with* [another life insurance company] *– put an explanatory memorandum to policy-holders.* [The Chief Executive] *asked for an early sight of what we might be able to say about the deal – assuming that we would find it reasonable.* <u>*[*[Action] [FSA's Director of GCD] + [the Head of Life Insurance] [please] *to produce draft.]*</u> *<u>Discipline</u>.* [FSA's Chairman] *asked why* [the Chief Executive] *attached such importance to this, given that any fine or censure would clearly relate to the past?* [Halifax's Chief Executive] *stressed that the reputation of the Equitable brand and sales force had suffered greatly already this was one risk too far.* [FSA's Chairman] *said that we would be prepared to put a proposal to the PIA Enforcement Committee. However, we would need an undertaking from Equitable that they would pay compensation in full and timely fashion (after it had been established by due process) and that the PIA could only reach agreement (if willing) in respect of currently known problems.* [The Chief Executive] *wondered whether Equitable needed to know why this undertaking was being required – he saw no problem in the undertaking being given.* <u>*[*[Action] *We need to revert to* [Halifax] *after Tuesday's PIA Committee meeting, with proposed wording and reach agreement on whether Equitable need to know the background – we think it would be better if they did.]*</u>

The extent of Halifax's influence on Equitable's Board is also discussed and '[Halifax's Chief Executive] *warmed to our suggestion that a single Director out of say 10 would better establish the desired relationship and avoid any suggestion that Halifax was in fact controlling Equitable*'.

29/01/2001 [17:54] FSA's Director of GCD comments on FSA's meeting with the prospective President of Equitable on 26/01/2001, saying that the fact that Equitable's Chairman had a GAR interest might be helpful '*if what is needed is to encourage GAR holders to give up guarantees. It would be clearly understood that a deal he was prepared to recommend could not be that bad for GAR holders!*'.

[**18:07**] The Director of Insurance gives his views on the problems that could arise if the individual, as a GAR policyholder, were to become Equitable's President. These included whether this might enable a challenge to any scheme to compromise the competing claims and a destabilising effect any controversy might have.

The following day, the Director of GCD says that, during the discussions with Halifax (on 29/01/2001), they had contemplated that '*a range of stronger and higher profile candidates might be available, who might not be affected by this problem*'.

29/01/2001 [19:08] PIA send FSA a draft paper to be given to their disciplinary committee the following morning. PIA ask for comments '*by 8am tomorrow*' and that Line Manager E should attend the committee meeting at 10:30.

[**19:21**] Line Manager E circulates the paper to other FSA officials, commenting that it had been '*prepared at some haste by enforcement colleagues*'. The Line Manager says that he had had '*a very quick look through*' and did not see anything immediately worrying.

[**19:33**] FSA's Managing Director A replies:

> *I don't think any of us can access this so comments will be few and far between. What I can say from the meeting tonight with* [Halifax's Chief Executive] *is that:*
>
> > *a) he confirms the importance of an understanding in this area to his willingness to proceed with the deal (he thinks the Equitable brand and sales force has suffered greatly already and Halifax's name would inevitably be associated with any discipline no matter how hard we tried to make it relate to the past)*
> >
> > *b) he understands that Equitable would have to commit to full and timely compensation once established by PIA after due process*
> >
> > *c) he also understands that PIA can't commit to how they would deal with anything they currently don't know about.*

[**19:33**] Line Manager E recirculates the paper.

[**19:49**] The Director of GCD says that Chief Counsel B had confirmed that PIA had a '*useful*' rule, which required companies to assess and pay compensation due to their customers.

[**20:35**] The Director of Insurance says that the paper looked fine to him, and:

> *If, against expectation, the* [Disciplinary Committee] *do not accept this advice we may need to consider the issue of consultation with the prudential regulator as provided in* [Schedule 10 of the FS Act 1986]. *In this context I am not clear:*
>
> - *whether* [self-regulatory organisations], *as opposed to the* [Securities and Investments Board] *(now FSA) are bound by the requirement to consult;*
> - *whether the Prudential Authority for this purpose is HMT or FSA (ie whether the relevant function was contracted out)*

- *whether, before the* [self-regulatory organisation] *has formed an intention to discipline (as opposed simply to refusing to rule it out) there is anything to consult about.*

But given the Schedule 10 arrangements it might seem pretty odd not to consider whether the possibility of damaging disciplinary action could be prevented by "prudential override".

But, of course, the expectation must be that the need will not arise.

[**20:58**] Chief Counsel A asks the Director of GCD and Chief Counsel B to look at the Schedule 10 issue raised by the Director of Insurance.

c29/01/2001	Having received a letter from an Equitable member asking that FSA give assurance that Equitable were not allowed to sell off any more of their assets without members having a chance to express their views, FSA's Chairman asks Managing Director A whether a sale would be subject to member approval.
30/01/2001 [09:02]	FSA's Chairman tells Managing Director A that he would be '*firmer*' than his suggestion for dealing with the approval of Equitable's Managing Director. [**09:55**] The Head of Life Insurance suggests asking Equitable to withdraw the notice and replace it with one where the appointment was for a limited time (he suggests six months). [**11:24**] Legal Adviser A reminds the Head of Life Insurance that FSA only had three months to serve notice of objection to the application, which had been received on 20 December 2000, and that they needed to allow one month for making oral representations. [**13:29**] The Head of Life Insurance suggests to Legal Adviser A that they should discuss, with a view to the Adviser drafting the best notice they could devise.
30/01/2001 [09:02]	FSA's Chairman comments that PIA's paper for the Disciplinary Committee '*Looks good*'.
30/01/2001 [09:47]	Equitable express their concern to FSA about an article that had appeared in a national newspaper, which had included the alleged views of a PIA Director that all Equitable policyholders over the age of 50 should exit the Society. FSA's supervision file includes a letter, dated 31 January 2001, from the PIA Director to the newspaper explaining that her comments had been made in her role as Director of a firm of independent financial advisers. She notes that some investors had wrongly construed her comments to be a regulatory endorsement to move funds from Equitable. Equitable also chase a response to the questions they had raised about the way that the GAR rectification scheme could handle complaints. Line Manager E asks Line Supervisor C to find out what their questions were.
30/01/2001 [10:00]	HMT and FSA hold their ninth quarterly meeting on insurance regulation issues. The meeting includes discussion on Equitable. FSA explain that a bid by another company had been made and that an announcement would be made on 4 February 2001. FSA say that the proposals were similar to another that had been put forward, in that it included the need to accommodate the issues of GAR policies. HMT express concern that the bid would be acceptable to policyholders. HMT also express concern that the bidder did not wish any disciplinary judgements in relation to mis-selling if the deal were to go ahead, but agreed that it was important to consider the public interest. HMT suggest that PIA might be content with intervention instead of disciplinary action, for example compensation by the bidder, for mis-selling.

30/01/2001 [10:30] PIA's Disciplinary Committee convene at the request of their Enforcement division to consider a paper on whether disciplinary action on conduct of business issues against Equitable would be appropriate. FSA (Line Manager E) attend. The note of the meeting records:

> *The Committee considered the details of the two matters that had been referred to them by Regulatory Enforcement in respect of Equitable, these being Pension Fund Withdrawals details of which were contained in Appendix 3 and the Pension Review failings in Appendix 4. In respect of Pension Fund Withdrawals, Regulatory Enforcement had estimated that if disciplinary action were to be taken the likely penalty in these circumstances would have been in the region of £500,000, whilst the current assessment of the likely fine in respect of the Pension Review failings was likely to be in the region of £250,000 – £350,000. The Committee noted that the Equitable were in discussions with PIA staff regarding the review of past Pension Fund Withdrawals business and were, at this point, co-operating fully with PIA.*
>
> *With the Equitable seeking a purchaser and only one bidder remaining, it was noted that if a public disciplinary action were mounted by PIA, the bidder would withdraw from the prospective purchase in order to avoid the reputational damage that would be likely in such circumstances. The principal question that the Committee therefore needed to address was whether or not PIA should discipline the Firm, taking into account the unique circumstances of the case when balanced out against the aims and provisions of PIA's disciplinary policy. By issuing disciplinary proceedings, PIA would destroy the chances of the rescue bid being successful, which in turn would not be to the advantage of Equitable's policyholders.*

The Committee decide to take no action against Equitable on the sale of Pension Fund Withdrawal contracts and on Pension Review failings, provided remedial action acceptable to PIA was taken.

The Committee note that PIA would not hesitate to take disciplinary action should Equitable fail to carry out the required remedial action. This applied also to any future failure in respect of the Pension Review and to any issues not covered by the current referrals to Regulatory Enforcement. Should the bidder withdraw, the Committee would require submissions from Regulatory Enforcement as to the desirability of bringing disciplinary action against the Society.

30/01/2001 [11:43] Equitable send FSA the latest information (as at 28 January 2001) on the GAR buy-out proposals. This begins by stating that: '*Our current best estimate of the GAR cost is about £1.5bn and the extra statutory reserve against that liability is similar. Of this, about £200m is the expected cost of the rectification scheme which is unlikely to vary much because we know most of the factors affecting its calculation. However, the remainder is subject to considerable possible variation depending on the trend of annuity rates, future premiums and take-up rates*'.

The information provided by Equitable continues:

> *This variation, although covered to some extent by a reinsurance arrangement, is undesirable. There would seem to be considerable merit in a scheme, if possible, whereby we buy out those GAR options now, for an affordable and fair cost. The purpose of this note is to set out the objectives of the proposal and a particular way forward.*

Appendix 2 to the note, under a heading '*Buying Out The Guaranteed Annuity Options*', states:

> *The proposal is to cancel both the prospective GAR liability entirely (in respect of both accrued fund and future premiums) and future minimum guaranteed 3.5% increases on GAR guaranteed fund. In compensation for giving up these guarantees, both the policy values and guaranteed fund of GAR policyholders is to be increased by a fixed 20%*

regardless of age or policy contract. These enhancements are made as part of a compulsory scheme.

Equitable's note then sets out detailed information as to '*the estimated pre and post-buy out impact on the statutory position of the fund, if the buy out were to take effect at 31 December 2000*', noting that '*it has been assumed that no reversionary bonus is declared during 2000 and that the end of 2000* [equity backing ratio] *is 67%*'.

The appendix also provided an assessment as to the effects of the proposal on specimen policyholders – and analysed this against attractive options.

[**13:32**] FSA's Head of Life Insurance distributes the information to FSA officials and GAD's Directing Actuary B, asking the latter to advise on whether there was anything significantly wrong or missing from the proposals.

[**15:31**] GAD's Directing Actuary B notes that the schedule showing the potential impact of the scheme on the statutory balance sheet purported to show improvement of nearly £2bn in Equitable's free reserves. The Directing Actuary says that this schedule was difficult to follow, and that GAD would wish to clarify in any event the following points with Equitable and with the appointed actuary:

> *1) Can they confirm that the post scheme free reserves still include both an implicit item of £0.8 Bn and the £0.3 Bn* [subordinated loan]*?*
>
> *2) It is not clear how they have allowed for resilience effects. These appear at first sight to be included in both lines (i) and (iv).*
>
> *3) I am not sure that the new Regulation 72 would allow them to achieve the reduction of £1 Bn in the provision as suggested in line (ii). This needs further explanation from them.*

[**16:37**] FSA reply, saying that they had spoken with Equitable about the points raised by GAD, along with others. FSA say that Equitable had emphasised that the draft was a preliminary one, but that they were grateful for those comments. FSA also say that they could expect further documentation, and probably a request for a meeting, from Equitable over the next day or two.

30/01/2001 [12:12] FSA's Director of GCD asks Chief Counsel B to confirm that PIA's ability to require assessment and compensation would not cease on 1 December 2001, when FSMA 2000 comes into force.

30/01/2001 [15:35] FSA write to Equitable to confirm their '*approach to the issue of whether the expected bid from* [Halifax] *should be put to* [Equitable's] *policyholders before it is agreed*'. FSA say that Equitable '*need to be sure that it is legally open*' to the Board to decide this issue, rather than through consultation with policyholders or whether policyholder approval was required by their Constitution. On the assumption that it was open to Equitable's Board to do so, FSA state:

> *We consider that for your Board to decide to go ahead without consulting policyholders, you would need to be fully satisfied that it was in their interests to do so. In practice, in the current circumstances, this will require you to assess the interests of policyholders in being consulted about the bid against the risk that if the bid were made subject to consultation, the bidder would withdraw it ...*
>
> *It seems to us that the judgement breaks down into two issues:*
>
> - *Whether you are satisfied that the proposed bid is better than any realistic alternative, either in the form of another possible deal, or in the form of alternatives in the absence of a deal.*
> - *If so, whether consultation would put the deal in jeopardy.*

FSA conclude:

In these circumstances, we have considered whether it would be open to us to intervene to require you to consult policyholders on the ground that not to consult would involve failing to give due regard to the interests of your policyholders. It would be open for us to do so, if we considered that going ahead without policyholder approval involved failing to pay due regard to their interests. But if your Board can assure us that it has considered the points set out above I can confirm that, on the basis of our own assessment of the situation, we would not expect to intervene require consultation on this ground. Indeed we would fully understand it if you reached the view that going ahead without consultation in these circumstances is in the best interests of all policyholders.

30/01/2001 [17:00] GAD inform FSA that they were happy with Equitable's proposals about German deferred annuity business (see 25/01/2001 [**entry 1**]). GAD also ask for a copy of a leaflet that Equitable had produced on the rectification scheme, which had come to their attention when it had been produced by the appointed actuary of another company at a recent meeting, held at FSA, on an unrelated matter at which GAD had been present.

30/01/2001 [18:08] FSA's Director of GCD sends Managing Director A a revised draft of the letter to be sent to Halifax which says that FSA '*are agreeable*' to the purchase of Equitable's assets.

The draft concludes by saying that: '*You also require that we should be ready publicly to confirm that this is the case, and this we are happy to do*'.

[**18:19**] Line Manager E, noting that the draft refers to the disciplinary hearing of that morning, says that he had been working on a letter to be sent to Equitable, informing them of the outcome, and that he was intending to ask Equitable to allow FSA to disclose it to Halifax. The Line Manager says that the letter should be ready by tomorrow.

30/01/2001 [20:18] FSA's Legal Adviser C sends Line Manager E a revised draft of the letter to the OFT, following a meeting that afternoon.

30/01/2001 [entry 12] FSA's Head of Life Insurance sends the Director of Insurance a copy of PIA's paper of 26/01/2001, annotating it by saying: '*Given the date, I think it needs to come under the terms of Enforcement's expression of willingness not to fine if remedial action is properly undertaken*'.

On 4 February 2001, the Head of Life Insurance writes '*Now done*'.

31/01/2001 [09:54] FSA's Chief Counsel B advises the Director of GCD that the PIA rule (which gave them the power to require a company to make an assessment of, and provide compensation for, mis-selling) was not being carried forward into the new regime. The Chief Counsel says that the nearest thing was a piece of guidance in the supervision manual.

[**10:16**] The Director of GCD asks a PIA Head of Enforcement whether he was content that this was adequate '*for purposes of the PIA "understanding"*'.

[**10:49**] An official advises Chief Counsel B and the Director of GCD of one additional rule that might be relevant, but which was far weaker than the PIA rule.

31/01/2001 [10:03] The Director of GCD sends the Director of Insurance (copied to other FSA officials, GAD and Counsel) a note that aimed to '*question the saleability*' of the GAR buy-out proposal. The Director explains: '*The current proposal is that there should be a standard policy uplift of 20%. As shown in the proposals from the Equitable, the effect of this for paid up policies varies according to the age of the holder. A 60 year old would be offered 8% less than the value of the benefit, while a 35 year old would be offered 12% more. Similarly for those policies where the premium is still being paid, the proposal is that everyone older than 35 should be paid an under value*'.

The Director of GCD says that the proposals '*do not look all that attractive*' and so, in order to be accepted by the people they were being offered to, Equitable must '*operate a sliding scale*'. He continues:

> *This issue also seems to me to impact on the legal achievability of the scheme.* [Counsel] *has advised that the way to avoid needing the approval of a multiplicity of classes is to create a tapered offer. This offer seems to involve everyone else subsidising those in the 35 to 45 year age range with paid up policies. This seems to me to be a recipe for those who pay the subsidies to ask to be treated as separate classes.*
>
> *The flat approach also seems to me to be problematic if we are to be asked to reach a judgement that the proposal is fair. Unless it is designed to give people a rough approximation of the value of the rights being bought out, it seems to me very difficult to regard it as fair.*

[**10:35**] In reply, GAD agree that the idea of operating a sliding scale would be preferable and say that they understood that Equitable were now working on this possibility. GAD advise that:

> *The amount to be offered to those with the option to pay further premiums is more judgemental and depends also on the amount of premiums likely to be paid and the likely effect of such payment on the Equitable's investment policy. In theory, though, the payment might be some multiple, varying by age, of the most recent premium paid.*
>
> *There is also the difficult issue of how much of the offer should be in the form of an increase to the guaranteed fund and how much offered as non-contractual final bonus. I would expect that those near retirement would need to be offered mainly guaranteed benefits (or possibly a rather higher overall uplift if only part is guaranteed).*

GAD continue: '*I am also apprehensive about including policyholders who are able to claim immediate benefits alongside those with no immediate contractual entitlement to benefits. I understand that the Courts have previously declined to implement any reduction in benefits under a scheme arrangement for policies where benefits have become due for payment. Equitable may therefore need either to have the policies included as a separate class, or ensure that the proposed formula will not result in any such reduction in benefits*'.

31/01/2001 [11:11] The Director of GCD sends Managing Director A a revised draft letter to be sent to Halifax (see 30/01/2001 [**18:08**]).

[**15:06**] The Director of GCD sends the Director of Insurance a further revised draft letter to be sent to Halifax. This version now says, in conclusion, that '*this letter therefore confirms that we are agreeable to it ... and* [that] *we will confirm publicly that this is the case*'.

[**17:02**] The Director sends the Director of Insurance a revised draft letter to be sent to Halifax, as amended by FSA's Chairman.

31/01/2001 [14:15] Equitable send FSA their latest discussion document, setting out their assessment of the three options for a compromise scheme under section 425 of the Companies Act 1985. The options are described as:

> <u>*Option 1 – High, flat % uplift to cash benefits*</u>
> *Description:*
>
> - *All GAR policyholders are offered a flat uplift to cash values*
> - *The level of the uplift is set so that it can be very favourably compared with the current GAR/CAR uplift. For this note the uplift is assumed to be 30%*
> - *The uplift may be partly in guaranteed form and partly in non-guaranteed form.*

- *The total cost of the benefits to GAR policyholders will be greater than the current best estimate of £1.3bn (assume £2bn for this note).*

<u>Option 2 – Medium, flat % uplift to cash benefits</u>
Description:

- *All GAR policyholders are offered a flat uplift to cash values*
- *The level of this uplift is set so that the total additional benefits are similar to the current best estimate of GAR costs of £1.3bn (20% for this paper)*
- *The uplift may be partly in guaranteed form and partly in non-guaranteed form*

<u>Option 3 – Graduated uplift to cash benefits</u>
Description:

- *GAR policyholders are offered an uplift to cash values depending on age with higher uplifts for older ages*
- *The level of uplift should be set so as to encourage the perception of fairness at each age but without adding much additional cost to be paid by non-GAR policyholders*
- *The uplift may be partly in guaranteed form and partly in non-guaranteed form*
- *Figures have been produced on a scale from 25% at age 60 and above down to 10% at 45 and below.*

FSA's Head of Life Insurance circulates the document within FSA and to GAD and Counsel.

31/01/2001 [15:47] GAD write further on Equitable's GAR buy-out proposals, having received a copy of the latest documents. GAD say that they could see why option 1 would be unattractive, as it would be costly and would give almost all the potential value of the Halifax payments to the GAR policyholders only. GAD say that they were less clear why option 3 was seen as unattractive and, regarding option 2, write: '*I remain apprehensive though about applying a single factor to all GAR policyholders and treating them as a single class. It still seems to me that many of those policyholders who are entitled to take immediate benefits could allege that they are losing out unreasonably. At the least, I would hope that such policyholders would be given the option to take these immediate benefits instead of the Section 425 potentially reduced benefits*'.

GAD also discuss the impact on Equitable's financial position, saying:

> *Regarding the effect on the balance sheet, they appear to have accepted our point about Regulation 72. However, they still include an expected release of around £0.5 Bn for the "resilience impact" of the payment by* [Halifax]. *The rationale for this figure is not yet clear to me.*
>
> *However, assuming that all these figures were accepted, then the scheme (if accepted) would appear to improve the statutory balance sheet directly by some £1 Bn, with a further £1.5 Bn resulting from the payments by* [Halifax] *(with the latter being of course dependent also in part on the actual performance of the salesforce, and the level of persistency of policies over the next few years.)*
>
> *At the same time, the fund would become more resilient to falling interest rates but still relatively vulnerable to a fall in equity values. Moreover, the bonus expectations would continue to be difficult to manage, as they could have to reduce the final bonuses below the level already illustrated to individual policyholders, and of course apply a significant MVA in that latter event.*

GAD note:

> *Incidentally, they have not, I think, mentioned the MVA in their recent papers, but I do not see anything to suggest that this could be reduced by more than 1-2 % in current investment conditions, even if the Scheme and the* [Halifax] *transactions could both take place.*

31/01/2001 [16:39] FSA's Director of Insurance informs the Director of GCD of a conversation he had had with Equitable about their preference for a '*straight line approach*' to uplifting GAR policy values, in which he had said that FSA were '*unpersuaded that this could be regarded as fair and did not understand their reasoning*'.

The Director of Insurance's record of the discussion continues:

> [Equitable's Chief Executive] *said that their view was the result of very considerable analysis of the impact on the different categories of policyholders and they believed quite strongly that a flat line approach was fairer than a tapered approach. The nub of the issue, from their perspective, was the sacrifice that younger GAR policyholders would be asked to make, in giving up the right to put in future premiums over a long period of years, attracting the guaranteed rate at maturity. They believed that this opportunity, which was not enjoyed in the same degree by policyholders nearer maturity, offset the need that they accepted would otherwise arise to taper. If all policies were paid up with no possibility of future premiums being paid in, then they would share our analysis and approach. He pointed to the scenarios set out in the annexes to this note as demonstrating this.*
>
> *We left it that we would need to reach a common view on this during the course of tomorrow morning. While such a view would not need to be definitive – the actual proposal needed to be worked up and might need to be amended subsequently in the light of the consultation which the Equitable plan to undertake with policyholders we did need to common understanding of the starting point if we were to be able to welcome the deal in suitable terms.* [Equitable's Chief Executive] *will ensure that suitably qualified and empowered people would meet us tomorrow morning. (He could not come himself but* [the Appointed Actuary] *would.)*

31/01/2001 [entry 7] PIA write to Equitable to formally inform them of PIA's decision not to take any disciplinary action with respect to sales of income drawdown products and the handling of the pensions review, in the event of the eventual conclusion of a disposal of all or parts of its business substantially on the terms currently proposed.

31/01/2001 [entry 8] FSA's Head of Life Insurance sends Halifax a copy of PIA's letter to Equitable setting out the decision of PIA's Disciplinary Committee. FSA write:

> *We discussed the fact that there is one issue which is not covered in that letter, which we think we should draw to your attention to avoid the risk of any subsequent misunderstanding. As you are aware some questions have been raised by policyholders about sales made by the Equitable in the months running up to its closure to new business, and whether the risks arising from the court action and from the uncertainty of the sale process were properly disclosed. We are considering the Equitable's actions in this context, and have made some initial enquiries of them. We have reached no view at this stage and I therefore cannot rule out the possibility that we may find that some misselling took place.*

You made clear that you would not wish to proceed with [Halifax's] *agreement with the Equitable without a similar understanding in respect of the possibility of disciplinary proceedings against the Equitable arising out of possible misselling in the circumstances I have described.*

As you know the decision of the PIA not to institute disciplinary proceeding in relation to the issues identified in their letter is conditional on receiving, and the Equitable honouring, certain undertakings as to remedial action including paying compensation to policyholders where appropriate. In the case of possible misselling in the context of uncertainty over the litigation and subsequently the sale process, it does not seem to us that it would be appropriate to seek any blanket undertaking from the Equitable in respect of remedial action and compensation. In our view it follows that the PIA could not be expected, at this stage, to reach a definitive view on whether disciplinary action would be appropriate as it has in respect of the two cases identified in the PIA's letter. I can say, however, that given the importance you attach to this issue in relation to your proposed agreement with the Equitable, and the clear interest that policyholders have in that agreement being reached, the FSA executive in advising the PIA, or the FSA (after N2) in determining whether itself to institute disciplinary proceedings, would take a similar approach to that taken by the PIA in the letter of [31 January 2001]*. That is, provided the Equitable acted reasonably and quickly to compensate any losses suffered by policyholders arising from any misselling which we might find to have taken place, we would not recommend that the PIA should institute, or ourselves institute, disciplinary proceedings against the Equitable in respect of that misselling.*

31/01/2001 [entry 9] FSA inform Equitable, in reply to their letter of 25/01/2001, that:

... we are indeed keen to ensure that there is no further unnecessary exposure to the with profit fund. However, in the circumstances that you have outlined where "these particular clients are seriously disadvantaged by the restricted choice they can make" we do not intend to object to the further exposure envisaged (up to 317 policies).

However, we are concerned that where there are different possible retirement options for policyholders (whether or not they are currently invested in the with profit fund) that these are properly explained to them and that the risks of investing/continuing to invest in the with profit fund are clearly explained.

For example, you state that "most clients either have no choice but [to] *buy their annuity from us, or to surrender and suffer a tax penalty". But some policyholders may decide in the context of their own tax planning arrangements that a surrender may be in their own best interests.*

Could you please confirm what the position is on best advice. We will wish to communicate the details of those arrangements to the [German regulatory authority].

31/01/2001 [entry 10] FSA's Chairman records in a note to Managing Director A that he had provided an update on the Equitable situation to the Cabinet Secretary and to the Treasury's Permanent Secretary.

31/01/2001 [entry 11] FSA's Chairman reports on a luncheon meeting he had had with Prospective Bidder A's Chairman and Chief Executive, saying: '*On the Equitable, they were careful not to ask what was going on.* [The Chief Executive] *said, looking backwards, that one of their key issues was the possibility of long drawn out litigation (a point he has also made to the Treasury, I understand). He also believes that expectations were so unrealistically high before Christmas that it was very difficult to make the deal add up. He was particularly scathing about the* [National Association of Pension Funds]. *He says that one of their people had attended a* [National Association of Pension Funds] *meeting to talk about the Equitable in the autumn, where the discussion had all been about how pension funds would handle demutualisation bonuses. Their people had reported that they were completely unrealistic about the position*'.

In a separate note, FSA's Chairman noted that Prospective Bidder A:

> *... recognises that the Equitable affair, coming on top of the problems with endowment mortgages, will have a damaging effect on the image of with-profits funds and with-profits policies. And he is concerned to try to find a way of improving the way the policies are presented, so as to protect that part of the market which has a continued rationale.*
>
> *He thinks one key is to improve the disclosure and the terminology. He agreed with me that the average bonus statement is incomprehensible and, indeed, that the term "bonus" itself is inappropriate for the yearly allocations to individual policies, which can hardly reasonably be described as bonuses. He was toying with terminology such as "minimum and guaranteed return" to replace the existing one about recurring bonuses or whatever.*

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01/02/2001 [entry 1] FSA reply to Prospective Bidder D's letter of 26/01/2001 saying that, even though they had withdrawn from the bidding process, and although FSA '*had not looked at all aspects of the proposal in any great detail*', the bidder might find it helpful to know that FSA had formed the view that they could see no regulatory show-stoppers in the proposals that had been outlined.

01/02/2001 [01:56] Equitable's solicitors send FSA a note of a conference with Counsel that had taken place on 31January 2001 concerning their Board's powers in relation to entering into the deal with Halifax, and in doing so without a resolution of the Society in a general meeting (that is, without the members' agreements). This note recorded that: '*Counsel advised in summary that there is no obstacle under the Society's Memorandum of Association in the Society entering into the transaction currently contemplated with Halifax, and that there is no obstacle to the Board approving the transaction without the support of a resolution of the Society in general meeting*'.

[**12:11**] Chief Counsel A passes the advice to the Director of GCD and Managing Director A saying that, while it did not allay all concerns, she believes '*it does provide additional comfort*'.

With the note of the conference, Equitable's solicitors also submitted their instructions to Counsel. As part of the background to the issue, the instructions stated that:

> [The] *financial position of the Society was adversely affected in July 2000 by the judgment of the House of Lords ... The Society's board of directors (the "Board") announced immediately after the judgment that it would seek to find a buyer for the Society by way of a demutualisation. Efforts in this regard were unfortunately not successful ... The Board thereafter took the view that it was probable that the most favourable return for the Society's members/with profits policyholders would be obtained if the Society were to find a purchaser for as much as possible of the Society's goodwill and operating assets, ideally combined with the negotiation of a third party administration agreement for the run-off of the Society's in-force business.*

After explaining that Board members were concerned about whether they had sufficient power to effect an agreement based on the Halifax proposals, the instructions indicated that:

> *... the pragmatic solution to the Board's concerns might be to agree voluntarily to seek ratification by the Society's members. There are strong commercial arguments in the present case that this would be not only inappropriate but also impossible in practice to achieve, largely because:*
>
> > *a) Halifax has made it clear that it is not willing to take the risk of entering into a transaction conditionally on members' approval; and*
> >
> > *b) in any case, the sales force is ... perceived to be a rapidly wasting asset.*

01/02/2001 [entry 3] FSA write to a policyholder who had written seeking their assurance that no further assets of Equitable would be sold until members had had an opportunity to express their views on whether they wished this to happen. FSA explain that Equitable must have due regard to the interests of policyholders when considering such issues and that it would be open to FSA to intervene if they considered that the Society was not doing so. FSA say '*I can therefore tell you that we will monitor this as necessary*'. Earlier drafting, which said that FSA did '*not believe that* [Equitable were not paying due regard to policyholders' interests]' was removed.

01/02/2001 [08:30] Equitable telephone FSA to report that their advisers for the sale had been approached by Prospective Bidder F with what they described as a '*spoiling proposal*'.

01/02/2001 [11:30]	Halifax telephone FSA to report that the deal was '*moving ahead well*' but Halifax '*are inclined to move the announcement*' of it to the following week. Halifax explain that the rationale for this was '*to focus on "getting the message right", specifically getting the right balance between the message to the City and policyholders*'.
01/02/2001 [18:26]	Equitable send FSA their analysis of the current benefits available to retirement annuity policyholders and the benefits that would be available after the proposed compromise scheme. The analysis concludes that, for policyholders who could take retirement benefits immediately, the benefits before and after the scheme were broadly comparable. For policyholders who could not take retirement benefits immediately, the analysis concludes that '*on a s425 uplift of 20% on policy value on average represents reasonable compensation for giving up the GAR benefit*'. Among the detailed analysis, it was noted that: • policyholders who could take retirement benefits immediately which attracted GARs would be able to gain '*an uplift in value over the policy value (a smoothed asset share) of around 35%*'; and • that, taking into account the loss of flexibility associated with taking GAR benefits in restricted forms of annuity and also the loss of the opportunity of tax-free cash, a '*realistic value*' of giving up their rights was '*an 18% uplift to the policy value*'. For those who could not take retirement benefits immediately, it was noted that the uplift available to GAR policyholders – if interest rates stayed the same and if mortality improvements were as predicted: *... the uplift ... factors at retirement would be:* *45 41%* *50 39%* *55 37%* FSA's Head of Life Insurance circulates the information, saying it was the follow-up to a meeting with Equitable that morning.
01/02/2001 [19:15]	Equitable inform FSA that they had been approached by Prospective Bidder F, '*acting with another party whose identity they could not disclose*', who had outlined a bid. It was explained that Equitable '*had received nothing in writing, but the outline of a bid, which could be confirmed immediately, had been given them over the telephone*'. FSA record that Equitable believed that FSA knew the identity of the other party. FSA also record that the substance of the bid is: *Phase one* • *£250m up front + £60m after two years + £70m after 5 years (both additional amounts subject to sales performance)* • *administration to be provided at cost +25% profit margin* • *asset management to be provided at arms length commercial rate* *Phase two* • *Subject to successful s425 compromise: £750m "surplus relief treaty" at best commercially available rate* Equitable tell FSA '*that in their view this proposed new offer ... was plainly less advantageous to policyholders than was the, now reasonably secure, agreement with the Halifax*'. FSA record that Equitable had asked for an indication of FSA's attitude.

FSA note that they had:

- reminded Equitable that both FSA and Equitable should '*have regard to the probable commitment of any prospective purchaser, and the likelihood that they would see a deal through*';
- asked Equitable whether, if they now believed there to be a genuine potential alternative proposal, they should consider whether this made it desirable to consult policyholders before committing to a deal; and
- asked Equitable '*whether they believed that it might be possible to secure an improvement in the proposed new deal, and what risks might be involved in trying to do so*'.

FSA record that Equitable were of the opinion that it was '*impossible to have any confidence*' in the new bid; that, as it '*clearly offered the better outcome*' for policyholders, their efforts should be to secure the Halifax bid; and that the Halifax deal would be at risk if Equitable delayed agreement with them.

FSA record that they had told Equitable that:

> *... we believed that the Halifax deal would represent a significantly better outcome than no deal or than any piecemeal disposal of assets that was likely to be achievable. From what they told me, I could see why they took the view that the proposed new bid – even taken at face value – was less attractive than that on the table from Halifax, though this must, of course be a matter for them to decide ... The issue of whether to consult their policyholders was one for the Equitable Board, but in the circumstances they faced I saw no reason to think that we should seek to influence their decision or to intervene to require consultation. Similarly, if they believed it to be in the best interests of policyholders to enter into the exclusivity agreement with the Halifax, without taking further time to see if the proposed new bid might be improved, because of the risk of jeopardising the Halifax deal, I saw no basis on which we should seek to second guess that view.*

FSA note that, after some discussion, they had indicated to Equitable that '*they could say, that we were closely in touch with the Equitable over the sale process; that we understood their position, and that we would continue to monitor the situation very closely*', when discussing these matters with Prospective Bidder F.

02/02/2001 [entry 1] FSA's Legal Adviser A writes to the Director of GCD about Equitable's proposal to appoint their new Managing Director. The Legal Adviser sets out the grounds for objecting to such an appointment, the process to be followed, and the possible grounds for objection in this case.

Legal Adviser A advises that FSA could object if a person were not 'fit and proper' to be appointed or where it appeared that, if the person were to be appointed, the criteria of sound and prudent management would not be, or might not continue to be, met. The Legal Adviser explains: '*The relevant criteria are that <u>each</u> controller (which includes* [the Managing Director]*) must be fit and proper, the company must be directed and managed by a sufficient number of persons who are fit and proper, the business of the company must be carried on with appropriate integrity, due care and professional skill and with due regard to the interests of policyholders*'. The Legal Adviser says, in this case, that it was likely to boil down to whether the individual was 'fit and proper'.

Legal Adviser A examines the meaning of 'fit and proper', noting that fitness and properness had to be judged in relation to the particular company to which the appointment related. He explains that the legislation required the serving of a preliminary notice before serving notice of objection and that, while HMT were not obliged to disclose the grounds on which they are making such an objection, this would not be acceptable in European Convention of Human Rights terms.

Legal Adviser A suggests there were three possible areas to consider in deciding whether there are grounds to object: the history leading up to closure to new business; matters arising after the closure to new business; and the effect of the appointment on the future of the company. The Legal Adviser advises:

> *I do not think it can be successfully argued that by reason only that a person has been involved with a company that has failed (or otherwise got into difficulties) that it must follow that he is not fit and proper to hold the position of* [Managing Director]. *It is necessary that we point to particular areas/decisions where we consider that he was at fault either by omission or commission. Without some specificity, it is difficult to see how he can defend himself.*
>
> *I have discussed this with* [the Head of Life Insurance]. *Although there may be a number of decisions made by the company which were questionable (and will be questioned) we do not believe there is anything which the FSA can say in a notice of objection, in effect, "this was wrong and your part in it demonstrates that you are not fit and proper".*

Legal Adviser A continues:

> *I understand the position to be the same with regard to the second area. I am not aware of any specific matters which can be put forward as evidence of lack of fitness and properness.*
>
> *The third area is dependent on the particular circumstances of the company. The argument is more tenuous and would run along the following lines.* [The individual] *is involved in the public mind with a management that has lost credibility in the eyes of the policyholders. This is at a time when the policyholders are going to be asked to make decisions in relation to their policies relying in part on information/recommendations made by the management. This could work against the interests of the policyholders i.e. by them going against a proposal because it is put up by a discredited management. This would be so even if, in fact,* [the individual] *has done nothing wrong and that the information/recommendations, viewed impartially, cannot be faulted.*

Legal Adviser A concludes:

> *However, this comes down to whether we have sufficient evidence for us to suggest that* [the proposed Managing Director] *is so closely involved in the policyholders mind with the perceived failure of the previous management that this is a serious risk. On present information I tend to doubt whether this is the case.*

02/02/2001 [10:41] FSA's Director of GCD says to the Director of Insurance that the material received from Equitable, on 01/02/2001, concerning the compromise proposals was disappointing. The Director of GCD says that, when FSA had met Equitable on the previous day, FSA had made it clear that the proposals should not just be fair between GAR and non-GAR policyholders but also that there should be '*a reasonable degree of fairness*' within those groups.

The Director of GCD notes:

> *The Equitable urged us that a flat line increase of 20% across the board was fairer than any form of sliding scale. This was on the basis that the value of top-up rights to younger policyholders would provide a reason for what we had previously regarded as disproportionately beneficial to them.*

We said that we could see that this argument meant that it might be fairer to operate a flat line, rather than some form of sliding scale. But we said that we were looking for some rational basis for believing that it actually was fairer.

In order to assist with this, we asked them to provide two sets of documents. The first was a set of illustrations of how the proposals would operate for policyholders in different positions. The second was a distribution graph which would show the proportions of policyholders who would do well by the offer, and those who would do less well by it. Neither of these is included in the material received yesterday evening.

In considering whether these proposals are fair, we need to be clear what we mean by "fair". We do not mean that each policyholder must necessarily be offered some estimate of the value of his own share. Though this might be an ideal, the Equitable have asserted, and our own advisers have not denied, that it is not practical, given the number of uncertainties, for such an estimate to be made.

But as Counsel pointed out, we do not mean only that the scheme is fair between the GAR and non-GAR policyholders as groups. In particular the court will look, under the Section 425 Scheme, at whether it is sufficiently fair to the dissentient minority for it to be prepared to bind them to the scheme.

In relation to the example, the Director of GCD says that the key question was whether the deal overall was sufficiently good to compel him to give up his GAR rights. He notes further:

What in my view we still need is a proper assessment from the Equitable of the different anomalies which a flat line proposal would create, and the basis for concluding that the deal is nevertheless fair for those concerned. If they cannot do this, my view would be that we should endorse the proposal only in terms which leave open the possibility that either a flat line or a sliding scale may be the route chosen.

[**13:15**] The Head of Life Insurance informs the two Directors that he had spoken to Equitable and they were going to send over some supplementary material and had suggested a meeting later that day to take FSA through it. Equitable had said that, in relation to providing a distribution graph, it would be difficult to produce anything meaningful, due to the element of discretion over future payments.

[**14:08**] The Director of GCD notes that the material provided did not compare different policyholders but the average policyholder and, therefore, '*it would be good to know how significant are the variations from the average*'. He also says '*the fundamental problem seems*' to be that a compromise offer '*based on the current value of a policy may not work well*' for policyholders whose interests result primarily '*from the fact that they have top-up rights, rather than the current value of their policies*'.

[**15:03**] The Head of Life Insurance gives his opinion that: '*the fundamental problem is that, because the value of the option depends crucially on how much an individual pays in future premiums – which is entirely at their discretion, and is by definition unknowable at this point – the only significant variable is age*'. The Head of Life Insurance concludes:

Since all policyholders have the right to pay future premiums, it may be reasonable to give greater weight to the results in that category. These are already pretty "flat" and thus arguably fair ... for younger policyholders, whose rights to future payments were more valuable than those of older policyholders, the benefit of the greater GAR value which they were giving up was broadly offset by the greater value they obtained from the effect of the uplift combined with greater investment freedom in the fund.

02/02/2001 [12:55] Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

02/02/2001 [13:13] Halifax send FSA their suggested amendments to a draft FSA press notice and letter to be sent to Halifax. Halifax suggest the inclusion of the following in FSA's letter to them:

> *Moreover we recognise the special circumstances surrounding this transaction and understand and accept the reasons why the contractual agreements do not follow our published guidelines on outsourcing.*

This drafting is not included in the final version of the letter sent on 04/02/2001. An official circulates the drafts and asks for comments by 17:00. FSA's Director of GCD notes in manuscript that '*we have a problem with saying that the proposed compromise scheme represents a fair deal*'.

Additional text is suggested by Halifax, including: '*at no stage will you exercise any control over its financial affairs. There are therefore no circumstances under which we would look to you to stand behind the closed fund if it were to get into difficulty*'.

Halifax also suggest deletion of text, which states:

> *The court will need to consider the transfer of the in force business under Schedule 2C of the Insurance Companies Act. On the basis of the proposals in the draft heads of agreement, we would not be minded to object to such a transfer.*

02/02/2001 [15:03] FSA's Director of GCD writes to the Head of Life Insurance about two substantive doubts that he has concerning the proposed compromise:

> *The first relates to the three statements about the proportion of GAR policyholders taking GARs, rather than alternative benefits. My concern is that we have no reason to doubt that these proportions represent the actions of policyholders who are properly advised. My worry would be if we thought that there was any reason to believe that, for example, people have been encouraged to take the maximum tax free cash sum because it was cheaper for the company rather than because it was in their own interests.*

The second is that he did not understand how the figures added up to the direct uplift of 18%. The Director of GCD says that, while '*these points are not fundamental*', he would be reassured to know that GAD were happy with the analysis and that the material was consistent with what they had seen before.

[**15:46**] GAD reply that they '*remain uncertain*' about Equitable's analysis and they set out some concerns. GAD say:

> *While I can understand that almost all policyholders would take the maximum cash sum (both for tax reasons and a likely preference for cash upfront), they do not indicate what alternative forms of annuity have been taken by the unquantified "majority" or what their reasons may have been for this alternative selection.*
>
> *... The note of* [the Head of Life Insurance's] *conversation with* [Halifax's Chief Executive] *suggests that they are now though thinking of presenting this as proposed uplift as being equal to 80% of the "value" of the annuity option, although this begs the question of what is the present "value". It sounds though as if they would like to be able to say that assuming everyone takes maximum cash, then they are making a further 20% deduction to allow for the additional flexibility that will be available for all policyholders. If this interpretation is correct, then I would guess that many policyholders near retirement would be willing to accept this percentage reduction in benefits as being a reasonable trade-off for the new flexibility.*

I am less sure though about his other suggestion of applying all of the 20% uplift only in the form of final bonus. Many policyholders may well not appreciate that they are giving up a guarantee and at the very least may consider that they have a reasonable expectation that this uplift will always be maintained. Accordingly, they may well still need to set aside some provision in the balance sheet for this uplift.

The flat rather than sliding scale probably can be rationalised by the arguments presented for an average policyholder. However, I agree that it would be useful to know rather more about the level of premiums relative to accumulated funds for a spread of policyholders. This should give some measure of how much benefit individual policyholders may be giving up. (Even though some may have the theoretical option to pay much higher levels of premiums now than they have in the past, I am not sure that they need to offer very much for such an option to increase the level of premiums paid each year, if in practice this option has never been utilised to its full extent.)

[**16:48**] The Director of GCD believes that FSA needed to urgently understand how the value of the uplift, being equal to 80% of the value of the guaranteed annuity rate, worked, as he had '*seen nothing on it beyond the original phone message this morning*'.

02/02/2001 [entry 6] FSA request from Equitable further information on the section 425 scheme. FSA say that they are concerned about the fairness of the scheme being fair to all policyholders. FSA note that the scheme was designed to attempt to be fair to average policyholders, but that they were still concerned about '*non-average policyholders*'. FSA ask for a '*breakdown of the fairness of the offer to policyholders*' of different age groups and size of policy. In doing so, FSA say that:

[We] *think that account needs to be taken of the different interests of two policyholders of the same age with policies in widely differing values. How are they properly to be described as fairly treated in respect of their top-up rights?*

In addition, FSA note that such a breakdown would be especially helpful if it were '*related to any method of determining expected take-up under top-up rights*'.

02/02/2001 [16:03] FSA's Head of Life Insurance informs Managing Director A that Halifax had called him about the press notice and letter to be issued. The drafting issues discussed include that the paragraph explaining the transfer of Equitable's unit-linked business by the Schedule 2c scheme was no longer needed, as Halifax now planned to transfer the business by means of reinsurance. FSA say that Halifax had been told that:

... we could not go as far as he wanted without further discussions with Equitable on the GAR/non-GAR compromise. He accepted that; said they wanted more time, and would come in on Monday. (In fact, I think we could accept this first amendment now; but the second ("represents") goes too far at this stage.)

The issues also include that: '[Halifax's Chief Executive] *wants a reference in this letter to the understanding already given on enforcement, and also to the understanding on marketing issues ...*'.

[**16:50**] The Director of GCD says that he did not understand why Halifax no longer needed a Schedule 2c scheme. He also asks whether the unit-linked business would no longer be automatically transferred.

02/02/2001 [17:25] An official informs FSA and PIA that Equitable's advisers for the sale had telephoned Managing Director A to say that Prospective Bidder F intended to make a further offer to Equitable that day.

02/02/2001 [17:31] Equitable provide FSA with the information requested earlier that day.

The Head of Life Insurance circulates the information within FSA and to GAD and suggests that they should meet on 5 February 2001.

04/02/2001 [entry 1] FSA write to Halifax and say that they saw no difficulty with them becoming the owner of the relevant parts of Equitable. FSA say:

> *We understand that the proposed relationship between you and Equitable Life means that it will not be a subsidiary and that at no stage will you exercise any control over its financial affairs. There are therefore no circumstances under which we would look to you to stand behind the closed fund if it were to get into difficulty ... We see no difficulty with you as owner of relevant parts of Equitable Life. No issues of regulatory standing or consulting an overseas regulator arise.*
>
> *The Board of Equitable Life will form its own views about whether the bid can be agreed without consulting policyholders. Our current assessment is that there is unlikely to be any basis for us to intervene to require such consultation.*

FSA continue:

> *... More work remains to be done, and the FSA will need to consider the detail before forming a definitive view, but the FSA's view is that this is a promising basis for a fair deal for policyholders. The FSA will continue to work with Equitable Life and the Halifax to ensure that the terms of the deal are communicated clearly to the policyholders, and that policyholders understand the choices they will have to make as part of the court process.*
>
> *Your proposed agreement indicates that it is subject to the FSA being agreeable to the proposed transaction. This letter therefore confirms that we are agreeable to it, as set out above, and we will confirm publicly that this is the case.*

FSA conclude:

> *You also have* [FSA's Head of Life Insurance's] *letter to you of 31 January 2001, enclosing a copy of a letter to Equitable Life on enforcement issues, and* [PIA's] *letter to* [you] *of 2 February 2001 on marketing issues.*

04/02/2001 [20:12] FSA's Line Manager E circulates a revised draft of a '*defensive briefing*' in the form of a question and answer guide and says that FSA's Consumer Relations Department was working on some general lines to take for the consumer helpline.

The briefing deals with the compromise, the sale to Halifax, and FSA's note in reference to both. Amongst the answers suggested in relation to the compromise, and for GAR policyholders, were:

- *... that buying out GARs will reduce uncertainties about the future liabilities of the Equitable. If policyholders agree to this, it would enable Equitable to achieve greater certainty about* [it] *in its financial position and it should be able to produce better returns for policyholders as its investment freedom is restored.*
- *Any proposals to buy out* [the right to a guaranteed investment return] *would be set out in the detailed compromise scheme.*
- *The cost of buying out the guarantees will be met from the with-profits fund. It is intended that reserves held to meet the GAR liability (estimated following the House of Lords judgement) will be used to cover the cost.*

In response to non-GAR policyholders, it was suggested that the following should be stated:

> *The value of your policy should be protected. Moreover, in future you should get the benefit of the increased investment freedom that will be available to the Equitable from the release of statutory reserves (and the consideration being paid by the Halifax). This should allow greater investment freedom which in turn should lead to higher bonuses than would otherwise have been available, although ultimately the benefits will depend on the relative performance of the different types of investments such as gilts and equities.*

The FSA, in relation to how the compromise might work, said that:

- [If] *the required majority vote in favour, dissenters can be bound to the terms of the compromise by the court ... If the proposed compromise is rejected, the second tranche of capital that was to be injected into the with-profit fund by Halifax will not happen. And the opportunity for the Equitable to release statutory reserves will be lost. This will mean that the constraints on the investment policy of the Equitable will continue. It will have to carry on investing more heavily in safer investments such as government stocks and bonds to protect its financial position.*
- *We cannot prejudge the court. And there are a number of steps to be taken before the matter can be taken to the court, including a vote of the policyholders concerned. Equitable and Halifax believe their proposals offer a fair compromise. At this preliminary stage, we would agree there is a promising basis for a fair deal for policyholders. However, there are still many details to be sorted out.*

In relation to the proposed Halifax deal in this context, FSA said that:

> *Equitable believes that the initial consideration of £500 million, that is not dependent on the compromise, is better than any other offer that had been firmly put on the table ... and that the bid from Halifax was the only firm proposal it received.*

In response to more general questions about whether the Equitable situation showed that '*it is risky to invest*', FSA suggest a reply as follows:

> *Investments do carry a certain risk and regulation seeks to ensure that people are protected from unreasonable risk and that consumers are aware of the risks that they face and the gains they may make.*
>
> *The FSA understands the importance of stability and certainty in personal finance arrangements, such as pension. We believe that this package goes a long way to achieving this. We think that there is a promising basis for a fair deal for policyholders. If a resolution is achieved this should improve investment freedom going forward which should help bonus levels. The actual levels of future bonus will depend on the relative performance of the different types of investment such as gilts and equities.*

In response to a question, which asked why there was '*such a rush ... If Equitable is solvent*', FSA state:

> *The last few months have caused anxiety for many Equitable customers. While the with-profits fund is still solvent, it had been seriously weakened by the House of Lords judgment; the longer the uncertainty about Equitable's future lasted, the greater the risk that the assets of the Equitable would fall in value. The directors of the Equitable believed that the Halifax deal on the table was too good to risk letting it slip away.*

On their own role, FSA state:

> *The deal announced ... is a commercial matter between Equitable and Halifax, and in the case of the compromise, the Equitable and its members. However, the FSA has powers to act if it believes that the reasonable expectations of policyholders may not be met or if it considers that policyholders have been treated unfairly. We therefore considered the broad terms of the deal before the Halifax went ahead ... We think the deal with Halifax is good news for all Equitable policyholders. We also think it is important that there is a compromise to deal with the GAR problems. At this stage, we think that there is a promising basis for a fair deal for policyholders.*
>
> *Ultimately it will be for the policyholders to express a view on the compromise and for the court to decide whether to approve it.*

FSA also explain that '*there was no case for* [an industry] *bail out*' as:

> [It] *is important to remember that ... the Equitable has been solvent throughout and the issue of compensation does not arise.*

FSA concluded that they have:

> *... acted in accordance with the statutory framework throughout, and in particular has always had as its priority the objective of protecting the interests of the policyholders. We have sought to facilitate a deal, by providing appropriate support to Equitable, Halifax and other interested parties, including representatives of policyholders and other prospective purchasers. We have also sought to ensure that so far as practicable, any outstanding regulatory issues have been dealt with so that a deal could be concluded at the earliest opportunity.*

Other points include that:

- FSA had done the same for Halifax as it would have done for any other bidder that was offering a deal that FSA thought would be fair to policyholders – that is, to reassure the bidder that the regulator would not seek to use its powers to prevent a deal being completed;
- FSA did not need to formally approve the deal, as a whole;
- if the majority of policyholders voted in favour of the compromise scheme, FSA need not give specific consent as the court must approve it; and
- FSA had met with various parties to facilitate a possible deal by discussing regulatory issues that might arise from a bid by these parties. FSA had also worked closely with Equitable's management to provide advice and assistance on regulatory matters.

04/02/2001 [entry 3] FSA's supervisory file includes an extract of the minutes of an Equitable Board meeting, held on 4 February 2001, where the Board had resolved that Halifax's offer should be accepted by Equitable.

05/02/2001 [10:00] FSA hold an Equitable Life Lawyers Group meeting.

Chief Counsel A reports that there appeared to have been little progress on formulating a response to the OFT's letter about Equitable's use of the market value adjuster. Legal Adviser C says that some concern had been raised by FSA's consumer protection division that the proposed letter to be sent to the OFT was too '*pro-Equitable*' and that such a letter might '*limit FSA's hands with a view to future policy*'. However, Legal Adviser C felt that this last concern was misplaced. The Director of GCD emphasises it was important that Equitable made a public statement to policyholders that: '*the MVA discretion was a fettered discretion so that the policy holders* *understood that there was an implied term that they could enforce*'. It is agreed that Legal Adviser C would ask Line Manager E to establish if he was content for the letter to be sent to the OFT.

Chief Counsel A reports that a meeting on winding up issues had been held on 2 February 2001 and an accountancy secondee (FSA's Insolvency Practitioner) was to be taken on to map out what would happen in the event of insolvency.

Chief Counsel A notes that the Halifax deal now proposed the use of reinsurance '*to avoid*' Schedule 2C of ICA 1982 procedures.

The Director of GCD requests that the minutes of their meetings were accompanied by a list of current legal issues and that the following issues were added: Article 4 of Equitable's Articles of Association; work on the compromise scheme; counterfactuals, including winding-up; and reviews.

Attached to the minutes is a list of outstanding legal issues.

05/02/2001 [13:38] Equitable send FSA a draft 'dear policyholder' letter about the sale to Halifax of its operating assets, sales force and non-profit and unit-linked business for a payment of up to £1bn into the with-profits fund. Equitable ask whether FSA were happy with it. Equitable also send FSA their policyholder question and answer material and an extract from their press release, which had been issued that morning.

05/02/2001 [14:30] FSA's Insurance Supervisory Committee approve, without discussion, the recommendations to approve Equitable's application for a section 68 Order on the admissibility limits of shares. (See 23/01/2001 [**entry 5**].)

05/02/2001 [15:51] GAD write to FSA, further to their comments on 22/01/2001 about how the sale of Permanent Insurance should be treated in Equitable's 2000 returns. GAD thank FSA for providing a copy of the sale agreement. GAD advise that, subject to certain caveats that they set out (which include that their comments are subject to any legal opinion FSA may receive), GAD believe it would be reasonable to treat the sale price as an unsecured debt in the 2000 returns.

05/02/2001 [entry 5] FSA's Chairman informs Managing Director A that he had updated the Chancellor of the Exchequer on 1 February 2001 about Equitable. The Chairman says that it had been useful to do so, as the Chancellor '*appeared to have been getting his information on progress largely from the press. I was able to explain the circumstances surrounding the switch of forces from* [Prospective Bidder D] *to Halifax. He was clearly relieved by these turn of events*'.

06/02/2001 [09:44] Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

06/02/2001 [10:01] Equitable's advisers for the sale send FSA a letter received by Equitable from Prospective Bidder F on 2 February 2001 and a draft comparison (of the deals from both Prospective Bidder F and Halifax) underlying the Board's decision to accept Halifax's offer.

FSA's Head of Life Insurance comments, when forwarding the document to various colleagues, that: '*At first glance, this looks inferior to* [Halifax's] *offer (see final paragraph). But it envisages reopening the* [Equitable] *with profits fund in due course*'.

06/02/2001 [entry 3] FSA meet with Prospective Bidder F, at their request, in order to be informed about the counter-bid which they envisage putting to Equitable the following day.

Following the meeting, FSA (Chairman, Managing Director A, Director of GCD, Director of Insurance, Head of Life Insurance, Head of Press Office and Line Manager E) meet to discuss the proposed bid.

According to Line Manager E's note, FSA say that the bid could be described as being worth £1.5bn (compared to the £1bn Halifax offer), but in real economic terms was worth much less. FSA agree to attempt to establish the true value of certain parts of the proposals. FSA note that the Halifax proposal was already '*in the bag*' and any negotiations that Equitable entered into with Prospective Bidder F could jeopardise that. The Line Manager's note also records that Prospective Bidder F had given an undertaking to sell the sales force to Prospective Bidder D on completion of the deal, which could complicate matters.

FSA agree that it would be important for Equitable to ensure they followed due process when reacting to any further bid. FSA record: '*The FSA was entitled to form a view as to the economic and legal assessment of Equitable and its professional advisers. However, on the basis of the facts before us, we saw no basis to intervene provided we were sure that the Society's and the Board's obligations had been properly assessed and considered*'.

FSA consider whether they could disclose information about the meeting to Equitable and Halifax. It is agreed that Managing Director A would warn both companies and the Head of Life Insurance would inform Equitable's advisers for the sale.

06/02/2001 [11:59] FSA receive a telephone call from a policyholder action group. The action group challenge the merits of the Halifax deal. FSA explain that the Halifax offer was the only offer on the table and better than other proposals that had been explored. FSA also indicate that they had looked carefully at the issues before the announcement and had concluded that it was in the best interests of policyholders.

06/02/2001 [19:00] FSA telephone Equitable to inform them that they could expect to receive an offer from Prospective Bidder F the following day. FSA say that they would need to be satisfied that Equitable's decision on the offer had been reached in a reasonable manner and with regard to due process.

06/02/2001 [20:15] Managing Director A informs the Director of Insurance that he had spoken to Halifax and informed them that a bid for Equitable's assets from Prospective Bidder F was likely the following morning.

07/02/2001 [entry 1] FSA write to the OFT setting out their thinking on Equitable's use of their market value adjuster. FSA provide a copy of a note prepared by FSA legal advisers, which concludes that it could be argued that the Unfair Terms in Consumer Contracts Regulations 1999 did not apply in this case.

FSA note that the OFT had:

> *... indicated that your latest thinking was to accept the arguments as to why it was not unfair for an adjustment to be made to the value of policies on early transfer or surrender.*

FSA's letter continues:

> *As I understand it, your concern is not so much about the application of an mva in itself, but rather the way in which any adjustment is calculated. You indicated that you might be looking to ask* [Equitable] *to take steps to amend the wording of its policy documentation to explain more precisely the basis on which adjustments would be made.*

There is of course a wider industry issue. I think I mentioned that [Equitable's] *position is slightly different to that of most other life offices (even if overall the outcome is the same in economic terms). This is because of the way in which* [Equitable] *has declared (annual) reversionary bonuses at higher than usual rates and because, in calculating the surrender value,* [Equitable] *also takes into account the value of the policyholder's share of the "terminal bonus" which in most companies would only be payable on a contractual date under the policy. Other companies are less transparent about the way in which the surrender values are calculated. However, I think that in the light of our discussion, you were going to talk to the Association of British Insurers to get a clearer picture of general industry practice.*

FSA inform the OFT that:

[Our] *own legal view is that the* [Unfair Terms in Consumer Contracts Regulations 1999] *are unlikely to apply to the mva, as it is currently applied to policy values, provided that the MVA operates in a way that is reasonable. If the mva were applied in a way that was entirely arbitrary and without regard to the kinds of factors described in my letter of 21 December 2000, we too would be concerned about the effect that that could have on policyholders (and indeed in such circumstances we would have to consider the exercise of our powers of intervention under section 45 of the Insurance Companies Act 1982). That seems to be consistent with the position that you are moving towards in looking for a more explicit form of words to be inserted in the policy documentation.*

FSA conclude by saying:

I think that achieving your objective by way of a contractual change may present some difficulties and you will understand our concern, for prudential reasons, that nothing should be done to undermine [Equitable's] *(or any other life office's) ability to adjust contract values at early termination in appropriate circumstances. Given that in policy terms we seem to be thinking along similar lines, and our objectives seem entirely consistent, I think it would be useful for us to meet fairly soon to work out how those objectives might best be achieved.*

07/02/2001 [08:50] FSA's Director of Insurance seeks advice from GAD's Directing Actuary B on the surplus relief treaty element of the bid by Prospective Bidder F. In particular, the Director of Insurance asks whether it was possible to evaluate what impact this would have on Equitable's investment freedom.

[**11:05**] The Directing Actuary says that it would be difficult to make such an assessment from the limited information he had. However, the Directing Actuary's '*very rough estimate would be that this might allow another 5% of the fund to be invested in equities, probably then generating no more than 0.1% per annum additional investment return*'. The Directing Actuary says that it would be helpful to see any notes or papers that had been received from the bidder.

[**12:57**] The Director of Insurance explains that Prospective Bidder F did not leave anything with FSA at their meeting the previous day but that FSA had just received copies of an offer that had been submitted to Equitable that morning.

[**14:14**] Directing Actuary B provides FSA's Director of Insurance with his views on the differences between the bids from the two companies.

07/02/2001 [10:37] Halifax reply to FSA's letter of 04/02/2001, saying that they were proceeding on the basis that FSA were satisfied with the proposed outsourcing arrangements that had been negotiated with Equitable – and that FSA saw '*no reason why IMRO should object to the proposed change of control of Equitable Investment Fund Managers Limited*'.

07/02/2001 [15:00]	FSA hold a conference with Counsel about their responsibilities in relation to the offer from Prospective Bidder F. FSA's note of the meeting states that Counsel advise that FSA should not suggest that an entity should breach its contract but they must ensure that Equitable had properly considered whether there were any lawful way out of the Halifax deal if the offer from Prospective Bidder F was a significant improvement.
07/02/2001 [15:07]	FSA's Director of Insurance writes to various people at FSA, commenting that the offer from Prospective Bidder F contained a condition that acceptance did not involve Equitable breaching any legal obligation. The Director of Insurance says that this meant the offer was not capable of being accepted, unless Equitable secured the agreement of Halifax.
07/02/2001 [16:49]	Equitable's advisers for the sale send FSA two draft responses to Prospective Bidder F's revised proposal, together with an outline side by side analysis of the value of both proposals.

07/02/2001 [entry 7] FSA hold a telephone conference with Equitable, their advisers and solicitors about the bid from Prospective Bidder F. According to Line Manager E's note, in summary:

> [Equitable's advisers] *had advised that the new offer was only of marginal better value;*
>
> *Equitable had clear legal advice that they could not entertain the new proposal;*
>
> *Halifax had made it clear that they would seek to enforce the contract;*
>
> *Equitable wanted to reject the offer quickly, but we recommended to them that they should ensure that in so doing, they followed due process including with the support of the board.*

FSA say that their starting point was that the bid was a commercial matter for Equitable, but:

> *... we felt we had a responsibility because of our duties and the statements we had made about being closely involved. We therefore wanted to be sure that due process had been followed. We therefore took the view that Equitable needed to:*
>
> - *take proper legal advice;*
> - *make a comparison of the merits of the offer, including as to security;*
> - *if they concluded the bid was very much better, they needed to look at the options available to them, including considering whether Halifax would release them;*
> - *consider the extent to which the board should be involved in the decision (which was not very clear from the minutes of the last board meeting).*
>
> [Equitable's Chief Executive] *said that the board had been appraised of the last* [Prospective Bidder F] *offer last Thursday, when it was telephoned through. It was for that reason that there was limited consideration given to it when the Board met on Sunday to commit to the Halifax deal.* [FSA's Director of Insurance] *said that our concern was that a disgruntled policyholder might seek to argue that the board had not properly considered all the options available. For that reason, we preferred the more detailed letter that made it clear that due process had been followed.* [The Director] *said that we would wish to be able to say that that had been done, and be satisfied that the position had the full support of the board.* [Equitable's Chief Executive] *took the point but said that he was concerned that the imperative in his mind was to close the matter as soon as possible to avoid the risks of a row in the media. He said there would be difficulty in calling a board meeting within the timescale required. He expressed concern about the fact that one regulated firm was seeking to induce another into breaking a binding contract.*

Equitable's solicitors confirm they had been told by Halifax that they would seek to obtain an injunction if they thought that Equitable would break the terms of the contract. The Society's solicitors also say that there would be a real risk of a claim against Equitable for loss of value, damages and performance of the contract.

FSA agree to review the drafting of a letter that had been prepared for Equitable to send to Prospective Bidder F, rejecting their proposals.

07/02/2001 [entry 8] FSA have a further discussion with Equitable, their advisers and solicitors, in which FSA offer comments on the proposed letter to Prospective Bidder F and clarify some points in the 'side by side' comparison of the Halifax and Prospective Bidder F bids which underpins it. On the letter, FSA:

- Ask whether Halifax were subject to regulatory clearance from PIA. Equitable's advisers say that they had received confirmation that clearance had been agreed.
- Express concern about the references to consideration of the bid by Prospective Bidder F by Equitable's Board, as: '*If, as seemed likely, consideration would formally* [be] *by a directors meeting (since it would be a minuted directors meeting by conference call rather than a board meeting which, under Equitable articles required the physical presence of a quorum meeting together) to claim that the board had been involved might leave the Society open to criticism and possible challenge*'.
- Repeat their concerns that Equitable should be absolutely certain that decisions taken on the basis of discussions in a directors' meeting had been properly taken and could not be challenged subsequently.

On the side by side comparison, FSA:

- Ask whether Equitable's advisers were confident that they had properly reflected the combined effect of the charges Prospective Bidder F had proposed on asset management and administration. Equitable's advisers say they are confident and there was no difference between the bids on charging structure. Therefore, Prospective Bidder F's proposals were not as good as Halifax's, as their cost charging was 25% higher.
- Seek clarification on the element in the comparison relating to the benefits obtainable from the different upfront cash offers and Prospective Bidder F's proposals for £400m '*surplus relief reinsurance*'. FSA's Director of Insurance records: '*While this showed some advantage to* [Prospective Bidder F] *the £400m was calculated to provide a benefit of only £40m.* [Equitable's advisers] *were confident of their calculation of this benefit. While neither* [Chief Counsel A] *or I were competent to judge the methodology (essentially calculating the charges payable as, in effect interest on a loan, and the return achievable through equity investment) was reassuringly familiar*'.

07/02/2001 [entry 9] FSA speak with Halifax, who say they are comfortable with the approach being taken by Equitable. Halifax say they would write to Equitable's Board stating that they were committed to seeing the deal through and there were no circumstances in which they would alter the value of the offer. FSA record that '[Halifax's Chief Executive] *concluded by* [commenting]*, with some feeling, and in reasonably predictable terms, about the conduct of a regulated entity* [Prospective Bidder F] *which appeared to be set on inducing a breach of contract between two well established financial institutions with long and honourable traditions*'.

07/02/2001 [20:53] FSA's Director of Insurance forwards to Managing Director A (copied to others at FSA) GAD's analysis of the proposals (see 07/02/2001 [**14:14**]), commenting that it '*confirms (independently because it was prepared before we had sight of* [Equitable's adviser's] *"side by side" analysis)*

	the overall conclusion that [Equitable's advisers] *have reached on the comparative merits of the bids which the Equitable directors are to be asked to consider*'.
07/02/2001 [21:21]	FSA inform Equitable's solicitors that they were aware of no circumstances which might warrant refusal of the proposed acquisition of Equitable Investment Fund Managers Limited by Clerical Medical Investment Group (Holdings) Limited (a subsidiary of Halifax).
08/02/2001 [11:24]	FSA's Managing Director's Office ask Line Manager E to draft a reply to Halifax's letter of 07/02/2001 about assumptions regarding outsourcing. There is some discussion about how to take this issue forward.
08/02/2001 [entry 2]	Halifax write to FSA to express their concern about Prospective Bidder F's approach to Equitable. Halifax say: [We] *are very much in uncharted waters. However, the situation is becoming so serious that I believe I have no alternative but to set out our position on paper.* *Throughout the process of our acquiring Equitable Life we have done everything in our power to ensure that our behaviour is completely beyond reproach, and in particular does nothing to destabilise the position of Equitable Life policyholders. And after eight months of uncertainty we were the only organisation prepared to stand up before its shareholders and argue for a transaction which genuinely holds out for the real prospect of ensuring the future solvency of the closed fund.*
08/02/2001 [entry 3]	FSA reply to Halifax's letter, saying that FSA have considered whether there was any basis for FSA to take '*legal action*' to protect Halifax's position or that of Equitable's policyholders, but that they had reached the conclusion that FSA had no powers which would be exercisable for this purpose.
08/02/2001 [13:02]	FSA's Director of Insurance informs Managing Director A about a conversation he had had with Equitable in relation to the bid by Prospective Bidder F. The Director of Insurance explains that: '*The Equitable held a board meeting yesterday evening* [and had] *concluded that they should reject the* [Prospective Bidder F] *in the terms of the longer of the two draft letters which we had seen earlier*'.
08/02/2001 [17:47]	Equitable send FSA a copy of a letter of that day to Prospective Bidder F about their offer, which had stated that Equitable cannot pursue further discussions with the bidder.
08/02/2001 [18:03]	Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.
08/02/2001 [entry 7]	FSA meet a policyholder action group to discuss recent developments at Equitable. FSA record: [FSA's Director of Insurance] *began with a few key points about the Halifax announcement. He noted that the Halifax deal was a good one, in the circumstances, and that the proposals for contracting with Clerical Medical were on the basis of reasonable charges. He then commented on the proposed compromise over which Equitable would be looking to consult before putting forward a formal proposal. Equitable wanted to be fair to all policyholders and the Halifax deal, with the goodwill element of the consideration conditional on a deal being accepted, gave an incentive for policyholders to accept it. He noted that the transfer of value as a result of the House of Lords judgment had happened so the intention was to seek to remove future uncertainties by crystallising current entitlements. There was no prospect of the lost bonuses being restored but the compromise, along with the sums payable by the Halifax,*

gave a reasonable prospect of restoring the investment freedom of the with-profits fund so that it would be able to support higher equity backing ratios going forward.

... [the Director of Insurance] *said that we had had discussions about Equitable's GAR liabilities in late 1998, which had led to an increase in their reserves of £1.6bn, which represented a prudent estimate of the likely GAR take up at the time.* [FSA's Head of Life Insurance] *said that there had been some discussion about the right level of reserving, with Equitable taking the view that it did not need to hold significant reserves because of the evidence of low levels of take up. However, we had insisted that reserves be held on the basis of close to full take up.* [The Director] *said that the reserving requirement had been met in part by the reinsurance, which would cover the costs if the take up exceeded 25% but that the cover was conditional on Equitable maintaining the same policy towards the allocation of terminal bonus. The House of Lords judgment imposed a new bonus policy, which meant that the reinsurance had to be renegotiated – it now provided cover if take up exceeded 60%. The combination of the impact of the judgment and the further tightening of the reserving requirements generally had left Equitable in a position where it had relatively few free assets which constrained its investment freedom, and this was the reason for looking for a buyer. Now that the deal had been done with the Halifax, the financial position would be stronger and current policy values should be protected.*

They asked whether there was any prospect of a sweetener being offered to non-GAR policyholders to sign the deal ... We ... pointed out that the removal of future uncertainty of the size of the GAR liability, the increased investment freedom and the fact that it was intended that the costs of the deal would be contained within the cost of the transfer of value that had already taken place would all be beneficial to non-GAR policyholders. They asked why this had not been proposed before now. We pointed out that before the closure announcement, it was unrealistic to believe that people would have agreed to any kind of deal – some were expecting windfall payments from the demutualisation at that stage. They also asked about the role of the independent actuary and whether it would be possible for the appointment to be made by one or more of the action groups. We said that it might be difficult for them to make the appointment, but we could consider whether there was any way that the action groups might have an input to the appointment, or the drafting of the terms of reference.

We answered a number of detailed questions. We confirmed that the Halifax deal did not have any impact on the operation of the Policyholders Protection Acts ... FSA's report into its regulation of Equitable was being worked on ...

In relation to the particular difficulties that with-profits annuitants currently faced, FSA acknowledged the difficulties and invited the action group to suggest what kind of protection might be achievable and desirable, perhaps as part of the compromise scheme.

08/02/2001 [entry 8] On FSA's supervisory file for Equitable is a copy of a letter from PIA to the Society about their continuing supervision work. In that letter, PIA had said:

Much of PIA's contact with Equitable over the last two months has concerned your firm's closure to new business and related issues. Whilst this new work has been undertaken, PIA has continued work on issues relating to Equitable before its closure to new business.

These pre-closure issues fall into two broad areas:

1) Work arising out of PIA's Supervision Visit to Equitable in June 2000.

2) Assessment of the standards of business written by Equitable since the Court of Appeal ruling on 21 January 2000.

	PIA had said that they had received Equitable's response to their supervision visit report and would respond in due course. PIA then explained that the purpose of writing had been to request information to help them quantify and assess the business written since the Court of Appeal ruling. PIA sought information from the Society on: new business data; information about all new with-profits and unit-linked contracts; complaints information; advertising and promotional material; training and briefing material for sales staff; standard paragraphs used in communications with policyholders; and sales process documentation. PIA asked for the information to be categorised into the periods: 21 July 1999 to 20 January 2000; 21 January to 20 July 2000; and 21 July to 8 December 2000.
09/02/2001 [entry 1]	FSA reply to Halifax's letter of 07/02/2001 saying that, while they would need to consider the details of outsourcing arrangements, they could confirm that, in principle, they saw no difficulty with the proposed arrangements. FSA also state that: '*On the proposed change of control of Equitable Investment Fund Managers Limited ... We are not aware of any circumstances that might warrant refusal by IMRO of this proposed acquisition*'.
09/02/2001 [entry 2]	Prospective Bidder D write to FSA to thank them for the '*very constructive approach*' that FSA had taken in connection with the asset management issues in relation to their bid. The Bidder said that it had been grateful for and impressed by the speed with which FSA had been able to come back to them.
12/02/2001 [09:05]	Equitable send FSA a copy of a letter that was being sent to policyholders about the sale to Halifax. Equitable also supply some information on their handling of telephone enquiries.
12/02/2001 [10:00]	FSA hold an Equitable Life Lawyers Group meeting. The minutes of the meeting record that: • FSA had now replied to the OFT's letter. • An update was provided on the sale to Halifax and the Prospective Bidder F bid. • FSA had not yet made a formal approach to Halifax/Equitable regarding amendments to Article 4 of Equitable's constitution. It is noted that, if at any stage it became necessary to express a view, the appropriate time would be during the second stage of the sale. • A paper on 'counterfactuals' was being prepared. • With regard to the proposed appointment of Equitable's Managing Director, FSA would serve notice under Schedule 2D of ICA 1982, requesting further information and that: *This will have the effect of preventing further moves to appoint* [the individual]. *The additional information will help the FSA to decide whether as a matter of fact* [he] *is fit and proper to act as managing director. As to whether the FSA can impose conditions on* [his] *appointment (should it go ahead) such as a time limit, we are reasonably confident that we can but there may be policy issues to consider fully first.*
12/02/2001 [entry 3]	FSA meet The Consumers' Association to discuss Equitable. According to a note of the meeting made by the Head of Life Insurance, FSA explain the recent history of the bidding process and indicate that FSA were satisfied that Equitable had gone through due process to decide that the Halifax offer was the best available. FSA explain that it was for Equitable to propose a compromise scheme and for FSA to satisfy themselves that the scheme was the result of a proper and thorough process.

12/02/2001 [entry 4]	FSA meet a policyholder action group. The note produced by FSA records, in summary, that '*the two sides agreed to differ on whether the sale of Equitable's businesses to the Halifax was in the interests of the Equitable's policyholders* [and] *that further meetings would be helpful*'.
13/02/2001 [entry 1]	Halifax's advisers send FSA copies of letters (dated 14 February 2001) to PIA and IMRO giving Notifications in respect of Equitable Investment Fund Managers Limited and a copy of a letter to their FSA supervisors about the outsourcing arrangements. (See 14/02/2001 [**entry 1**].)
13/02/2001 [18:29]	Equitable send FSA information on calls to Equitable's helpline.
13/02/2001 [19:45]	FSA have a telephone conversation with Equitable about their new President, advertising post-House of Lords, and the value of withholding seven months' bonus. FSA say that their PIA colleagues had not been successful in getting information from Equitable on advertising post-House of Lords' decision. Equitable promise to provide some figures the following day; however, Equitable say that they did not think that their expenditure on advertising at that time had been out of line with previous years. On the loss of bonus, Equitable's Chief Executive estimated that it represented a 5% reduction in policy value: '*But he thought that this somewhat misrepresented the true position*'. FSA record the Chief Executive as saying: *To set aside funds to cover the transfer of value from non-GAR to GAR it would have been necessary for the Equitable to distribute less by way of bonus in earlier years. While this would avoid some of the inter-generational unfairness the overall result would have been no different. The Equitable would be trying to get this point across at the* [Treasury Select Committee], *emphasising that no funds had been lost or misappropriated and that the value of the fund remained as it would otherwise had been. It was the uncertainty which currently afflicted the fund, and which limited investment freedom, which was the major problem. This would be resolved by the Halifax deal and the GAR/non-GAR accommodation <u>if it went through</u>.*
14/02/2001 [entry 1]	FSA's regulatory supervisor for Halifax sends Line Manager E a copy of the Administration and Asset Management Agreement that they had received that day. He suggests that Line Manager E should take the lead on this.
14/02/2001 [12:04]	Commenting on the Director of Insurance's note of the call (see 13/02/2001 [**19:45**]), the Director of GCD says: *We need to be cautious about appearing to accept the Equitable's characterisation of the* [House of Lords'] *decision as involving a <u>transfer</u> of value from non-GAR to GAR. The effects of the* [House of Lords'] *decision is that all with-profits holders participate in the overall profitability of the business, and similarly bear their share of its liabilities. This may appear to be a transfer of value, but only because the Equitable had characterised the position of the non-GAR with profits policyholders as participants in a separate non-GAR fund, unaffected by the liabilities to the GAR holders – a characterisation the Court did not accept.* [**12:29**] The Director of Insurance replies: *Yes, but it certainly represents a change from what had previously been assumed to be the aggregate shares of the fund represented by the GAR and non GAR policies so that the assumed value of the one declined by the same amount that the assumed value of the other increased.*

I don't think, as a matter of fact, that the Equitable did characterise the GAR and non GAR policy groups as separate sub-funds. In practice their belief that they could distinguish on the basis of exercise rather than availability of the option meant that they never faced up to this issue. It is interesting to consider what the [House of Lords] *might have concluded, had they been faced with a situation in which there had been two defined and separate sub-funds (even if the assets were pooled).*

Nonetheless I am sure your analysis is correct. But for the purposes of gaining understanding it seems to me that the concept of transfer is very helpful, provided it is clear that this is a transfer between the shares in the fund that had previously been assumed.

14/02/2001 [14:22] FSA's Director of GCD asks Chief Counsel A, in the light of a point made at the meeting on 12/02/2001 with one of the policyholder action groups, whether it was right that there could be no ring-fencing of the costs of providing a guaranteed interest rate on certain policies.

[**21:10**] Chief Counsel A replies: '*The 3½% guarantee is not an issue now because it has not been triggered. Investment returns continue to be well in excess of 3½%. If it were triggered, then I am not sure the Equitable judgment would necessarily mean no ring fencing, but it would almost certainly raise a "case to answer".*'

15/02/2001 [entry 1] The OFT reply to FSA's letter of 07/02/2001 about the Unfair Terms in Consumer Contracts Regulations 1999. The OFT say:

[We] *are clear that the Regulations apply here. We cannot agree with the argument that the mva terms are fair or fall outside our scope to take action under the Regulations if they are operated fairly. The question is whether the terms have the potential to be used unfairly in the future or mislead customers, and we consider that they have. Equitable will need, in order to meet the requirements of the Regulation, to limit the scope of its "absolute discretion" and conform its conditions to the fair practices that it says it applies and the fair principles that are enforced by regulation, though these principles may need further elucidation. Similarly, the scope of the FSA to regulate Equitable and Equitable's present practice in operating the relevant terms, do not remove the problem or confer any kind of exemption. The Regulations set a new and high standard for business and public authorities contracting with consumers; they give consumers additional protection, and they put us under a continuing obligation to ensure that unfair terms with potential for unfairness are modified or removed. Whether a standard term is unfair does not depend on an assessment of factors such as the practices and potential remit of any regulators, the likelihood that the courts will overturn the unfair term when it is challenged, or the current practices and policies or culture of the business using the terms.*

The OFT continue that:

We discern few points of agreement with the legal advice that you have received. The second and third paragraphs lead to an analysis of the "core terms" exemptions in Regulations 6(2) which is incorrect. [A named bank] *failed to persuade the High Court and then the Court of Appeal of the validity of this kind of approach in relation to the use of the "interest after judgement" clause. The court preferred a narrow definition of what was a "core term" and considered that the exemption could not apply to terms that determined what would happen if the agreement was in default (or thus – by extension – was terminated early).*

The advice discusses the application of the core terms exemption. But a core term is by definition very much at the forefront of the consumer's mind (even ambiguity in core *terms relieves it of the exemption). So the argument that consumers invest in full knowledge that the Society might decide to give them nothing at all is implausible. Equitable would have been in severe difficulties many years before if it had tried to sell its products on that proposition.*

The arguments on "absolute discretion" are addressed in the letter to Equitable. The width of the discretion is at the core of our concern. The term in question does not at all imply that the term will be exercised "reasonably". "Absolute" means precisely that – the discretion cannot be challenged – and the whole point of including this word is to make the discretion immune to any such challenge. This is reinforced by the inclusion of "(if any)". The reason that the term is not expressly subject to "reasonableness" is that it would modify or contradict the "absoluteness" of the discretion. At any event if there were an implied reasonableness requirement in the term, it would not meet the transparency requirements of Regulation 7 unless it were expressed.

The OFT conclude by stating:

I note your concern that nothing should be done to undermine Equitable's ability to adjust contract values at early termination in appropriate circumstances. However the effect of the Regulations is that the relevant terms should not enable Equitable to make unfair adjustments. The width of the terms is without doubt challengeable under the Regulations and could therefore be seen as unenforceable, whereas fair terms would not be. It seems to us essential therefore for Equitable to face this concern and that it would meet both your prudential concerns and ours for Equitable to do so by revisiting the terms to clarify and objectify the expectation that investors can legitimately have. Given, as you say, that our objectives essentially mesh together, I agree that it would be very useful to meet, perhaps early next week, to discuss these issues and next steps.

The OFT also enclose a copy of a letter to Equitable, dated 8 February 2001.

15/02/2001 [entry 2] FSA's Managing Director A submits a paper (dated 8 February 2001) to FSA's Board on the decisions on the bids for Equitable and the results of their ongoing supervision of the Society. The paper sets out the sequence of events on the bidding process following Equitable's closure to new business and explains the consideration and actions which had been given and taken by FSA and PIA.

15/02/2001 [entry 3] FSA provide PIA with their views on a booklet intended for Equitable policyholders that had been prepared by an independent financial adviser. FSA comment on those parts which were wrong or misleading.

16/02/2001 [13:09] FSA's Line Manager E asks for comments on a draft letter to Equitable on the proposed appointment of their new Chief Executive. The letter says that FSA '*cannot properly reach a decision on the application without additional information*', which is requested.

16/02/2001 [18:53] Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

16/02/2001 [entry 3] FSA send PIA and IMRO information, received on 15 February 2001 from Halifax's advisers, on the change of control of Equitable Investment Fund Managers Limited.

16/02/2001 [entry 4] FSA meet the National Association of Pension Funds to discuss recent developments at Equitable.

19/02/2001 [09:17]	FSA's Head of Life Insurance asks Line Manager E to put together an agenda for a proposed meeting with Equitable's Appointed Actuary. The Head of Life Insurance says that he had spoken to the Appointed Actuary and that possible topics for discussion would include: end-2000 results; current and ongoing solvency position; surrender rates; and section 425 scheme. A meeting is arranged for the following day. [**18:15**] FSA send Equitable a letter setting out these key issues that they would like to discuss at the meeting, in the following terms. <u>End year 2000 results</u> FSA would like an update on Equitable's likely year end solvency position (i.e. 31 December 2000). FSA would also like to explore the possibility of their returns being provided to an accelerated timetable. <u>Current and ongoing solvency position</u> FSA would like an indication of the latest solvency position. FSA emphasise the importance of the timely provision of all reports on the solvency position of the Society, while noting that Equitable had not yet provided the monthly reports for November and December 2000 and that the January 2001 report was now due. <u>Surrender rates</u> FSA suggest that it would be helpful to discuss trends in the levels of surrender requests since closure to new business and since the announcement of the Halifax deal. FSA say that relevant to this was the discussion with the OFT regarding the market value adjuster. <u>Section 425 scheme</u> FSA request an update on the compromise scheme, including a discussion on the approach that the Society would take and its thinking on whether an uplift to GAR policy values should be on a flat rate or a sliding scale. FSA say that it would be helpful to have an indication of the likely timetable. <u>The Halifax deal</u> FSA ask for an indication of when the contracting-out agreements were to be finalised and whether any late changes were being proposed. On a copy of this letter, an official has written the following further points to raise: • *Assuming no compromise what can be done to protect position?* • [financial condition report] *at some point* • *2000 bonus declaration, content/timing*.
19/02/2001 [10:00]	FSA hold an Equitable Life Lawyers Group meeting. Among other things, the Group discuss the issues on the legal issues list and add a status report to each of the actions. Chief Counsel B informs the Group that he had recently become aware of a letter from Equitable to PIA of 20 December 2000, informing them that, prior to the court case, they had vested several policyholders with annuity rate guarantees into non-guaranteed rate annuity policies. He says that Equitable were proposing a mechanism for dealing with complaints about this but, as it would not be ready in time, had requested a PIA Rule waiver. Chief Counsel B reports that PIA were minded to grant the waiver but that it would need senior approval. The legal issues list attached to the minutes of the meeting includes: • Advice from Counsel on the interpretation of Article 4 had not yet been received. • The OFT had responded to FSA's letter of 07/02/2001, disagreeing with FSA's interpretation. It is noted that FSA were to meet the OFT on 22/02/2001 [**13:27**] and

also that FSA had concerns about the implications for the industry of the OFT's stance on market value adjusters.

- Under '*Possible use of intervention powers should MVA be further increased*', the Group record that this is '*not an issue at the moment, though it may become so should the FTSE index drop below 6000*' which '*was at one stage mentioned as a potential "trigger" for a further review by the Equitable of the amount of the mva*'.
- Work on the need to consider the full implications if winding up were undertaken and on any breach of solvency margin was ongoing.
- It is noted that there was a difference of view between FSA and GAD on the interpretation of Regulation 72 of ICR 1994 and that a meeting was to be held on 21 February 2001.

19/02/2001 [12:56] An email exchange occurs between FSA officials about a proposed meeting with the OFT regarding Equitable's use of the market value adjuster.

[**13:33**] Legal Adviser C notes:

> [If] *this is to be a meeting primarily to discuss the legitimacy of the Equitable's mva provisions in its policy documents, I wonder what a meeting with the OFT is going to achieve. I attended a meeting of the Equitable Life Lawyers Group this morning at which the letters to Equitable and to ourselves from the OFT were briefly discussed; the feeling around the table was that were we not likely to persuade the OFT to change their minds on this and would be wasting our time and energy doing so.*
>
> *... The good point that emerges from the OFT letter is that they at least appear to agree with us that on 8 December Equitable exercised its discretion to increase the mva in a way that was not unreasonable. Consequently, the prospect of action against Equitable by the OFT for the increase itself seems very remote.*

Line Manager E replies that his:

> *... concerns are wider than just the interests of Equitable in all this since it has potential implications for the whole industry ...*
>
> [It] *also seems to me that their analysis is a bit theoretical and does not take into account certain practical realities – not least that the "notional fund values" take into account growth, in the form of bonuses, that would never have been awarded if Equitable had the slightest idea that something was suddenly going to be found to be objectionable about its current practice. If the answer is for Equitable to clarify the basis on which the discretion might be exercised, I would like to know how OFT think that the terms of the contract might be amended. If a satisfactory exchange cannot be delivered and the terms were struck down, in practical terms this could cause a risk of insolvency and if that happened, people would get less than they would had an mva been applied since they would lose the entitlement to terminal bonus, and so get less than the surrender value. And going forward, Equitable and other firms will just reduce the amount of the bonuses they declare in the future.*
>
> *It may be that this does not affect the underlying analysis, but it seems odd that legislation that is designed to protect the interests of consumers might be used in a way that leaves them clearly disadvantaged.*

20/02/2001 [11:36] FSA's Line Manager E provides the Head of Life Insurance with the action points for FSA that arose out of the recent meetings with the National Association of Pension Funds and with a policyholder action group. (Note: these were provided as points to be raised with Equitable at the meeting later that day.)

Line Manager E says that, for the National Association of Pension Funds, FSA were to:

- seek clarification from Equitable on how pension fund trustees would vote on any compromise. The Line Manager notes that the Association was also concerned about what would happen where the group schemes included GAR and non-GAR policyholders; and
- seek reassurances from Equitable that '*"sensible" suggestions for new* [non-executive] *appointments were being given proper consideration*'.

In relation to FSA's meeting with the policyholder action group, Line Manager E says that the action group:

- wanted a '*token sweetener*' for non-GAR policyholders;
- believed that something needed to be done to protect the interests of with-profits annuitants, as this group had been disproportionately affected by '*recent events*'; and
- were concerned about the '*independence of the independent actuary*' and would like to see policyholder action groups having some involvement in the appointment and/or the terms of reference for that appointment.

20/02/2001 [14:00] FSA and GAD meet Equitable's Appointed Actuary.

Equitable provide the monthly solvency figures for December 2000 (note: I have not seen the information disclosed) and explain that one of the reasons for the delay had been due to the strain that had continually been put on resources since closure. FSA record:

> *The position disclosed demonstrated fairly thin solvency cover and had assumed that both the concessions for the artificial bond (valuation rate of interest) and for an increased valuation taking into account the sale of the Permanent* [Insurance] *had already been given. Without these concessions the company would not be able to demonstrate coverage of the* [required minimum margin] *in its statutory returns. The* [Appointed Actuary] *had, however, now adopted the stronger resilience basis that had been required by recent changes in the regulations in these figures. He thought that all other reserving issues had been ironed out but GAD pointed out that there was still an issue surrounding Regulation 72 and retirement dates to be resolved.*

FSA confirm that Equitable had not yet applied formally for the section 68 Order for the valuation of Permanent Insurance and for the '*artificial bond*' Order that Equitable still needed to confirm that, once issued, it would be used permanently.

Equitable say that they thought that their current financial position had improved as they had disposed of £1bn of equities since the year end, which had reduced the resilience reserve required. Equitable report that their equity backing ratio was now 61%, down from 68% last year, and which had historically been as high as 75-80%. Equitable say that the £500m Halifax payment, due next month, should boost solvency.

Equitable say that the current effect of the market value adjuster on remaining members was broadly neutral. Equitable inform FSA that they had rejected the OFT's arguments about the need to identify the circumstances in which an adjuster would be used and how it would be applied. Equitable say that they thought the OFT had raised generic industry issues to which the whole industry had to respond.

Equitable say that they were not keen on the possibility of having to submit accelerated returns, as staff would be concentrating on integration with Halifax and on the compromise scheme. FSA explain that the main driver for accelerated reporting would be that the information was in the public interest. Equitable argue that the compromise scheme would make available to policyholders a lot of details on solvency and that '*it was also possible that the availability of further public information at this time could muddy the waters*'.

Equitable next explain that the timetable for the compromise scheme was not clear, although the substance would need to be settled and made public by the annual general meeting set for 23 May 2001. FSA say that they would need to be involved in the construction of the scheme proposals, as they might be able to play a role of 'honest broker' in the proceedings, as they had done in another case. FSA say that they would also like to vet the Independent Actuary for the scheme and be involved in setting his terms of reference.

On the bonus declaration for 2000, FSA record:

> *The* [Appointed Actuary] *proposed to postpone the 2000 bonus notice until after the vote on the accommodation. If there was a positive vote it may be possible to offer a* [guaranteed] *bonus to everyone for 2000 of possibly 4%, (although as 3.5% is guaranteed under some GAR policies the real additional cost of this bonus was effectively the same as a 1% bonus across the board). This could be another carrot to help "sell" the deal to all classes of policyholders.*

Under '*Action Points*', Equitable agree to send FSA their latest response to the OFT as soon as possible and to provide their January 2001 solvency figures in the next two weeks. FSA's action is '*to push Equitable to apply for Section 68 orders*'.

20/02/2001 [17:01] FSA's Managing Director A sends a note to the Director of Insurance and others at FSA saying that the FTSE 100 Index '*fell like a stone this* [afternoon]*, through the 6000 barrier*'. The Managing Director suggests that the most obvious impact of this would be on Equitable and their solvency cover. He says: '*I'm hoping? correctly? that Halifax's £500 mn gives a fair bit of lee-way below 6,000 before our technical solvency requirements are breached*'.

[**17:45**] Line Manager E replies and relays information from the meeting with Equitable earlier. The Line Manager says that he did not wish to speculate on Equitable's solvency position but suggests that the current level of the stock market was the same as it had been on 31 December 2000. On the meeting, the Line Manager says:

> ... [Equitable's Appointed Actuary] *reported that at the year end (at 31 December 2000), Equitable had free assets of £340 million, giving 1.3 times coverage of the solvency margin. That valuation relies on the granting by the Treasury of certain accounting concessions, none of which has actually been granted yet:*
>
> - *allowing them to count more than the normal permissible number of shares in* [a company] *following the merger, which is fairly straightforward and routine (and worth less than £10* [million]*);*
> - *the valuation of Permanent* [Insurance]*, which was on the books at about £30 million, but the sale of which was agreed before the year end at £150 million. Our willingness to recommend the concession may depend on the auditors' willingness to allow the higher valuation in the companies act account, but I think there is a good case for a fair valuation to be on the basis of the agreed value of the transaction;*
> - *and the valuation of the synthetic bond, which is still under discussion, but the likely impact on the final figures is an improvement of up to £300m.*

So there will be issues for us and the Treasury to consider about the way in which the statutory returns show the end year position – the third of the concessions above seems to me to be the most difficult one to deal with.

Since the year end, Equitable has sold £1 billion of equities which reduces exposure to the market, but even now 61% of the assets are in equities. The first tranche of the Halifax payment will help matters, but it is not payable until completion, scheduled for 1 March 2001.

The above does point to the need to be careful about what we say, if we want to be certain that we are right. Either we should refer specifically to the position at 8 December, or simply say that the company is solvent.

[**17:58**] The Managing Director responds with a few points:

a) re [the newly merged company]*, I think their shares have fallen quite a lot in recent weeks ...*

b) the extra valuation for Permanent [Insurance] *sounds reasonable.*

c) I'm unsighted on the synthetic bond. Can we [please] *have a bit more on this? (we are going to have to be very careful in the current climate before giving anything remotely unusual to* [Equitable]*).*

[**18:13**] In response to '*a)*', Line Manager E explains that Equitable's application for a section 68 Order (see 12/01/2001 [**entry 2**]) is:

... one of a kind that has been granted whenever major plcs merge, and so is routine. Several companies are in line to receive concessions for this, and it has been with the Treasury for weeks. There is no reason to treat Equitable differently.

Line Manager E provides some text from a note on section 68 concessions that he had prepared '*a while back*'. He says:

On the face of it, the concessions themselves are not of great concern, though clearly they will be subject to abnormal levels of scrutiny. What is more difficult (assuming that the concessions have been granted before the returns are due) is that Equitable would like to be able to report the year end position as if the concessions had been in place at the year end.

FSA's Chairman underlines '*as if the concessions had been in place at the year end*' and writes '*If we are to concede that, I hope there are precedents (and preferably hundreds of them)!*'. His comments are sent back to Line Manager E, Managing Director A, the Director of Insurance and the Head of Life Insurance.

21/02/2001 [16:02] Equitable send FSA a copy of a draft letter to the OFT dated 16 February 2001.

21/02/2001 [14:18] In response to the minutes of the previous day's meeting with Equitable, GAD's Scrutinising Actuary F says to Directing Actuary B that he thought that Equitable had said that they accepted GAD's stance on Regulation 72 but the minutes of the meeting did not reflect this.

22/02/2001 [entry 1] FSA's Managing Director A informs the Director of Insurance that he had received a telephone call from Equitable's Chief Executive, who had confirmed that he was moving to the new administration company and had asked what FSA's reaction would be to Equitable's current Appointed Actuary taking on the dual role of Equitable's Appointed Actuary and Chief Executive. The Managing Director says that he told him that FSA '*would not favour*' that happening.

22/02/2001 [entry 2] HMT send Equitable the section 68 Order on admissibility limits of shares which Equitable had applied for on 12/01/2001.

22/02/2001 [entry 3] Having been passed the documents by FSA's supervisory officer for Halifax, Line Manager E distributes to colleagues at FSA and GAD the agreements which set out the basis on which Halifax would provide services to Equitable. The Line Manager writes:

> *I am not aware that any of these arrangements require formal approval under any of the regulatory regimes. However, we will wish to ensure that the contracts enable Equitable to maintain satisfactory arrangements, for example, for the protection of its policyholders, and to ensure that it continues to be able to comply with PIA conduct of business rules. We probably need, therefore, to focus on whether the contracts transfer to Halifax group any responsibilities that we consider should not be contracted out by an authorised insurance company. It will be important to ensure also that adequate arrangements will be maintained by Equitable to monitor performance against the contracts, and we will in due course need to discuss that with the Society.*

22/02/2001 [13:27] FSA meet the OFT to discuss Equitable's application of a market value adjuster on surrenders and transfers. According to Line Manager E's note of the meeting, FSA and the OFT continue to disagree on the underlying legal analysis of the application of the Unfair Terms in Consumer Contracts Regulations 1999 but did not pursue their differences; instead, they '*focussed on the substance of the issue, using the fact that we agree that a 10% adjustment is not unreasonable or unfair as a starting point*'.

FSA point out that, as Equitable were no longer writing new business, they could not improve the terms of contracts for the future. FSA also suggest that policyholders might be reluctant to consent to any changes to their current contracts. The OFT indicate that they would be satisfied if Equitable were to explain to policyholders the basis on which they would exercise their discretion and provide some examples. FSA say they would be happy to attempt to encourage Equitable to reply to the OFT along those lines. However, Line Manager E:

> *... also emphasised the need for us to be sure that whatever was done would not leave the Equitable exposed to unforeseen events; and that it would not cause problems for the industry ...*
>
> *I also warned against us trying to do too much at this stage, pointing to the fact that it is an industry wide issue about the operation of with-profits business, and that it is something that really needed to be looked at in the context of practice among all life offices. I told them about the with-profits review that we have announced and suggested that it was an issue that would very usefully be addressed in that context. Again they thought that would be helpful (and indicated that they had no appetite for carrying out an industry-wide review themselves).*

The following day, FSA's Head of Life Insurance comments that the meeting appeared to have produced a promising means of defusing the issue.

23/02/2001 [14:43] FSA's Legal Adviser A expresses some concerns about the agreements with Halifax. He notes:

> [That] *we are going to have to be satisfied with all the* [reinsurance agreements related to the Halifax bid] *that they are satisfactory with regard to the interests of the policyholders in Equitable, Halifax and* [Clerical Medical] *although I accept that not all the agreements are going to impact equally or at all on all the companies ...*
>
> [We] *need to be satisfied that there will be no variation in the rights of policyholders such that they should have been given an opportunity to make representations. Therefore it is necessary to bottom out exactly how the rights of policyholders will be changed if the reassurance goes ahead.*

Chief Counsel A notes to the Director of Insurance and the Director of GCD that some of these were significant issues '*to bottom out*' by 1 March 2001.

26/02/2001 [entry 1] Equitable write to FSA about the issue of whether they could continue to write certain new business. Equitable say that they would like to honour certain options to transfer to other policies, where they were not now writing such business, even though the policy option specified that they must still be writing such business.

26/02/2001 [entry 2] Halifax's advisers for the sale send FSA a copy of the '*Merged Agreement*' which replaces the '*Asset Management Agreement*' and the '*Administration Agreement*'.

26/02/2001 [entry 3] FSA write to Equitable about the sale to Halifax. FSA explain that PIA and IMRO had given urgent consideration to the applications in respect of the change of control of Equitable Investment Fund Managers Ltd. FSA say they understand that a letter confirming approval of the change of control was to be sent later that day.

FSA state that they needed to examine the detail of the transaction and consider whether to give approval to those areas that required it and whether to use their intervention powers. FSA say:

> *It remains the case that we do not have any objections in principle to the proposals. However, this is a complex transaction and we have not had sufficient time properly to review the papers that have been provided so far by the Halifax's legal advisers and the Equitable. Indeed even now we understand that we do not have a complete set of the final documents.*
>
> *In reviewing the papers that have been provided we have already identified some issues that we would need to pursue further. For example, in the proposed reassurance agreement under which the Equitable's unit linked and non-profit business is to be effectively transferred to Halifax Life, we have concerns about the position of relevant policyholders in the unlikely event of the insolvency of Equitable Life. We also wish to have a better understanding of the continuing powers of the Board of the Equitable to control aspects of the business for which they retain legal responsibility. Finally, we will wish to be satisfied that the arrangements are properly communicated and explained to the relevant policyholders. We have been looking at the reassurance agreement with ... the appointed actuary of Halifax Life, today who has been able to give us comfort on some of our concerns.*

FSA reiterate that they do not have any fundamental objections to the proposed transaction and say they did not wish to frustrate or delay completion of the deal. FSA say it would, therefore, be helpful for Equitable and Halifax to give an undertaking that they would address any reasonable concerns FSA might raise.

FSA write similarly to Halifax.

26/02/2001 [entry 4] FSA's Legal Adviser A writes to Line Manager E about the interpretation of Regulation 72. The Legal Adviser notes that benefits under personal pensions policies could be taken at any time from the age of 50. Legal Adviser A sets out GAD's view, quoting them as saying:

> *We take the view that Regulation 72(3) overrides Regulation 72(1) and requires the actuary to set up a liability to cover the cash payment that would result from an exercising of the vesting of the option, at any time that the option may be exercised.*

and Equitable's view, being that:

I am not sure why you feel that Regulation 72(3) requires that one should assume that all policy holders will take retirement benefits at age 50. The regulation states that one should ensure that the value will provide for payment if the option were exercised assuming the valuation assumptions were fulfilled in practice.

Legal Adviser A says that his preference is for Equitable's interpretation. He reproduces the Regulation and advises:

Regulation 72(3), of course, deals with the provision that must be maintained in respect of options under the contract. It must be such as to ensure that if the assumptions adopted for the valuation of the contract are fulfilled in practice then the provision is not less than the amount required to provide for the payment which would have to be made if the option were exercised.

The fundamental question is whether the "assumptions" in regulation 72(3) can include assumptions as to the age at which benefits are taken. I cannot see anything in the wording or structure of the regulation that leads me to the view that the (prudent) assumptions that are to be made do not include assumptions as to the age at which benefits are taken.

Additionally, I am struck by the contrast between regulations 72(2) and 72(3). Regulation 72(2) requires a provision to be made on the basis that the option will be exercised with no scope for assumptions as to whether or not the option will be exercised. I would have thought similar drafting could have been employed if the intention was to give a similar effect to regulation 72(3).

Thirdly, as a matter of practicalities, there seems no good reason for the regulation to <u>demand</u> a scenario (everyone retiring at 50) that is highly unlikely to be fulfilled in practice. Obviously, if the particular circumstances of a company made that more likely then the actuary would have to take this into account in deciding what assumption was prudent.

Legal Adviser A says that he has circulated the note fairly widely given the importance of the matter and that he understands that the amounts involved could be around £200m, depending on the assumption taken.

26/02/2001 [entry 5] The Financial Ombudsman Service's Chief Ombudsman writes to FSA '*because of my concern about how* [the Financial Ombudsman Service] *and FSA can handle complaints arising from Equitable Life's closure to new business*'. The Chief Ombudsman says that there had been a significant number of complaints arising from Equitable's use of a differential bonus policy for GAR policies. He informs FSA that: '*Unsurprisingly, following the announcement in December that Equitable Life was closing to new business, we have received a significant number of new contacts from policyholders concerned that they had not been properly advised and were not informed of the potential impact on the company of an adverse House of Lords' decision*'.

The Chief Ombudsman says: '*the level of co-operation required to ensure that Equitable Life's policyholders who have complaints, whether raised solely with the company or in due course referred to* [the Personal Investment Authority Ombudsman]*, are treated fairly and have their complaints resolved appropriately seems to be singularly absent*'.

26/02/2001 [15:23] FSA's Press Office inform the Director of Insurance and the Head of Life Insurance that a national newspaper had obtained Equitable Board papers and was going to use them for a number of negative stories about the Board and management. The Press Office say that some of those papers indicate that Equitable's management had not been keen for FSA to see certain information.

27/02/2001 [10:40]	FSA's Director of GCD suggests to Managing Director A that: '*If* [Equitable's Chief Executive] *is to have any continuing role, I think we should now revisit the evidence we have about inadequacy of disclosure to the regulator*'. [**14:08**] The Managing Director says that he does not think the Chief Executive's future role was subject to FSA's approval. The Managing Director says that this suggests to him that FSA should await all relevant material, including the actuarial profession's report on Equitable (the Corley Report), before deciding whether to launch an investigation. He says that he was '*not keen to spend very scarce resources now unless we have to (because* [the individual's] *new position is indeed authorisable)*'.
27/02/2001 [entry 2]	FSA's Managing Director A notifies the Director of Insurance that, in a telephone call that day, Equitable's Chief Executive had confirmed that he was going to run the Administration company. The Chief Executive had also asked what FSA's reaction would be to Equitable's Appointed Actuary taking on the dual role of Appointed Actuary and Chief Executive, to which he had said that FSA would not favour this. The note reports that they '*talked very briefly about the future, with me reminding* [Equitable's Chief Executive] *of the importance of keeping a very close eye on the solvency position*'.
27/02/2001 [entry 3]	Equitable reply to FSA's letter of 26/02/2001 about the sale. Equitable say that they are happy to agree that they '*will take steps to address any reasonable concerns that the FSA might raise*' regarding the sale including, if necessary, amendment to the terms of the agreements.
27/02/2001 [11:10]	FSA's Director of GCD suggests to the Director of Insurance that it would be wise for FSA '*to stand back a little from the view that the only way of achieving an accommodation among the Equitable's policyholders is by means of a court process following majority policyholders votes*'. The Director of GCD says that, while it would bind policyholders, it was '*a high risk strategy, where dissentient policyholders can cause difficulties*'. The Director of GCD suggests that FSA should explore the possibility of a '*pro tanto*' accommodation. [**13:57**] Managing Director A agrees that FSA should rule nothing out but understood that a '*pro tanto*' approach would be '*suboptimal*' because: *a) ... it leaves more uncertainty (in respect of the policies that don't accommodate, reducing the possibility of reducing reserves)* *b) it involves adverse selection in that those who don't agree stand to benefit from those who do (because in* [the Director of Insurance's] *immortal words the piranha have more goldfish to eat). It therefore encourages people to vote against accommodation and subsequently those who don't accommodate are more likely to put more money in compounding the problem.* *A third issue is whether the Halifax deal is all or nothing – if as I suspect it is, that is a 3rd reason why pro tanto is clearly sub-optimal (albeit no doubt better than nothing at all).* [**16:20**] The Director of GCD responds to the Managing Director's arguments, and says that '*it is precisely this mutuality* [of the scheme proposed] *that makes what the Equitable has discussed so far high risk. It means that each policyholder is invited to give up his rights in the interests of policyholders as a whole rather than his own interests. So it encourages the designers of the scheme to believe they need not make the offer to each policyholder reflect a fair offer* [for] *that policyholder's own rights*'.
27/02/2001 [17:47]	Equitable send FSA a draft letter that they proposed to send to the OFT. Equitable ask FSA for any comments. In the letter, Equitable say:

> *I was obviously disturbed by your belief that a term reserving to the Society discretion in setting surrender values is unfair within the meaning of the Regulations because of the breach of the reserved discretion; and by your belief that a number of other policy terms are insufficiently clear as to be transparent and intelligible to policyholders.*
>
> *The Society's rules and policy terms in respect of its with profits business are at least as clear as most used elsewhere in the industry, and the provision reserving discretion on surrender values is, I believe, virtually standard.*

FSA speak to Equitable and they: '*Suggested they might offer an olive branch up front. And also noted the final paragraph on publicity was out of date following the leak*'.

28/02/2001 [entry 1] Halifax write to FSA about the sale. They make a similar statement in reply to FSA's letter of 26/02/2001 to that made by Equitable: they would consider and address any issues that FSA might raise in regard to the sale.

On '*Other Regulatory Issues*', Halifax say that, in conjunction with the Equitable management, they would do their best to ensure that the various issues with PIA's enforcement team were satisfactorily resolved. Halifax say that they have commissioned an independent compliance risk assessment and would share the results with FSA.

Halifax give their thanks to FSA '*for the exceptional and very flexible manner in which you and your colleagues have responded to our various requests over recent weeks*'.

FSA reply the same day saying that, on the basis of their letter and a similar undertaking by Equitable, FSA had no objection to the sale being completed as planned.

FSA write similarly to Equitable.

28/02/2001 [10:43] FSA receive a copy of a letter from Equitable to PIA dated 27 February 2001, in response to a letter from PIA dated 15 February 2001. Equitable give their formal undertaking that they would implement a programme of remedial action in relation to income drawdown mis-selling. They say that the programme would include provisions for fair and reasonable compensation in appropriate cases. The basis and criteria for such compensation were to be agreed with PIA. Equitable explain that, under the planned transfer of administrative functions to Halifax, the review might be carried out by Halifax staff. However, responsibility for the review would remain with Equitable as the regulated entity.

28/02/2001 [entry 3] FSA's Line Manager E asks Line Supervisor C to consider Equitable's letter of 26/02/2001 about new business and to consult with their legal department and GAD. He says that he has '*no objection in principle to allowing this provided they ensure policyholders are clear about any implications of exercising the options*'.

Line Supervisor C sends Legal Adviser A and GAD a copy of Equitable's letter of 26/02/2001 about continuing to write new business in limited circumstances. He notes that Equitable remain authorised to write new business but had given FSA a formal undertaking to '*stop writing new risks*'. The Line Supervisor says that FSA had generally adopted a sympathetic approach to the small number of cases where policyholders had wanted to switch to a different product. The Line Supervisor asks Legal Adviser A and GAD for their views about this case.

28/02/2001 [entry 4] GAD prepare a review of the administration and asset management agreement between Equitable and Clerical Medical.

March 2001

01/03/2001 [entry 1]	Equitable's administrative and asset functions are transferred to Halifax.

01/03/2001 [entry 2] FSA's Director of GCD forwards FSA's note of the meeting with Equitable on 20/02/2001 [**14:00**] to Managing Director A and comments in manuscript as follows:

> *1. In case you were not aware of this note, which I have only seen today.*
>
> *2. I do not know the context of the discussions on s68 orders, but we will need a very clear record of the basis for making such orders in the current circumstances.*
>
> *3. The sidelined passages seem to me to reflect a dangerous degree of robustness about OFT and about the need to sell a compromise to all policyholders, to persuade the court it is right to bind dissentients.*

The sidelined passages referred to by the Director of GCD are:

> *On the OFT investigation* [Equitable's Appointed Actuary] *had rejected the OFT's arguments about the need to identify the circumstances under which the MVA would be used and how it would be applied. He thought that Equitable's contracts contained clauses that were "industry standard" and were necessary for any actuary operating a WP fund. He thought that the OFT had raised generic industry issues that the industry (not just the Equitable) had to respond to. Furthermore it would not be realistic to consider amending existing contracts and since the Company was no longer writing new business, there were no new contracts to amend.*'; and:
>
> [The Appointed Actuary] *said that the test for a s425 scheme would be different from that of a Schedule 2C because in a 2C the* [Independent Actuary] *needs to argue that no policyholder would lose out. By definition, this test was not relevant in a compromise.*

01/03/2001 [08:56] FSA's Managing Director A informs the Director of Insurance (copied to others) that the FTSE 100 Index had fallen that morning and now stands at 5.5% below the end-2000 level. The Managing Director notes, '*on the positive side*', that the Halifax money would arrive that day, which would boost Equitable's solvency position. The Managing Director says that he thinks that FSA should '*increase contact*' with Equitable and review their position on two key issues:

> *a) the MVA. We've always understood that the MVA would have to be increased in the face of a sharp fall in equity prices. Do we know how near we are to that? Shouldn't we?*
>
> *b) solvency. Obviously it's helpful (from the solvency point of view) for 2000 bonuses to be "final" only but just how confident are we that* [we] *can identify pretty promptly the point at which* [Equitable] *would fall below our solvency standards?*

[**10:24**] The Head of Life Insurance replies, saying that he had spoken to Equitable that morning. The Head of Life Insurance reports that the Society's Appointed Actuary: '*is acutely aware that the solvency margin is thinly covered. The Halifax £500m. removes immediate concern, but he would regard a fall in FTSE100 below 5,900 as a trigger for review of the MVA. If it were to be increased (and he recognised the political sensitivity of that) his actuarial gut feel would suggest a rise to 20%, but realism would suggest 15% (any smaller increase would incur more PR downside than the financial benefit would justify). But at present, he can justify no increase to the MVA because he can use the cash from the December/January asset sales to pay surrenders; if he had to sell more assets, the case for an increased MVA would be very strong*'.

[**10:27**] Managing Director A thanks the Head of Life Insurance for the quick action, commenting that '[the Appointed Actuary's] *reaction shows how little room there is*' and '[regarding] *the "fall below 5,900" in the FTSE I would just point out that, as I write this, the figure is 5882!!!*'.

[**11:24**] The Director of GCD replies, saying:

> *1. You need to know that there is some £200m of solvency dependent on a view of the interpretation of regulation 72 of the Insurance Companies Regulations.*
>
> *2. ... GAD's view was that provisions for options need to be made on* [the] *basis that all will be exercised at 50. Our legal analysis (though this is not beyond doubt) is that the regulation allows provisions to be made on the basis of assumptions about when people will exercise.*
>
> *3. Given the importance of the issue, we will need some more due diligence before offering a final view, for example, about generally accepted actuarial practice, and views taken previously. But in any event you should know that this sum is dependent on which provisioning route is used.*

[**11:58**] The Head of Life Insurance adds that GAD now accepted FSA's provisional interpretation and that Equitable had not yet taken credit for this interpretation in their solvency calculation.

01/03/2001 [11:25] FSA's Director of GCD responds to Legal Adviser A's advice on Regulation 72 (see 27/02/2001 [**14:32**]), saying he agreed that the interpretation of the Regulation was not free from doubt. Given the significance of the matter, the Director says that he wants to check past advice, check professional guidance, establish what other companies do, ask GAD for analysis, and seek confirmation from Counsel.

[**17:26**] Chief Counsel B writes to the Director to explain why he believed Regulation 72(3) would have the effect of requiring policies to be valued on the basis that policyholders would exercise the option to retire at 50 where this was provided for in the contract.

01/03/2001 [12:34] GAD send FSA and PIA their review of the Merged Agreement between Equitable and Clerical Medical (sent to FSA on 26/02/2001).

GAD note that they have '*only identified one issue where we recommend clarification to be obtained from the company – this relates to the provision of "Fixed Price Services"*'. (Note: these were described in the agreement as '*ongoing support and company care in respect of customers*'. The issues which GAD suggest should be raised in relation to these were the exact nature of the services to be provided, and whether the charges for these services (which are specified in the agreement) were reasonable).

After describing the detailed arrangements, GAD welcome the inclusion of a provision that:

> *On termination of the administration agreement (for whatever reason), Clerical Medical shall return to Equitable all "Retained Business data" and all books, records, registers, computer data, documentation and information held by it in relation to the provision of the administrative services, together with copies of all such information held in hard copy ... to the extent to which such data, books, records, registers, computer data, data, documentation and information are not required for it to discharge its obligations under the asset management agreement.*

01/03/2001 [15:26] FSA's Legal Adviser A advises Line Manager E on Regulation 72, following a discussion on the issue the previous day. The Legal Adviser says that he was not aware that any legal advice had been given on this issue prior to it arising in relation to Equitable but, having had a chance to look into the background of the Insurance Companies (Amendment) Regulations 2000 which had introduced Regulations 72(3) to 72(5) into ICR 1994, he was now able to provide such advice.

Legal Adviser A explains the aim of the Regulation as being '*designed to ensure consistency of reserving for unitised with profit policies where there was an option to surrender*'.

After giving a hypothetical example of how a market value adjuster might operate in practice, the Legal Adviser continues by listing three points that arose in the particular context under consideration. These being:

> *First, if the Amendment Regulation 2000 had not been passed, then there would not be any question of reserving having to be made on the basis of retirement at 50. The Consultation Document (so far as is relevant) talked of the general need to establish a sound and consistent standard which is not currently achieved to a consistent degree by the existing regulations. It did not foreshadow any considerable change.*
>
> *Secondly, it was pointed out by* [an official] *who drafted the regulations that the reference to assumptions in 72(3) opened up a gap between regulation 72(2) and 72(3). This was accepted.*
>
> *Thirdly, and more pertinently, I quote from* [GAD's Chief Actuary D] *"There must be a reference to the assumptions adopted for the valuation, else it makes no actuarial sense. Otherwise it would not be acceptable to assume some people die before they get to the option date, for example." If (in the context for which the regulations were designed) it is permissible to make mortality assumptions with respect to the amount of people who can take up the surrender options, I do not see why the regulations should not be interpreted as permitting assumptions as to the date at which people will take retirement.*

Legal Adviser A concludes by stating that he: '*cannot find anything which leads me to assume that the intended interpretation was contrary to that I have suggested*' and that the professional guidance notes: '*do not directly deal with the issue. In so far as they are largely concerned with prudency of assumptions in relation to regulation 72 they, if anything more favour the "Equitable interpretation". I note, at least the Equitable has purported (in part) to rely on them*'.

01/03/2001 [16:14] FSA's Head of Life Insurance writes to the Head of Press Office, referring to Equitable's announcement of the Society's Appointed Actuary as the new Chief Executive. The Head of Life Insurance notes that this was subject to regulatory approval which had not yet been given. He says that FSA had established that Equitable would now seek a new Appointed Actuary to replace him as '*we shared* [the Appointed Actuary's] *view that it would be better not to combine the two roles*'.

02/03/2001 [12:10] FSA's Director of GCD responds to Chief Counsel B (see 01/03/2001 [**17:26**]) with his understanding of the operation of Regulation 72.

05/03/2001 [entry 1] On FSA's files, a copy is held of information dated 5 March 2001 produced by Equitable for their policyholders. The purpose of the information sheet was to give more information about both the deal with Halifax and the possibility of a GAR compromise scheme. The sheet says that:

> *When considering the deal, the Board had many factors to take into account. They received advice from the Society's bankers, lawyers, accountants and actuarial advisers and from the Society's actuaries and others.*

An important benchmark against which to judge a deal is the option of closing the fund and continuing as an independent entity. This is not a simple comparison as the business risks for the closed fund would have been particularly acute. Likely ranges of values were considered for the components of the business. The advantage and disadvantages of the closed fund route in comparison to the Halifax deal were compared for each component.

The results of the analysis were annexed to the sheet. In relation to a possible compromise, the sheet explained:

The consultation document is intended to show how the current value of the GAR liabilities are estimated and to consider the issues which arise regarding how the cost of a GAR compromise scheme could be distributed to the GAR members. Both GAR and non GAR members will need to agree [to] *the scheme for it to be adopted. At this stage there is no specific proposal. The Society is collecting feedback from a wide range of clients and other interested parties. The results of this consultation will be used to inform the design of a proposal which will then be the subject of further consultation.*

05/03/2001 [11:00] FSA hold an Equitable Life Lawyers Group meeting. The Group discuss aspects of the sale process, noting that the transfer to Halifax would be done by reinsurance rather than through a Schedule 2C transfer. It is agreed that the Head of Life Insurance and Line Manager E should be contacted to ensure that they had discussed such reassurance arrangements with Halifax's supervisors.

Chief Counsel A and the Director of GCD note that there were a number of points arising from the Treasury Select Committee hearing and that the Director would prepare a note on whether the Companies Act 1985 required disclosure of contingent liabilities.

The Group discuss the appointment of Equitable's new Managing Director and the fact that FSA had not received notification of this. The Group note that, according to reports in the press, the previous Chief Executive was to head up a services company at Halifax. The Director of GCD says that he would take up with the Director of Insurance the issue of whether FSA should make a complaint concerning the previous Appointed Actuary to the Institute of Actuaries.

The Group consider a revised list of legal issues. On market value adjusters, the minutes of the meeting state that:

... the decline in the FTSE may result in the raising of MVAs. [The Director of GCD] *stated it was important that the Equitable made a public statement setting out the criteria for exercising the MVA. Such a statement would constitute a contractual term.* [Legal Adviser A] *is to pursue this with* [FSA] *to encourage Equitable* [to] *take action.*

With respect to the compromise scheme, it is said that:

... winding-up could be dropped from the list of legal issues and that counterfactuals, compromise and follow up work on accommodation, could be amalgamated as one issue.

It was noted that policyholder approval was still required on the compromise and as such counterfactuals were still required. [The Director of GCD] *noted that the compromise would inevitably be detrimental to a minority of policyholders.* [Chief Counsel A] *advised the group that better argument/explanation was still awaited from the Equitable on this issue.*

Finally, it was noted that:

[FSA's Insolvency Practitioner] *was still in the process of preparing his note on insolvency. The group agreed that he should be invited to the next meeting of the group so that he could provide a review of his findings.*

05/03/2001 [11:12] GAD's Directing Actuary B responds to Legal Adviser A's advice on Regulation 72 (see 27/02/2001 [**14:32**]), saying he feels that the arguments were '*a little tenuous*'.

The Directing Actuary explains that his reasoning for this was that such an interpretation would involve the regulators saying:

> *... that the date on which the option is exercised (ie age retirement) is one of the relevant assumptions. This makes the whole regulation rather circular, and I am not sure that the difference in wording between paragraphs (2) and (3) is really that great.*

The Directing Actuary continues:

> *We also then need to be satisfied that our guidance on reserving for guaranteed annuity options is consistent with this interpretation, and that the regulation still achieves the intended outcome on reserving for accumulated with-profits business.*

[**17:44**] The Director of GCD asks Legal Adviser A to ensure that the Directing Actuary's points were brought out in instructions to Counsel.

05/03/2001 [14:54] GAD advise FSA that Equitable's proposals about new business (see 26/02/2001 [**entry 1**] and 28/02/2001 [**entry 3**]) were not unreasonable and note that they had in fact been reserving for this option.

05/03/2001 [18:31] FSA's Director of GCD writes to Chief Counsel A, following a meeting held that afternoon with Managing Director A. This had been called to consider, among other issues, whether FSA should ask for the Equitable Board papers referred to in an article that had appeared in a national newspaper. The Director says that he had indicated that FSA's powers were very wide and allowed them to call for the relevant Equitable Board papers. The Director of GCD says: '*Before doing so, however, colleagues would like to be clear as to the exact use which we would make of them. I have been asked to commission work from you or* [Legal Adviser A] *on the regulatory functions for which we might use such information*'.

The Director of GCD notes that FSA were to meet Equitable's new Chairman the following day and that the agenda would include: '*its financial situation; the need to ensure that the proposed compromise works for all policyholders, if we are to avoid finding that we are unable to recommend the court to buy out on a compulsory basis those who do not accept; the OFT concern about the ability to impose an MVA, which needs to be resolved by a public statement as to the criteria on which MVAs would be set, certainly before any increase in the MVA is contemplated*'.

The Director of GCD says that he had also mentioned in the meeting that afternoon that he thought that FSA might want to complain to the Institute of Actuaries about Equitable's former Appointed Actuary and that the Director of Insurance had said that there had been '*some movement on this front*'.

06/03/2001 [entry 1] FSA and GAD meet Equitable, at the request of FSA, to get an update on some '*key issues*' facing the Society. FSA's note of the meeting records the issues discussed under the following headings:

<u>Solvency</u>
Equitable's new Chief Executive reports that the £500m from the Halifax sale had given a boost to solvency greater than its value '*because the Society was now invested heavier in gilts and the £500m gave a disproportionate benefit when the effect of this worked through the resilience testing*'. Equitable disclose that the money was at that time still invested in cash but that they intended to invest 61% of the £500m in equities. FSA's note records:

For the year end financial position as demonstrated in the statutory return (due 30 June 2001) solvency cover was likely to be tight with only £300m free assets after [required minimum margin] *coverage. In making this assessment the Society was taking into account the benefit from the "artificial bond" concession that had yet to be formally applied for or given (which itself would be worth c£300m). It was also taking into account the debt from the sale of the Permanent* [Insurance] *to Liverpool Victoria which was not completed until 2001 ...*

As at the end of January (before the £500m injection) the Society believed that it had c£700m of free assets after coverage of the [required minimum margin]*. Solvency was boosted by the sale of £1.8bn of equities and the reduction in the resilience test. It was thought that current solvency cover was of a similar magnitude despite the £500m injection, this was because the FTSE at c5900 was a lot lower than it was at the end of January.* [Equitable's Chief Executive] *disclosed that prior to the end of February with weak equity markets solvency cover was thin.*

The Regulation 72 issue is discussed and Equitable say that they were taking account of the higher reserving standard suggested by GAD, which had a reserving impact of approximately £200m. FSA note that they had not yet decided on the correct approach and say that they would write to Equitable, confirming their position as soon as possible.

Equitable's Chief Executive agrees to provide GAD with information on the sensitivities of their financial position, and:

It was confirmed that the main monitoring triggers were the FTSE and long term interest rates, although knee jerk reacting to these triggers could be damaging and policyholders interests would not benefit if equities were sold at the bottom of the market. It was thought that the Society should now be able to withstand a market slump down to FTSE 5000 before solvency margin cover was jeopardised.

Equitable's equity backing ratio is discussed and they state that, prior to closure, the ratio had been 72%, reducing to 68% at the end of 2000 and to 61% currently. Equitable confirm that, in their ratio, equities included investments in property. The Chief Executive says that he was keen to keep the ratio at 61% until the result of the compromise was known, arguing that this was in the interests of policyholders. Furthermore:

He also felt that even in the unlikely event of technical statutory solvency not being maintained he would still not wish, in the interim, to indulge in a fire sale of equities. [The Head of Life Insurance] *said that both FSA and the Society have continued to state that the Society is solvent whatever definition of solvency is used. There would be a major confidence issue if this statement needed to be qualified.*

Equitable's Chief Executive says that the Society's auditors wished to include a paragraph in the Companies Act report and accounts referring to '*fundamental uncertainty post the House of Lords judgement*' and that the Appointed Actuary's certificate would also need to cover the issue of GAR uncertainty.

<u>Policyholder Compromise</u>
Equitable explain that the purpose of the roadshows was to gain an understanding of policyholder concerns, to lay the ground for the compromise scheme, and to '[take] *the sting out of the annual general meeting*'. FSA note that:

... the Society needed to convince policyholders as to why it needed a scheme. Issues to be addressed also included what the transfer of value should be from non-GAR to GAR ... whether transfer could be done using an age related (or other scale) and what the cut off date for this should be. [Equitable's Chief Executive] *thought that logically it should apply prior to the House of Lords ruling.*

Equitable say that their solicitors were currently working on the structure of policyholder classes for the scheme. FSA stress that they would need to be closely involved in this work, and would want to see the proposals, together with the underpinning information.

Market value adjuster
FSA record: '*It was confirmed that the rationale for the size of the MVA was not to make either surrender losses or profits. The size was determined by the level of the FTSE, the extent to which up front charges/expenses were spread over the duration of the policy and the need to maintain solvency and investment freedom. It was confirmed that for the MVA to be currently neutral it would need to be pegged nearer to 15% as the Society was making surrender losses with the FTSE being so low. However, because the level of surrenders were now modest there was no imperative to increase the MVA which would be very damaging in PR terms*'.

The Chief Executive undertakes to give FSA '*forewarning of any proposed change to the level of the MVA*'.

The OFT
FSA inform Equitable of their understanding of the OFT's thinking on Equitable's application of the market value adjuster. This was that the contract term gave too much discretion to the company and this was unfair. However, they had accepted that, in practice, the term had not operated unfairly. Equitable's Chief Executive argues that Equitable's With Profit Guides had set out the basis for the market value adjuster and says that he thought the OFT had looked at the terms of the contract in isolation. Equitable say that they had written to the OFT on 28 February 2001, offering to make the position clearer in their annual statements. FSA note that: '*The Equitable was now awaiting a response from the OFT but* [the Chief Executive] *argued that if the OFT continued to argue that the contract was "unfair" he would need to get both the regulator and the* [Association of British Insurers] *involved because the issues raised were generic and did not just apply to the Equitable*'.

Bonuses
Equitable confirm that, as had been reported in the press, no guaranteed bonus would be allocated for 2000, except for policies that included a guaranteed interest rate but that a non-guaranteed terminal bonus would be allocated. Equitable say that the 2000 bonus would be reviewed after the result of the compromise vote, '*when guaranteed bonus might be reinstated*'. FSA record that: '*An 8% rate of bonus would be the implied rate used for 2000 (although most policyholders would only get 5 months of this 1 Aug – 31 December = 3.3%). This was much better than the market because of the smoothing reserve. The previous year the Society had declared 4% less than what it had earned*'.

Board Papers
Equitable disclose that a full set of Board papers had gone missing and that it appeared that a courier might have been responsible. Equitable say that, having threatened legal action, the newspaper had returned the papers, after they had used them, and stated that they had destroyed all copies. FSA note: '[The Chief Executive] *was relieved that the broadsheets had not obtained copies of the papers as they could have caused a lot more damage. The statements referred to in the article referring to risk control statements were according to* [the Chief Executive] *fairly innocuous and were connected to the standard type of issues for Boards of Directors to address under Turnbull.* [FSA's Head of Life Insurance] *reserved the right to ask for copies of these papers*'.

Action Points
Under '*Action Points*', it was noted that Equitable were to: provide GAD with information on solvency sensitivities; send FSA their January 2001 solvency statement; apply for a section 68 Order to permit the use of an artificial bond; and liaise with their auditors and FSA on the

valuation at the year end of Permanent Insurance. The action point recorded for FSA is that they would confirm their position on the Regulation 72 issue.

It is agreed that FSA and Equitable would meet weekly or fortnightly to keep each other informed on developments.

06/03/2001 [entry 2] FSA meet Equitable's new Chairman, at FSA's request, to discuss the outstanding issues facing Equitable and the way forward. FSA's note of the meeting records the issues discussed under the following headings:

New Board
Progress on putting together a new Board is discussed and the Society's Chairman reports that a promising start had been made.

Compromise Proposal
The Chairman sets out what he believes are the stages for a compromise. These stages were:

> *... first, the company itself must be satisfied that any proposal was both clear and understandable to policyholders; the advantages and disadvantages would have to be set out clearly, and any recommendation would have to be made separately. The next three stages would require the Independent Actuary, the regulator and finally the Court to be satisfied that the proposals were fair.*

He says that the annual general meeting on 23 May 2001 would be too soon to announce the scheme and his plan was to report briefly on the events of 2000 and to set out in general terms Equitable's current position, including the need for an accommodation between GAR and non-GAR policyholders.

Market value adjuster
FSA record that there was '*agreement on the public relations importance*' of the level of the market value adjuster. FSA say that they would want to be consulted on any proposal to change the level from 10%. FSA also explain '*the importance of the OFT investigation into the MVA; we believed that a satisfactory outcome was achievable, if the Equitable were prepared to indicate in some suitably public way the criteria which they used in exercising their discretion to apply and adjust the MVA*'.

House of Lords' judgment
The Society's Chairman informs FSA that, as a result of '*pressure from a policyholder action group*', they had sought Counsel's opinion on whether the House of Lords' judgment might be challenged. The Chairman says that:

> *It would then be a difficult judgment for the society as to whether or not to spend more money pursuing such a challenge. The financial consequences both for the society and individual policyholders were so great that it would be difficult not to pursue even a small chance.* [Equitable's Chairman] *believed that the House of Lords would be willing to look at the issue "quite quickly". But he would probably want a second legal opinion before making a decision.*

The Chairman notes that in, any further case, both GAR and non-GAR policyholders would have to be separately represented.

Mis-selling
FSA's note records:

> [The Chairman] *said that he saw three primary sources of claims: from mis-selling, against the auditors, and against the previous board. He was inclined to take the view that if there was a prima facie case for a claim, the Equitable would not wish to stand in the way of the claimant pursuing redress.* [FSA's Director of Insurance] *urged caution*

about being too ready to offer redress which might set difficult precedents; the costs would in general have to be met by other policyholders, and there is a need to balance out the interests of all policyholders. The FSA was undertaking some internal work on the principles which might properly be applied to assessing claims for redress, and we were also in discussion with the Financial Services Ombudsman. It would be regrettable if this work was pre-empted by early isolated cases of compensation.

Public Relations
FSA suggest that the Chairman opens a dialogue with The Consumers' Association and that he should brief the FSA Consumer Panel. Equitable's Chairman says that he would be '*very happy to do this*'.

06/03/2001 [09:24] Equitable provide FSA with updated information from 1 March 2001 on the value of payments made on surrenders, transfers and switches and calls to Equitable's helpline.

[**10:54**] Line Manager E circulates a summary of this information, which he has prepared.

06/03/2001 [10:59] FSA's Director of GCD replies to Legal Adviser A's note on Regulation 72 of 01/03/2001 [**15:16**]. The Director of GCD says: '*This fortifies me in the view we should take advice from* [Counsel]. *Also makes me* [uncomfortable] *with use of MVA in reserving – I had seen it as a step to be taken if assets were inadequate, rather than a means to allow reserving requirements* [to] *be reduced to match available assets!*'.

[**11:13**] GAD's Directing Actuary B says: '*There is, I agree, some circularity in that the actuary of the insurer has to determine the appropriate MVA to assume for reserving purposes, taking account of the available assets, but having regard of course to policyholder reasonable expectations. The relevant assumed MVA does though have to be published in the FSA returns*'.

06/03/2001 [12:03] FSA's Legal Adviser A advises the Director of GCD that there were two areas in which FSA might use the information contained in the Equitable Board papers which they were considering requesting. The Legal Adviser says:

First, it might give rise to the exercise of powers under section 45 to require the Society to take action for the purposes of ensuring that the criteria of sound and prudent management are fulfilled. The information might, for example, reveal lack of fitness and properness on the part of the directors or deficiencies in systems of control or records. It is difficult to be more specific but sight of the board papers might give a greater insight into the internal workings of the company which has the potential to reveal a failure to fulfil any of the criteria of sound and prudent management as set out in Schedule 2A which [it] *might be necessary to redress by the use of section 45.*

The second area, which is perhaps more likely given the tone of the article, relates to possible future regulatory action in respect of individuals. It may be the case that information obtained shows a lack of fitness and properness on the part of persons who may be notified to us as notifiable persons in respect of another company at some time in the future.

07/03/2001 [entry 1] Halifax write to FSA's Line Manager E, as lead supervisor, to notify them, as required under PIA and IMRO rules, of Notifiable and Clearance Events in relation to the change of control of Equitable Investment Fund Managers Limited.

07/03/2001 [13:34] The Director of GCD informs Legal Adviser A that Managing Director A was now doubtful about his first point (in his advice of 06/03/2001 [**12:03**]), given that all the Society's existing directors were resigning. The Director also says, on the second point, that he thought FSA would need to get HMT to exercise these powers, as the power to require individuals to produce information under section 44 (2)(a) of ICA 1982 had not been delegated to FSA.

On 8 March 2001, Legal Adviser A says that he took the point on the first argument but adds that there could be systemic problems with Equitable's Board.

On 12 March 2001, the Director of GCD says that, if Legal Adviser A could put a convincing argument on systemic concerns, '*all to the good*'.

07/03/2001 [17:02] GAD prepare a review of the reinsurance agreement between Equitable and Halifax in respect of non-profit business (other than immediate annuities). GAD make several suggestions to FSA, including:

- '*The effect of the reassurance is that the profits from the business will emerge in Halifax Life. Indeed, Halifax Life are paying commission of £300m. to Equitable in respect of this Agreement. However, profits from the non-profits and unit linked business would formerly have been a source of miscellaneous surplus, which would have benefited the with profits policyholders in the form of an enhancement to the return credited to their smoothed asset shares. Now that these profits have been capitalised, this will no longer be so. <u>We suggest the company are asked what enhancements the with profits policyholders formerly enjoyed on this account, and whether the scale of the enhancements projected to be foregone in the future is similar.</u>*'
- that FSA should ask Equitable to clarify how they intended to meet any charges for future expenses as there appeared to be no margins left from which they could meet any such charges.
- that FSA should ask Equitable about the statement in the agreement that '*Halifax Life shall not be required to indemnify Equitable in respect of any guaranteed investment options in respect of Covered [i.e. reassured] Policies*'. GAD say that it was not clear what those options were, how significant they were, or how any costs would be met.
- that FSA should clarify with Equitable what impact the reassurance had on the reasonable expectations of unit-linked policyholders in relation to the deduction of charges.
- that FSA should ask Equitable for further information on the tax consequences of the reassurance on policyholders, as it appeared to be adverse.

08/03/2001 [entry 1] Equitable send FSA a summary of their estimated solvency position as at 31 January 2001. The position is set out as follows:

<u>Solvency position at 31 January 2001</u>

	£m	£m
Value of non-linked assets		*29,715*
Future Profits Implicit Item		*1,000*
		30,715
Mathematical Reserves		
– Basic (including GAR)	*27,145*	
– resilience	*1,640*	
		28,785
		1,930
Required Minimum Margin		*1,215*
Excess Assets		*715*

08/03/2001 [15:00]	FSA (including the supervision teams for Equitable and Halifax), IMRO, PIA and GAD meet with Clerical Medical and Halifax. The issues discussed include personnel, integration of Equitable and Halifax business, the performance of unit-linked funds and training for Equitable sales staff.
09/03/2001 [09:58]	An FSA official writes to Managing Director A's office, following the meeting with Halifax the previous day. The meeting was attended by Clerical Medical who had given a presentation on the key aspects of the transaction, integration issues and future corporate governance – and who answered questions. After setting out some staffing changes, the official writes that: '*Contrary to original expectations, it had been decided to close Equitable's international operations in Dublin, Dubai, Germany and Guernsey. The existing business will remain with the closed fund*'.
09/03/2001 [16:10]	An FSA legal adviser circulates revised minutes of the Equitable Life Lawyers Group's meeting of 05/03/2001, revised legal issues list, and the draft agenda for the next meeting.
09/03/2001 [16:47]	FSA's Director of GCD sends Legal Adviser A a note, dated 8 March 2001, concerning his draft instructions to Counsel on the issue of Regulation 72. In his note, the Director suggests that FSA should consider the position they wanted to take on this issue '*in the new world*' (i.e. under the regulatory regime which was to come into force with FSMA 2000). The Director suggests: '*Since no one has, I think, suggested that the more restrictive view is the right approach from a policy viewpoint, surely we should ensure that the less restrictive view is given clear effect in the new rules*'; adding that: '*This would also, it seems to me, help to make clear that this is not a case of convenient special treatment for a particular company*'. [**16:58**] Line Manager E thanks the Director of GCD for his comments and says: '*Our discussions have really been on two levels – what is the effect of the regulations, and what is the effect we are seeking to achieve in policy terms. I am now fairly clear, and that is consistent with my understanding of the position we reached when discussing the point with GAD, that the correct result is that the actuary should make reasonable assumptions about variables when valuing for the purposes of regulation 72(3)*'.
12/03/2001 [entry 1]	Halifax send FSA a copy of a report which they had commissioned, described as a '*high level Compliance Risk Assessment*' in relation to Equitable. (As promised at the meeting on 08/03/2001.) In relation to PIA activity, the report outlines the following conclusions: • *Significant recent regulatory activity – themed visits from PIA in key areas. May indicate the "risk" considered by the PIA to be posed by ELAS.* • *Compliance failures have been identified in most of the key areas of regulatory risk. In particular, failures in* [pension fund withdrawal] *and* [free-standing AVC] *sales process and subsequent tone of response to PIA's report, may indicate material lack of understanding of regulatory risks and standards.* • *The approach of "delegating" compliance to the business does not appear to have been successful in establishing robust systems and controls.* • *The regulatory relationship appears to have been flawed. Substantive discussion and disagreement followed most regulatory reports.* • *The failures identified, particularly in relation to the repeat breaches identified in* [PIA's visit conducted in June 2000] *may indicate that a strong compliance culture is not embedded throughout ELAS.*

- *A substantial amount of remedial work required to address past issues and significant forward planning to ensure compliance in the future.*

In relation to IMRO issues, it is noted that:

> *Conclusion which may be drawn from the documents covering the supervision of* [Equitable Unit Trust Managers Limited]*:*
>
> - *there is a concern that Senior Management appear to have failed to either recognise or acknowledge the seriousness of front office issues and risks faced as a regulated entity;*
> - *in the light of the history it appears that Senior Management have not developed the role of Compliance to address the issues and mitigates regulatory risk;*
> - *compliance initiatives from Senior Management appear weak;*
> - *at its worst, the front office attitude appears to be resistant to complying with existing procedures and to acknowledging the importance of regulatory compliance.*
>
> *Information from the "compliance" documents give the following perceptions*
>
> *Management appear:*
>
> - *to place over reliance on people doing what they are asked to do without placing sufficient checks on performance;*
> - *to assume that procedures will be followed and yet, when they are not, have underplayed the need for and benefit of checks and compliance monitoring; and*
> - *to have put insufficient preventative and detective controls in place over the fund managers/front office.*

In the conclusions on IMRO issues, it is noted that the information available was '*generally historic*' and that the report did not assess the impact of recent compliance initiatives – in particular, Equitable's new Central Compliance Department.

12/03/2001 [10:35] Equitable send FSA technical information about the terms and conditions applying to investment in the Clerical Medical fund available to existing Equitable group pension policies, where benefits are purchased on a money purchase basis. This information concludes:

> *In the normal course of events it will be possible for an individual member to switch investments between the Equitable's funds and between Equitable and Clerical Medical funds. There is no guarantee that a switch between Equitable and Clerical funds will be allowed in future.*
>
> *There is no guarantee whatsoever of the terms for switching between Equitable and Clerical Medical funds. The terms for these may change at any time or the availability to switch into Clerical Medical funds may be withdrawn at any time. The terms and availability of switching between Equitable funds at any time will not affect the terms or availability of switches between any Clerical Medical funds.*
>
> *There is currently no charge for switching between any Equitable or Clerical Medical funds but the Equitable reserves the right to apply an administration charge in the future.*

12/03/2001 [13:03]	Equitable send FSA a copy of a letter that is '*about to be issued*' to policyholders by Halifax Equitable. The letter concerns the transfer of personal information which Equitable held about policyholders. Amongst other matters, the letter informed policyholders that, while '*Halifax has not acquired existing Equitable Life with-profits policies* [it] *will be administering those policies for Equitable Life in accordance with its instructions*'. Line Manager E records that he had notified PIA that FSA had received the letter.
12/03/2001 [entry 4]	FSA reply to Equitable's letter of 08/03/2001, which included the report on their estimated solvency position at 31 January 2001. FSA point out that Equitable continued to rely on a future profits implicit item of £1bn. FSA ask, '*In view of the changed circumstances at the Equitable, and in particular its closure to new business last December and the subsequent Halifax transaction*', that Equitable should provide an actuarial certificate to confirm that the item was still sustainable prospectively from 31 December 2000. FSA continue: *It should also be supported by a note of the key assumptions, particularly on future investment returns, persistency rates and GAR take-up rates, that are made for the purposes of the certificate. The calculation should of course take into account the effect of any potential payments to be made under the reinsurance treaty.* (Note: it appears that the letter, although dated 12 March 2001, was actually sent on 13 March 2001 after FSA had sought comments on it from GAD.) GAD's Scrutinising Actuary F had noted that Equitable: *... should of course take account of the effect of any potential payments under the* [IRECO] *reinsurance treaty. The GAO take-up rate is itself another key assumption. (We need to be satisfied that there is no double counting as between the future profits implicit item and any obligations under the reinsurance treaty.)* The following day, Chief Actuary C comments that the letter '*should also make it clear that we expect the actuary to take account of the changes that have taken place after the end of 2000*'. The relevant GAD file contains an undated note by Scrutinising Actuary F that was not sent to FSA, as FSA had already issued the letter. The Scrutinising Actuary's note reads: *For the record, the Society's application of 27.06.2000 (for a future profits implicit item of £1.1bn.) showed estimated future profits of £3.3bn. on the retrospective approach (based on projecting past year's profits into future years). However, the Actuary only certified that the profits expected to emerge prospectively were no less than the £1.1bn. applied for (after taking into account the impact of the GAR treaty), so we do not know what margin there was in that calculation.* *It would be worth asking for the results of the prospective calculation, as well as the assumptions used, and what the impact of the existence of the GAR treaty is on the calculations.* *The Halifax deal is unlikely to have any more than a second order effect on the above – the £500m. injection per se does not alter the profit stream from the existing business, but persistency sounds as though it is now reverting to more normal levels, and the changes to the asset mix as between equities/gilts are having a beneficial effect on the valuation interest rates (which may feed through to the assumptions the Actuary makes when assessing the amount of future profits).*

12/03/2001 [16:36]	FSA inform GAD that GAD might be contacted by a trustee of FSA's pension scheme, which contained '*inherited*' elements provided by Equitable. FSA say that they were happy for GAD to talk with him, but that he '*should not be told anything that* [FSA] *would not normally tell a person in the same position elsewhere*'. FSA continue: '*We are only allowing him access to files that contain papers that are in the public domain*'.

[**16:37**] A trustee of the FSA Pension Plan approaches GAD. The trustee explains that FSA had inherited people paying into Equitable AVCs from various organisations – including the Civil Service, the Bank of England, the Securities and Investments Board '*and most of the* [self-regulatory organisations]'. The Trustee says that, while they have now combined those schemes, the trustees were having problems establishing what charges should be applied. The trustee's particular concern was a 2% administration charge that had been referred to in the Civil Service scheme booklet, but was not referred to in the annual returns for 1999, 1998 or 1997. The trustee asks GAD for comments.

13/03/2001 [09:56]	FSA's Head of Life Insurance records that Equitable's Chief Executive had notified FSA that Equitable were seriously considering raising the market value adjuster to 15%, following recent falls in the FTSE 100 Index. The Chief Executive had said that he was going to discuss the issue with the Society's Chairman and would revert to FSA before a decision was taken, although he added that Equitable might need to announce the increase that night. The Head of Life Insurance's note continues:

> [Equitable's Chief Executive] *recognises the PR implications. But the issue is not solvency, but fair value between leavers and stayers. In strictly financial terms,* [he] *is clear that an MVA of 15% is now justified. With surrenders at their current low level, it might be possible to justify not raising the MVA (and accept that the fund is subsidising the leavers). But this is a moot point, and will not be suitable if surrenders run higher, as policyholders seek to "select against" the fund by getting out with a fund value above their asset share. If a rise is announced, requests for surrender/transfer in the pipeline will be dealt with at 10%, with new requests attracting the higher rate.*

The Head of Life Insurance continues that:

> *... this must be a decision for the Equitable. If* [the Chief Executive] *rings back to say they want to raise the MVA, I propose to note that, but agree a public line which stresses that this is a question of fair value between policyholders, and not prompted by solvency considerations. We can expect press and consumer queries.*

[**10:30**] FSA meet to discuss the issue. FSA's note (prepared on 14 March 2001) records:

> *Action:*
>
> - [FSA's Head of Life Insurance] *to contact* [Equitable's Chief Executive/Chairman] *to relay FSA's perception of possible risks (as below) in increasing MVA [Done]. Equitable would need to undertake additional work to minimise expected negative media/policyholder reaction.*
> - *FSA to continue monitoring levels of withdrawals from fund and in addition, to establish the amount of withdrawal that represents over-valuation of individual policies (and consequently detriment to overall fund value) in current circumstances. [*[Action]*:* [The Head of Life Insurance]*.]*

The note then records the key supporting points, as follows:

> *1.* [FSA's Managing Director A] *requested additional information on analysis undertaken by Equitable before concluding that 15% was an appropriate level for the MVA. This was necessary to enable FSA to take a view on whether the company was exercising its*

discretion in a reasonable way. [Subsequently received note from Equitable setting out main factors that would trigger a closer review of the level.]

2. [FSA's Chairman] *noted that there had been no evidence to date of surrender rate increasing following falls in FTSE. The existence of such evidence would provide stronger grounds for increasing the MVA. Otherwise, risk remains that an increase in the MVA would itself precipitate a run on the fund.*

3. [The Director of Insurance] *noted that any increase in the MVA might damage prospect of reaching a compromise between GAR/non-GAR policyholders and equally may damage* [Equitable's Chairman's] *reputation at a critical point in the negotiations.*

4. In considering, Equitable's basis for increasing the MVA, [FSA's Chairman] *asked whether other companies were also considering increasing their MVA as a result of recent stock market movements.* [FSA] *believed that in principle, this would be the case but were not aware of any specific examples. Equally, any action taken by other companies was unlikely to be as transparent as action taken by Equitable* [as] *other companies did not publish detailed information re announced (but not guaranteed) terminal bonuses.*

5. Given the subjective nature of the decision regarding the appropriate level of the MVA, it seemed unlikely that FSA would be able to invoke any statutory powers if Equitable concluded that increasing the MVA was necessary to ensure fairness of treatment between different policyholders.

13/03/2001 [14:26] GAD respond to the trustee of the FSA Pension Plan. GAD agree that there was no obvious reference to the 2% administration charge in Equitable's returns. GAD ask the trustee whether the charge was annual or one-off and whether it was expressed as a proportion of contributions or of the fund. GAD point out that it might be the same thing as another upfront charge described in the trustee's letter (and earlier in their reply), reflecting the combination of an allocation rate and an initial charge, both of which were disclosed in the returns. GAD also suggest that it might be a charge which had been levied by the Principal Civil Service Pension Scheme but not remitted to Equitable. GAD say that if there were a charge that is not being disclosed in the returns, then Equitable's disclosure could be deficient, but that it was premature to conclude that yet. GAD suggest that, if the trustee and GAD were unable to resolve the issue with the information to hand, the trustee should approach Equitable for a response.

13/03/2001 [15:38] FSA's Director of GCD writes to Chief Counsel A about the meeting held that morning. According to the Director of GCD:

On a preliminary analysis, we had no reason to believe that the Equitable were not paying due regard to the interests of policyholders. As a result, it seemed unlikely that we would be able to intervene, one way or the other.

It was noted that the Equitable had not yet made a public statement as to how they would exercise their powers to impose MVAs. This would mean that any early decision would potentially not carry the OFT with it.

I indicated that we needed to consider not only the downside of an increase to the MVA, but also the risks of damage to policyholders from allowing withdrawals to be made at an overvalue, to the detriment of those who remained. It was reported that the level of withdrawals was currently around £1–2mn per day, and, even if the MVA was some 5% out, the reduction in value was not significant.

In contrast, it was also thought relevant to take into account the damaging effect which an FSA mandated increase in the MVA could have on the stability of the company, and the prospects for an accommodation. In any event, the company seemed more likely to increase the MVA than to keep it as now.

13/03/2001 [17:18] Equitable send FSA a copy of Equitable's note '*Application of financial adjuster by Equitable Life*' (see 19/12/2000 [**16:08**]), along with an update as at 13 March 2001. The update states:

Policy values have continued to grow although the interim rate of return from 1 August 2000 was reduced from 9% p.a. to 8% p.a. on 5 March 2001. Final bonus therefore fell on that date as did total policy values.

Volumes of individual surrenders have fallen from 5–7 times normal volumes to less than 2 times normal volumes.

Requests for Group Scheme bulk surrender terms have continued and a few schemes have gone.

[An actuarial consultancy] *have written to the President indicating that they feel the 10% financial adjustment is too low considering the current level of markets and they may feel that the best advice is to surrender in order to protect the current position of schemes. They feel that those who stay in the fund are not sufficiently protected.*

At 9 March 2001 the appropriate Type 1 and Type 2 theoretical adjusters would be:

Level of FTSE-100	*Type 1*	*Type 2*
6,300	*8.5*	*2.0*
6,100	*10.0*	*2.0*
5,900	*11.5*	*2.0*
5,800	*12.25*	*2.0*
5,700	*13.0*	*2.0*

On 13 March the FTSE-100 closed at 5720, a level at which a 10% adjuster is clearly unsustainable.

Levels of surrenders will be closely monitored as will the views of benefit consultants.

[**17:47**] The note and update are forwarded to senior FSA officials.

[**18:36**] Managing Director A asks whether there was any way that Equitable:

... can distinguish in their rules between different kinds of with-profits policy. This could have 2 possible uses:

a) a PR benefit, because it would help to get away from a "there has been a rise from 10% to 15%" or whatever (because actually there would be a variety of rates dependent upon eg length of time policy held). Comment this might not help greatly on the first rise but it could be [particularly] *useful if there had to be more.*

b) more questionably to load the increase into those policies (like the Group Policies) that were most likely to be pulled quickly.

The Managing Director concludes that '*a)*' obviously is possible – because they had a system like it before closing to new business – and asks whether FSA were aware of where the Society's Chairman stood.

[**19:05**] The Director of Insurance reports that FSA had not heard from Equitable's Chief Executive or Chairman and suggests that FSA could assume nothing was going to happen immediately. In response to the Managing Director's suggestion, the Director of Insurance says that Equitable had always dealt differently with group schemes than individual policyholders.

13/03/2001 [18:27] Equitable send FSA information on the calls to Equitable's helpline.

14/03/2001 [10:20] FSA's Head of Life Insurance informs the Director of Insurance of two other '*less urgent*' issues which arose from his conversation with Equitable on 13/03/2001:

1) On the compromise scheme: '*We agreed that FSA should receive all papers for* [the steering group] *… and that in the light of these we might attend some meetings on an ad hoc basis as observers, (depending on the agenda, state of play etc.). But I agreed with* [the Chief Executive] *that we would not want full membership, because we needed to preserve our distance from decisions taken by Equitable, and be free to form our own view. This arrangement is also easier to handle in PR terms (for both FSA and Equitable)*'.

2) The Head of Life Insurance had informed Equitable's Chief Executive that FSA would be requesting further information in relation to his appointment as Managing Director of Equitable.

[**10:23**] Managing Director A comments that he was sure these responses '*have to be right*'. He also warns, in relation to discussion about the market value adjuster, that the FTSE 100 Index had fallen, as of that morning, a further 1% to 5660.

14/03/2001 [13:11] The OFT send FSA copies of correspondence between them and a bank who had complained, on behalf of their staff who were policyholders, about Equitable's use of the market value adjuster. The OFT's response to the bank explains:

> *We have no plans at this time to proceed against the Society in respect of its increase in the financial adjuster imposed on 8th December. This is not least because our powers under the Regulations are to prevent the continued use of unfair terms and do not extend to, for example, requiring the Society to compensate customers for penalty charges applied since December. Our concern lies with the clause in the Equitable's Terms and Conditions which gives it "absolute discretion" in relation to the basis for calculation of the sum paid to policyholders on early withdrawal from the fund. The term is unfair because it has the potential to cause a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer. Lack of transparency in consumer contracts is a well established concern among regulators, watchdogs and consumer associations alike.*

The OFT continue, saying that they were:

> *… discussing with the Equitable ways in which the term can be made less opaque and restricted in the discretion granted to the Society. Our main aim is to develop wording which reflects considerations of fairness and equity, including meeting the legitimate expectations of contributors to the fund and reflecting the legitimate interests of both those who decide to leave the fund early (whether in 'draw down' or not) and those who remain until the contracted departures date(s).*

14/03/2001 [16:07] FSA's Legal Adviser A replies to Line Supervisor C's request for advice of 28/02/2001 about Equitable writing new business (see 26/02/2001 [**entry 1**], 28/02/2001 [**entry 3**] and 05/03/2001 [**14:54**]). The Legal Adviser advises that: '*Given the general sympathy for the policyholders concerned and* [Scrutinising Actuary F's] *advice that the company has reserved for this and the fund will not be disadvantaged financially by allowing the switch, it does not seem unreasonable to allow this in the limited circumstances set out in the letter as referred to by* [Scrutinising Actuary F]'.

Legal Adviser A concludes '*that policyholders should be made aware of any implications of exercising the options*'.

14/03/2001 [16:15] FSA's Director of GCD sends Managing Director A a draft of a public statement of the kind that Equitable might consider issuing. It is intended to illustrate what he had in mind because: '*I have been saying for some time that I thought that the Equitable would considerably strengthen its position from the viewpoint of the unfair contract terms legislation by a clear statement as to its approach to imposing market value adjusters*'. The Director of GCD acknowledges that it was not for FSA to draft public statements on behalf of Equitable or to micro-manage their affairs.

The Director of GCD goes on to say: '*But I thought it nevertheless desirable to make clear that what would be needed to ensure that the powers do not amount to an absolute discretion is achievable without needing to attempt an actuarial certainty which could never cover all situations*'.

[**16:25**] The Managing Director says that the statement was helpful and makes some suggestions as to how it could be improved.

14/03/2001 [16:30] FSA's Head of Life Insurance queries with the Director of GCD whether he was saying, in his note of 05/03/2001 [**18:31**] that, if a single policyholder were to be disadvantaged by its terms, the FSA might not be able to recommend the compromise scheme.

[**17:00**] The Director of GCD replies: '*the court will need to decide whether it is fair that the compromise should bind dissentients. If we are to advise that it should do so we will need a basis for assessing whether it is fair to them.* [The] *more the conclusion is that the* [proposal] *is fair to each, the easier to conclude that it is fair to all*'.

15/03/2001 [09:33] FSA's Head of Life Insurance asks all insurance company supervisors to organise '*a quick straw poll of their main life offices to establish the extent of the use of market value adjusters*'. The Head of Life Insurance says that they should: '*explain this as FSA wishing to establish how life offices are responding to the current stock market falls. (An additional, but confidential, reason is that if Equitable Life raise their MVA, we would like to know whether this is part of a more general pattern, or a problem specific to the Equitable.)*' He sets out '*four key questions*' to ask and says that it would be helpful to include five companies on the survey who had been described in a recent press article as being particularly weak.

The four key questions are:

a) Is the company currently imposing an MVA?

b) If so, at what level? (any details about how it is calculated would be helpful but not essential).

c) How long has it been in place, and are there any plans to adjust it up or down?

d) If there is no MVA in place at the moment, are there any plans to introduce one, and what would be the criteria for doing so?

15/03/2001 [entry 2] FSA inform Equitable that they have no objection to them '*honouring the options under the level temporary assurance*' (see 26/02/2001 [**entry 1**]), provided:

> *... that this was responding to a client request and that policyholders are made clear about the implications of exercising the option.*
>
> *We are generally sympathetic to this approach being extended in similar circumstances but could you please give us advance notice of which contracts you intend to take this*

approach with. We would want to ensure that there were no material costs to the Society from allowing non compulsory options.

15/03/2001 [entry 3] FSA write to Equitable to confirm a point that had been discussed on the telephone the previous day about the proposed compromise scheme. FSA say that it had been agreed that Equitable would provide all the papers on the scheme that were going to Equitable's steering group and that someone from FSA might attend meetings of the group as an observer.

FSA note that a round-up meeting with Equitable was planned for the following day and that this would be an opportunity to discuss the proposals further. FSA also suggest the following agenda items for that meeting: feedback on the roadshows; impact of the falling stock market on solvency, asset mix and the market value adjuster; discussions with the OFT; and restructuring/control arrangements within Equitable.

15/03/2001 [entry 4] FSA's Managing Director A reports to the FSA Board on the ongoing supervision of Equitable. His report, dated 7 March 2001, provides an update on various aspects of the position.

The Managing Director's report includes the following statements:

There have been a number of developments on Equitable Life over the last month. Most notably, the sale of the operating business to the <u>Halifax Group plc</u> was announced on 5 February and completed on 1 March. The transaction includes the sale of the infrastructure of the Society (including its administration and marketing staff and IT systems) and the Equitable's fund management subsidiary to Halifax. The Equitable's non-profit and unit-linked businesses will be reinsured into Halifax Life (personal lines) and Clerical Medical (group business). Halifax will provide services back to the with-profits fund, which will remain within Equitable Life. Certain regulatory consents were given before completion and both companies have undertaken to co-operate to address any regulatory concerns that might arise on closer examination of the detailed documentation relating to the transaction.

<u>Solvency</u>
Equitable Life is currently preparing its accounts and statutory returns for the 2000 year end. At this stage, the financial information available is provisional and subject to audit. The free assets of the Society (i.e. those above our conservative statutory minimum requirements) should be of the order of £300 million (compared with total funds of over £30 billion). The figures take into account the more rigorous reserving standards that have been introduced by the Insurance Companies (Amendment) Regulations 2000, but they also rely on certain accounting concessions that have been requested but not yet granted. If those concessions cannot be given, the position will be very tight. We continue to receive monthly reports. Looking forward, there will have been the immediate improvement following the payment of the initial £500 million from Halifax on 1 March 2001; against that, equity prices have fallen since year end. Overall, the fund is reasonably stable, and after an initial rise in December, the rate of surrenders has fallen with the news of the Halifax deal.

<u>Market Value Adjuster</u>
Policyholders had been complaining to the Office of Fair Trading that the adjustments made to the policy values on surrender (which was increased from an average of 5% to 10% after the closure announcement) were contrary to the unfair contract terms legislation. As a matter of policy, we share the concerns that adjustments should not be excessive and serve materially to disadvantage one group of policyholders over another. However, for prudential reasons, it is important that any life office has sufficient flexibility to protect its insurance funds. OFT accepted that a 10% penalty was not unfair but were concerned about the 'absolute discretion' reserved to the Society to determine surrender values. We have worked

closely with both the OFT and Equitable on this and assisted them [to] *reach agreement about a way forward. OFT will not seek to challenge the relevant powers, and in return, Equitable will seek to improve the information about MVAs available to policyholders, including the reasons why they may be applied. The biggest short-term concern is that continuing falls in equity prices may lead Equitable to want to raise the MVA ...*

Policyholder Compromise
At the time of the Halifax announcement, Equitable also announced that it would be looking to put forward proposals for a compromise between policyholders under section 425 of the Companies Act 1985. Any proposal would require the support of a majority of policyholders voting, and be subject to court approval. In substance, Equitable is looking to buy out the guarantees in policies in return for an uplift of around 20 per cent in policy values. This would be funded from the additional reserves set aside to cover the cost of the guarantees. Equitable are already making arrangements for the new President to tour the country to meet policyholders to get support. The field force are also being lined up to explain and canvas the level of support for the proposals. If agreement is achieved, it will attract a payment of up to £500 million more from the Halifax, for goodwill, and improve the financial position by releasing statutory reserves held to cover the guarantees (these reserves are over and above the likely cost of a compromise along the lines set out above).

Equitable will be writing to policyholders soon about bonus rates. They have announced that in present circumstances, the entire annual bonus to be declared in March will be allocated to final bonuses, and none to guaranteed bonuses, because guaranteed bonuses add to the reserving requirement, and thus constrain investment freedom. They have held out the prospect of a guaranteed bonus if a compromise agreement on GARs is achieved, and will review the position later in the year.

In addition, the Managing Director's report deals with changes in Equitable's senior management, PIA review work on advice provided both prior to and after closure to new business, relations with policyholder action groups, and the Treasury Select Committee inquiry.

16/03/2001	GAD's files contain a copy of Equitable's press notice, announcing that they had increased the level of the market value adjuster from 10% to 15%. The notice includes the explanation that: '*Benefits under with profits policies are smoothed and this means that at times the smoothed value of a policy is greater than its underlying value. Life companies can provide this smoothed value as long as the conditions under which it is payable are controlled by the terms of the policies. The smoothed policy value may be reduced on early surrender to protect ongoing policyholders if, for example, market values are depressed*'.
19/03/2001 [10:00]	FSA hold an Equitable Life Lawyers Group meeting. The only issue discussed is the work of the Insolvency Practitioner on secondment to FSA on the implications of a liquidation of Equitable.
19/03/2001 [11:34]	The Insolvency Practitioner provides the Director of Insurance, the Head of Life Insurance and another official with a 12-page analysis of the consequences and conduct of a liquidation of Equitable. The Insolvency Practitioner's report's summary reads: *There are no material benefits in liquidation to policyholders as a whole, or to any particular group of policyholders. Only one minor advantage to non-GAO policyholders arises: the prevention of GAO policyholders topping up their contracts.* *Significant disadvantages arise: the termination of the reinsurance cover for high GAO take-up; a hiatus in any ongoing benefit payments being made whilst the liquidator and* [Policyholders Protection Board] *assess the position; and a short-term investment strategy being adopted.*

A liquidator would seek a transfer or sale of the with-profits fund, but this would be difficult or impossible to achieve. During this period, compensation payments on policies maturing would be met by the [Policyholders Protection Board], *but compensation in respect of terminal bonuses is excluded. This adds pressure for an early move to a "cash liquidation" – where the court makes a stop order and the liquidator ceases to carry on the business. Any transfer of business funded by the* [Policyholders Protection Board] *would also exclude "rights" to terminal bonuses: to the detriment of both GAO and non-GAO policyholders.*

On a cash liquidation, substantial costs arise when all funds must be paid into the ISA and the Halifax administration and fund management contract is terminated with penalties. These costs could be of the order of £500m. These consequences are so severe that a liquidator is likely to explore the support for a [company voluntary arrangement] *as an alternative distribution mechanism.*

The compensation paid by the [Policyholders Protection Board] *would now include PRE (as the compensation is by reference to the valuation of claims in a liquidation which includes PRE at the court's discretion). It would also include the value of GAOs.*

The Insolvency Practitioner says that he was now working on the wider problems with the Insurance Companies (Winding Up) Rules and on what the appropriate test of insolvency might be for an insurance company.

[**18:27**] Line Manager E sends the Insolvency Practitioner his thoughts on the issue. These include:

As a general matter, I thought that a liquidation could have tax implications for policyholders. For example, termination of some policies could as I understood lead to a chargeable event. Also am not clear what would happen to contributions made to pension funds. Presumably they would have to be transferred to another provider in some form or other, even if only on the basis of a new contract being entered into and the historic funds being added into the new pension. (Such matters may be quite important and at least as persuasive to a court and policyholder groups as any other issues).

[With reference] *to GAR options. As a matter of fact, I understand (and this is consistent with my reading of the policy) is that GAR entitlement is actually set out in the policy, and the option under the contract is actually not to take the GAR. I mention this because it seems to me that it could be material in assessing the basis on which a policy would be valued on liquidation.*

[With] *reference to the* [Policyholders Protection Board]. *So far as I am aware, the new arrangements under part XV of* [FSMA 2000] *will not (so far) be materially different from those under the* [Policyholders Protection Act 1975] *and it might be worth recording this in the note for the benefit of other readers who may be less familiar with the schemes.*

... some of the comments that arise later about the prohibitions under the agreements between Equitable and the Halifax Group [are questionable]. *For example, would Clerical Medical, Halifax Life and the service company really insist on withdrawing altogether from their agreements at a time of insolvency, which would simply leave the Equitable policyholders in complete chaos, rather than coming to an arrangement with the liquidator,* [Policyholders Protection Board] *or the court to provide the necessary support and administration? ...*

... there are a number of reasons why we would expect the value of the reinsurance to be lost, but if take up of the GAR had already reached the 60% level, any claims that had already been made, then any amounts due in respect of those policies would presumably still flow through. As I understand it, GAR effective take up would automatically become 100% in insolvency, since that is the only way of establishing a

value of the right, but at least the GAR would apply to lower levels of fund than would have been anticipated.

[With reference to the subordinated loan, if that] *is subordinated to the rights of other creditors, I assume that it would continue to be subordinated in liquidation. That seems quite fundamental to allowing credit to be taken for it in solvency calculations. We (and Equitable) sought Counsel's opinion on the interpretation of Article 4. I am not sure if you have seen the papers, but while we (and Equitable) were unable to obtain a definitive view of what Article 4 does mean, we managed to rule out certain interpretations, including the one that is most obvious from words (and which appears to be the one you are alluding to).*

... what would happen if the contract provided for a further contract to be issued. For example, if a pension plan provided for an annuity to be paid at retirement, does the policyholder get his annuity including a GAR or does the liquidator/[Policyholders Protection Board] *have to give him a cheque and send him out to the open market? As to the last sentence, that possibility is precluded in Equitable's case by the terms of the Halifax agreement, as you mention later.*

[On a future sale] *I see the logic of what you say in sub-paragraph (a) – it is fairly clear that as things stand the Equitable's with-profits fund is not something that anyone is prepared to take on so if the situation were to get worse, there seems little prospect of a company coming forward to take it over. In reality, this is precisely the point when the* [Policyholders Protection Board's] *powers to provide assistance are important since it enables a subsidised transfer of reduced policies to take place. No doubt the costs of ongoing (or not) relationship with Halifax group will be a consideration when assessing who might be the most likely transferee. Even if the transfer were not made to a company in the Halifax group, there are a number of presentational reasons why Halifax might not be difficult about making sensible arrangements. The parties might agree that Halifax should continue to provide services for some time, and Halifax would certainly not wish to be seen to be frustrating arrangements that would be beneficial to policyholders if they can be concluded in a satisfactory way because of the significant reputational damage to the group. There must be questions about whether the Halifax could in any event enforce the contract, or at least some of the penalty clauses, if the company had become insolvent and the court had sanctioned a transfer to a third party ...*

[On a compromise scheme] *I would not rule out at this point even if Equitable's own attempts had been successful. For the time being, some policyholders will think if they hold out there is the prospect of getting a better deal. Once an insolvency has happened and the liabilities have crystallised, people may be keen to find some way of ensuring that their funds can be released quickly and in an orderly way. Interestingly, while it is those closest to retirement who I see as most likely to frustrate the Equitable scheme, they seem to be the most likely to want to sort things out quickly if an insolvency happened.*

Line Manager E also made other, more technical, points.

19/03/2001 [12:22]	Equitable send FSA a copy of an internal paper, dated 13 February 2001, from the Assistant General Manager entitled '*Transfers out from The Equitable Managed Pension*'.
19/03/2001 [19:42]	Equitable send FSA a copy of an internal note, setting out a supplementary memorandum to be submitted to the Treasury Select Committee.

20/03/2001 [entry 1] FSA and GAD meet Equitable to discuss the proposed compromise scheme and other matters. FSA's note of the meeting records discussion under the following headings:

<u>S425 Compromise Arrangements</u>
Equitable's Chief Executive explains that Equitable were examining the compromise proposals under four areas: actuarial, legal, public relations and implementation. FSA repeat the need for them to be kept closely informed on developments. It is agreed that, while FSA '*would not wish to be formally associated with this accommodation*', FSA would nominate someone to attend meetings of Equitable's steering group as an observer. The Chief Executive says that he was concerned about possible strain on the Society's human resources, given the likely work involved if, as he had been advised, it could be '*as difficult as a formal Schedule 2C transfer of business*'. Equitable report that the debate on the numbers of policyholder voting classes was continuing. They also say that the offer to GAR policyholders might be differentiated according to the '*perceived "value" of the option*' and was now unlikely to be a straightforward percentage increase.

<u>Roadshows/PR</u>
Equitable's Chief Executive says that the roadshows had gone well and he thought '*there was 98-99% agreement from those that he spoke to that some form of accommodation should go through*'.

<u>Market Value Adjuster</u>
Equitable's Chief Executive says the announcement to increase the market value adjuster had '*gone down as well as could be expected*' and that: '*He would not have been happy to let existing policyholders subsidise those that were leaving*'. FSA also record:

> *It was confirmed that when calculating an MVA the same principles applied to Group Schemes as individuals. However, when evaluating the Group MVA closer attention is spent on gauging the precise level of markets at the time of surrender and this is one of the reasons that a Group MVA can be different to an individual MVA.*
>
> *The Society had also deterred groups from selecting against the Society on the odd occasion a group provider has sought to surrender non GAR contracts and maintain the GAR contracts. The Society had quoted on these occasions fairly stiff surrender penalties on the non GARs.*

On a copy of the note of the meeting, the Director of Insurance highlights the second paragraph and underlines '*on the non GARs*'. On 23 March 2001, the Director asks Chief Counsel A whether she saw a problem with this.

<u>The OFT</u>
The note records that:

> *Both FSA and the Society had forewarned the OFT about the increases in the MVA but all sides appreciated that this did not really change the rationale and arguments behind this issue. The Equitable had formally responded to the OFT at the end of February and were awaiting OFT's response.*

Equitable's Chief Executive says that he thought the matter with the OFT was largely closed. FSA say that they thought the OFT wanted Equitable to attempt to explain the basis for applying the market value adjuster in their literature.

<u>Solvency/Asset Mix</u>
FSA's note records:

> *The* [equity backing ratio] *was still being maintained at 61% and this was the plan until the compromise plan was voted on. Solvency margin coverage was still relatively safe and could withstand another 10% fall in the markets.*

[FSA's Head of Life Insurance] *said that we were still considering the Regulation 72 reserving issue with our legal team (retirement age assumption on certain contracts) and we would get back to the Society on this.* [The Chief Executive] *confirmed that the Society was currently using the more conservative reserving method so there could be a c£100m release from reserves if we accepted their interpretation.* [An Equitable actuary] *confirmed that the actuarial team were still checking the basis for applying for the synthetic bond Section 68 Order which was needed for the 31/12/2000 Annual Returns.* [Line Manager E] *had already communicated FSA's views on the Permanent* [Insurance] *valuation and the Society needed to sort out any presentational issues with its auditors.* [The Head of Life Insurance] *stressed the need to take care with the presentation of the year end position.*

It was confirmed that the auditors ... will put in a fundamental uncertainty clause in the 2000 accounts and returns. The Directors' statement will elaborate on this issue explaining what the uncertainties are in the balance sheet. It was also confirmed that after 2000 sign off the Society would seek to appoint new auditors as part of its attempt to make a clean break from the past.

Appointments
Equitable report that they were close to appointing a new Appointed Actuary and that the Appointed Actuary would be from an accounting or actuarial firm, but would be '*expected to dedicate his time full time to the Society*'. Equitable say that they had not yet finalised the appointment of the eight new Board members.

Control Arrangements
FSA's note records: '*It does appear that the haste at which the Halifax deal was put together had left a few holes in the arrangements between the two parties. There was no written material available on what the formal control responsibilities were between the Halifax and the Equitable in certain areas. This was an area that the Equitable's audit committee was currently examining and the Halifax were also aware of shortcomings in this area*'.

20/03/2001 [entry 2]	Following the meeting with Equitable earlier that day, the Head of Life Insurance says that Line Manager E would attend the meetings of Equitable's Compromise Scheme Steering Group, and that he would be FSA's co-ordinating point for the work to be carried out by various parts of FSA over the coming months.
20/03/2001 [12:42]	FSA's Managing Director A informs the Director of Insurance of a conversation with an Equitable Director. The Managing Director had offered to provide suggestions on the drafting of Equitable's note to the Treasury Select Committee, which they intended to reproduce in their annual report, '*for improving the clarity of it*'. The Society's Director had reported that the roadshows '*though painful, ... are worthwhile*'. He also expected the annual general meeting to be '*pretty bloody*'.
20/03/2001 [17:28]	PIA seek views from FSA and GAD on the adequacy of Equitable's rectification scheme.
21/03/2001 [16:12]	FSA's Line Manager E attends a meeting of Equitable's steering group on the compromise scheme. The terms of reference of the group were to '*oversee the implementation of the section 425 scheme at a general management level*'. He circulates his notes of the meeting to FSA and GAD, saying that there '*is not much new to report*'. Line Manager E says that it had been noted during the discussion that there was a very heavy workload being placed on some parts of Equitable and that they were trying to buy in resources to cope. The Line Manager says: '*There was already a risk to delivering to their existing timetables for the pensions review work and the GAR rectification scheme. They*

have also been constrained in the progress they have been able to make on the pension fund withdrawal review. I thought it would be helpful to mention this so that PIA colleagues are aware of the problems, and also that Equitable are aware of them and trying to resolve them. It is, I think, also helpful to remind ourselves that corporately we attach importance to the delivery of the compromise and would ask PIA colleagues to take that into account (and talk to me) before taking further action'.

21/03/2001 [17:00]	FSA's Line Manager E reports on a discussion that he had had with Equitable about section 68 Orders, following the meeting of Equitable's Compromise Scheme Steering Goup. The Line Manager says that he had informed Equitable that: *I was concerned that if we were to get things done in time, we would now need to move quickly. This is in part because the Easter recess is not far away, and also because there is still allegedly a significant possibility of a general election being called. We will not get approval from ministers in that period, particularly on something that will be seen as vaguely contentious.* [Equitable] *took the point on board and will chase up work at their end.* The Line Manager records that Equitable had: *... updated me on the valuation of Permanent* [Insurance]. *They have established for Companies Act Accounts, the correct valuation is the sale price, but they have reached the view that it could not be treated as a debt. They will therefore require a concession that will enable them to count the consideration over and above the admissibility limits that normally apply. (Presentationally, I think that one is not too difficult – the contracted sale price is clearly a more useful valuation and I think we can argue that the payment was reasonably secure in this case.) I understand that this is simply a matter of specifying the valuation that should be applied for Form 9, but I would welcome advice on that.* Line Manager E continues: *For consistency, we probably need additionally to have a* [section] *68 order that deals with the presentation of the year end returns. It might be that that would pick up on Permanent* [Insurance] *(if my understanding above is correct), and also the admissibility of* [a company's] *shares at the year end, a section 68 order for which has been granted since the start of the new year. It might also be helpful if the* [synthetic] *bond presentation in the 2000 returns could be dealt with in the same order, so that the general acceptability of their valuation basis and the presentation of the end 2000 returns are dealt with separately. That way Press Office have only to explain once that the 2000 returns have been presented in a way that shows a "proper" valuation that is meaningful, rather than one that is technically correct but misleading. Discussions with* [the Head of Insurance Policy] *and* [Legal Adviser A] *persuade me that there are precedents.* [**18:51**] FSA's Head of Life Insurance responds that he agreed with the overall approach. He says that FSA needed to press on with their view on the interpretation of Regulation 72.
21/03/2001 [19:58]	PIA inform FSA of their understanding of the arrangements for lead supervision of Halifax, Halifax Equitable Clerical Medical and Clerical Medical.
22/03/2001 [09:24]	Further to his note of 21/03/2001 [**17:00**], Line Manager E adds that he had also discussed with Equitable the issue of Regulation 72 and their retirement age assumptions. Equitable had told him that they still believed that retirement at age 55 would be a very prudent assumption and, if FSA conceded this issue, Equitable's solvency position would improve by around £100m. [**11:56**] GAD reply to FSA saying that they supported FSA granting Equitable a concession on the valuation of Permanent Insurance along the lines suggested.

	GAD also say that they were '*surprised*' that Equitable were: '*now saying that moving the personal pensions retirement age from 50 to 55 would only release £100m – in earlier discussions (based on figures from the* [Equitable's Auditor's] *Reports) we had believed that the change would reduce liabilities by £200m – £250m. Or to put it the other way, reserving at 50 has not caused so large a strain as we had anticipated*'.
22/03/2001 [entry 2]	Instructions to Counsel are provided by FSA's Legal Adviser A for advice on Regulation 72.
23/03/2001 [entry 1]	Halifax send FSA details of '*the state of play*' in relation to Equitable's Guernsey operations.
23/03/2001 [entry 2]	Equitable write to FSA to update them on identifying new Directors and to provide further information on the functions to be carried out by the Chief Executive, as part of the application for FSA approval of his appointment.
23/03/2001 [16:51]	Equitable apply to FSA for a section 68 Order in respect of the calculation of the rates of interest on fixed interest assets. Equitable ask for the Order to be granted with effect from 31 December 2000, as originally requested. Line Manager E advises Line Supervisor C that FSA would have to tell Equitable '*again!*' that any Order would have effect from the day it were made but '*you can tell them that we will consider the possibility that we might order them to* <u>*report*</u> *as if the order have been in place. But they need to be clear that it will be tough getting HMT to sign up to this, and presentationally this (as opposed to Permanent +* [the Order in relation to admissibility limits for shares in an individual company]*) will be* [very] *difficult*'.
23/03/2001 [17:41]	FSA's Line Manager E sends Line Supervisor C, Legal Adviser A and GAD a draft letter to Halifax's advisers about the merged services agreement between Equitable and Clerical Medical. He says that he is satisfied with it.
26/03/2001 [entry 1]	FSA's Head of Life Insurance asks Line Manager E to check that Equitable's letter of 23/03/2001 covered all the issues previously raised with them.
26/03/2001 [17:17]	GAD reply to FSA about the draft letter to Halifax's advisers. GAD suggest that there were further points that FSA should question Equitable about and refer them to their analysis of 07/03/2001. GAD point out that the letter refers to reinsurance of the relevant policies into Halifax and Clerical Medical, when their understanding was that this would be into Halifax only. GAD say that the reinsurance agreement was more than the '*very minor point*' which it appears in the letter. GAD say that they assumed FSA would be writing separately to Equitable to raise other points on the reinsurance agreement.
27/03/2001 [entry 1]	FSA reply to Equitable's application for a section 68 Order (see 23/03/2001 [**16:51**]), stating that they could not recommend to HMT that they should issue such an Order with retrospective effect, which '*we believe to be outside their powers*'. However, FSA explain how Equitable could submit an application which would be acceptable. FSA say: *... that it is possible for the Treasury to make an order under section 68 that would require the Society to prepare its annual returns on a particular basis, even though that information would relate to a period that has already ended but has not yet been reported upon.* *... the application that we believe we would be able to consider would be for an order in respect of:*

a) the future calculation of rates of interest on defined segments of fixed interest assets; and

b) the formation to be included in the 2000 year end returns.

However, in order to draft the order we need you to define clearly the different segments of the fixed interest assets. The order would require that this segmentation, and the method of determining the yield, is applied thereafter. Any application would need to explain fully why the Society considers that it should report a valuation other than one determined in accordance with the 1994 Regulations.

FSA continue that their understanding is that:

... the Society would like to obtain a concession that would enable it to show the value of the Permanent Insurance Company Ltd in its 2000 annual returns on the basis of the agreed sale price rather than on a look through basis. I understand from [an Equitable actuary] *that the agreed sale price will be the figure shown in the Companies Act accounts for the period ending 31 December* [2000]. *If you wished to pursue that, we would need you to make an application for that concession as soon as possible. Again the application would need to set out the reasons why you consider that the Society should report a valuation other than as required by the 1994 regulations. You should also specify in an application the statutory provisions that you wish to see disapplied, or the modifications to such provisions that you would wish to see applied.*

FSA conclude that:

... if you would like to proceed on the basis outlined above, I would be grateful if you could provide confirmation as soon as possible. I should make it clear that once such an application has been made, I will need to seek the approval of the FSA's Insurance Supervisory Committee before making recommendations to the Treasury as to whether it should grant such concessions.

27/03/2001 [09:00] FSA and GAD hold a conference with Counsel on Equitable's approach to assumptions on the retirement ages of policyholders. The advice of Counsel was that:

(i) the contracts had to be valued on an <u>individual</u> basis;

(ii) Regulations 65(3) or (4) did not permit any reduction in provisions as these were concerned with circumstances in which an increase, or at least no reduction, was required;

(iii) Regulation 66 was concerned with situations where there was a valuation strain in respect of <u>groups of contracts</u> and was not concerned with the value of individual contracts;

(iv) Regulation 72(3) <u>did</u> permit assumptions to be made as to the age at which the individual would take the benefits.

Counsel further advised that there was scope for amendments to (i) clarify regulation 72(3) so that it is clear that assumptions as to the retirement age can be made and (ii) put in a requirement for reserving so that there was a smooth curve leading to the position where regulation 72(2) took effect. There was also a scope for the issue of helpful guidance on regulation 72(3).

27/03/2001 [11:51] Equitable send FSA information on the calls to Equitable's helpline. Equitable apologise for the gap in providing information, which had been due to an oversight '*due to everything else going on*'.

27/03/2001 [12:19] PIA meet with Halifax to discuss compliance arrangements for the new Halifax Equitable sales force. The note of the meeting is sent to FSA.

27/03/2001 [14:08] GAD provide advice to PIA on the rectification scheme (see 20/03/2001 [**17:28**]). This includes the following:

> *GAD need to be satisfied that the rectification Scheme is fair between policyholders who retire(d) before, during and after the period January 1994 – July 2000, and that the New Bonus Resolution is consistent with the terms offered to policyholders who have taken retirement benefits since bonus rates were revised to take account of the House of Lords judgment. To enable us to reach a view on these matters, it would help if some additional information could be obtained from the Society, as follows ...*
>
> - *What approach was used to determine the new bonus rates under the New Bonus Resolution? Details of the method and basis used would be helpful.*
> - *What criteria were used to determine whether the new rates of bonus were "fair"?*
> - *How are the rates of bonus under the New Bonus Resolution expressed? Do they form an "end-piece" adjustment to the previous year-by-year roll up rates, or have the roll up rates themselves been restated?*
> - *Examples of the application of the New Bonus Resolution to policies maturing over the period, say in each of 1994, 1997 and 2000.*
> - *What proportion of smoothed asset shares do policyholders receive under the New Bonus Resolution for retirements over the period 1994 – 2000, if they exercise/do not exercise the GAR option?*
> - *What proportion of smoothed asset shares have policyholders received on retirement since the House of Lords judgment in July 2000, if they exercise/do not exercise the GAR option?*
> - *The Rectification Scheme booklet states (on* [page 2]*) that retirement benefits since 20 July 2000 have been calculated in line with the judgment. It also says (on* [page 2]*) that revised final bonus rates were set in October 2000, and that these took account of the judgment. Could the Society clarify which changes, in July and in October, are being referred to here?*

27/03/2001 [14:58] FSA's Line Manager E asks Managing Director A and FSA's Chairman whether they were content with a response prepared to claims for compensation from Equitable policyholders. Part of the suggested responses states:

> *In your letter you say that you expect the FSA to compensate you for the losses you consider you have suffered. The FSA considers that it has throughout, acted reasonably and in good faith in performing its regulatory functions in relation to the Equitable. I note too that it is still very early days and, for the vast majority of policyholders, any conclusions about any amount they might have lost over the period of their policy would be premature.*

On 28 March 2001 [**15:39**], the Director of GCD suggests to the Managing Director that, given the recent Bank of Credit and Commerce International case, the wording should be:

> *You suggest that the FSA should compensate you for losses incurred through your investment with the Equitable. We understand why you make this suggestion. But the reality is that regulation cannot provide a guarantee of the performance of every investment product. Our position is that we fully discharged our responsibilities in*

supervision of the Equitable. So I am sorry to say that there can be no question of us offering to pay compensation.

The final version of the response reads:

> *In your letter you say that you expect the FSA to compensate you for the losses you consider you have suffered. The FSA considers that throughout, it has discharged its responsibilities in performing its regulatory functions in relation to the Equitable and that there is no basis on which we could or should offer compensation. I note too that, for the vast majority of policyholders, any conclusions about any amount they might have lost over the period of their policy would be premature.*

27/03/2001 [17:05] FSA write to Equitable about the interpretation of Regulation 72, in order to conclude their scrutiny of the company's 1999 returns. FSA state:

> *Our discussions sought to establish the basis on which the Society should determine the statutory reserves needed to cover the potential cost of policyholders choosing to exercise the option to take early retirement. The latest correspondence on the subject was* [Equitable's] *letter of 21 December 2000 and* [GAD's] *reply of 9 January 2001.*
>
> *I have now had the opportunity to review the relevant provisions with our actuarial and legal advisers. We have concluded that a correct interpretation of Regulation 72(3) is that it requires the appointed actuary to make <u>prudent assumptions</u> (as set out in broad terms in Regulation 72(1)) about additional liabilities that might arise if the option is exercised. We have reached the view that it is appropriate therefore for the Appointed Actuary to make prudent assumptions about the variable factors underlying the calculation, and this would include making assumptions about the age at which the option is exercised. I believe this is consistent with the Society's interpretation of the relevant provisions.*

27/03/2001 [entry 8] FSA (Chief Counsel B) provide advice to PIA on the role of the independent assessor in the GAR rectification review and on policyholders' rights to complain to the Personal Investment Authority Ombudsman.

28/03/2001 [17:37] FSA's Director of Insurance informs Managing Director A that he had received a telephone call from Equitable's Chairman, following a meeting between Managing Director A and the Society's Chairman that afternoon. (Note: I have not seen a record of that meeting.) The Director of Insurance says that they were to announce that their auditors were not being put forward for reappointment and that the Chairman was sorry to see them go, but was '*firm that they will continue to be involved behind the scenes*'. The Director of Insurance also gave updates on the compromise roadshow, possible claims against Directors, auditors and regulators, and the Treasury Select Committee inquiry.

[**17:52**] The Head of Life Insurance adds that Equitable's Chief Executive had telephoned to say that the Board had agreed yesterday that a new company should be proposed as the new auditors at the annual general meeting (the current auditors having indicated that they did not wish to be considered for reappointment) and that they had also approved the appointment of a new Appointed Actuary (a consultant from an actuarial firm), with immediate effect.

28/03/2001 [entry 2] FSA write to Equitable in response to their letter of 23/03/2001, about approval of the appointment of their new Chief Executive. In order to help FSA understand what the role of the Chief Executive involved, they requested a copy of a report that they understood had been submitted to Equitable's audit committee about control arrangements so that they could review those arrangements against the contracts with Halifax.

29/03/2001 [12:15] A GAD actuary sends Scrutinising Actuary F correspondence that he has had with the trustees of an Equitable AVC scheme of a government agency that was due to be privatised. In reply, the Scrutinising Actuary states:

> *The email from Equitable at the foot of this memo states that the absence of a 3.5% guaranteed rate of roll-up on the new policies will make no practical significant difference, since it just affects the apportionment of the declared bonus. However, the declared bonus for 2000 was nil, so those with a 3.5% guarantee received a 3.5% uplift to their guaranteed benefits, whilst policyholders without the 3.5% guarantee would have been credited with nil. On the other hand, final bonus (which applies to the whole fund) was declared at the rate of 9% for the last 5 months of the year, and so policyholders' total funds would have increased by 5/12 of 9%, i.e. 3.75%, regardless of whether the guaranteed benefits were increased by 3.5%. The difference thus becomes one of the extent to which benefits are increased in guaranteed or non-guaranteed form; non-guaranteed benefits are exposed to the possibility that they can subsequently be taken away (via the MVA).*

30/03/2001 [11:53] GAD (Scrutinising Actuary F) write to FSA (Line Manager E and the Head of Life Insurance), setting out '*some aspects of the way in which Equitable is currently managing its affairs which, despite our numerous discussions with the Society, I feel I do not fully understand*'. GAD write:

> *1. The 15% MVA only appears to be being applied to non-contractual surrenders, and is designed to scale back surrender/transfer values to a "fair" amount, taking into account primarily current investment conditions (the "type 1" adjustment) but also other factors such as unrecouped acquisition expenses (types 2 & 3 adjusters). Currently the type 1 adjuster is almost 15% in its own right. However, I understand that the MVA is not applied at all on contractual terminations, and so in these cases the policyholder is receiving about 15% too much (relative to current market levels). I would have thought there was a case for applying the MVA on contractual terminations also, provided it was only used to cut back the final (terminal) bonus and leave the guaranteed benefits intact. (On a non-contractual exit, it is OK for the MVA to eliminate not only the whole of the non-guaranteed bonus, but to erode some of the guaranteed benefits as well.) As things stand, those who leave the fund on contractual exit seem to be getting an unfairly good deal (at the expense of other policyholders).*
>
> *2. If, on a contractual termination, the policyholder exercises the GAR option as well, the situation is exacerbated by the policyholder receiving not only an underlying "fund" 15% above its true value, but also a GAR on top worth perhaps a further 25%.*
>
> *3. Following on from the above, presumably the current "interim" bonus rate of 8% p.a., which is all being added in "final" (non-guaranteed) form, would not be clawed back on contractual terminations either. Given the recent gyrations in the stock market, to allow funds to roll up at a rate of 8% p.a. seems very brave – the premise seems to be "it will be all right in the end"!*
>
> *In essence, these questions are all about the extent to which the Society feels able to cut back final (non-guaranteed) bonus to reflect market conditions on contractual exits. (I raised some similar issues in my note to* [PIA] *on the Rectification Scheme earlier in the week.)*

If my understanding is correct, then I presume that the Society may be taking the view that they do not want to "rock the boat" too much by cutting back benefits on contractual terminations at a time when they are desperately keen to achieve a GAR/non-GAR compromise deal. However, they could not go on paying excessive amounts on contractual terminations indefinitely.

GAD say that they wanted to raise these issues with Equitable at the meeting on 04/04/2001.

30/03/2001 [entry 2] Clerical Medical send FSA information on the progress of the Equitable integration programme.

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01/04/2001 [evening] Equitable's Chairman telephones FSA's Managing Director A with '*a disturbing resumé of the position*'. The Chairman says that he is increasingly worried by a combination of the hostile atmosphere at the roadshows and in the press. The Chairman also says that relations with the action groups have deteriorated, as those groups were trying to have a say in the approval of the new Board or to get '*one of their "own"*' on to it, to which the Chairman was refusing to accede.

FSA's Managing Director reports to FSA's Chairman that there was a possibility by late May of '*near anarchy on the Board and/or the departure of key members of the remaining executive in the face of policy-holder resentment*'.

Managing Director A comments that FSA needed to be clear about their responsibilities and '*game plan*' for the period prior to Equitable's annual general meeting.

02/04/2001 [entry 1] Halifax write to FSA about an issue raised at the meeting on 08/03/2001 about the potential impact on Equitable's fund of the Minimum Funding Requirement for occupational pension schemes being removed. Halifax say that this was an issue for Equitable, as Clerical Medical were simply managing the assets of Equitable's fund in accordance with the fund management agreement.

02/04/2001 [entry 2] FSA supervisors and management meet to discuss Equitable (and another insurance company). FSA's note of the meeting records:

> *It was noted that the AGM, which was scheduled for 23 May, could prove extremely difficult. It was possible that some or all of the action groups would put up slates of candidates.* [Equitable's Chairman] *might end up with a hostile Board, or alternatively it was possible that a "hung parliament" outcome might occur.* [The Director of Insurance] *would speak to* [the Society's Chairman] *to find out in more detail what his handling plan is.* [Insurance Division] *would also clarify whether there were circumstances in which we would wish to use our (limited) powers in this area.*

02/04/2001 [13:30] FSA hold an Equitable Life Lawyers Group meeting. The Group express concern that Equitable had still not made a public statement on the market value adjuster and Chief Counsel A says that she intended to raise the issue with Equitable at a meeting on 03/04/2001.

Concern is also expressed that FSA had still not been provided with important information on the reinsurance aspect of the sale to Halifax and Legal Adviser A notes that issues on some of the other agreements remained outstanding.

Legal Adviser A says that a request for a section 68 Order relating to the 2000 returns '*had not been received but it would be needed*' and that Line Manager E had written to Equitable about this. (See 27/03/2001 [**entry 1**].)

It is noted that the Regulation 72 issue had been dealt with. Chief Counsel B informs the group that he had advised PIA and FSA that Equitable could not circumvent the Personal Investment Authority Ombudsman complaints procedure. However, the Chief Counsel had subsequently been shown a letter from solicitors which had raised issues about whether his advice had been correct. The group update the status of the items on the legal issues list.

02/04/2001 [14:42] PIA send FSA a copy of correspondence about Equitable's complaints handling arrangements, along with a draft letter which they proposed to send in reply to Equitable.

The draft letter notes that Equitable had asked what impact being a closed fund would have on complaints handling requirements and obligation to contribute to the funding of the Financial Ombudsman Service.

PIA quote a relevant section of their Complainants Sourcebook and say that they hoped that this clarified the position.

02/04/2001 [17:01] PIA send FSA and GAD a copy of a note of a telephone conversation with Equitable about PIA's letter of 29/03/2001 about the rectification scheme.

[**17:05**] GAD confirm that they are happy to discuss actuarial issues with Equitable directly and ask PIA for a copy of their letter.

02/04/2001 [17:19] Halifax inform FSA of three notifiable events relating to the transfer of Equitable Investment Fund Managers Limited.

03/04/2001 [entry 1] The Deputy Director General of Fair Trading writes to FSA's Chairman about Equitable and the Unfair Terms in Consumer Contracts Regulations 1999. The Deputy Director General explains that she is writing in place of the Director General who was prevented by a conflict of interest in dealing with Equitable matters.

The Deputy Director General says that the OFT have already begun enforcement action against Equitable following more than 60 complaints about the way they used the market value adjuster. She explains that the OFT's key concern was not with the amount of the market value adjuster but with Equitable's '*absolute discretion*' clause. She says:

> *Equitable has explained how it exercises this discretion in practice but it is clear that there is no transparency and consumers cannot take an objective view of how it will be used. We think Equitable may be able to meet our concerns by giving an undertaking to limit the exercise of the discretion so that the term is used fairly and in a way that is – within the limitations imposed by varying market conditions – predictable and objectively verifiable by consumers. However, we would need to undertake a good deal of research before we could be confident that the undertaking effectively met our serious consumer protection concerns.*

The Deputy Director General notes the general review of with-profits business announced by FSA on 23 February 2001 and that this would overlap with their work.

She explains that, therefore, the OFT have been considering the best way forward. She suggests that it might be more sensible for FSA to take the lead on this, including the complaints lodged with the OFT, '*given the ambit of the review and your expertise in the area*'.

03/04/2001 [entry 2] FSA send Equitable a suggested outline agenda for the meeting planned for the following day, which includes: with-profits fund experience '*(solvency, withdrawals, MVA)*'; the compromise scheme; Board appointments; the preparation for and handling of the annual general meeting; control arrangements between Equitable and Halifax; and correspondence with the OFT.

03/04/2001 [14:04] PIA send FSA copies of correspondence from Halifax about the initiative (planned for 9 April 2001) to allow Equitable's former sales force to begin to sell Halifax Equitable products.

An enclosed letter from Halifax explained the training and the revision of the sales process that had been carried out. The letter also set out the short and long term arrangements that had been put in place to detect, as far as was possible, cases of mis-selling.

03/04/2001 [16:13]	FSA's Legal Adviser A provides Line Manager E with his thoughts (dated 2 April 2001) on the management agreement with Clerical Medical. Amongst other issues, the Legal Adviser says that he is concerned that a clause provides that the management of the company could be subcontracted, which would mean that FSA had no direct power in relation to the subcontractor, who might not be a regulated entity. Legal Adviser A notes that the agreement might be terminated upon the direction of the regulator. [**18:03**] Line Manager E replies, answering some of the questions raised by the Legal Adviser.
04/04/2001 [entry 1]	FSA's Chairman comments on the Deputy Director of Fair Trading's letter that their proposal looked like a sensible way forward: '*But we will need to be careful, since clearly the OFT will continue to take an interest*'.
04/04/2001 [11:00]	FSA and GAD meet Equitable. FSA's note of the meeting includes the following:

Solvency position
Equitable say that their year-end position was close to being finalised but had not changed materially from that reported previously and that they would provide the information requested about the section 68 Order application shortly. Equitable say that they were clear that their ongoing solvency position would be improved by the Halifax deal.

The issue of whether the relevant certificates in the 2000 returns would be signed off by the Society's former or current auditors and appointed actuaries is discussed.

Market value adjuster
GAD ask about Equitable's approach to payouts on policies at maturity and whether the justification underlying the market value adjuster on non-contractual surrenders meant that there was also a need to reduce levels of terminal bonus on contractual surrenders. FSA note:

> *Whilst* [Equitable's Chief Executive] *conceded that maturity payouts were currently in excess of "smoothed asset shares", he said that they had no plans further to reduce terminal bonus at this stage. The current levels of maturity were in line with predictions, so there were no arguments for making a reduction on the grounds that underlying assets were having to be sold unexpectedly and at disadvantageous prices. He thought it fairly fundamental that the effect of smoothing on a with-profits policy meant that there would be some consistency in the levels of benefits paid even if the markets were unstable.* [An Equitable actuary] *noted also that the interim rate of return (IRR) had already been adjusted down to 8% per annum in February and on the basis of current experience there was no need to adjust this further.* [The Chief Executive] *said it was also a consideration that current maturity values were being met from cash realised when equities were sold earlier in the year when the FTSE 100 was around the 6,200 level.* [The actuary] *confirmed however that the IRR was kept under constant review.*

The possible use of a differential market value adjuster for GAR and non-GAR policyholders so that non-contractual surrenders reflected their asset share is discussed.

Equitable's Chief Executive says that he considered the approach to be reasonable and notes that the House of Lords' ruling related to contractual maturities, the implications for non-contractual withdrawals being unclear.

FSA's Head of Life Insurance notes that the information about Equitable's market value adjuster on FSA's website was being updated to focus on surrender values rather than exit penalties.

Compromise scheme
Equitable suggest that it would be useful if Line Manager E attended the next scheme steering group meeting. FSA say that there had been a '*breakdown in communications*' about meetings on the compromise scheme and that it is important that FSA were kept in touch and were provided with relevant papers.

Board appointments
Equitable say that they were in the process of making offers for Board positions but that no positions were being offered to candidates put forward by the action groups '*since none were considered to have been of sufficient calibre*'.

Control arrangements
FSA raise some concerns over the control and contact arrangements. Equitable hand FSA a copy of an internal submission to their audit committee on corporate governance and the responsibilities and procedures arising from the outsourcing of their administration to Halifax Equitable Clerical Medical.

Other issues
Equitable report that they had been asked by the Personal Investment Authority Ombudsman for copies of Board papers but, as they were not content to accede to the request, they held a meeting to discuss mis-selling issues instead. Equitable say that they had understood that the Personal Investment Authority Ombudsman would continue to deal with some individual complaints, but, for generic mis-selling complaints, would wait for the conclusion of FSA's work on post-Court of Appeal advice.

The Head of Life Insurance states that FSA were strongly resisting demands from policyholders for compensation.

Equitable's Chief Executive says that the Society was awaiting advice from Counsel on possible legal action but that he was '*instinctively ... reluctant to embark on lengthy legal processes where there was little prospect of success*'.

04/04/2001 [13:14] FSA are informed by an Equitable Director that the Society's Chairman was instructing solicitors to test the potential liability to Equitable of directors, former directors and advisers.

05/04/2001 [08:05] PIA send GAD a copy of their letter to Equitable about the rectification scheme of 29 March 2001.

[**11:13**] GAD thank them for this and ask for a copy of the Independent Actuarial Expert's report.

05/04/2001 [08:52] Equitable send FSA a copy of their solicitors' paper on the determination of voting classes for the GAR compromise scheme.

[**10:46**] Line Manager E distributes the note, along with an Equitable progress report as at 4 April 2001. This included an outline timetable and the contents list for the Independent Actuarial Expert's report.

05/04/2001 [10:49] FSA send GAD a copy of Equitable's audit committee paper handed over at the meeting the previous day.

05/04/2001 [11:27] An FSA Legal Adviser (Legal Adviser D) distributes a note (dated 4 April 2001) on Equitable's Memorandum & Articles of Association with regard to the powers of members and directors to table resolutions and to elect directors.

05/04/2001 [entry 5] FSA's Director of Insurance suggests to the Head of Life Insurance that he or Line Manager E should discuss with FSA's Head of Consumer Protection the Deputy Director General of Fair Trading's letter of 03/04/2001 and the handling of the complaints against Equitable.

05/04/2001 [entry 6] FSA attend a meeting of Equitable's Compromise Scheme Steering Group. According to Equitable's minutes of the meeting, the group largely report on progress to date and on the timetable going forward.

05/04/2001 [entry 7] FSA's Director of Insurance seeks advice from Line Manager E on the letter from Halifax of 02/04/2001.

05/04/2001 [entry 8] PIA send FSA a copy of a letter from their Complaints Policy Department sent that day to Equitable about complaints data reporting requirements.

05/04/2001 [entry 9] FSA's Lead Supervisor file includes a copy of a report produced by IMRO of their '*periodic visit*' to Equitable Investment Fund Managers Limited. The visit took place from 26 to 30 March 2001.

The report explains that the aims of such visits were:

> *(a) to identify instances of investor risk; (b) to obtain reasonable assurance that Firms are complying with IMRO's Rules; and (c) to assess whether they continue to meet the fit and proper criteria for authorisation.*

Under 's*ignificant findings*', the report states that IMRO had been unable to satisfy themselves that Equitable Investment Fund Managers Limited's complaints handling procedures and recording systems were correctly identifying, recording and classifying complaints.

05/04/2001 [entry 10] GAD's Equitable file includes a notice from the Civil Service pension scheme, which advises that the deadline for the contributions amnesty (allowing policyholders to transfer any payments into the with-profits fund since 8 December 2000 into the Equitable Life Money Fund without incurring a market value adjuster) had been extended from 31 March to 30 April 2001.

05/04/2001 [20:05] FSA's Director of Insurance informs the Head of Life Insurance (copied to Managing Director A, Head of GCD, Chief Counsel A and a PIA official) of a telephone call he had taken from one of Equitable's proposed new directors. The proposed director was concerned about a PIA investigation into his former employer.

The Director of Insurance records two issues that the proposed director was concerned about:

- *The first concerned his own position. Was it likely that after his appointment we might decide that anything coming out of the PIA work suggested he was inappropriate for the job.*
- *The second concerned possibly "contagion" for the Equitable. Was there any possibility that the PIA might do something spectacular to* [the company] *before (possibly immediately before) the AGM or the vote on the compromise scheme, such that his earlier connection with* [the company] *might embarrass the* [Equitable] *and make it vulnerable to generalised "run by rogues" criticism.*

The Director of Insurance says that he had told the proposed director that he thought both possibilities were unlikely to transpire but that he would revert to the proposed director if, on reflection, he had reason to doubt this view. The Director of Insurance also records that he had told the proposed director that FSA '*could not subordinate proper action in relation to one company to considerations of the interests of another*'.

The Director asks the Head of Life Insurance and PIA for any information that they could give on the current situation with the investigation into the former employer. He says:

> *Notwithstanding what I said to* [the proposed director]*, we probably do have some influence over the timing and presentation of events and should consider whether it would be proper/appropriate to exercise it in the wider interests of policyholders.*

06/04/2001 [entry 1]	Equitable inform FSA that they have appointed a new Appointed Actuary with effect from 28 March 2001.
06/04/2001 [entry 2]	FSA's Head of Consumer Protection provides FSA's Chairman with a draft reply to the Deputy Director General of Fair Trading's letter of 03/04/2001, saying: *I have agreed with* [the Director of Insurance] *(as well as* [the Director of Consumer Relations]*) that there would be advantage in being able to deal with these cases ourselves ...*
06/04/2001 [11:01]	FSA's Chief Counsel A sends Counsel copies of the latest compromise scheme documents, which had been received on 05/04/2001 [**08:52**].
06/04/2001 [11:17]	FSA's Line Manager E circulates a note of the Compromise Scheme Steering Group meeting that he had attended the previous day. The Line Manager sets out the draft outline timetable, the details of the plans for consultation of policyholders, and the possible legal representation of policyholder classes. The Line Manager says that he had had a brief discussion with Equitable's Appointed Actuary after the meeting, during which he had talked about the information and analysis FSA would expect to see to enable them to express a view on the scheme.
06/04/2001 [12:57]	FSA's Line Manager E seeks comments from Legal Adviser A and GAD on a revised draft letter to Halifax's advisers.
06/04/2001 [14:25]	FSA seek advice from GAD on the letter from Halifax of 02/04/2001. [**15:15**] GAD say that, as far as the actuary who attended the meeting could recall, the Director of Insurance: *... asked a fairly general question about the impact of the abolition of the* [Minimum Funding Requirement] *– this abolition had just been announced the day before – on Equitable. The thrust of the question ... was whether the supply of long dated gilts might increase, should pension funds liquidate some of their holdings. Gilt yields might then fall.* GAD agree that it was a matter for Equitable rather than Clerical Medical and suggest that FSA should pursue the matter with Equitable's Chief Executive, should they wish to do so.
06/04/2001 [17:20]	FSA's Director of GCD queries where FSA have got to on '*the coverage of the Equitable by the compensation scheme*'. The Director of GCD says that it would be appropriate now to make HMT aware of the situation, as they were currently considering other aspects of the scheme in the context of another case.
06/04/2001 [17:20]	FSA's Director of GCD writes to FSA's Director of Consumer Relations saying that:

As I understand it, there have been a series of discussions with the OFT, in which it has been plain that they would not seek to take action against the Equitable under their unfair terms in consumer contract powers, if the Equitable made clear in a public statement the criteria they would apply when calculating the MVA.

We have encouraged the Equitable to do this over a fair period, but so far without success.

The Director of GCD suggests that, as her division had lead responsibility for the Unfair Terms in Consumer Contracts Regulations, she and the Director of Insurance, as a fellow regulator in the same field, might want to discuss how to take matters forward.

09/04/2001 [10:52] FSA write to Equitable's solicitors as '*there is concern about the power of the Action Groups to vote for new Directors, engage in spoiling tactics by seeking Special resolutions etc*'.

FSA ask whether Equitable's Memorandum and Articles, reprinted on 19 May 1995, was the current version and whether there had been any amendments made since then.

[**16:05**] Equitable's solicitors reply that they understood that this version was the up to date one but say that they would confirm this with Equitable.

09/04/2001 [12:06] PIA send GAD copies of the Independent Actuarial Expert's and the Independent Legal Expert's reports for the rectification scheme.

09/04/2001 [12:26] FSA's Insolvency Practitioner replies to Line Manager E's note of 06/04/2001 [**11:17**] asking a number of questions, including: about the timing of receipt of the '*Explanatory Statement*'; whether Equitable wish FSA to provide a statement for inclusion in the documentation; and:

Will each policyholder be sent a statement showing the value of his policy now and after the proposed uplift. If this includes a statement of asset shares then, from [Equitable's Chief Executive's] *comments on 4 April, the aggregate asset shares might exceed the present market value of assets. Can they avoid showing any aggregate financial position?*

[**13:29**] Line Manager E provides some comments on these questions. On the last point, he says:

It will be based on some figures that will clearly need to be explained to policyholders. They have not finally settled which "valuation" figure to use, but they are likely to go with a year end valuation.

[**17:57**] GAD comment:

[The Insolvency Practitioner] *asks ... which "value" the Society will quote to policyholders in any statement they receive. From* [Line Manager E's] *reply it looks that they expect to use year-end valuation reserves from the regulatory returns (which exclude terminal bonus). They are unlikely to use aggregate asset shares – even though these represent the policyholders' interest in the fund – because they feature in neither the regulatory returns nor the companies act accounts. However we would wish to keep an eye on what they are proposing, so please can you keep us in the picture.*

GAD also ask to be invited to any meeting with Equitable's Appointed Actuary about the scheme.

09/04/2001 [15:55] Further to FSA's letter of 27/03/2001, Equitable apply for two section 68 Orders to require them to prepare their returns on a particular basis.

The first is to require the proceeds of the sale of Permanent Insurance to be included in the returns as at 31 December 2000, as a binding agreement had been in place at that time (although subject to regulatory approval). Equitable state that the sale had been completed on 16 February 2001.

The second is to require Equitable to use an aggregate rate of interest for the fixed interest assets held.

09/04/2001 [17:01] GAD send FSA two further points from the meeting with Equitable on 04/04/2001 that they say might be worth recording.

The first is that Equitable's Chief Executive had said that Equitable reserved the right to impose a specific surrender penalty to improve the financial position of the fund. GAD say that they had indicated that this would be potentially unfair to departing policyholders, which might raise regulatory issues with FSA and the OFT.

The second point concerned the 2000 returns, as GAD would have concerns if these were solely signed off by the individual who had been Appointed Actuary as at 31 December 2000, as:

> *He has been displaced successfully as finance director, appointed actuary and chief executive, and may yet be the subject of possible action by either the society, its members, or the actuarial profession. Accordingly, we believe that it would be prudent to seek another actuary's signature on these returns.*

09/04/2001 [19:35] FSA's Director of Consumer Relations tells the Director of GCD that her division would take forward, in discussion with the Director of Insurance, the work on the Unfair Terms in Consumer Contracts Regulations 1999 and the complaints about Equitable's use of the market value adjuster.

[**19:56**] The Director of Insurance comments:

> *I have already expressed the view that we should take the lead on responding to complaints against the* [Equitable] *on* [unfair contract terms] *grounds. As I understand it we gain our new powers on 1 May. But that should not inhibit us from taking matters up with the Society before then so that we have a settled position (and hopefully they have done whatever is necessary) by 1 May. We will in any case come under immediate pressure as soon as complainants know that we are in the lead.*
>
> *I understand that OFT have offered to share their expertise with us, at least in the early months. It will be* [the Director of Consumer Relations'] *call whether we accept this, but my instinct is that we should (and that we should gain whatever public advantage/protection we can by so doing). Some people will inevitably complain that we are insufficiently impartial and that we will give insufficient weight to the interest of individual policyholders, given our interest in seeing an outcome that is in the interests of policyholders as a whole. I think this would be unreasonable (and probably to misunderstand the approach we will take to our responsibilities under the* [unfair contract terms] *legislation), but it will not stop people thinking and saying it.*

09/04/2001 [20:12] FSA's Chief Counsel A asks the Director of GCD if they could discuss Line Manager E's note of 06/04/2001 about the compromise scheme, as she was concerned about appointing lawyers to represent each policyholder class.

After an exchange of correspondence, the Director of GCD later agrees (on 11 April 2001) that it would be a good idea to speak with Counsel about the matter.

10/04/2001 [entry 1] FSA's Line Manager E says that Equitable's notification of the appointment of their new Appointed Actuary given on 06/04/2001 appears to comply with section 19(2) of ICA 1982. Next to this Line Supervisor C has written: '*we would like a form*'.

10/04/2001 [09:11]	In reply to 09/04/2001 [**19:56**], FSA's Director of Consumer Relations agrees that it would be a good idea, and in their interests, for FSA to involve the OFT. [**15:50**] The Head of Life Insurance tells Line Manager E that FSA '*will need to reach an agreed view as to what exactly we consider that* [Equitable] *need to do to satisfy us on* [unfair contract terms]'. [**16:02**] Line Manager E sets out his understanding of the position as being: *i) Equitable have replied to the OFT's last letter, offering to go forward on the basis I agreed with OFT;* *ii) we and Equitable are awaiting a response from OFT confirming they continue to hold the view that they had expressed previously;* *iii) when that has been done, or when a suitable opportunity next arises (such as in material about the GAR compromise scheme, or as part of the next with-profits guide), we will work with Equitable to get them to put out material that gives the clarification that we all want to see;* *iv) there is a need to take forward the same issue on an industry wide basis, and the with profits review appears the most sensible place for that work to take place.*
10/04/2001 [09:37]	FSA's Legal Adviser D sends the Director of GCD a copy of her note of 05/04/2001 [**11:27**]. [**11:22**] The Director comments that it is '*important to remember the importance of the board representing the policyholders fully, even though this may look to make it more difficult short term for the management to secure a resolution of the GAR/non GAR issue*'.
10/04/2001 [10:32]	FSA ask GAD for help with a paper for FSA's Insurance Supervisory Committee and how to describe Regulation 69 and Equitable's intended valuation of fixed interest stocks in their 2000 returns.
10/04/2001 [11:24]	FSA ask GAD for assistance in relation to the wording of the draft section 68 Order which they had discussed on 27/03/2001. FSA say: '*There has now been discussion about "segments" and I wondered if something needed to be said to cover the concept of those segments. Do they need to be defined, perhaps by explicit reference to the three categories set out in Equitable's draft letter? Or is "relevant asset portfolio" enough?*'. FSA set out part of the wording of a draft Order that had been prepared in December 2000. [**12:19**] GAD say that they think the section 68 Order should make reference to the three segments as described in Equitable's letter of 23/03/2001. GAD suggest a form of words and ask Legal Adviser A to confirm whether he thinks this is okay.
10/04/2001 [16:37]	FSA's Line Manager E sends the Head of Life Insurance, Legal Adviser A and Line Supervisor C and GAD a draft paper for the Insurance Supervisory Committee and draft section 68 Order for the valuation of Permanent Insurance. The Line Manager explains that: '*I have put that the order expires on 30 December 2001 – since it seems to me that the revised valuation has to apply as at end 2000, up until the cash was paid over, and for* [at] *least until the day on which the returns are submitted*'. The Line Manager also explains that he had tried not to focus on the impact of an Order not being granted and the valuation in the regulatory returns remaining at £25m (rather than £150m), instead focusing on consistency with the Companies Act accounts. [**17:36**] The Head of Life Insurance says '*OK by me*'.

10/04/2001 [17:20] FSA's Line Manager E seeks comments from the Head of Life Insurance, Line Supervisor C and Legal Adviser A and GAD on a draft paper for the Insurance Supervisory Committee, which suggests that they should recommend to HMT that Equitable's section 68 Order for the valuation of fixed interest securities should be granted.

The '*Background*' section of the paper explains:

> *Equitable has identified a problem with the valuation (of liabilities) regulations in that Regulation 69, when applied to a portfolio of fixed interest assets, can produce anomalous results in certain circumstances. The problem arises because the Regulations require the gross redemption yield on fixed interest stocks to be calculated on a stock-by-stock basis. The "average" gross redemption yield on a portfolio of stocks, which are used to match a particular block of liabilities, is then a weighted average of the gross redemption yields of each stock held, where the "weights" are solely the market values of the stocks. In theory, the result should also be weighted by the term (i.e. the outstanding duration) of each stock.*
>
> *In the resilience tests, the assumed changes in yields of fixed interest securities do not necessarily lead to a uniform change in market values of the stocks held (i.e. the market values of some stocks will change by proportionately more than is the case for others, depending on the outstanding duration of the stock).*
>
> *This means that in the resilience scenario, even if the assets and liabilities were matched (by amount and duration) in the first place, the valuation rate of interest which is used to determine the liabilities may be determined inappropriately, and this can lead to a spurious release of reserves, or a strain on the fund.*
>
> *The problem was previously identified by* [an insurance company] *in 1995, and by* [another insurance company] *in 2000, each of whom now have similar section 68 Orders to overcome the problem.*

FSA's paper continues:

> *Whilst the Section 68 Order sought by the Equitable is similar to that granted to the two companies above, it differs in the detail.* [The two insurance companies] *identify a block of assets which is deemed to match a particular liability, and treat that block (which may include different types of fixed interest securities with different characteristics) as one "large" asset when calculating the yield. Equitable, however, wants to divide the fixed interest portfolio into three segments, calculate the yield on each segment as if that segment were one asset, and then bundle together parts of each segment to match a particular liability. Each segment constitutes a "synthetic bond".*
>
> *The three segments are as follows:*
>
> - *approved fixed interest securities;*
> - *other fixed interest securities excluding convertible fixed interest securities; and*
> - *convertible fixed interest securities.*
>
> *Equitable believes that, by calculating the valuation rate of interest on "segments" of assets in this way, artificial strains and releases in the resilience scenarios will be avoided. Indeed, in discussions with Equitable last December, they indicated that the resilience reserve they were then holding was inflated unnecessarily by £300m on account of this feature.*

It continues:

> *As noted above, the effect of concession being sought as an alternative to the methodology required by regulation 69 can vary from year to year depending on economic circumstances. At the moment, the concession would lead to an improvement in the company's financial position by removing an unnecessary strain. However, since the position could move the other way, we have made it clear to the company that a request for a concession would only be considered if the company would also use that valuation basis in future years, when it produced a less favourable result. For that reason, the Order has permanent effect and cannot cease to have effect other than where it is expressly withdrawn by the Treasury. Equitable will not therefore be able to opt out of this valuation basis by failing to make the necessary disclosure in its annual return or failing to notify a material change to the circumstances of the company.*
>
> *GAD believe that, on that basis, it would be reasonable to grant this Order to the Society.*

10/04/2001 [19:43] Equitable's solicitors send FSA confirmation from Equitable that the Memorandum and Articles that they have (i.e. the version reprinted on 19 May 1995) is the current version.

11/04/2001 [11:03] FSA's Legal Adviser A provides Line Manager E with a redrafted section 68 Order for the valuation of Permanent Insurance as '*I am not sure your draft will work*'. The Legal Adviser explains:

> *I think we have a difficulty here. We have agreed that, in principle, we can give a reporting concession in respect of the position at the 2000 year end. That is what my draft is intended to do. However in respect of the position going forward up to the date the agreement was completed, what would be needed would be a substantive concession. However, if we grant this now to cover the period from 1 January or whenever then we would be granting the concession retrospectively which it is generally accepted that we cannot do. For practical purposes, it seems to me that the lack of a concession will only matter if the company in 2001 would be unable to certify that the margin of solvency had been maintained throughout the year.*

[**11:41**] GAD say that they support the alternative approach but advise FSA that:

> *Since ... the reporting concession does not give the Society any benefit over the period from 1 January 2001 to the date the sale was completed, we recommend that the Society are alerted to this. They can then consider what impact (if any) this has on their solvency coverage over the period.*

11/04/2001 [13:06] FSA's Line Manager E sends the Insurance Supervisory Committee and GAD copies of two papers for consideration at the Committee's next meeting on 17/04/2001 [**14:30**].

The Line Manager states:

> *Core members for next week's committee may also wish to note that both papers will also be subject to approval (or otherwise) by* [FSA's Chairman] *and* [Managing Director A] *before a recommendation is made to the Treasury. That will be done in parallel with the committee's consideration.*

[**15:51**] GAD suggest some amendments to the wording of the Order for the valuation rates of interest for fixed interest securities.

11/04/2001 [13:54] GAD write further to their comments of 09/04/2001 [**17:01**], saying:

> *... I believe that we shall need to consider what action maybe appropriate to take over ... the former Appointed Actuary to Equitable Life. Although he has now relinquished this role, I understand from our last meeting with Equitable that he is still the appointed actuary of University Life and of course still retains his practising certificate from the profession.*
>
> *The 2 specific issues on which we have hard evidence that could be referred to the profession in order for them to investigate his conduct, relate to his assessment of the mathematical reserves.*
>
> > *1) He did not hold any reserve for* [guaranteed annuity options] *in the 1997 returns (even though they were then "in the money"), and was opposed to holding any significant reserves in the 1998 returns. However, we know that his argument to support this position was rejected as unsound by a working party of actuaries in 1997.*
> >
> > *2) He included a very odd "Zillmer-type" adjustment for pension policies in the 1997 and subsequent returns, which we believe is likely to be contrary to professional guidance note GN8 (although in mitigation he did hold a hidden margin that largely offset this adjustment).*

GAD continue:

> *There may of course be further issues that emerge from any investigation of Equitable that may take place, regarding for example whether he took reasonable steps to ensure that incoming policyholders were not misled as to their expectations.*
>
> *We had held off any action while he still had a central role in the Court cases and subsequent "sale" of Equitable, but I think we shall now need to decide when would be an opportune time to present any case to the actuarial profession for further investigation.*

11/04/2001 [14:30] FSA's Legal Adviser D sends the Director of GCD (copied to other officials) a paper on FSA's powers of intervention under ICA 1982 in relation to appointments to Equitable's Board of Directors nominated by policyholder action groups.

The Legal Adviser notes that prior approval of the appointment of a director was not required. She then sets out FSA's sound and prudent management powers:

> *Under its delegated powers from HMT, the FSA can intervene under Section 37(2)(aa) Insurance Companies Act 1982 ... if it appears to the FSA "that any of the criteria of sound and prudent management is not or has not been <u>or may not be</u> or may not have been fulfilled with respect to the company". (Emphasis added). I construe this as an anticipatory power of intervention which could be exercised if any Action Group was insistent upon a particular candidate about whom the FSA could be satisfied that he/she was not fit and proper. However it has to be kept in mind that powers of intervention are excisable against the company. In these circumstances it will be difficult to prevent the members electing particular directors.*

Legal Adviser D then highlights some of the criteria of sound and prudent management including:

> *Paragraph 7 of Schedule 2A might also be relevant since it provides "The insurance company shall <u>not</u> be regarded as conducting its business in a sound and prudent manner if it fails to conduct its business with due regard to the interest of policyholders and potential policyholders.*

	Legal Adviser D explains FSA's powers to impose requirements under section 45 of ICA 1982 and that '*there may be scope, for example, to require the company to call an* [emergency general meeting] *with a view to electing further directors with insurance experience or to change its Articles relating to the requirement as to the number of directors ...*'. The paper concludes with an explanation of FSA's ability to petition to wind up the company: *Should Equitable Life end up with a wholly unsuitable board of new directors, then the FSA could in the last resort present a petition for its winding up on the grounds that this was expedient in the public interest. Should the Equitable be ungovernable that might, at the end of the day, be the only solution. However I presume that with the benefit of prior informal consultation it is unlikely that a wholly unsuitable board will be elected and this draconian measure will not be necessary.*
11/04/2001 [15:20]	FSA's Line Manager E seeks confirmation that he should recommend to Managing Director A that FSA should approve the appointment of Equitable's new Chief Executive.
11/04/2001 [15:43]	Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.
11/04/2001 [15:50]	FSA write to Halifax's advisers for the sale with a number of questions and observations about the Merged Agreement between Equitable and Clerical Medical.
11/04/2001 [16:42]	FSA's Line Manager E prepares a summary of the information supplied by Equitable on the handling of calls and requests for transfers and switches. The Line Manager says that there were still a considerable number of calls from consumers and an analysis of the content of the calls shows: *1.2% wanted to move out of the with profits fund, and 7.6% wanted information about doing so.* [Still] *1 caller in a hundred believed that the society was insolvent. 31% were chasing payments, and 19% were chasing other forms of servicing work. 6% had questions about the recent bonus notices. The balance (about 30%) are recorded as "general enquiries".* On requests for surrenders, the Line Manager reports: *The total level of surrenders since December 2000 has now reached £801 million. This includes leavers from the unit-linked funds and switches from with profits to unit linked. £642 million has been withdrawn from the with-profits fund. The corresponding cumulative figures for the period from closure to end January (roughly 7 weeks) were £427m and £360m, which means* [that] *in the last 10-11 weeks, the amounts have increased by £374m and £282m respectively.*
11/04/2001 [16:49]	FSA's Line Manager E informs the Insurance Supervisory Committee of a mistake in the paper on the valuation of Permanent Insurance. The Line Manager also explains that the Order sought was a '*one off*' reporting concession and not a permanent one, as the paper had suggested.
11/04/2001 [17:09]	FSA's Line Manager E asks Legal Adviser A and GAD to check his understanding of the position in relation to whether Equitable's auditors at 31 December 2000 or their current ones should sign off the auditors' certificate in the returns. This, it is said, was in response to Equitable seeking comfort from FSA about asking their former auditors to do it.
11/04/2001 [18:40]	The Financial Services Consumer Panel send FSA a note explaining the research on Equitable that they proposed to carry out. The Panel say that their aim is to test whether policyholders

'*are suffering an information gap about Equitable Life's situation, and whether there is any consumer detriment as a result*'. The Panel explain that:

> *Such consumer detriment might come about because policyholders are distressed, because they have taken inappropriate action (or are not taking action due to lack of information), or because of a drop in market confidence.*

and say that:

> *The Panel share some of the FSA's concerns that they must not become or be seen to want to become quasi-decision makers for the Equitable, and certainly not prejudice any regulatory action nor the outcome of a vote.*

The Panel also say that: '*This research is not intended to test whether consumers feel that they were mis-sold (*[post-House of Lords'] *ruling) nor whether they understand the GAR compromise deal (not least because it won't be on the table at that stage). Further research may test these things and clearly they are highly sensitive. Following his meeting with* [FSA's Chairman] *on Monday,* [the chairman of the Panel] *is extremely keen to ensure that any research would not jeopardise enforcement action regarding the sale of Equitable Life products post-*[House of Lords'] *ruling*'.

11/04/2001 [entry 12] FSA meet Equitable's Chairman for a brief update on developments.

The points discussed include:

1. that Equitable had heard no more from the OFT in response to their letter. FSA inform Equitable that they were now taking the lead on the Unfair Terms in Consumer Contracts Regulations and would deal with current and future complaints against Equitable;
2. that Equitable had no developments on the market value adjuster to report;
3. that Equitable had suggested that mis-selling complaints might be reviewed by the Centre for Effective Dispute Resolution and that they would welcome FSA's views on this approach;
4. that the preliminary results of an Equitable survey had suggested that both GAR and non-GAR policyholders were keen to settle their claims through a compromise scheme. Work done by Equitable on the compromise suggested that a flat rate uplift to policy values of 20% looked justifiable;
5. that the new Board appointments would be announced on 12 April 2001 but would have to be confirmed through re-election at the annual general meeting;
6. that the old Board had now resigned but had signed off the Companies Act reports and accounts; and
7. that Equitable had been presented with a case for legal action against the former directors and advisers which was '*sufficiently substantial to make it impossible to ignore*'.

12/04/2001 [08:38] FSA's Chairman comments, on the meeting with Equitable's Chairman the previous day, that the position '*sounds a touch more optimistic than we might have feared*'.

[**10:51**] The Director of GCD tells Chief Counsel B that the main legal action point was to think through the proposal to ask the Centre for Effective Dispute Resolution to look at mis-selling claims.

[**11:59**] An FSA official provides advice on how the Centre generally operates.

[**13:50**] Managing Director A relays to the Director of GCD and Chief Counsel B that FSA's Chairman has strong reservations about FSA allowing Equitable to use the Centre for Effective Dispute Resolution and '*most importantly, he feels any investigations of* [mis-selling] *ought to be done by us – this is where the buck stops*'.

[**11:04**] FSA inform PIA of the approach that was being considered.

[**14:00**] PIA update FSA on the timetable for completing their review of Equitable's disclosure of the risk of losing the court case.

12/04/2001 [08:54] FSA's Head of Life Insurance comments that there was to be an investigation undertaken by the actuarial profession into Equitable which would presumably cover the ground suggested by GAD on 11/04/2001 [**13:54**].

[**09:02**] GAD reply that they understood that the actuarial profession's inquiry was to look at the overall circumstances rather than the conduct of particular individuals. GAD add, however, that they had heard confidentially that a complaint had been made to the profession about the former Appointed Actuary in question.

GAD suggest that, as they did not know what evidence had been presented in support of this complaint, there was still the outstanding question of whether FSA, as regulators, should present a case against the former Appointed Actuary.

[**10:40**] The Director of Insurance comments that it might be preferable to wait for the actuarial profession to ask for evidence from FSA, rather than initiating a complaint themselves at a time when FSA's own role was under review. The Director of Insurance asks how FSA could ensure that the actuarial profession sought evidence from FSA.

[**11:14**] GAD explain that the rules of the profession's investigation committee appeared to allow them to require any member of the profession to give evidence in relation to a complaint against another member. GAD explain that FSA could reasonably expect to be contacted for information, although there '*would no doubt then be some legal hurdles that we would need to look at carefully*'.

12/04/2001 [09:45] FSA's Director of GCD writes to Chief Counsel A about FSA's meeting with Equitable on 04/04/2001 [**11:00**]. He raises four queries about the note including, in relation to Board appointments:

> *I do not know Jeremy Lever QC, but it sounds very odd to regard him as of insufficient calibre. This sounds like just an excuse to keep action group members off the Board.*

12/04/2001 [09:50] FSA's Head of Life Insurance tells Line Manager E that he agreed with the substantive conclusion that FSA should approve the appointment of Equitable's new Chief Executive.

12/04/2001 [11:27] FSA's Line Manager E seeks the views of Legal Adviser A and Chief Counsel A on a note to Managing Director A (copied to FSA's Chairman) seeking his agreement for FSA approval of the appointment of Equitable's new Chief Executive.

[**14:51**] Legal Adviser A suggests that, as the only information requested that FSA were yet to receive in relation to the appointment concerned the final composition of the Board, Line Manager E needed to consider whether he was '*satisfied that <u>whatever the composition of the board</u>* [the individual] *is fit and proper to be chief executive*'.

[**15:02**] The Line Manager sends the note to the Managing Director recommending that FSA should not object to the appointment of the Society's new Chief Executive.

FSA's Chairman comments '*I agree*'.

12/04/2001 [12:21]	FSA's Line Manager E suggests to Legal Adviser A and GAD that FSA should not provide any comments to Equitable or Halifax on the few short agreements relating to the transfer of '*things such as real or intellectual property*'. The Line Manager does, however, say that FSA should remind them that FSA were yet to receive the final version of the reinsurance agreements. Later, on 18 April 2001 [**10:09**], the Head of Life Insurance says that he is happy to go with Line Manager E's judgement on this.
12/04/2001 [12:27]	In relation to Equitable's application for a section 68 Order for the valuation rates of interest for fixed interest securities, a member of FSA's Insurance Supervisory Committee advises Line Manager E and the Committee that: *From previous experience I have come to the view that the existing regulations are defective in this respect ... A proper calculation of the yield on the total portfolio, which effectively weights the yield on each stock by its mean term, is required to produce theoretically correct results.*
12/04/2001 [15:45]	FSA's Legal Adviser A advises Line Manager E that there was nothing in the regulations of which he was aware that would prevent Equitable's former auditors from providing the auditors' certificate to the 2000 returns, by reason only that they had ceased to be auditors of the company at a time subsequent to the period to which the returns related.
12/04/2001 [16:01]	FSA's Legal Adviser D provides comments to Chief Counsel A on Equitable's solicitors' timetable for the compromise scheme. She says that it is '*very optimistic indeed*' and she outlines the stages to reach the suggested date for a court hearing to sanction the scheme of 3 November 2001. The Legal Adviser concludes that the: '*... bottom line is that I cannot see Equitable,* [their solicitors] *and FSA between us achieving the outline timetable. There are too many issues still to be resolved*'.
12/04/2001 [entry 10]	The Financial Services Consumer Panel send FSA a copy of a letter from their Chairman to Equitable dated 2 April 2001 and Equitable's response of 9 April 2001. The letters detail the discussions that had taken place at a meeting the previous week about how the Society was communicating with its policyholders.
17/04/2001 [12:32]	FSA's Consumer Panel Secretariat seek comments from Line Manager E on what groups of Equitable policyholder should be used when conducting some consumer research that they proposed to carry out, and also on a draft letter to Equitable about this project.
17/04/2001 [14:30]	FSA's Insurance Supervisory Committee consider Equitable's application for a section 68 Order in respect of the valuation of Permanent Insurance as at 31 December 2000 (Paper 180/2001). The minutes record: *The Committee noted that* [Managing Director A] *would take the FSA's decision on whether to recommend such an order to the Treasury.* [Line Manager E] *opened the discussion by saying that the committee was dealing with events that had already happened, and was a true reporting concession. The sale of the Permanent* [Insurance] *had been agreed before the year end and was conditional only on regulatory approval. Companies Act accounts would properly value the Permanent* [Insurance] *at the sale price.*

The Committee concluded that, although circumstances like this did not arise often, it would be prepared to recommend an Order along these lines for any company in similar circumstances.

<u>The Committee recommended to</u> <u>[the Managing Director]</u> *<u>that he should recommend the Order as proposed.</u>*

The Committee also consider Equitable's application for a section 68 Order in respect of the valuing of the interests rates of fixed interest assets in aggregate.

The minutes record:

<u>Issue:</u> Whether the company should (a) be granted a permanent section 68 Order allowing it to adopt a method of determining the valuation rate of interest that is different from that prescribed by Regulation 69(11) of the Insurance Companies Regulations 1994 and, (b) whether it should be able to report the 2000 year end position as if such a concession had been in place.

The Committee noted that [the Managing Director] *would take the FSA's decision on whether to recommend such an order to the Treasury.*

The Chairman thanked [an actuarial member of the committee] *for circulating a note about the general problems with Regulation 69(11) as drafted. (This note is attached at the end of this minute.)*

The Committee noted that Regulation 69(11) was flawed and that a technically more defensible method of valuation would involve weighting all the securities in the portfolio by duration as well as value. Three major insurance companies had been given concessions allowing them to do this.

The committee noted that it would be desirable to change Regulation 69(11) when we get to the Integrated Prudential Sourcebook. It was pointed out that this was not done in the Interim Prudential Sourcebook.

The Committee noted, however, that the concession sought by Equitable Life was not in the same form as for other companies, but involved "bundling" the assets into three categories. It was explained that this approach had been recommended by GAD. GAD were not able to attend the committee, however, and neither of the actuaries present could immediately explain the rationale for the bundling approach.

<u>The Committee considered that, whilst it would have been prepared to recommend a concession for Equitable Life similar to that granted to other insurance companies, it was not prepared to recommend one in the form proposed without further justification. It invited the supervisory team to give further consideration to the way forward, in consultation with GAD. If urgent action were needed, the issue could be considered by the core members ... by correspondence.</u>

The note by the actuarial member of the Committee demonstrates in a simplified way the perverse results that Regulation 69(11) could produce where a company whose assets were insufficient to cover their liabilities could be demonstrated to be solvent under the Regulations, and insolvent using the proposed approach and vice versa.

17/04/2001 [entry 3] FSA report to GAD the outcome of the Insurance Supervisory Committee's consideration, saying that, while the principle of addressing the deficiencies in the regulations had been supported, the method proposed by Equitable had been questioned. FSA say:

The centre of the issue was whether it was proper to do the calculation on the basis of segments of assets rather than on the portfolio as a whole.

FSA say that they needed to establish whether Equitable's approach was better than that used in the Orders already granted or whether they needed to persuade Equitable to adopt the other approach.

17/04/2001 [14:52] FSA's Managing Director A reminds Equitable's supervisors that care was needed in their current dealings with the company, given that they had instructed solicitors to review the possibility of taking action against '*anyone "responsible" for past losses*'. The Managing Director says:

> *While* [Equitable's Chairman] *has not suggested that the FSA is in the firing line, it is equally true that he has not ruled us out (indeed it is hard to see how he could in the circumstances). It therefore follows that anything said to him or to other Executives (especially put in writing) is more than usually at risk of being used in subsequent litigation. There is particular need (again this probably needs no reminder given that we have seen misuse/ misrepresentation already by the press) to avoid saying anything that implies the regulators in the past have made mistakes.*
>
> *I will speak to* [their Chairman] *next time I see him to point out as politely as possible that – while FSA might in due course be in the firing line – he has to understand that our relationship will inevitably be constrained, especially when it veers into the pre-December 2000 period.*

17/04/2001 [17:56] FSA's Managing Director A advises Line Manager E that, having discussed the issue with FSA's Chairman, FSA should confirm the appointment of Equitable's Chief Executive.

17/04/2001 [entry 6] FSA and PIA meet to discuss Equitable's proposal that they should ask the Centre for Effective Dispute Resolution to consider complaints from policyholders that all non-GAR policies had been mis-sold. Managing Director A and another official provide FSA's Chairman with a note of the items discussed and a number of decisions for FSA.

On mis-selling in the period between the Court of Appeal decision and closure to new business, the note explains that a report on PIA's review of marketing literature, training material and guidance to advisers issued by Equitable would be completed by 30/04/2001.

It was noted that a second stage report on the information FSA would expect to be disclosed would be completed by 31 May 2001. FSA set out two questions:

> *There is a risk that at the end-May, we will be unable to reach a final conclusion about the reasonableness of Equitable's disclosure due to lack of information. For example, at an early stage, we decided not to request copies of Board papers from Equitable. <u>Should we reverse that decision at this stage?</u>*
>
> *Ultimately, the* [Financial Services] *Ombudsman will consider individual claims for compensation. The Ombudsman will be required to review cases in light of Court requirements. <u>Should we seek Counsel's opinion on how a Court might react before finalising Stage II of our review?</u>*

FSA set out the discussion on claims that all non-GAR policies had been mis-sold. They consider seeking a ruling from the Centre for Effective Dispute Resolution not to be an attractive option unless Equitable were satisfied that it fitted with the objective of securing a compromise between policyholders.

FSA say that FSA and PIA needed to fully explore the issues that were within their ambits, '*and any mis-selling* [post-1988] *potentially must be*', before they could take a view on the compromise scheme that was to be put to policyholders. FSA suggest an early meeting to discuss these issues.

17/04/2001 [entry 7] FSA's Chairman replies to the Deputy Director General of Fair Trading's letter of 03/04/2001. The Chairman says:

> *I am sure you are correct to suggest that for OFT to pursue these cases would risk cutting across the review of with-profits business which I announced in February. Since the FSA will shortly gain powers under the* [Unfair Terms in Consumer Contracts] *Regulations I think it does make sense for us to take on these complaints, and we shall be happy to do so.*

17/04/2001 [entry 8] FSA's regulatory supervisor for Halifax sends Line Manager E copies of reports by Halifax on the progress, as at the week ending 23 March 2001, of the programme for the integration of Equitable's assets.

17/04/2001 [entry 9] Halifax inform FSA of the change of name of Equitable Investment Fund Managers Limited to Halifax Investment Fund Management Limited.

18/04/2001 [09:28] FSA write again to GAD's Scrutinising Actuary F about Equitable's proposed method valuing fixed interest securities (see 17/04/2001 [**14:30 and entry 3**]). FSA say that they had spoken to Chief Actuary C, who had seen no difficulty with Equitable's segmented approach. However, FSA note that the actuarial member of the Insurance Supervisory Committee had raised objections (though not strongly) that the approach could be used to '*pick and choose*'.

18/04/2001 [15:06] PIA provide FSA with an update on their work in assessing Equitable's disclosures to investors after the Court of Appeal decision.

PIA say that they are assessing Equitable's written communications in the areas of: advised sales documentation; complaints cases; advertising and promotion material; and training and briefing material for sales staff. PIA say that they hoped to produce a summary of this factual report by 30/04/2001. PIA continue:

> *Assessment of this material makes Equitable's position clear. It did not disclose to potential investors the following risks:*
>
> > *a) the risks (following the Court of Appeal) of an adverse House of Lords ruling that might have a material financial impact.*
> >
> > *b) that (especially after the House of Lords decision) its with profits fund contained a population of GAR investors who, on exercising their rights through further investment, as a result of falling interest rates or otherwise, could reduce the funds available to meet the claims or growth expectations of non-GAR with profits policyholders.*
> >
> > *c) that a purchaser of the business might not* [be] *found, and what the consequences of this could be.*

PIA note that it is Equitable's view that they had not disclosed these risks as they thought them unlikely to occur.

PIA explain that the next stage for them was, by 31 May 2001, to establish the relevant PIA and Adopted LAUTRO Rules standards and whether Equitable were in breach of these standards.

PIA ask for FSA's help so that they could obtain a reasonable and objective view of the probabilities and impact of the risks described above and, in particular, seek FSA's thoughts on:

> *a) The risk position after the Court of Appeal decision, and whether this changed in the period up to the House of Lords ruling.*

> *b) The impact the House of Lords ruling on other investors of GAR holders investing further into their existing policies (or their rights otherwise becoming more costly)? What was a reasonable assessment of the impact of GAR policyholders on non-GAR policyholders' investments?*
>
> *c) The consequences of a purchaser not being found.*

PIA suggest that a meeting is held during the next couple of days.

19/04/2001 [entry 1]	FSA inform Equitable that, after consideration of the notifications and the information available to them, they had decided not to object to the appointment of Equitable's Chief Executive. [**10:43**] Before it is sent, Line Manager E asks for comments on the draft for Legal Adviser A and the Head of Life Insurance, saying that '*it is sensible to have a slightly more technical (and possibly fuller) response than we might normally have given*'.
19/04/2001 [entry 2]	FSA's Managing Director A submits his Managing Director's report to a meeting of the FSA Board, which includes an update on their regulation of Equitable. Among the issues reported, he says that Equitable's financial position was '*much improved*' following the Halifax deal.
19/04/2001 [19:33]	Equitable inform FSA that they had decided to '*remove the potential to write new business from the scope of the Society's proposed agent in Ireland*'. Equitable ask for FSA's approval, by the following day, of the appointment of the agent.
20/04/2001 [entry 1]	A GAD actuary passes Scrutinising Actuary F a copy of the progress report on the integration of Equitable and Halifax/Clerical Medical, noting: *Interesting Risk on the last page: Closed Fund of ELAS may not be getting enough attention/resources.*
20/04/2001 [entry 2]	FSA write to Equitable about the issue of the auditor's report for the 2000 returns. FSA say that it would be desirable for the Society's soon-to-be former auditors to provide the auditors' certificate in the returns as they had been the auditors at 31 December 2000.
20/04/2001 [09:07]	An FSA legal adviser circulates an agenda for an Equitable Life Lawyers Group meeting planned for 23 April 2001. (Note: it appears that the meeting did not take place.)
20/04/2001 [09:18]	FSA's Line Manager E circulates Equitable's minutes of their Compromise Scheme Steering Group meeting on 05/04/2001 (which he had received the previous day). The Line Manager says that there was no news on the whereabouts of the actuarial report that was due to be discussed at the next meeting on 23/04/2001. [**15:36**] Chief Counsel A also sends Counsel copies of Equitable's solicitors' note on the determination of voting classes for the scheme, along with an Equitable progress report as at 4 April 2001. [**15:50**] Chief Counsel A sends the minutes to Counsel.
20/04/2001 [12:30]	FSA's Line Manager E seeks advice from Legal Adviser A on whether Equitable's proposals for their Republic of Ireland branch constituted it continuing or closing.
20/04/2001 [12:49]	FSA's Legal Adviser D circulates a list of issues and action points relating to the compromise scheme. [**14:19**] Chief Counsel A passes the list to the Insolvency Practitioner and to GAD.

20/04/2001 [14:00]	FSA send Equitable a suggested agenda for their meeting to be held on 23/04/2001, being: communications with policyholders; the compromise scheme; Equitable's current financial position as '*the latest position we have seen relates to end January*'; and their 2000 returns and applications for section 68 Orders.
20/04/2001 [14:56]	FSA's Consumer Panel Secretariat write to Equitable to seek policyholder details so that they could carry out some consumer research. The Secretariat send a copy of their letter to Line Manager E.
20/04/2001 [16:36]	Equitable send FSA the latest documents on the compromise scheme ahead of a meeting of the steering group on 23/04/2001 [**14:30**].
20/04/2001 [16:42]	FSA speak to Equitable's solicitors, who say that they were having difficulty finding '*heavyweight*' legal representatives for the GAR and non-GAR policyholder classes. Chief Counsel A also speaks to Counsel.
20/04/2001 [19:23]	FSA's Chief Counsel A asks an FSA official whether FSA or previous insurance regulators had ever appeared before the court in section 425 proceedings. She asks how FSA's views would be made known (to the company and to the court).
22/04/2001 [20:04]	FSA's Chief Counsel A responds to the Director of GCD's queries of 12/04/2001 [**09:45**] about the meeting with Equitable on 04/04/2001 [**11:00**]. The Chief Counsel says that she was happy with Equitable's answer about the market value adjuster applied to group schemes, as: *The Equitable say they have (so far at least) calculated these MVAs on a group basis, applying the same MVA to both GAR and non-GAR policyholders*. On whether FSA needed to request the Equitable Board papers in order to do their review of mis-selling, Chief Counsel A suggests that this was a matter for PIA, noting: *I suggested at the time of the leak of Board papers that we might obtain the papers to consider whether they raised fit and proper concerns. I believe it was considered, but presumably rejected.* Chief Counsel A agrees with the Director's comments about one of the policyholder action group's nominations for appointment to Equitable's Board but points out that: [Equitable's Chairman] *is reported as saying that he will only resist appointments that are made to represent a factional interest, and we said at the meeting that we thought Directors nominated by Action Groups could not be resisted on that ground alone*.
23/04/2001 [09:46]	FSA's Line Manager E notes that the key issue from the compromise scheme documents received on 20/04/2001 [**16:36**] is that Equitable believed they were unlikely to be able to complete the scheme by November and had suggested that the scheme should be put back to February 2002.
23/04/2001 [10:05]	FSA's Legal Adviser D seeks comments on a draft paper on section 425 of the Companies Act and the power to compromise.
23/04/2001 [11:40]	FSA's Chief Counsel A notes, for the record, that the FSA official questioned had informed her that:

... we have never appeared in s 425 proceedings, but we very closely check all schemes in draft (whether solvent or insolvent), and, once content, we write to the company to confirm we have seen the scheme in draft, which letter we assume is put before the Court.

The Chief Counsel comments that '*of course, so far as we are aware, this is the first life scheme ever under s 425*'.

Chief Counsel A later notes that this may not be the first life insurance company to propose a section 425 scheme, referring to a case which had taken place around 20 years ago. She says that FSA were checking their records.

23/04/2001 [12:00] FSA and GAD meet Equitable as part of a regular round of update meetings.

FSA's note of the meeting includes excerpts that deal with the following:

Communication with policyholders
Equitable had acknowledged that there were some backlogs in communicating to individual policyholders and had said that they would look to see if more could be done to improve the position.

Compromise scheme
Equitable had said that they remained encouraged by the progress made towards a scheme that would be simple in structure. GAD had asked to see the terms of reference for the Independent Actuary. In relation to this request, FSA note:

This was not yet prepared but [Equitable's Chief Executive] *was concerned that the Independent Actuary should not get involved in issues surrounding classes of policyholder, as this could further complicate matters, but should concentrate on examining financial fairness.*

Equitable had reported that they were to meet with almost all of the policyholder action groups to discuss the proposed scheme on 26 April 2001 and that it was envisaged that a final draft scheme would be presented at the annual general meeting on 23 May 2001. FSA record:

It was not thought that the scheme could be used to sweep up all of the related issues relating to GARs (such as alleged mis-selling during 2000) as this could over complicate the scheme and lead to more classes of policyholder. [Equitable's Chief Executive] *added that for alleged mis-selling there would not in any case be much of* [an] *amount to claim, (5% for one year only).*

Financial position
FSA record that:

The end of March figures were almost complete and would show the notable improvement in solvency following the £500m injection and the added knock on benefit of the reduction in resilience. Both the end of February and March figures are based on the latest test 2 for resilience, assume the Section 68 Orders for Permanent/equivalent bond but take a more conservative approach than required by the regulations for Regulation 72 (assumed age of retirement). The value of the equivalent bond concession was estimated at c£200m for the end of the year, although this would be reduced over time as the yield curve flattens.

[FSA's Line Manager E] *explained that the FSA would in due course be able to recommend to HMT that the Section 68 Order for the Permanent valuation (which reflects the treatment to be adopted in the Report and Accounts) should be issued. On the equivalent bond Section 68 Order it was well understood by* [FSA] *that Regulation 69 was deficient and other Companies had applied for and received an Order disapplying* *this provision and applying an alternative more accurate measure across the board. However, Equitable had asked to apply a new valuation basis separately to bundles of contracts. This approach was new and we wanted to understand better the rationale behind this.* [An Equitable actuary] *confirmed that the banding approach was crucial to the valuation basis and agreed to supply further justification to us asap.*

The Appointed Actuary was aware of our request that the use of the £1bn implicit item should be revisited and justified. The [Appointed Actuary] *was aware of this and agreed. It was not anticipated that there should be a problem in doing this particularly since linked business (effectively sold to the Halifax) had not been used in the original calculation.*

It was reported that there had been an increase in surrenders when the market fell severely but this activity had now levelled out when the MVA increased. Surrenders were currently running at twice the normal level for the Equitable at £4-5m per day as opposed to £2-£3m.

The current level of GAR top ups was well below what was reserved for (assumed decrement 10% but 5% in the Annual Returns) although there was a noticeable trend of certain policyholders making large additions to GAR policies to try and get what [Equitable's Chief Executive] *described as "a free ride". He had asked for these cases to be investigated. It was in any case possible that if the 425 scheme took effect the effective date might be retrospective and these policyholders would not then benefit.*

The Report and Accounts were now prepared and the auditors' opinion was not qualified. However, the narrative included discussion of "fundamental uncertainty" we would receive a copy of the Report and Accounts by the end of the week.

Under '*Action Points*', Equitable agree to: consider whether someone from FSA could attend the annual general meeting; supply further justification for the section 68 Order on the valuation of fixed interest securities; supply justification for the future profits implicit item; and provide the Companies Act report and accounts for 2000. FSA agree to: consider which Appointed Actuary should sign off the 2000 returns; and provide early feedback on the draft actuarial section of the compromise agreement, if possible by 4 May 2001.

At the meeting, Equitable hand over a summary of their estimated solvency position as at 28 February 2001, which was as follows:

	£m	*£m*
Value of non-linked assets		*28,735*
Future Profits Implicit Item		*1,000*
		29,735
Mathematical Reserves		
– Basic (including GAR)	*26,925*	
– resilience	*1,310*	
		28,235
		1,500
Required Minimum Margin		*1,200*
Excess Assets		*300*

23/04/2001 [14:30] FSA attend a meeting of the Compromise Scheme Steering Group. According to Equitable's minutes of the meeting which were held on FSA's supervisory file, the group mainly discuss progress to date and the timetable going forward.

23/04/2001 [15:46]	FSA's Head of Consumer Protection thanks the Head of Life Insurance for inviting her to the meeting with Equitable that day. She says that '*for reasons you will understand*' she did not mention that FSA were taking over from the OFT the 60 complaints about Equitable's application of the market value adjuster. The Head of Consumer Protection informs him that she expected to meet the OFT the following week and to take over the complaints cases immediately. The Head of Consumer Protection also asks for an update on what was happening with mis-selling complaints against Equitable, as she had responsibility within FSA for '*Ombudsman and Compensation Schemes,* [unfair terms in consumer contracts]*, firms' complaints handling under the Rules, and the Correspondence Unit*'.
24/04/2001 [entry 1]	Equitable write to FSA about the circumstances in which they would issue new policies. Equitable explain that a new situation had arisen, not previously considered, where they felt that they should offer to issue new policies to members of existing group schemes.
24/04/2001 [11:33]	An FSA official writes to Managing Director A in response to the note to the Chairman of 17/04/2001 about involving the Centre for Effective Dispute Resolution with Equitable's mis-selling complaints. The official explains that the Centre would not themselves give an opinion on the dispute but simply arrange for a suitable person to do so. The official suggests that it would be a matter for Equitable to decide how useful this would be.
24/04/2001 [18:08]	FSA's Line Manager E writes to the Director of Insurance about the same subject, saying: *At our recent internal meeting, we concluded that we might wish to recommend to Equitable that it might use the* [Centre for Effective Dispute Resolution] *process to identify cases of misselling that could be remedied within the compromise. But we were concerned that the* [Centre for Effective Dispute Resolution] *process should not derail the compromise.* *We discussed with Equitable yesterday the extent to which they were inclined to use the scheme to do various bits of tidying up.* [Equitable's Chief Executive] *said that he thought it desirable in theory, but in practice they had taken the view that it would be impossible to get agreement to the scheme if it were extended to cover anything other than the simple buyout of guarantees. Their inclination therefore was also to leave any allegations of misselling outside the scope of the scheme. Of course, their thinking on whether to proceed in that way will be materially affected by the conclusions of the work we have been doing separately on post court of appeal sales (and on which a further* [FSA]*/PIA meeting is planned for later this week).*
25/04/2001 [10:17]	PIA send FSA a paper on their review of past sales by Equitable that PIA had prepared for a meeting that day but which had not gone ahead.
25/04/2001 [11:51]	FSA's Line Manager E provides comments to FSA's Consumer Panel on their survey of Equitable policyholders.
25/04/2001 [12:53]	FSA's Chief Counsel A sends legal advisers (copied to others) the note of the meeting with Equitable on 23/04/2001 [**12:00**] and says that she hoped that the note could serve as an update, instead of holding a meeting of the Equitable Life Lawyers Group. Chief Counsel A adds some comments further to the note, including that:

1. the Chief Counsel and GAD had told Equitable that they did not see how the Independent Actuary for the compromise scheme could be prevented from assessing the policyholder classes used;
2. Equitable had said that, although levels of surrender had been high relative to their experience last year, they were about average for the industry; and
3. the Chief Counsel had expressed '*strong scepticism*' about the possibility of ring fencing by year.

25/04/2001 [15:21] FSA's Legal Adviser A advises Line Manager E that, for Equitable's proposals of 19/04/2001 [**19:33**]: '*there is a gap between what the company intends to do "close the branch operation in Ireland" and the power to be vested in the Attorney "to conduct, manage and carry on the authorised insurance business of the Society in the Republic of Ireland"*'. The Legal Adviser says that it was necessary for FSA to know exactly what the Attorney would be doing.

26/04/2001 [entry 1] Actuaries transfer from GAD to FSA.

GAD's formal role in the prudential regulation of insurance companies comes to an end.

26/04/2001 [entry 2] FSA and PIA meet again to discuss Equitable's proposal that they should ask the Centre for Effective Dispute Resolution to consider complaints from policyholders that all non-GAR policies had been mis-sold and the questions raised in the note of 17/04/2001.

FSA's Chairman concludes:

> *... that FSA should consider the issue under the ARROW framework* [FSA's risk assessment framework] *establishing the likely scale of losses to Equitable policyholders and the implications for other companies and the industry more generally to enable us to establish whether a case existed for major review and whether we were able to give the* [PIA] *Ombudsman any guidance for dealing with mis-selling claims*.

It is agreed that FSA should consider taking Counsel's opinion and that Managing Director A would find out from Equitable whether they considered it necessary to bring mis-selling claims within the scope of the compromise scheme.

The Managing Director is also to relay to Equitable FSA's concerns about involving the Centre for Effective Dispute Resolution.

26/04/2001 [11:48] FSA respond to Equitable's correspondence about their intention to stop writing new business in the Republic of Ireland. FSA explain:

> *If the company has no presence in the Irish Republic other than the attorney and (a) the attorney is not effecting any new contracts on behalf of the company and (b) he is not carrying out any contracts (i.e. the payment of benefits etc is all being dealt with from the UK); then it seems reasonable to conclude that the company has ceased to carry on insurance business through the branch. If that is the case (which reflects our understanding of the facts), all Equitable Life needs to do is to give us notification after the closure has taken place under paragraph 8 of Schedule 2G of the Insurance Companies Act 1982.*

26/04/2001 [13:10] Further to Chief Counsel A's note of 25/04/2001 [**12:53**], Directing Actuary B (who has transferred to FSA and has become FSA's Insurance Division's Head of Actuarial Support (the Head of Actuarial Support)) adds that FSA had touched on the fact that the value of guaranteed annuity rates was dependent on the current market annuity rate, which could vary before the scheme was agreed. The Head of Actuarial Support also says that it was unlikely that the Independent Actuary's report would be able to conclude that the scheme was fair to all policyholders.

[**14:17**] Chief Counsel A says that she recalls that:

> *... the court will not be considering whether the scheme is fair to every policyholder within each class (the test is not that high), so presumably the terms of reference of the Independent Actuary will not go that far either.*

[**14:22**] Line Manager E says that he would circulate the final terms of reference for the Independent Actuary when they arrived.

[**15:33**] Legal Adviser D clarifies the legal requirements related to a section 425 scheme and notes that there was no requirement for such a scheme to be fair.

[**18:10**] Line Manager E adds:

> *However, there is also the question whether the FSA needs to intervene by exercising its formal powers to protect the interests of policyholders, and our judgement will be influenced by whether or not the proposed scheme is fair. So in that sense, we will want to be satisfied about fairness, whatever the requirements of section 425. I agree with* [Chief Counsel A's] *point though – and there are going to be difficult issues about the extent to which the fairness to the majority can override the interests of the minority.*

26/04/2001 [14:58] PIA send FSA some background material ahead of a meeting planned for the following day. (Note: it appears that the meeting did not go ahead.)

26/04/2001 [15:03] Legal Adviser A informs Line Manager E that, other than the two matters they had discussed, there was nothing else in relation to the sale agreements (excluding the Merged Administration Agreement) that the Legal Adviser could bring to his attention.

26/04/2001 [15:31] FSA's Line Supervisor C asks Scrutinising Actuary F and Legal Adviser A for their comments on Equitable's letter of 24/04/2001 about the circumstances in which they would issue new policies.

27/04/2001 [11:19] FSA's Legal Adviser A responds to Line Supervisor C, checking that his understanding of the position was correct and advising that, subject to any actuarial comment, it seemed to him:

> *... that any objection on our part would have the effect of disadvantaging the affected Equitable policyholders and it would be subject to considerable criticism if we were to raise an objection.*

[**11:30**] Line Manager E adds that FSA needed to be sure that new Free-Standing AVC contracts were only written on an individual policyholder basis and following a personal request.

27/04/2001 [14:01] Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

27/04/2001 [15:06] Equitable write to FSA to clarify their proposed changes to their branch operation in the Republic of Ireland. Equitable explain:

> *In the long term, Equitable wishes to change the nature of its operations in Ireland from a branch basis to a services basis from the UK.*
>
> *However, we are currently awaiting a decision by the Irish Revenue as to what, if any, presence they will require us to maintain in Ireland in order for our Irish policyholders to continue to qualify for income tax relief on premiums paid.*

Our tax advisors have recommended that pending a decision from the Irish Revenue (which we hope to receive within the next couple of weeks), we retain a presence in Ireland.

Interim appointment of a new authorised agent/change to branch structure:

Therefore, for tax reasons, Equitable wishes in the very short term to maintain its branch presence in Ireland. To do so, we are aware that we are required to have an authorised agent there. However, the release of all staff from the Irish branch, including our existing authorised agent, means that we must make an interim appointment ...

We realise that changes to branch structure (release of employees) and the identity of the authorised agent should normally be notified to both the FSA and Irish Department of Enterprise Trade and Employment (DETE) one month in advance of the change. Our Irish advisors have been in contact with DETE, who have given verbal confirmation that they are satisfied that the appointment be made. We apologise for not having given you sufficient notice as is required under the relevant legislation. However, the final member of staff at our Irish branch office leaves today. In order to provide continuity for clients, and for the tax reasons explained above, we will therefore be appointing our new authorised agent today, by means of the Power of Attorney previously forwarded to you.

[**16:26**] Line Manager E informs officials of Equitable's intentions. He notes that Equitable's:

... new arrangements come into immediate effect, even though the necessary one month's notice has not been given ... However, I am prepared to treat this as a change "occasioned by circumstances beyond the insurer's control" and note that notice of the proposed change was given "as soon as practicable" once it was known that it would happen. In such circumstances paragraph 2(3) of Schedule 2G applies, and Equitable appear to have complied with the requirements that apply in that case.

[**17:46**] Legal Adviser A advises:

Certainly paragraph 2(3) seems clear on this. The Society must give notice to [the Treasury] and the supervisory authority of the member state of the branch. A breach of paragraph 2 is a criminal offence so you need to be satisfied on good grounds that (a) the change was occasioned by circumstances beyond the company's control and (b) that they are giving the notice as soon as practicable.

The Legal Adviser also says that FSA would require formal notification of the new manager but did not need to provide prior approval.

FSA reply to Equitable, noting that '*because of circumstances beyond your control*' Equitable had not been able to give the one month's notice that was required for a change of requisite details of an EU branch. FSA say that they would treat the previous correspondence as notice to FSA and that they did not anticipate any further action on this.

27/04/2001 [16:03] Solicitors provide FSA with comments on Equitable's solicitors' draft issues paper and FSA's note of 23/04/2001 [**10:05**] on section 425 of the Companies Act.

27/04/2001 [16:37] Equitable thank FSA for providing comments on their actuarial paper. Equitable explain that they were currently incorporating comments, that they planned to issue an updated version of the document on 30 April 2001 and would meet with the Independent Actuary on 4 May 2001.

27/04/2001 [18:18]	FSA's Line Manager E gives warning to Legal Adviser D that FSA would need to form a view on their role in relation to the compromise scheme. He suggests that this could form part of a paper that she was to prepare on the scheme. [**20:39**] Chief Counsel A agrees.
30/04/2001 [entry 1]	FSA reply to Equitable's letter of 06/04/2001 about notifiable appointments. FSA request a managers' notification form for Equitable's Appointed Actuary and authorised agent for their Republic of Ireland branch. FSA also remind Equitable that they would need to confirm the recent resignations and appointments of directors.
30/04/2001 [14:00]	FSA hold a meeting of the Equitable Life Lawyers Group.
30/04/2001 [14:04]	Equitable send FSA a revised application for a section 68 Order to allow them to calculate the rates of interest on fixed interest equities in aggregate. Chief Actuary C comments to Scrutinising Actuary F: [Equitable's Appointed Actuary's] *request for the year 2000 seems to be a half way house for administrative convenience. His real objective appears to be the paragraph* [which read: '*Going forward we would wish to be able to group fixed interest securities to match major blocks of business and to apply the aggregate yield on those securities as appropriate.*']. *This appears to be more akin to the* [second company's] *approach. It may be worth looking at* [that company's] *order in this respect. I have sympathy with what* [the Appointed Actuary] *is seeking but we will need to ensure that the Order is drafted tightly so as to avoid any possibility of manipulating the result.*
30/04/2001 [16:34]	FSA's Director of GCD writes to PIA (in response to 25/04/2001 [**10:17**]) and, among other things, states that he did not share the view expressed in the paper that FSA could not ask for Equitable Board papers now on the grounds that they would need reasonable belief that serious breaches had occurred before they could do so.
30/04/2001 [17:13]	FSA's Line Manager E points out that Equitable's Companies Act annual reports and accounts for 2000 had been published on their website, along with details of the candidates for election to the Board. The annual reports and accounts include the following information about Equitable's business. In their '*Management Report for 2000*', Equitable set out the main issues from 2000 and the early part of 2001. Under the heading '*Guaranteed annuity rates and the court cases*', they explain the effect of the House of Lords' ruling and the reason for no bonuses being allotted for the first seven months of 2000. Equitable also discuss the negotiations that took place around the attempted sale of the whole of the business and the subsequent sale of parts of it. Under '*Criticism of the Society*', Equitable say that one of the criticisms received had related to their continuing to advertise and sell policies in the periods following the Court of Appeal and the House of Lords' judgments. Equitable state their view that: *It was expected to be in members' interests that the Society should be sold as a going concern, with its sales force and other operations intact. In this way, the greatest value could be achieved for the benefit of members.* Equitable also set out their reasons for applying a financial adjustment to non-contractual surrenders. Equitable say that they were in correspondence with the OFT on this issue.

On '*Investment Performance*', Equitable say that 2000 was a year of '*good relative investment performance*' with a return on the with-profits fund of 2.7% (compared with -1.8% for UK pension funds as a whole). Equitable also state: '*Significant selling of equities took place in December 2000 and early in 2001 to reduce the risks to policyholders of a serious fall in equity markets. In total, these sales realised almost £3.4 billion, of which £2 billion occurred in 2001. This latter sum was slightly in excess of the value of the relevant securities at 31 December 2000*'.

Under '*Overall rates of return for 2000*', the report says:

> *Under the with-profits approach, the directors of the Society determine an appropriate smoothed overall rate of return for each year, taking into account the actual investment experience of current and recent years.*
>
> *The directors decided to allocate an overall rate of return to pension plans for the period from 1 August 2000 to 31 December 2000 at an annual rate of 8%. For existing with-profits pension funds in force for the whole of 2000 this gives an effective return for the year of 3.3%. For pension plans, the ongoing interim rate was set at 8% p.a. so the rate of 8% p.a. applies from 1 August 2000 until further notice.*

Under the heading '*Guaranteed Annuity Rates*', Equitable say that there were a number of aspects relating to the annuity guarantee issue that were frequently misunderstood. Equitable explain the terms used to describe the different costs that could be ascribed to the annuity guarantees. These were:

> *"Best estimate commercial cost" – this is used to describe the impact on policyholder benefits of the future additional cost of GARs. It is calculated on the Society's best estimate of future circumstances that are likely to be experienced, including future interest rates, mortality experience, take-up rate of GARs and future contributions to GAR policies.*
>
> *"Realistically prudent technical provisions" – this is the amount shown in the Companies Act accounts for the additional cost of GARs and incorporates a degree of prudence over and above that included in the "best estimate commercial cost". The assumptions as to future circumstances are made on a more adverse basis, to give that extra degree of prudence, and for this reason the "realistically prudent technical provisions" will be higher than the "best estimate commercial cost".*
>
> *"Statutory reserves" – these are the reserves which need to be shown in the statutory returns to the Financial Services Authority (FSA). They are calculated on extremely prudent assumptions as they are designed to show that guaranteed liabilities could be paid in a range of very adverse future scenarios. The assumptions are governed by regulation and by professional guidance. In such a valuation, it is necessary to assume that almost all GAR policyholders exercise their GAR options. "Statutory reserves" will therefore be considerably higher than the "realistically prudent technical provisions" contained in the Companies Act accounts.*

On '*Statutory reserves compared with the impact of the House of Lords' decision*', Equitable say:

> *It has been suggested that had policyholders been more fully aware of the statutory reserves required for GARs, this would have given them an early indication of the potential impact of the most adverse of the possible outcomes from the House of Lords. This is not the case. There is little or no connection between the statutory reserves and the impact on policyholder benefits of the House of Lords' decision. This misunderstanding may arise from the fact that the figure of £1.6 billion for the statutory reserves (appearing in the regulatory return for the period ending 31 December 1998) is similar to the amount the Society estimated needed to be set aside to deal with the*

consequences of the House of Lords' decision (£1.5 billion). The fact that the two figures are similar is coincidental. They deal with quite different sets of circumstances, which are described below.

In relation to their statutory reserves, Equitable explain:

There are two main elements to the benefits under with-profits policies. These are (a) the guaranteed benefits including the annual or reversionary bonus and (b) the non-guaranteed final bonus. The statutory reserves are required to ensure that all life companies are able to meet their liabilities to pay the guaranteed benefits even in very adverse economic circumstances.

GAR policyholders have the option of taking their guaranteed benefits in either cash form or as an annuity. The statutory reserves were set in line with new regulatory guidance issued in January 1999 by HM Treasury at £1.6 billion as at 31 December 1998 and at £1.7 billion as at 31 December 1999. This regulatory guidance required the Society to assume a very high rate of take up amongst GAR policyholders of the GAR annuity, in preference to the cash option. But even under these new assumptions, the statutory reserves were still concerned only with the guaranteed annuity benefits produced by applying the guaranteed annuity rate to the guaranteed cash form of benefits. The guidance did not require the Society to assume that the rate should be applied to total benefits, including a final bonus or, indeed, to anticipate a final bonus at all.

As at 31 December 2000, the statutory reserves for GARs were £2.6 billion as even more prudent assumptions were required. The large increase in these statutory reserves is due to clarification of earlier guidance and stronger assumptions in the basis on which these reserves are calculated and the decrease in long-term interest rates over the year.

For the statutory reserves to be fully called upon would require there to be not just a significantly adverse set of conditions, but for these conditions to prevail throughout the whole period during which retirement benefits would be drawn. As this is unlikely to apply, it has been possible for the Society to transfer some of the risk via a reassurance policy. This is mentioned further below. The statutory reserves are not, and were never intended to be, a means for providing for the consequences of the eventual decision of the House of Lords.

In relation to the impact of the House of Lords' judgment, Equitable explain:

The litigation on which the Society embarked was designed to establish if it was lawful to pay different final bonuses to GAR policyholders depending on whether or not those holders exercised the right to take their benefits in annuity form at a rate guaranteed by the Society. It related therefore to the treatment of final bonuses, not the guaranteed benefits with which the statutory reserves are concerned.

The Court of Appeal determined by a majority of 2:1 that it was not lawful to differentiate in this way within the group of GAR holders. A GAR policyholder should receive the same proportionate final bonus irrespective of the form of benefits selected. The Court did not, however, rule that it was unacceptable for the Society to differentiate between GAR and non-GAR holders in this respect, so still allowing any cost of the GARS to be "ring fenced" to those policyholders with GARs.

The House of Lords' ruling took matters beyond this by saying that the Society could not apply a different bonus policy to GAR and non-GAR holders dependent on the existence or absence of GAR provisions in their policies.

The effect of this ruling was to bring about an economic transfer from non-GAR holders to GAR holders. The with-profits fund is a single pot of money. The House of Lords' judgement affects the way in which the assets in this fund are allocated between *different categories of policyholder. Following the House of Lords' decision, this necessary reallocation of assets was assessed at £1.3 billion for the future best estimate commercial cost and £200 million for rectification of those policies that had matured since January 1994 (when the differential bonus system was first introduced), making £1.5 billion in total. The estimated commercial cost was based on the Society's understanding of the type of annuity to which GARs apply and assumptions regarding future interest rates, mortality experience, take-up rates and the level of future contributions to GAR policies.*

The House of Lords' ruling did not, and has not since, determined the level of the Society's statutory reserves. Provision for additional statutory reserves would still have had to [be] *made as at the end of 1998, 1999 and 2000, even if the House of Lords' decision had upheld the Society's approach.*

On '*Estimates of the commercial cost and prudent technical provisions*', Equitable explain:

Before the House of Lords' ruling, the Society estimated the commercial cost of GARs as £50 million. This was because its approach of applying different final bonus rates, depending on whether or not benefits were taken in GAR form, meant that there was no commercial cost except where it was not possible to adjust the final bonus sufficiently to reflect fully the cost of the benefits being taken in GAR form. This remained the case, even after the Court of Appeal judgement as the Society believed it remained able to "ring fence" GAR policies as described in the Management Report on pages 2 to 5. Because of this, the Society continued to explain that, if the House of Lords upheld either the High Court judgement or the Court of Appeal judgement, the estimated commercial cost of GARs would not exceed £50 million.

Although, until the House of Lords' ruling, the estimated commercial cost of GARs was £50 million, a realistically prudent technical provision of £200 million was established in the balance sheet in the Report and Accounts for 1999. This provided an allowance for more extreme future changes in financial conditions and mortality experience, in order to give a more prudent provision in the accounts.

It was only as a result of the fact that the House of Lords went further than the Court of Appeal judgement, in that it prohibited "ring fencing" the GAR policies, that the best estimate commercial cost rose to £1.3 billion.

As described above, in ascertaining provisions to be made in the accounts, a degree of prudence is applied over and above that included in the best estimate commercial cost. The future interest rates are assumed to be lower and the take-up rate of GAR options is assumed to be higher than those used for the best estimate commercial cost. For this reason the technical provision included in the accounts is higher than the best estimate commercial cost. The provision included in the 2000 accounts is £1.7 billion as disclosed in note 18 on the accounts.

Equitable also provide an explanation of the '*Reinsurance arrangements*'. Equitable write:

As mentioned above, for the statutory reserves to be fully called upon would require there to be very adverse financial conditions prevailing throughout the whole period during which retirement benefits under GARs are payable. As these very adverse conditions are unlikely to apply, it has been possible for the Society to arrange a reassurance policy under which, if the GAR take-up rate exceeds 60%, the excess cost to the Society is recoverable from the reassurer. The reassurer can recover from the Society any such costs from future surpluses as they emerge. If no such surpluses emerge, the cost is borne by the reassurer. The reassurance is reflected in a reduction from the statutory reserves otherwise required but does not impact on the technical provisions in *these accounts. The premium for this reassurance is small in relation to the reserves released. The reassurance arrangements had to be renegotiated after the House of Lords' decision as the reassurance was originally based on the Society maintaining its pre-House of Lords bonus system. As a consequence there was a reduction in the reserve released by the reassurance which resulted in higher statutory reserves for the Society.*

As explained above, the statutory reserves are based on the assumption of very adverse conditions prevailing. Although these are unlikely to be met in practice, the reserves have to be maintained and can affect the degree of investment freedom of the Society. The higher the reserves, the more that investment freedom is restricted. The reserve for GARs in the Society's statutory reserving requirements as at 31 December 2000 was £1.8 billion allowing for the reassurance rather than £2.6 billion which would otherwise be the case. This enables the Society to invest more freely in the interests of policyholders.

In their '*Directors' Report for 2000*', Equitable note that they had completed the sale of their operating assets and the economic interest in their non-profit and unit-linked business to Halifax on 1 March 2001. They refer readers to note 22 to the accounts for more details.

On '*Financial results*', Equitable state: '*There are a number of uncertainties in respect of this year's accounts*'. Equitable say that these are referred to in the report and in notes 18 and 25 to the accounts. Equitable also refer to the paragraph of the auditor's report entitled '*Fundamental uncertainties*'.

Equitable say that Permanent Insurance had been sold on 16 February 2001.

On '*Valuation and bonus declaration*', Equitable explain:

In arriving at the technical provisions the Society's Appointed Actuary has had to make an assessment of the increased liability to the GAR policyholders following the House of Lords' decision.

There has been little experience since that decision of the intentions of policyholders to take an annuity with the benefit of the GAR in preference to alternative annuity products or policy options. The majority of the Society's GAR policies express the GAR only to apply to a single life level annuity. Some policyholders have lodged complaints with the PIA Ombudsman concerning the restrictive form of GAR annuity. None of these complaints has been upheld by any PIA Ombudsman decision. There is also, against the background of all the recent uncertainty, limited experience of the extent to which GAR policyholders will maintain their recent level of contributions. Whilst the Directors believe that the provision made is realistic, because of the limited experience they recognise that there is significant uncertainty as to the quantum of the additional liability.

In the event that the compromise scheme that the Directors are seeking to promote is adopted, the impact of these uncertainties on the technical provisions and the corresponding impact on the Fund for Future Appropriations will be removed.

In accordance with the Society's Articles of Association and insurance company legislation, the Society's Appointed Actuary carried out a valuation of the assets and liabilities of the Society as at 31 December 2000. Although the Society is still able to meet the exacting standards of solvency as required by the Financial Services Authority, the Directors decided that it would be unwise to add bonuses in declared guaranteed form at this time as this would further restrict future investment freedom.

On '*Final bonus*', Equitable repeat the information provided in their Management Report that the return on the fund was 2.7% and the growth allocated for the year was effectively 3.3%. They explain:

These overall rates of return are used to calculate levels of final bonus which is not guaranteed.

Where a policy has a guaranteed growth rate applied to a guaranteed fund that has, of course, been given.

Final bonus rates may be changed by the Directors at any time.

The reports and accounts include a section on '*Corporate Governance*'. Under the heading '*Going Concern*', Equitable state:

The Society closed to new business on 8 December 2000. The Directors consider that the Society, operating as a closed fund, has adequate resources to continue in business for the foreseeable future. Further, the Society has complied and continues to comply with the appropriate statutory and regulatory requirements. For these reasons, the Board continues to adopt the going concern basis in preparing the accounts.

In Note 25, headed '*Contingent Liabilities*', Equitable state:

Subsequent to the House of Lords' decision, a number of enquiries by various regulatory and professional bodies have been instigated including the Treasury Committee of the House of Commons. In those proceedings and elsewhere certain policyholders have indicated they believe that they have grounds for an action against the Society for mis-selling of business due to the non-disclosure of the guarantees to GAR policyholders. There is the further possibility that other causes of action may arise. It is not possible to assess the impact of the outcome of these matters, if any, on the financial position of the Society and no provisions have been made.

30/04/2001 [17:34] FSA's Chief Counsel B asks the Head of Consumer Protection if they could discuss the complaints that FSA were to take over from the OFT.

[**17:49**] The Head of Consumer Protection says that she now planned to meet the OFT on 4 May 2001, and that: '*I think the first issue will be to sight the work vis-à-vis the* [With Profits] *Review because of "discretion"*'.

30/04/2001 [18:12] FSA's Insolvency Practitioner provides comments in reply to the list of issues for the compromise scheme (see 20/04/2001 [**12:49**]).

30/04/2001 [18:24] FSA's Head of Actuarial Support provides comments on Legal Adviser D's note of 23/04/2001 on the compromise scheme.

30/04/2001 [entry 9] FSA's Legal Adviser D submits to Chief Counsel A a paper entitled '*Section 425 Power to Compromise*', setting out the legal process of a scheme of arrangement under section 425 of the Companies Act 1985.

Legal Adviser D also provides Chief Counsel A with a list of issues on the proposed scheme.

30/04/2001 [20:42] PIA send FSA their '*Stage 1*' report into Equitable's disclosure of risk to potential with-profits investors after the Court of Appeal's ruling. PIA explain that this part of their report gave a factual account of what Equitable had disclosed to potential investors and recommended further action, while '*Stage 2*' would establish what risks should have been disclosed.

May 2001

01/05/2001 [10:55] FSA's Director of GCD outlines to Chief Counsel A some issues to be resolved about Equitable's draft actuarial report (received on 20/04/2001 [**16:36**]) for the compromise scheme. These include:

- Whether it is sufficient that the scheme should be fair to a particular group of policyholders as a whole, even if it was not fair to individual policyholders within that group.
- Whether the claim by Equitable's solicitors is right that an option to purchase additional benefit was not material.
- Whether a single flat rate uplift of 25% for a particular group should be used when the value of their rights had been shown to vary from 14% to 30%.
- Why policyholders in group schemes were not treated as a separate class.
- Why the classes of policyholders had been determined the way they have.

[**14:19**] Line Manager E says to Chief Counsel A and Legal Adviser D that '*it did strike me that* [the Director's] *concerns about "fairness" may be overstated or misplaced, since I am not sure that "fairness" is strictly a relevant test*'. [**20:33**] Chief Counsel A replies that the issue would be addressed in Legal Adviser D's paper on the section 425 process.

[**14:46**] FSA's Head of Actuarial Support notes that he had raised a number of issues with Equitable's Appointed Actuary the previous evening. The Head of Actuarial Support reports that:

> [Equitable's Appointed Actuary] *accepted the point that the assumed take-up proportions meant that those policyholders electing to take full GARs with no cash benefits and no spouses' benefit could be seen as losing out. In practice, though, very few would decline to take the maximum cash benefit available since this could be taken tax-free. Moreover, he considered that their assumed current interest rate of 5.1% was lower than that available in the market for the most competitive current annuity rates (a point that we can look at further). If they assumed a slightly higher interest rate, then the corresponding assumed GAR take-up rate (to produce the same overall figures) would be rather higher.*
>
> *I also suggested to him that they might like to look at applying financial option theory to value (1) the GAR option available at retirement and (2) the 3.5% guaranteed accumulation rate that policyholders are also being asked to renounce.*
>
> *Regarding future movement in interest rates, he thought that this could be hedged by purchasing appropriate fixed-interest rate securities. I think this would protect the overall fund but it does still mean that they should adjust the offer to policyholders in line with the movement in interest rates.*

The Head of Actuarial Support's note continues:

> *Apparently, the take-up rates for group pensions are indeed rather lower than for individual policies (this is not a reflection as first thought of different early withdrawal rates). He believes that this relates mainly to the larger public sector schemes, as the smaller* [schemes] *behave similarly to the individuals. It was not at all clear to me why there should be this difference for larger schemes.*
>
> *On a separate issue, they are looking to purchase a number of long-dated zero coupon bonds to hedge the overall GAR risk against movements in interest rates. I think this would certainly help the financial position of the fund in respect of accrued GAR rights but it still leaves a largely unhedgeable exposure in respect of future top-up premiums*

(the main source of the fundamental uncertainty mentioned in their 2000 report and accounts).

The Head of Actuarial Support then suggests ten points that should be pursued with Equitable, those being:

> *1) How have they determined that 5.1% is the appropriate long-term rate of interest to apply for all policyholders?*
>
> *2) How do they believe that they could justify the assumed 60% proportion in the calculation of a "fair" offer for a policyholder taking all the annuity benefit in GAR form (and either maximum cash or no cash benefit)?*
>
> *3) Have they considered applying financial option theory to value (1) the GAR option available at retirement and (2) the 3.5% guaranteed accumulation rate that policyholders are also being asked to renounce?*
>
> *4) Why is the take-up rate for group schemes apparently much lower than for individuals? Does this relate mainly to larger* [schemes]*? If so, why do they think there is this difference in experience? Does it relate to differences in policy wordings? Is the choice in group schemes made by trustees rather than individuals?*
>
> *5) Even with the assumed lower take-up rate of 40% (rather than 60%) for group schemes, why is the calculated uplift only 13.6% for group schemes rather than around 25% for individuals?*
>
> *6) Will the overall package be affected by movements in the value of equity (and other) investments covering the GAR liability (the answer should I think be in the negative as they are offering a proportionate increase rather than an absolute amount of compensation)?*
>
> *7) What is the reason for the strange pattern of figures (moving up and down) in the first column on page 16?*
>
> *8) On a point of detail, what is the origin of the factor of "ten" for valuing each with-profits annuity in Appendix D?*
>
> *9) Similarly, why are they applying the "MFR liability" to derive the value of certain pension plans on page 42 of Appendix D?*
>
> *10) I could not understand the calculation, or the rationale for the calculation set out in Appendix I.*

01/05/2001 [17:46] FSA write to PIA, with a note entitled '*Equitable – disclosure issues*', following a meeting that morning at which they had discussed whether the disclosure of particular facts was expected under PIA Rules. FSA set out some thoughts on whether certain disclosures should be made and, if so, when.

[**21:36**] PIA agree that they should be looking separately at the two issues indicated by FSA.

02/05/2001 [08:42] PIA thank FSA for their comments on disclosure of the previous day. PIA explain that they would be considering the issue of whether '*potential investors* [should] *have been told about the "problems" because it was an additional Risk factor in entering into the contract*'. PIA say: '*What is of interest is whether the position materially changed financially rather than just legally as a result of each court decision*'.

[**08:54**] FSA say that their concern:

... has been around the question of what the PIA rules could reasonably be construed as requiring. My impression is that for a company adviser (ie one who did not have the freedom to offer products from a range of different companies), the issue is largely one of the suitability of the product type having regard to the circumstances, intentions and attitude to risk of the prospective purchaser. I think we will need to be very clear of our grounds (and of the precedents we will be setting) if we now construe the rules as imposing an obligation on the company adviser to advise on the financial position of his/her employer.

But going on from this, there may well be issues about what the company itself said about its position, or instructed its sales force to say. I wonder if here we are into a more complex area of the relationship between PIA rules and the common law.

[**09:59**] FSA say that they are considering similar issues in relation to another company and thought that '*it would be useful to have a rather different "problem" case to test our thinking on the* [Equitable case]'.

02/05/2001 [18:23] FSA provide instructions to Counsel to advise on whether they had any major concerns about the proposed compromise scheme as set out in the draft actuarial report. FSA state that they and their advisers did not have any major concerns at that stage.

02/05/2001 [18:38] FSA's Line Manager E writes to members of the Insurance Supervisory Committee about Equitable's application for a section 68 Order relating to the calculation of interest rates for fixed interest securities, previously considered by the Committee on 17/04/2001. The Line Manager writes:

In short, the point at issue is the method to be used in determining the valuation rate of interest. The method required by regulation 69, which relies on a weighted average, is quite simplistic and can have some unexpected effects, particularly when companies do the resilience tests. Equitable would like a "concession" that requires a more sophisticated valuation method. Some other companies ... already have broadly similar concessions. However, the [Insurance Supervisory Committee] *questioned why the approach that the Equitable had proposed appeared less sophisticated than that adopted by the other companies.*

Core members will also recall that as well as a change to the requirements on an ongoing basis, there was a need for a reporting concession in relation to the 2000 year end.

I have now taken the matter up with Equitable and the Society has said that, going forward, it would be content to follow a valuation basis that more closely corresponds to that used by the other companies mentioned above. (I should add that neither the Society nor I are entirely convinced that this approach is better, as opposed to different.)

However, it faces a practical difficulty in that it had been doing its calculations for last year on the basis that a concession as described in paper 179/2001 would be granted. It does not believe therefore that it is practicable for it to revisit the old calculations, particularly at a time when the Society is under huge pressures, including in trying to come up with a compromise scheme to deal with its GAR problems.

<u>Conclusions and Recommendations</u>
<u>2000 Year end</u> – I do not think we can require the company to recalculate its solvency going backwards. The choice is therefore one of approving what it has done and recommending a reporting concession on that basis, or requiring it to stick to the Regulations. [Insurance Supervisory Committee] *members should be aware however that if they opt for the latter, it will require the Society to report a [unrealistically] weak financial position. This will be confusing for observers and may not be helpful to anyone. I recommend therefore that we should support the reporting concession.*

<u>Going forward</u> – There are arguments that above all we should be seeking to achieve consistency in the valuation basis – at least in terms of what a company does from year to year – since it may otherwise select the most favourable valuation method at any given point. However, in response to [Insurance Supervisory Committee] *concerns that I reported back, the Society has agreed to move to a basis consistent with that adopted by other firms. I would like more time to evaluate the arguments before deciding to go for one approach rather than another (ie the method proposed in the report concession or the more usual approach used by eg* [an insurance company]*). There are arguments either way, and we have time to look at those more carefully in the coming weeks.*

If the core members agree that we can proceed with the reporting concession, I will come back with a further paper and draft order about what should be done going forward.

I have discussed this with [Scrutinising Actuary F] *and* [the Head of Life Insurance]*, who are both content with this approach.*

[**19:24**] FSA's Director of Insurance comments: '*I look forward to seeing the committee's views on this. To an untutored eye the case appears persuasive, particularly if, as I understand it, the approach the company has taken thus far reflects discussions with us. I certainly hope we can resolve this quickly. We and HMT would rightly be criticised if this got delayed and a negative decision taken by default*'.

03/05/2001 [08:37] FSA's Managing Director A asks the Director of Insurance where FSA were on Equitable's 2000 returns, saying: '*I saw something in the press last week about the end-year GAR allowance but have not seen anything providing an overview nor any commentary/recommendations on outstanding issues* [of] *valuation (which, knowing the Equitable there must be)*'. The Managing Director says that Line Manager E had mentioned '*reporting concessions*', adding: '*I have to say that* [FSA's Chairman] *and I are going to need to be taken through this all in detail and an idea of time and likely complexity would be much appreciated. I can forecast that we are likely to be very interested*'.

[**10:35**] Line Manager E draws the Managing Director's attention to his note of 30/04/2001 [**17:13**] and the fact that Equitable's Companies Act reports and accounts had been published recently. The Line Manager goes on to explain that he is:

... hoping to get a paper together today on the reporting concessions for the statutory returns. The returns are due to be submitted by 30 June and we would normally expect them to be available at Companies House a few weeks after that. There is nothing to prevent the Society submitting their returns earlier or making their returns publicly available when they are submitted.

As to what they will show, the last headline figure reported to us by [Equitable's Chief Executive] *was that the Society had £300 million of surplus assets (ie after covering the solvency margin and resilience reserve). That took into account the benefit of the concessions being sought in relation to the valuation of Permanent Insurance (+ £100 m) and the yield on its fixed interest assets (approx +£200 m). Without the concessions things will clearly be very close.*

However the above numbers ... did not take into account the conclusions of discussions we had about assumptions on retirement age. GAD had been interpreting one of the regulations in a way that Equitable disagreed with. We looked at it further and have taken advice from Leading Counsel, and since concluded that Equitable was right all along. Equitable had in the meantime given up the fight and so had made the adjustment in its solvency calculations that GAD had asked for. The benefit to Equitable of our current position is a reduction in the reserving requirements of the order of at least £100 million. This should be taken into account when they submit the formal returns.

03/05/2001 [11:05] A member of the Committee replies to Line Manager E about Equitable's application for a section 68 Order, in which he states:

I have to say that I am deeply uncomfortable about this. We have not yet seen any arguments justifying the method of calculation put forward in the paper, though I am prepared to accept that they may exist. It is not a method that has been approved for any other company. Without seeing a justification, therefore, we cannot give a concession to Equitable on the basis that it is something we would have given to any comparable insurer that asked for it.

This leaves us considering a concession on a rather different basis: that we have led Equitable to believe that they will get a concession in a particular form, that they have done their calculations on that basis and that, precisely because they are the Equitable, and therefore under huge pressures, we should not now require them to change.

I can just about swallow this, but it clearly does not meet the criterion you previously urged us to use when dealing with Equitable cases, which is that set out in my first paragraph. I'd be much happier if someone from Actuarial Support Department could set down why the "bundling" approach is a sensible way to proceed. If we could get some comfort that this is a reasonable approach in general, then we could take the view that we should be prepared to do this for any other company, and also that we should be content for Equitable to lock themselves into this method in the longer term (thus removing concerns about regulatory arbitrage between years). Would this really take too long to do?

[**11:51**] Another member of the Committee comments:

I generally agree with [the Committee member's] *comments.*

I thought the point was that there were some circumstances where Equitable's proposed treatment would work in their favour and other circumstances where it wouldn't. So, surely this boils down to just two points:

- *are we (FSA) satisfied that what Equitable are proposing is in accordance with the real intention of the regulations? – I gather that we should be but, as* [the Committee Member] *suggests, I think it would be helpful to have some actuarial explanation of why the approach is acceptable;*
- *that if we agree this approach then Equitable must stick to it – ie they can't switch to a more favourable approach if this approach doesn't work in their favour in future years. I think that this is the condition that both* [insurance companies] *had to agree to get approval of their approaches.*

I'm not aware that we've previously said or implied that the solution developed by [the two insurance companies] are the only possible solutions. We presumably therefore think there is room for alternative solutions. As such, and provided actuarial support are happy with the Equitable proposal, I don't see any reason to object to Equitable being granted the concession originally sought. Surely there is a big risk to the FSA if we "force" the company down the [other] route only to find that in a few years time that method has serious repercussions for Equitable solvency that the original proposal wouldn't have had.

Re the last paragraph of the Detail, weren't Equitable being a bit presumptuous in assuming they'd get a concession to do the calculation that way? Do we (or have we already done so) need to say something to them about that?

[**11:54**] Line Manager E replies:

There are two issues here – one of substance and one that is largely presentational.

On the substance, there is the question whether the approach originally suggested by the Equitable was better or worse than the approach used by [one of the two insurance companies]*, for example. From my discussions with our actuarial advisers, my understanding of what they have said is that they do not obviously see one methodology as being better than the other – they are just different. But either approach is preferable to the alternative of following the Regulation 69 method, which takes no account of the duration of the fixed interest assets. At no point in the discussions has the issue of the identity of the applicant influenced our conclusion that the Equitable's methodology was acceptable. I am not in a position to provide the "proof" that you are after. However, I can honestly say that I am not aware of any reason why we should object to their original proposal.*

In any case, that may no longer be an issue because after further discussion with the company, it has said it is perfectly happy to use the alternative [insurance company] *approach if that is what we would like it to do. However there is a consistency issue with what they have been doing in the current year (to which I will return in a moment). As I think I explained, I have not yet been able to reach a view whether consistency with the approach adopted by some other insurance firms or consistency with what the company has done previously would be preferable. I think there are arguments both ways, and I will therefore return to that at a later date.*

The more presentational – or maybe practical – issue is what we do about the 2000 year end. I think there is special pleading for the company about what it should do about its solvency returns for the year, at least to the extent that I am saying that a particular company faces a particular logistical difficulty and I would like us to be able to take that into account. My understanding is that there is no real reason to believe that the two methodologies are going to produce wildly different results. As [the Director of Insurance] *commented, the company has in part been doing what it has on the basis of discussions it had had with us (inc GAD) over recent months.*

In reality, there is a special case because the company is in a difficult financial position and is proposing a major financial reconstruction in order to sort out its difficulties. I think there are very defensible arguments for the FSA to take into account such factors – see for example sections 2(3) and 148(4) of [FSMA 2000]*. If we were to apply a "risk model" to our use of various regulatory tools (as people talk these days) I would have to say that of all the things that we could ask Equitable Life to do at this point, getting them to redo calculations that relate to the past and that are of entirely academic interest comes a very poor second to requiring it to sort things out going forward. But in the meantime, I do not see that it is desirable (from anybody's point of view) to require the company to report on the basis of a regulation that does not work as it was intended to – to do so would simply give a misleading impression about the company's real financial condition in a way that will simply cause unnecessary anxiety for members of the public who are already very confused.*

[**14:52**] The first Committee member explains:

I think that one principle to which we have clung firmly, and rightly, is that firms should not be able to change their valuation principles at whim, because of the risk of regulatory arbitrage this introduces. Consistent with this principle, it seems to me there are three ways forward for Equitable's accounts:

- *Stick with Regulation 69 for 2000, and make a change for 2001 and subsequent years to whichever method on reflection seems best.*
- *Move to the ... method* [used by one of the two companies] *for 2000 and subsequent years.*

- *Move to the "bundling" method for 2000 and subsequent years, subject to the actuaries being able to convince us that this is a sensible method for companies to adopt going forward. (I do think we need to see this justification, given that the two actuaries present at the* [Insurance Supervisory Committee] *meeting were not convinced.)*

I should be prepared to support any one of these three approaches. The fourth option, which I find less palatable, is to allow the "bundling" method for this year only, on the kind of basis set out in my earlier message. But in that case we could not pretend that we were treating Equitable as we would treat any other company.

[**14:59**] Chief Actuary C advises that:

I have noted that a request has been made for a view to be expressed by Actuarial Support on the Equitable's application for a s68 Order. Although I am not fully aware of all of the arguments that have been aired on this matter I am sufficiently familiar with Equitable's application to give our view.

I confirm that we are in agreement with the views expressed by [Line Manager E] *as attached.*

Equitable are seeking a s68 Order that would address an anomaly in Regulation 69 of the ICR94. The anomaly is described in [the paper submitted to the Insurance Supervisory Committee]*. The request is to group the fixed interest assets into two blocks or segments (i.e. approved fixed interest stocks and other fixed interest stocks). The yield on each segment would then be calculated accurately as the rate which equates the discounted value of the aggregate cash flows arising on the assets in each segment to the market value of those assets. The interest rate used to value liabilities would then take account of these yields where approved and other fixed interest assets are hypothecated to match such liabilities.*

Similar orders have been granted to [two insurance companies]*. Those orders sought to address the same anomaly. In those cases the order permitted the company to hypothecate fixed interest assets (both approved and other) to match blocks of business and calculate the yield on the hypothecated assets in the same way as requested by the Equitable. In the* [first company's] *case the order provides for the one block of business that exists (i.e. annuities), whereas in the* [other company's] *case the order enables the actuary to identify more than one block of business and hypothecate assets more appropriately to match liabilities with different characteristics.*

For the 2000 year end, the Equitable order effectively assumes only one block of business exists (i.e. the [first company's] *approach). In practice the Equitable would have been better advised to* [have] *adopted the* [other] *approach in order to address the different types of business that exist. However the Equitable consider that their request for an order that splits the fixed interest assets into the two segments, as described above, is a pragmatic half way house to the theoretically ideal solution (i.e. the* [other] *approach). We have been told by the Actuary that the difference in the liabilities assessed on each basis is not material based on modelling that they have undertaken.*

We recommend that you accept the request made by the Equitable. We are told that Equitable would be prepared to adopt an approach similar to that used by [the other company] *in future but that it is administratively inconvenient to adopt that approach at this stage for the 2000 returns.*

[**15:37**] The Committee member concedes: '*If* [the actuarial member of the Committee] *and* [a special adviser to FSA] *are convinced by these arguments I should be prepared to go along with the bundling approach, but on the basis that Equitable must then stick with it for a period of years*'.

[**15:47**] The special adviser states that: '*Given the two precedents, I am content. Perhaps we should treat it as a priority to change* [Regulation] *69 and our Actuarial Support could start discussing a consultation document for issue later in the year*'.

[**16:12**] Line Manager E distributes a note to Managing Director A on the issues, saying:

> *Thank you to all those who have contributed to the debate. In the meantime I have discussed this further with Equitable Life and – as you will see from the [optimistically drafted] draft memo to* [the Managing Director] *attached – been given information that leads me to conclude that the returns will not be materially different whether they use the Equitable segmented approach or the* [two insurance companies'] *method – either way will reduce the reserving requirement by somewhere in the range £150-200 million (compared with a total of £29 billion).*
>
> *Reporting for 2000 on the* [two insurance companies'] *basis is simply not on. So the first question is do we allow the Equitable to report on a more accurate basis than it would if it complied with regulation 69.* [The special adviser] *and* [Chief Actuary C] *(and* [the Director of Insurance]*) are arguing in favour.*
>
> *There is a separate question about what should happen for the future, and that is of course not one that I had asked. I have noted that, while I fully support the consistency argument, regrettably, whatever we require will produce some consistencies and some inconsistencies. I am not yet in a position to take a view as to whether going forward we should go for consistency between firms or within one of them. There are arguments both ways and I thought I had made it clear that I would want to consider them carefully before making a recommendation to the Committee. I do not therefore think I can proceed with a conditional agreement as proposed by* [the first Committee member] *– namely that the Committee should only give approval provided the same valuation basis is used in future years.*

[**17:15**] The first Committee member adds:

> *I know I'm being difficult on this case, but you did say at the* [Insurance Supervisory Committee] *that a major criterion in considering any request from the Equitable should be whether we would grant that request if it came from any other company. We have also established that our policy in relation to other companies is that they should not have freedom to shift the basis of valuation from year to year.*
>
> *If I were dealing with a company X, therefore, my starting point, following resolution of the technical issues around bundling, would be that they have 3 choices:*
>
> - *They can stick with Regulation 69 (and possibly seek a change at some time in the future).*
> - *They can shift to the* [first company's] *basis now, and stick with it.*
> - *They can shift to the "bundling" basis now, and stick with it.*
>
> *If the request came late in the day, after preparation of the accounts was well advanced, I should say rude things about the company's management, but I might be persuaded to let them use the bundling basis for one year and then switch to the* [first company's] *method, provided that they had no discretion in the matter (so that the question of regulatory arbitrage would not apply). I should not be willing simply to postpone the decision about what would happen after the first year.*
>
> *So much for company X. I recognise that the circumstances of Equitable are special and that both management and supervisors have had other things on their minds. If you want to put your recommendation to* [Managing Director A] *on the basis that Equitable is*

special, and that we are justified in doing (relatively minor) things that we would not do for another company, I shall not die in a ditch. But all concerned will need to be clear that that is indeed the basis of the argument.

[**17:30**] The Director of Insurance responds that: '*Surely the key to this is that it should be FSA, rather than the* [Equitable]*, who should determine which form of consistency is the more important – ie, whether we are more concerned about consistency between years or consistency between companies. The* [Equitable] *will always have the choice as to whether to apply for any form of this concession. Provided that they are aware that we may not be prepared to grant... exactly the same concession next year, and conversely that we might not be prepared to let them move to the other version, then I see no particular problem. And since, in any event, we cannot fetter our discretion, pointing out that we are reserving our discretion in this particular way ought not to cause them, or us, any grief*'.

[**17:32**] The first Committee member says: '*I think this was roughly where* [Line Manager E] *and I had got to in some off-line discussion*'.

[**17:41**] The Director of Insurance says that this is: '*Excellent*'.

[**18:12**] Line Manager E sends Managing Director A a final paper on the two section 68 Orders applied for by Equitable. The Line Manager explains that: '*Achieving internal agreement to the position (on the second of the concessions about yield calculations) has taken some time but I <u>believe</u> we have now reached a position all are comfortable with. The reason for an element of doubt in the last sentence is because I have not had confirmation from the requisite quorum of* [Heads of Department] *and managers. There are however no dissenters and I thought it best not to delay until next week*'.

The paper explains that both concessions had been looked at by FSA's Insurance Supervisory Committee and that this reflected the position agreed by that Committee. On the valuation of Permanent Insurance, Line Manager E sets out the sequence of events of the sale of the company and the conclusion that: '*We consider that as the sale was confirmed, the agreed sale price provides a sensible basis for a valuation of this asset. We believe that equivalent concessions, requiring a proven market valuation to be used, have been given in other similar circumstances. It is also not unusual for a requirement to report on a particular basis to be imposed after the event, provided that the requirement is imposed in advance of the reporting date*'.

On the other section 68 Order, the paper sets out the following:

Regulation 69 of the Insurance Companies Regulations 1994 specifies the basis on which future payments are to be valued. In effect, the requirement is to assume an interest rate no higher than the average yield currently being achieved on the assets supporting the long term business. The regulation specifies how that yield is to be calculated. However, there is a slight defect in the averaging method prescribed in the regulations which means that depending on economic circumstances they can place (and at the moment they are placing) an <u>artificial</u> strain on the company (or lead to an artificial release of reserves). This arises because of the simplistic basis of the calculations for fixed interest assets, which averages the rates interest by value of the underlying investments, but takes no account of their duration. At the time the regulations were made, more sophisticated calculations were not thought possible.

The problems with the valuation method in regulation 69 become evident when doing the calculations for resilience test 2. Many companies just live with the consequences. However some have preferred to report more accurately (including [two insurance companies]*) and have therefore been given section 68 orders requiring them to perform more sophisticated calculations. Equitable Life has asked for a similar concession. Their* *original proposal was to calculate the yield on the basis of two segments of fixed interest securities (approved and non-approved). This is slightly different from the methodology that has been applied by other companies. Following discussion at the* [Insurance Supervisory Committee]*, I have gone back to the company which has since agreed that for future it would be willing to use the approach that has been adopted by other firms. That alternative methodology effectively involves the company seeking to hypothecate blocks of fixed interest assets to particular areas of business in order to calculate the yield.*

For the last financial year, Equitable Life does not believe it is possible to rework its past calculations on the "third" way (or at least it says that the work involved in so doing would be disproportionate). This is unfortunate because ideally we would have liked the reporting concession for the year end 2000 to have been consistent both with what the company was proposing for the future and what certain other companies are already doing. I have discussed the effects of the different approaches and the company has indicated that (at least with current economic conditions) it believes the financial effects of either methodology would be broadly similar, although the "third way" might produce a very slightly less favourable result. If Equitable Life goes ahead on the basis it had proposed the benefit to its solvency position will be of the order of £150-200 million as compared with the regulations. The company's actuary believes that the third way would also have produced a benefit within that range.

After some debate, we have concluded that it would be appropriate to allow the Equitable Life to report the end 2000 position as it has proposed. This produces a more accurate reflection of the financial position than would be the case if it followed the requirements of regulation 69. We have also concluded that it would be unrealistic, and an unnecessary distraction, to require the company to rework its historic calculations. It is worth remembering that Equitable Life's actuarial team [is] *central to the work on the compromise scheme.*

However, that leaves a problem for the future. As noted above, it was our preference that the valuation basis used by Equitable Life was consistent with what is done by other companies. On the other hand, it is normally a requirement when such concessions are granted that a company has to continue to use the same valuation basis in future years, so that it cannot select the method that is most favourable at any given point. The evidence suggests that it will be possible to go for the former, without being overtly inconsistent, in numerical terms, with the Society's track record. There is certainly no question of the Society trying to select the most favourable basis from year to year. I will look further at the issue of the approach for the future valuation basis, which can be the subject of a separate order (or a rule waiver).

At this stage, I therefore would welcome your agreement that we should recommend to the Treasury that a section 68 order should be given to address [only] the 2000 reporting question.

[**19:01**] FSA's Managing Director asks the Director of Insurance and the Head of Life Insurance for a meeting to discuss the applications, saying: '*to me concession (1) is unarguably right (2) more difficult. But more generally I would like before we go snap on anything reassurance that all other solvency/reserving issues between* [Equitable] *and us have been resolved totally as* <u>*we*</u> *would want them. I recall a note from last November that said as that stage there was some £1bn difference between us and them overall on the reserving question. What has happened to all of that?*'.

[**19:10**] In response to Line Manager E's note to the Managing Director, Chief Counsel A says that she would be surprised if there were '*any significant legal issues arising here*' but that she would review the papers the following week.

03/05/2001 [15:47] FSA send Director of GCD's comments of 01/05/2001 [**10:55**] to their legal advisers and to Counsel, for information.

[**16:33**] Chief Counsel A queries with the Director of GCD whether FSA should send the comments to Equitable and inform them that they raised '*major*' issues.

[**18:40**] The Director says that they should be sent to Equitable pretty soon as they were all or nearly all points of substance, while making it plain that FSA had not yet reached concluded views on them.

03/05/2001 [15:53] Equitable's solicitors send FSA some information about their Articles of Association relating to the election and required numbers of directors.

[**16:24**] Legal Adviser D forwards the information to other officials at FSA, saying that the note cleared up some of FSA's knowledge gaps; the important point being that there would continue to be eight directors.

03/05/2001 [16:39] FSA send PIA some documents to help explain how the risk environment might have been perceived by Equitable in the period surrounding the Court of Appeal case. The documents are Equitable's letter to FSA (dated 21/06/1999) and an accompanying note entitled '*Court case scenarios*' (dated 17 June 1999), FSA's note of the meeting with Equitable on 29/06/1999 and FSA's note of the meeting with Equitable on 18/07/2000.

03/05/2001 [18:26] In response to a request for some information for FSA's Board on Equitable's Companies Act reports and accounts, '*particularly as … much has been made of the increase in the reserves figure to* [greater than] *£1.5bn*', Line Manager E provides the following:

> *Equitable published its annual report and accounts in the week beginning 30 April. From a regulatory perspective, they show little of interest since we have much more up to date information about the Society's financial position. However, it is helpful that the report give some useful information about the valuation of a life office's liabilities, and in particular an explanation of the development of the Society's GAR liability during the court process, and subsequently. Equitable is due to submit its regulatory returns for the end of 2000 in June.*

Line Manager E says that: '*Unless* [the Head of Life Insurance] *can think of anything more useful to say. I feel a bit nervous saying that the statutory accounts don't tell us much, but I think in this case it is true!*'.

03/05/2001 [entry 7] Equitable notify FSA of the appointment of four directors.

04/05/2001 [08:46] An FSA official tells Line Manager E that his note for the Board of 03/05/2001 [**18:26**] would not do, as it '*omits to mention* [Managing Director A's] *key concern which I alluded to … i.e. the figure quoted for gross liabilities and why this is different to the number that has previously been quoted i.e. £1.5bn*'.

[**10:36**] The Head of Life Insurance amends the statement to read:

> *Equitable published its annual report and accounts in the week beginning 30 April. From a regulatory perspective, they show little of interest since we have much more up to date information about the Society's financial position. However, it is helpful that the report gives some useful information about the valuation of a life office's liabilities. In particular it explains clearly why the technical provisions in respect of the GAR liability increased from £200m in 1999 to £1.668bn in 2000 (made up of £1.468bn for the GAR provision, and £200m for the GAR rectification scheme). This significant increase in the provision reflects*

the impact of the House of Lords' decision. The provision included at 31st December 1999 was set assuming that either the Court of Appeal or the High Court decision would be upheld. The House of Lords' decision went further than the Court of Appeal's decision and prohibited "ring fencing" of GAR policies. Equitable is due to submit its regulatory returns for the end of 2000 in June.

[**12:36**] The FSA official later confirms that this amendment had addressed the point about which the Managing Director had been concerned.

[**12:46**] FSA's Head of Actuarial Support adds that: '*The report and accounts does also provide some detailed explanation of the derivation of the different figures for the value of the GAR option. For example, the increase in technical provisions from £200 million to £1.67 billion only relates to the figure in the Company Act accounts and not to that in the FSA returns*'. He also adds that: '*There are also some relevant comments about the fundamental uncertainty attaching to this figure. This relates, I believe, primarily to the issue of the level of future premiums that may be payable but also to potential future changes in long-term interest rates (though we understand that* [Equitable's Appointed Actuary] *is recommending to them some form of limited hedging of this latter risk). There is also the uncertainty of the effect of possible future legal actions*'.

04/05/2001 [09:00] FSA's Head of Life Insurance replies to Managing Director A's suggestion of a meeting to discuss Equitable's section 68 Orders, saying:

In brief, Equitable have accepted our position on the £1bn, so although the position is tight (£300m free assets) and subject to two concessions from HMT, there is no outstanding disagreement between us and [Equitable].

[**10:47**] The Managing Director says that he had talked to FSA's Chairman about this and that they had agreed that this would be especially sensitive if:

... giving the disputed concession (he agrees the first is fine) is the difference between solvency/non-solvency or makes a near-zero level look rather better. So by the time we meet early next week can we [please] *(not closer than one or two tens of millions) have an idea of what the position is. My own understanding is that without either concession the outcome is a near "zero" surplus possibly even a deficit, while if the first concession is given but the second one not, the surplus is of the order of £100mn (i.e. very close for comfort)*

On the substance of the 2nd concession, [the Chairman] *feels that my fudge won't do and that the real choice is between no concession or getting them to do it* [properly] *if they are so desperate to have it. He also asks why is it that other firms have bothered to go down this route of greater complexity when they themselves have a sizeable surplus however the numbers are calculated. If there* [were] *a good reason it might help to dissipate the idea (perish the thought) that Equitable are doing this only through desperation.*

[**11:59**] The Director of Insurance expresses concern that the Managing Director was implying that Equitable were not '*doing it properly*'. The Director of Insurance says:

I don't think that this is a fair representation. They are not doing it the way other companies have. But as I understand it, the way they are doing it has come out of a dialogue with our actuarial advisers who advise that, from a technical perspective, the request should be met. Clearly we need to be careful that we do not do favours to the Equitable in the sense that we are not unreasonable in refusing a concession on the basis simply that it is not in the form in which <u>it happens</u> that others have previously sought it.

No doubt [the Head of Actuarial Support] *and/or* [Chief Actuary C] *can advise. But I don't think that there is any major significance to be attached to the fact that other companies have previously adopted a less complicated approach. Perhaps simply a refinement of actuarial thought both here and in the Company?*

[**16:23**] Scrutinising Actuary F writes to the Head of Actuarial Support with a draft response, intended to clear up a number of points. He comments that the section 68 Order sought by Equitable (and given to other companies) was seeking to correct what he explained was a '*flaw*' in Regulation 69.

The Scrutinising Actuary also comments on Equitable's solvency position at 31 December 2000 and the latest position. He says:

The Society have told us that at 31.12.2000 they had excess assets of about £500m., after meeting their required margin of solvency. This anticipated both an Order in respect of the valuation of Permanent (worth about an extra £125m.), and an Order in respect of the treatment of the fixed interest assets (worth about £150m - £200m.). Without these Orders, the excess assets would be about £200m.

Markets have been volatile during the year to date. We understand that at end-January the position was somewhat better than at 31.12.00, and excess assets amounted to around £700m. At end-February, however, the position was somewhat tighter. Then on 01 March the Society received an injection of £500m. from the Halifax, which boosted the position accordingly. (In fact, the Society told us that this injection improved the free assets by more than £500m., because of some secondary benefits elsewhere in the valuation).

To summarise, the position at 31.12.2000 would have been excess assets of the order of £200m., rather than zero, were neither of the Orders granted. Both approaches to the fixed interest stocks (as at 31.12.00 and as at 31.12.01) are acceptable; the Society's proposed approach to 31.12.01 reflects our discussions with them last week, and there really is not time to ask them to rework their calculations at 31.12.00 on the 2001 basis, given the impact this would have on their workload.

04/05/2001 [09:20] FSA's Director of GCD tells Chief Counsel A that FSA should perhaps delay in sending their points on the compromise proposals to Equitable so that FSA could assess them a bit further to '*avoid going off half cocked*'.

04/05/2001 [10:22] Equitable write to FSA about changes to Equitable's German branch operations. Equitable explain that the overall objective was to change the nature of the Society's operations in Germany from a branch basis to a service basis from the United Kingdom, which would eliminate their physical presence in Germany.

04/05/2001 [11:04] Another member of FSA's Insurance Supervisory Committee comments on the discussion the previous day, having discussed the matter with some of the officials. The Committee member says that he is:

... broadly content, but remain concerned about the "consistency" concept. [Equitable] *must tell us their intention. If it were any other company applying for any S68 we would want to know their future strategy (intention). In return we would indicate our intention. I have no problem with the options but it is for* [Equitable] *to say to us what is the most appropriate treatment technically (thus avoiding the problem of switching to most favourable). If they say the* [first company's] *method is technically the most correct but they cant do till next year then fine. Allow bundling this year and expect a switch next year. If bundling is correct then expect this consistently.*

[**11:48**] Scrutinising Actuary F says that Equitable had informed FSA of their intention in their letter of 30/04/2001 [**14:04**], and that this was:

... to group their fixed interest securities into two blocks, or "segments" (one block to comprise gilt-edged securities and the other to comprise other fixed interest stocks, e.g. loan stocks & debentures) for the valuation as at 31.12.2000. For the valuation at 31.12.2001 they will group the securities differently to match specific major blocks of business (e.g. they will allocate one "basket" of assets to support their annuities in payment, and a separate "basket" to support other business. Each "basket" would comprise for example x% gilts, y% other fixed interest, z% cash, where x+y+z=100%).

They are adopting the "segment" approach for the 31.12.2000 valuation, because it builds on how the assets are reported on Forms 48 & 49 of the Returns, and retains the distinction between gilts and non-gilts. [The Chief Actuary's] *e-mail yesterday describes how the Society intend to use these segments in their 31.12.00 valuation. GAD previously reviewed this approach and were content with it.*

However, at a recent meeting at FSA on 23 April ... FSA ... said it would be preferable for the Society to adopt an approach consistent with other companies which already have similar concessions.

Therefore Equitable have said in their 30.04.01 letter, referred to above, that they will change their approach for the future, as described above.

As [Line Manager E] *explained in his first e-mail, it is impractical to ask the Society to rework their calculations in respect of the 31.12.2000 valuation at this late stage. The impact on their internal* [computer] *systems, mainframe systems and reporting systems, timetable for auditing the returns and so on would be more than I believe they could accommodate. Equitable's stated intention to change their approach for the future reflects what FSA have asked them to do.*

The first Committee member notes what the Scrutinising Actuary had said. The Committee member says, however, that he believed that Line Manager E's submission to Managing Director A and his comments the previous day '*makes it clear that we at any rate have not decided what approach we will support going forward, and I had assumed that reaching a decision on this point would be likely to involve some discussion with the company*'.

04/05/2001 [16:25] Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

04/05/2001 [entry 7] FSA write to Equitable about the draft actuarial section of the compromise agreement (as previously agreed at the meeting on 23/04/2001). FSA say that they were concerned that Equitable had not provided objective reasons as to the appropriate method of determining the value of GAR rights. FSA state, in particular, that it was not clear, and no argument had been put forward, as to why occupational group pension holders should receive less than individual policyholders. FSA note that Equitable had said that the GAR take-up rates were a key assumption but they had not explained why the rates should be regarded as providing a reliable indication of the value to be placed on GAR rights. FSA ask what the explanation had been for lower take-up rates of GARs by group scheme policyholders. FSA say: '*Even if there is sufficient objective reason to offer less to occupational policyholders, we do not understand why the differential is set at 25% and 14%. Further, if a differential is objectively justified, that fact would seem to us to support an argument that the two groups should be treated as separate classes. If so ... that would suggest a possible 4 classes*'. FSA ask to discuss these issues at the next meeting, arranged for 09/05/2001.

08/05/2001 [entry 1] Equitable notify FSA of the resignations of ten of the Society's directors.

08/05/2001 [11:02] FSA's Scrutinising Actuary F advises Line Supervisor C that Equitable's request of 24/04/2001, for FSA's approval to permit the Society to allow group scheme AVC policyholders to switch to Free-Standing AVC policies, looked reasonable and that FSA should agree to it.

08/05/2001 [entry 3] FSA meet Equitable's Chairman. The Chairman provides FSA with a copy of their Counsel's joint opinion on whether it was possible to change the House of Lords' decision, and on the possibility of mis-selling claims to be made by non-GAR policyholders. (Note: it appears that no note of the meeting was made.)

[**12:40**] Following the meeting, FSA hold a further meeting to discuss the work that they needed to put in hand. The Director of Insurance reports to Managing Director A that:

> *Broadly speaking this fell into the following groups:*
>
> > *a) Was there any reason why Equitable should* <u>*not*</u> *publish a summary of* [their Counsel's] *opinion. It might arguably be inconsistent with the directors duty to act in the best interests of the company. It might prejudice the work* [solicitors] *are doing to investigate the possibility of action against the company's advisers;*
> >
> > *b) What were the implications for the company's solvency under the Companies and the Insurance Companies Act. The former was primarily an issue for the directors. But the latter was an immediate issue for us. Either way we needed to know, on whatever basis, whether the answer to the question "Is the company solvent?" is changed, or called into doubt, by the opinion;*
> >
> > *c) What were the implications for our responsibilities for other companies. If the sense of the opinion was, essentially, that writing non GAR policies in a fund which also contained GAR policies, without disclosing the potential cross-exposure amounted to misselling under LAUTRO and PIA rules (as well as misrepresentation) then the question arose whether other companies were also similarly exposed. The issue for us would be whether other companies had been guilty of misselling and, more importantly, were they still misselling. If the latter we needed to consider what action we might appropriately take to prevent this;*
> >
> > *d) What the reserving implications might be for other companies;*
> >
> > *e) Whether any of this had implications for the application of the MVA (primarily by the Equitable, but perhaps by other companies)*
>
> *We will be seeing* [Equitable's Chief Executive] *tomorrow morning. We needed to address the reserving and solvency issue with him at that meeting.*

The Director of Insurance also reports that:

> *Following this discussion I spoke again to* [Equitable's Chairman]*, primarily to ensure that* [the Society's Chief Executive] *was fully in the loop, but also to discover how firmly committed the Equitable felt to early publication of a summary of* [their Counsel's] *opinion.* [The Chairman] *told me that* [the Chief Executive] *was now fully briefed, had read the conclusions of the* [Society's Counsel's] *opinion but not the opinion in full. He agreed that the reserving and solvency issues needed to be addressed urgently and would warn* [the Chief Executive] *that we would be raising these with him. On early publication he felt that the Equitable had no option on this. They had discussed this with* [their solicitors] *this morning who saw no obstacle of the sort we envisaged. The opinion was already the subject of leaks;* [Counsel] *himself had drafted it in the expectation that it would be published. It was clear that it would have to published at some point and it was not clear that anything was to be gained by delay. Preliminary discussion with some of the directors (there is to be a fuller discussion tomorrow morning) had resulted in*

agreement on this point. In the Equitable's view the opinion raised fundamental issues which would need to be settled in court before progress could be made. In terms of publication the key sensitivity would be what the Equitable themselves said about the opinion. Their present view was that they would say that the opinion raised issues of great complexity, that they were considering these carefully, with a view to testing the conclusions expressed in the opinion in the courts.

On timing, [the Chairman] *said that they would not publish before late tomorrow afternoon, but that they would probably not hold much later than that. They would ensure that we received notice, together with a draft of what they planned to say. But, despite my protestations, he did not promise that we would get much notice. I said that, given our own concerns about early publication, we were bound to ask ourselves whether this was appropriate or whether, if we concluded that it was not, we should take formal action to prevent it. I thought this "very unlikely", but thought in all the circumstances that it was right to let* [the Chairman] *know that the possibility existed.* [Equitable's Chairman] *said that he would assume that we were not minded to do this until such time as we told him otherwise.*

The Director of Insurance then suggests to the Managing Director the action that FSA needed to take, saying:

All of this suggests we will need to get our ducks into a semblance of a row pretty quickly:

We need to decide very quickly indeed if there are grounds for our intervening to prevent early publication and, if so whether we should do so, (bearing in mind that we would almost certainly need to make this action and the reasons for it public). [Managing Director A]*: if immediate action on this is needed it is likely to fall to you to take the decision. You may need to consider whether you should stand aside from the preparatory "investigation" which might lead up to this.*

[FSA's Head of Actuarial Support]*, with legal support, will lead the work on reserving. But this cannot be progressed very far until we have studied the opinion – and we may well need Counsel's advice ourselves;*

[Chief Counsel B] *(with* [PIA]*, to whom I have not yet spoken) will consider the issue of possible misselling by other companies. In practice we should not allow ourselves to be stampeded into anything by an as yet untested opinion. But we will need a holding line at least, and to decide what work we should put in hand. (You had suggested earlier that this raises the issue of whether we should suspend/change our own investigation of possible misselling by the Equitable);*

[Chief Counsel A] *will "warm up"* [Counsel] *on the issues, primarily to take his mind on whether there are other important issues or questions that we have not identified.*

[**13:15**] The Managing Director replies, having spoken to FSA's Chairman. Managing Director A says: '*We do not think there is any basis on which we could seek to prevent/delay publication of this report – a fortiori in the light of the view taken by* [Equitable's solicitors] *that it does not affect their work. We would be grateful if you could pull out of* [an overseas conference of regulators]'.

08/05/2001 [entry 4] FSA's Director of GCD provides the Director of Insurance with a note on the opinion of Counsel for Equitable. The Director of GCD says:

I have not yet read the opinion myself, but on the basis of the description given to us by [Equitable's Chairman] *this morning, its conclusions are that:*

- *attempting to get the House of Lords to change its original decision is "a dead duck";*

- *however, non-GAR holders have alternative causes of action which could be taken to counterbalance the rights of the GAR holders.*

It is suggested that the non-GAR holders have three possible causes of action, that is, for:

- *breach of Lautro rules, which it was said provides absolute liability, under which it is not a defence to show that you misunderstood the position;*
- *misrepresentation in failing to disclose the true position;*
- *breach of an implied warranty that non-GAR holders would receive a certain share of the assets.*

Possible implications we need to consider are:

- *impact on the proposed section 425 scheme: the implication seems to be to support the argument for bringing these liabilities into account into the Section 425 scheme, but it is recognised that further consideration will need to be given to the degree of certainty/ascertain ability that the Court will require for this purpose, particularly the level of impact on different individuals, rather than groups as a whole with implications not least for the scope and timing of the scheme;*
- *the need for provisioning against these liabilities: while in the context of the compromise, they may be seen as counterbalancing the rights of the GAR holders, we need also to consider them as potential claims against the company which could potentially increase its overall liabilities and to determine the approach which needs to be made to provisioning in that light;*
- *the provisioning issue needs to be regarded as urgent both because of the need for the Equitable to produce statutory returns, and because of our own need to respond to questions when the opinion goes on to the Equitable web site later this week;*
- *there are also issues in relation to other companies which have sold GARs: what approach should be taken to provisioning in their accounts, and should any action be taken in relation to ongoing sales which they make?*
- *the analysis in this opinion needs to be factored into the work on duties to disclose on which we have concluded we should seek external counsel ourselves, and also borne in mind in considering the draft PIA disclosure report;*
- *we need to return rapidly to* [Counsel] *for further advice in relation to Article 4 of the Equitable's constitution;*
- *we also need to look at the implied warranty analysis to see whether there is anything in it which affects our approach in relation to the MVA, which colleagues are looking at in the context of our contract terms responsibilities.*

There was one other point which was raised at today's meeting which is worth noting in this context, though it does not arise directly from the opinion. This relates to the work which [Equitable's solicitors] *have been asked to do to look at the claims which the Equitable can make against others. The meeting identified the fact that this work would potentially have an impact on the Section 425 scheme. On a straightforward view, any additional assets recovered in this way would simply be available as additional assets of the company. However, there was a counter argument that duties were owed, and loss suffered, specifically in relation to the non-GAR policyholders. If this was the case, this too would arguably need to be brought into account in the Section 425 scheme. Presumably, this would need to be brought into account by providing in the scheme for any sums received by this route to be allocated to non-GAR policy holders, but even then it would still be tricky to work out exactly how the prospect of such credits would impact on the amount of the settlement overall.*

08/05/2001 [14:00]	FSA hold an Equitable Life Lawyers Group meeting. The Group discuss Counsel's opinion. The Group note that FSA's Chairman and Managing Director had expressed their views that '*there was little the FSA could do to prevent the Equitable publishing the opinion, as they were minded to do – despite the fact that the Equitable were not proposing to say whether they agreed with its conclusions or not on the liability of the Equitable to various classes of policyholder*'. Chief Counsel B says that he '*wondered how the directors of the Equitable could be acting in the best interests of the company by publishing such an opinion*'.

09/05/2001 [11:31] An FSA official distributes a note of a conversation that FSA's Chairman had had with Equitable's Chairman the previous evening, while attending a dinner hosted by a recruitment and management assessment company. The note records:

> [FSA's Chairman] *spoke to* [Equitable's Chairman] *at a dinner last night and asked about whether he had considered disentangling the* [Counsel's] *opinion so that the parts about not being able to challenge the House of Lords could be released but not the sections saying on LAUTRO rules.* [Equitable's Chairman] *had considered it but had found that it would disrupt the logical flow of the argument and that it would all be exposed by the non-GARS the moment the Court considered a proposed arrangement so it was better off getting it out into the open now.* [Counsel] *had put forward a much shorter version but Equitable had felt this had only served to make the issue look much more stark.* [Equitable's Chairman] *expects that Equitable,* [Counsel for the Society]*, and colleagues to do the further work that they recommend.*
>
> *Equitable planned to put out a press release on all of this, probably today. They would send us a copy prior to it being released (which we presume will be handed over by* [Equitable's Chief Executive] *this morning).* [FSA's Chairman] *would like urgent thought to be given to how we would respond, which we presume will be along the lines that we would be studying the opinion carefully [action –* [FSA's Head of Press Office] *and interested parties].*
>
> [FSA's Chairman] *asked what form he would want a Court decision to take.* [Equitable's Chairman] *said that he was looking for a* [declaratory] *judgement, but would like to have an early discussion with us about our views on how they should proceed. We need to give immediate thought to what our line should be. Clearly, there is a risk that a Court might say that the proper course of action was for a policyholder to take a case to the Ombudsman and then, if they wished, to seek judicial review. we need to consider how this relates to complaints the Ombudsman has already received (of which there must be many, one would presume) and also whether we should be considering any action ourselves in this area [action –* [The Director of GCD] *and interested parties]. We also need to give consideration to how the consequences might affect Equitable's solvency (which was not a point* [Equitable's Chairman] *had focused on) [action –* [The Director of Insurance] *and interested parties].*
>
> *He said that he hopes to persuade* [Halifax's Chairman] *to extend the timetable for the Halifax deal, if necessary (*[FSA's Chairman] *is sceptical about the likelihood of this, especially if it is an open-ended commitment).*

FSA's Chairman later (on 21 May 2001) provides a '*Note for Record*' of the conversation.

09/05/2001 [entry 2] FSA meet Equitable to discuss the opinion given by Counsel for Equitable.

Equitable confirm that Counsel '*had been given a fairly wide and open ended brief by the Society to look into the House of Lords ruling*'. On the first part of the opinion, FSA record:

It appeared that the draft opinion ruled out challenging the House of Lords verdict on the basis of process, conflict of interest or lack of representation for non GAR policyholders. The [House of Lords'] *judgement was here to stay, although there was still considerable doubt as to how this ruling could be interpreted.* [Equitable's Chief Executive] *had referred in an early meeting to allocating bonuses on a calendar year basis. This approach could recognise the extent to which pre 1988 policies had GAR options when setting overall bonus levels. Although it could be argued that such an approach was attempting to frustrate the* [House of Lords'] *judgement – but* [the Chief Executive] *thought that other companies operated in this way.*

On the second part of the opinion about non-GAR policyholders, FSA record:

[Counsel] *appeared to advocate that non GARs may have either a contractual right to receive full asset shares or a case for mis-selling ... because of the lack of disclosure on GARs. This part of his opinion needed further work. It was recognised that these interim conclusions could be damaging to the 425 process as they would lead the non GAR pressure groups to press for the halt of the transfer of value to the GARs. If the contractual right argument was valid then this could elevate non GARs rights above those of the GARs. They would be entitled to asset share and would not have to prove financial loss as they would for mis-selling. It was also recognised that the rectification scheme could be under threat if* [Counsel for Equitable's] *arguments were found to have merit.*

FSA note that publication of the opinion is planned for later that day, '*although the conclusion about the inability of challenging the* [House of Lords'] *decision had already been leaked and was in last weekend's press*'. FSA express concern about publishing the opinion before examining it more closely. On implications for the compromise scheme, FSA record:

It was unclear how the Society was going to handle this issue in relation to the 425 scheme. Although it did appear that further work was needed to assess both the basis of [the Society's Counsel's] *arguments and what further work was needed.* [Equitable's Chief Executive] *believed that the majority of policyholders wanted an end to litigation and for example funding test cases on this issue was not immediately an attractive option. There was also the importance of getting a scheme in place by February 2002. It was still unclear as to whether an extension of time for this would be granted by the Halifax.* [The Chief Executive] *estimated that the further work required in unravelling* [Counsel's] *opinion would take at least two months. It was confirmed that the Halifax would be kept up to speed on this issue as Halifax had a right to be informed on matters affecting the 425 scheme.*

On the impact of the opinion on Equitable's financial position, FSA record:

It appeared that the potential balance sheet effect of any mis-selling had yet to be formally considered by the Society. Conceptually it might be possible to perceive that the transfer of value from one set of policyholders to another (non GARs to GARs) that occurred after the [House of Lords] *could either be eliminated or mitigated by a reverse transfer of value. However, as far as balance sheet liabilities are concerned this could also be construed to be an additional liability.* [FSA's Director of Insurance] *reminded the visitors of their obligations as Appointed Actuary and Chief Executive and said that they needed to consider whether or not it was necessary to put up a reserve for this amount.* [Equitable's Chief Executive] *was reminded about the need to ensure that this potential issue was considered vis a vis Directors and Officers Insurance.*

It was also noted that the requirement of Companies Act and [Insurance Companies Act] *were different. The Companies Act accounts could, for example carry this potential liability off balance sheet as a contingent liability (although the accounting treatment in* *the* [Companies Act] *accounts would be subject to* [Financial Reporting System 12] *and relevant accounting standards). However, the more conservative valuation basis required by the* [Insurance Companies Act] *might require the additional reserve to be included in the Annual Return. A significant additional reserve would almost certainly lead to the Society not covering its* [Required Minimum Margin]. *The Appointed Actuary said that if required the Society could find the amount required in the worse case scenario (the £1.5bn) but this would mean that the Society would have to move entirely out of equities and into gilts. The 2000 Annual Return had yet to be submitted (due 30 June) and thought would need to be given as to how this potential liability should be treated.*

FSA's letter of 04/05/2001 which gave some feedback on the actuarial part of the compromise scheme is discussed. FSA note: '[Equitable's Chief Executive] *was concerned about our comments about why less value was being given to occupational pension holders than individual pension holders.* [FSA's Head of Life Insurance] *thought that a lower uplift could be used to different groups of policyholder provided this was borne out by informed behaviour.* [Equitable's Chief Executive] *agreed that further justification was required to explain why the GAR take up rate amongst occupational pension holders was so low and further work was being carried out in this area. This work would also examine whether behaviour was different according to the size of scheme and if necessary uplift rates could be subdivided between large and small schemes*'.

Under '*Action Points*', Equitable agree to let FSA know when they planned to publish their press notice on the opinion and to provide them with a copy prior to issue.

09/05/2001 [14:43] PIA thank FSA for the information provided on 03/05/2001 [**16:39**] about Equitable's perception of risk linked to the court cases and potential mis-selling. PIA say that the material was confirmation of what Equitable thought. However, PIA ask FSA if they had any evidence as to why the Society had thought that way, specifically:

1) Why did Equitable think scenarios 5 and 6 (June 1999) were unlikely and "inconceivable"?

2) Why, on 18th July 2000, did Equitable still feel the eventual outcome was "unlikely"?

3) When did planning for the possibility of no purchaser being found start? It seems not until late [November] *2000 – do we have documentation explaining why there was no planning before this?*

09/05/2001 [14:53] FSA's Press Office inform the Director of GCD and other officials that Equitable were due to issue a press notice on Counsel's opinion the following day, and planned to publish the opinion in full.

[**15:41**] The Director of Insurance says: '*This is bad news – and disappointing given* [the Chief Executive's] *clear recognition this morning that an early release of the whole opinion would create major difficulties for the company*'. The Director notes that Line Manager E was preparing a question and answer briefing paper, but:

... there are particular areas of difficulty:

a) we will clearly not be in a position to cover the "misselling" issue in relation both to ELAS (and more particularly to other companies) in the context of a wider statement about [PIA's] *work (as* [the Director of GCD] *had suggested earlier this week) and we will need some sort of holding line;*

b) we and the company will need to be ready to say something about solvency margin coverage/reserving implications if challenged. Ideally we will need to say things which are not inconsistent;

For the rest I imagine that both we and the company will wish to [emphasise] *the extremely speculative nature of* [Counsel's] *opinion on misselling/contractual warranties (there is a helpful piece in which he draws attention to the fact that he has done no more than identify a theoretical possibility; that substantial work would need to be done to ascertain whether there is any substance to it, and that no-one should rush to the view that it will be possible to establish offsetting rights that might "neutralise" the House of Lords judgement in whole or in part.*

The Director of Insurance adds:

I imagine the company will need to concede that this may delay the presentation of an outline of the s425 scheme, and the scheme itself. But they (and I think we) will need to stick to the line that such a scheme still offers the best way of achieving certainty and stability.

I guess the Halifax may be asked whether they would be prepared to extend their deadline. I imagine that they will be (at best) non-committal, and that we should not get drawn on this.

I will try to touch base with [Equitable's Chief Executive] *to discuss how they will be handling, particularly on the solvency margin issue.*

[**16:07**] The Director of GCD warns that FSA needed to be cautious about describing the opinion as '*speculative*'. He says: '*The analysis of the* [LAUTRO] *rules is serious stuff, and does in my view raise real issues about whether compliant disclosure was made. That does not mean that further work is not needed. But that should be our emphasis, rather than describing the paper as speculative, which we would later regret as too dismissive*'.

[**16:29**] The Director of Insurance writes again, having spoken to Equitable's Chief Executive, recording that:

He was apologetic that he had not carried the day on publication. However he felt that the revised press notice was "incomparably better" than the original version (which we had not seen).

He agreed that we should liaise over the lines we would each use with the press. He was considering what to say [about] *two of the key issues – reserving and the future of the s425 scheme.*

On <u>reserving</u> he thinks the [Equitable's] *line will be that the opinion changes nothing. The possibility of non-GAR policyholders having a right of action against the Society has been a matter of debate for some time. The Society are confident, on the basis of their current understanding of the position, that they continue to meet the statutory solvency margin requirements. Should the further work now put in hand on the non-GAR rights of a action issue put that position in doubt the Society have adequate room for manoeuvre to ensure that the statutory margins remain covered;.*

On the <u>s425 scheme</u> the Society are likely to take the position that this remains the best way forward in the interests of all policyholders. They will express the hope, if asked, that this will not lead to a delay in their bringing forward proposals. (They had not planned to produce an outline plan before the AGM, only to comment on the progress being made, so that there is nothing that had been planned for the immediate future that will be put back).

09/05/2001 [entry 5] Equitable send FSA a summary of their estimated solvency position at 31 March 2001, which showed:

<u>Solvency position at 31 March 2001</u>

	£m	£m
Value of non-linked assets		*28,295*
Future Profits Implicit Item		*1,000*
		29,295
Mathematical Reserves		
Basic (including GAR)	*26,640*	
resilience	*635*	
		27,275
		2,020
Required Minimum Margin		*1,150*
Excess Assets		*870*

Equitable say work was continuing on the production of an actuarial certificate in support of the implicit item and they would let FSA have that as soon as possible.

09/05/2001 [entry 6] Equitable notify FSA of the appointment of two new directors.

09/05/2001 [entry 7] FSA meet to discuss Line Manager E's note of 03/05/2001 about the reporting concessions sought by Equitable. FSA's note of the meeting (which is not written up until 22 May 2001) records:

> *The meeting agreed that the concession relating to the valuation of Permanent Insurance was acceptable.*
>
> *There was some discussion of the concession relating to fixed interest assets. It was noted in discussion that we had not objected to the method originally favoured by Equitable Life when the matter was first raised, and that we considered their approach to be preferable to that under the regulations (which we consider are defective). However, the approach was different from that adopted by certain other companies. The differences were thought to be justifiable because of the different types of business. Equitable Life has said it would move to the other basis for future years for consistency with the methodology used by others, but could not do so in relation to the 2000 year end. The FSA would be able to decide which would be the appropriate basis going forward, not the Society. It was also noted that* [FSA] *would be looking to amend the relevant part of the Integrated Prudential Sourcebook going forward and work on amending the defective regulations was already in hand.*
>
> *It was understood that the Society would be solvent whether or not the concession were granted. However, without it, the position would be very tight and particularly with the* [Counsel for Equitable's] *opinion could lead to concerns about the true solvency position. It was noted that while the concession of itself seemed innocuous, when considered alongside others such as the implicit item for future profits and the subordinated loan, for example, pointed to a tendency for Equitable Life to select the most favourable valuation method in every case. However, it was pointed out that the proposal for the concession arose as part of a review by GAD of the society's reserving basis, with most of the improvements being adopted leading to an uplift in the reserving requirement, with a small number moving the other way. Overall, the Society was faced with an uplift in excess of £1 billion in its reserves. The issue had been live since November 2000 though it had taken some time before Equitable Life had been able to formalise its application.*

> *The meeting considered that the basis on which the FSA was required to assess the application.* [FSA's Director of GCD] *advised that the test under section 68 there was an open discretion but that was constrained by a requirement to act reasonably. He also noted that the decision was ultimately for the Treasury and that the FSA had to advise.*
>
> *The meeting concluded... on balance it supported the application, largely on the basis there were no clear grounds for rejecting it. It was agreed that this should be made clear to the Treasury, along with the points about the impact and reasonableness of Equitable Life's tendency to use the most favourable valuation basis to it.*

FSA also discuss Counsel's opinion and '*It was agreed that the aim was to make as little comment as possible, noting that we would be looking at the opinion carefully, that it was only preliminary in its nature and noting that there was nothing new since we had already said publicly that we were considering some related issues on post court of appeal sales*'.

10/05/2001 [10:04] FSA's Director of GCD says that Legal Adviser D's view relating to Equitable's appointment of directors (see 03/05/2001 [**16:24**]) is not what he understood Equitable's advice to be and, while only eight directors would be appointed at the annual general meeting, Equitable would co-opt additional directors up to the maximum of 15. The Director notes that, according to the Society's Chairman, Equitable were considering doing so.

10/05/2001 [10:07] FSA's Line Manager E seeks comments on some draft press lines for the publication of Counsel's opinion.

[**10:43**] In response to this, the Head of Actuarial Support says:

> *Although we probably do not wish to mention it here, I believe that the Opinion would have much wider implications for insurers if it were accepted. In my view, it is not about GAR's at all but about the question of inadequate representations being made to policyholders about how with-profit funds operate. In particular, it seems to be saying that policyholders were not made sufficiently aware that they would share in all trading profits and losses of the insurers and not just in the investment returns.*
>
> *As such, this issue could affect all insurers that have written with-profit policies that envisage this wider participation in the profits (and losses) of the business. Of course, though, both the actual representations made to policyholders and the practice followed in the distribution of profits (including any contributions from or to the "estate") will vary from company to company.*

10/05/2001 [10:56] PIA send FSA a copy of a draft note on '*the purpose and desired effect of the PIA Disclosure Rules for new business during the periods when the Courts were considering the Equitable's bonus policy in relation to policies with GAR (Guaranteed Annuity Rates) until its closure to new business*'. PIA note that the draft note did not cover '*the discretion given by signing a proposal*'. PIA say that this: '*is one of the fundamental aspects of the with-profits review. I would observe that you must not be misled into signing a proposal. Last November I said that the minimum expectations of a with-profit contract were asset shares on investment after expenses. Some discretion is inherent e.g. smoothing. Financing losses elsewhere is not what the customer will expect*'.

10/05/2001 [entry 4] FSA confirm to Equitable, in reply to their letter of 24/04/2001, that they did not object to their proposal about writing new free-standing additional voluntary contributions business.

10/05/2001 [entry 5] FSA and PIA meet to discuss their review of Equitable's selling practices. FSA note that '*Stage 2*' of PIA's review was due to be completed by the end of May and that they needed to seek their own opinion from Counsel on mis-selling and that this needed to be done in the same time frame as the second part of work being done for Equitable by

Counsel. FSA also agree to consider whether they should make a public statement about their review of the Society's selling practices.

10/05/2001 [entry 6] FSA's supervisory file for Equitable contains a letter from PIA to the Society. The letter is in response to earlier correspondence from Equitable (dated 9 April 2001) about the approach they were taking to dealing with correspondence from policyholders about issues concerning the House of Lords' ruling and Equitable's subsequent closure to new business.

In that letter, Equitable explain that, due to '*exceptional circumstances and levels of work being experienced*', they were not always answering each policyholder letter individually. Instead, Equitable were often answering queries about their corporate approach to these issues by mail shot. Equitable say that, given their approach, it was not possible to guarantee that all specific complaints of an individual nature, which might require investigation, were being answered. Equitable acknowledge, therefore, that there could be instances where they would not have complied with PIA rules on complaint handling.

PIA's reply notes that this: '*does not comply with PIA Rules and as such is unacceptable. However, given the "exceptional circumstances" that you indicate, PIA recognise that, for the immediate future, the most pragmatic approach is to carry on with the adopted process. However, I would request your urgent proposals for rectifying the position, including how you intend to address the potential for regulated complaints to be completely overlooked*'.

10/05/2001 [12:14] FSA's Chief Counsel B informs the Director of Insurance of the '*preliminary observations*' of their Counsel on the opinion of Counsel that Equitable had received. The Chief Counsel says that Counsel had been unsurprised about what was said in the first part of the opinion on the possibility of reopening the House of Lords' decision. Chief Counsel B goes on to record that Counsel:

> *... is, however, unnerved by the second part of the opinion which deals with possible liabilities which Equitable may have occurred in relation to the non-GAR policyholders. He is very concerned that the analysis is superficial and is without any proper or full analysis of what the implications are for Society and policyholders particularly as to how any such rights might be substantiated and its impact upon the process for reaching a compromise. To use his words, the Equitable must be mad if it is to publish the opinion as it stands on their website. He is concerned that the opinion will raise false hopes and or panic amongst policyholders and that it will, in the press and elsewhere, raise instant questions about the solvency of Equitable and conceivably precipitate events leading to a very early liquidation of the company.*
>
> *Looking at the substance of some of* [Counsel for Equitable's] *points,* [Counsel] *thinks that there is a very serious question to be addressed as to whether any of the regulatory rules, including those which on their face imposed strict obligations, have the effect contended for by* [Counsel for Equitable]. *One important issue is whether the disclosure requirements should be read as being subject to an implied term that the company's duty to disclose extended only to those matters of which it had knowledge at the time or which, with reasonable diligence, it could have had knowledge. The analysis does not mention at all the significance of the guidance which had been issued to insurance companies (and later withdrawn) on the treatment of GAR policies in terms of bonus distribution.* [Counsel for FSA] *acknowledges that the Equitable's duty of disclosure may well have changed with the onset of the Hyman litigation although further analysis will be needed to ascertain at what point the Equitable came under a duty to disclose the potential range of risks presented by the litigation and its various potential outcomes.* [The FSA's Counsel] *took the point that the issues raised by* [Counsel for Equitable] *are ones which may also affect other companies which have issued GAR policies.*

	Chief Counsel B says that he would arrange for FSA to meet with Counsel the following day. [**12:30**] The Director of Insurance welcomes the opportunity of a meeting, noting that: '*As* [the Head of Actuarial Support] *has pointed out separately, this has potentially huge implications for the industry generally. If non disclosure of exposure to GAR liabilities amounts to any of the things* [Counsel for Equitable] *suggests then what about non (or non-effective) disclosure in with-profits business of exposure to mortality risk, business risk etc etc*'. The Director also states that FSA had '*discussed briefly whether we should go back to the Equitable to urge them again not to publish the full opinion. You said that* [the Director of GCD] *had discussed this with* [FSA's Chairman] *who took the view that we had done all we could*'.
10/05/2001 [12:32]	Equitable send FSA a copy of a press notice to be issued at 14:00 that day about Counsel's opinion. (Note: the notice did not, in fact, go out that day.)
10/05/2001 [13:11]	FSA's Line Manager E distributes the 'lines to take' for dealing with enquiries about Counsel for Equitable's opinion. In answer to the question '*What does this mean for the solvency of the Society*', FSA state: '*The opinion raises the possibility of certain legal actions. However, it is far from conclusive about the likelihood of success or possible value of claims that might be made. Against that background, it is difficult to reach firm conclusions about the financial effects of possible legal actions. This is something that Equitable Life will need to consider very carefully. We will be keeping very closely in touch with them over this*'.
10/05/2001 [14:14]	FSA's Director of GCD responds to the FSA official's query of 09/05/2001 [**11:31**] with his '*immediate comments*'. The Director identifies two separate contexts in which the issue raised by Counsel could go to court. First, '*as part of the s425 scheme, where the court would need to reach a view on the fairness of the scheme, having regard to the rights being given up*'. Secondly, '*as part of an independent attempt by Equitable to determine the extent of the rights, or by policyholders to enforce them*'. The Director of GCD says that his preference would be for the valuation of the claims as part of the compromise scheme. The Director says that he considered that Equitable should decide how they would want the scheme to take account of the value of the claims and obtain appropriate substantiation to demonstrate to FSA, policyholders and the court that it was a fair basis for a compromise. [**14:16**] The FSA official says that this did not answer the question of whether there was any regulatory action that FSA could take that they should consider.
10/05/2001 [17:07]	FSA write to Counsel ahead of a meeting planned for the following day. [**17:21**] In response to receiving a copy of the letter, the Head of Actuarial Support says: '*If the company end up having to submit a set of returns showing that they have insufficient assets to cover their liabilities, then HMT would seem to have the right to petition for a winding-up, and Section 54(3) of ICA 1982 says that we would then have sufficient evidence that they were unable to pay their debts. This would then seem to allow Section 58 to be applied, namely for a court to reduce the amount of the contracts on such terms and conditions as it considers just. I suppose this might be an alternative to the Section 425 scheme, though I am not sure exactly how it would work procedurally, or how it would be received by policyholders. Is this worth looking at with Counsel as well?*'. [**17:54**] The Director of Insurance replies: '*I'm inclined to think that we need to do rather more analysis (policy as well as legal) before seeking counsel's views. For the present I think we might better focus on the work that might be done to decide whether there is a reasonable likelihood that there might be valid claims, how these might be quantified (if this is necessary) and how this might be factored into a fair s425 scheme. I suspect that petitioning for winding*

	up would still be contrary to policyholders interests, and not something that we should contemplate while the company is still solvent – even if it is below required margins of solvency. After all our natural first step if margins are uncovered is to require the submission of a plan. It would surely only be if the company could not put together a credible plan that we would contemplate a petition. And the company have at least two possible avenues if required to submit a plan: to promote a s425 scheme, and to rebalance their equity/fixed interest investments'.
10/05/2001 [evening]	FSA's Director of GCD attends an Inner Temple guest night, during which he has a '*fairly cautious on* [his] *part*' conversation with Counsel for Equitable about the opinion which had been provided. The Director's note of the conversation (which he circulates on 15 May 2001) includes that: • [Counsel] *recognised that his Opinion was much more comprehensive and detailed on the inability to reopen the House of Lords case than it was on the possibility of parallel rights, but he did not see any particular difficulty with this, even though he recognised that it was the second part which would be seen as more significant;* • [Counsel] *expected to be asked to advise further on the issue of collateral claims, and did not see anything odd in being asked to do so by the Equitable, notwithstanding that their own position might be prejudiced by his conclusions;* • [Counsel] *expected that it would be a couple of months before he was able to complete his work on the second part;* • [Counsel] *recognised that his conclusions would potentially lead to issues about the solvency of the company, and that it was not clear how the rights he had identified could be brought into account in the section 425 scheme, but thought these were points for others to address;* [and] • [Counsel] *also recognised that his work here was likely to make him a focus for controversy, but had no difficulty with this*'.
11/05/2001 [11:00]	FSA hold a conference with their Counsel to consider the draft opinion of Counsel for Equitable. FSA record the headline points from the conference as being: • *he believed that* [Counsel for Equitable] *was wrong to say that the court had implied a term into the policies: rather they had done it into the articles;* • *the significance of this was that it was, in his view, legally impossible for them to imply a contrary term into the policies, namely that GAR policyholders should be entitled to their asset share, less a limited range of specified expenses;* • *this was because if there was an implied term in the articles, it covered everyone, both GAR and non GAR;* • *it cannot be accepted that the court would imply two contradictory implied terms: the true implied term is a single one, that a discretion cannot be exercised to deprive people of their legal rights;* • [the FSA's Counsel] *was also unhappy with the implied assumption in the opinion that the court was requiring the company to act unfairly: this had been the Equitable's traditional view, but the true position was that the premise from which the court would decide fairness was the contractual obligations of the parties;* • *the contractual rights of parties was also the proper foundation for policyholders reasonable expectations;*

- [Counsel for FSA] *noted that the* [Society's Counsel's] *Opinion seemed to be premised on the idea that a non GAR policyholder was entitled to his smoothed asset share less expenses and that anything which might deprive him of this ought to be disclosed, but it was noted that all that non GAR policyholders were entitled to was a smoothed return, "reflecting asset share";*
- *there was a parallel issue raised by the instructions about what access policyholders had to information about their rights;*
- *his view was that, in a mutual, you must be taken to know that all other members have rights, and that the society must comply with all of them;*
- *he was much less sceptical about whether there had been a material non disclosure, but noted that this would only lead to tort damages, not contract damages;*
- *there was an important point on burden of proof according to whether this was common law negligence, or negligent misrepresentation under the misrepresentation act: in the latter case, it was for the misrepresentor to show the innocence of the misrepresentation;*
- *there was an assumption in the* [Counsel for Equitable's] *Opinion that if the risks had been properly disclosed, the policies were unmarketable, but he doubted whether this was the case;*
- *we asked him to consider whether the classification of rights as between contract and tort made any difference to the way in which they would be treated in the section 425 scheme: his initial view was that, if these were not rights of members which were compromisable in that way, they were rights of creditors which could be compromised as such;* [and]
- *overall, his view was that courts below the House of Lords would be very wary of seeking to neutralise the position taken by that court*'.

FSA agree that they should alert Equitable to the fundamental concerns which FSA's Counsel had expressed about the opinion provided by Counsel to Equitable.

11/05/2001 [14:45] Following the conference with Counsel, FSA telephone Equitable to discuss publication of their Counsel's opinion. Equitable tell FSA that Halifax had objected to publication on the grounds that the agreements between the two companies provided for consultation before any action was taken which might affect the possibility of achieving the policyholder compromise. FSA inform Equitable of the advice that FSA had received that morning and FSA raise concerns about Equitable going ahead with publication. Equitable say that it would be inappropriate for them to proceed to publication without having considered the views of Counsel for FSA and agree to give FSA advance warning before publication, whenever that were to happen.

The Director of Insurance distributes his note of the telephone call, along with a draft letter to Equitable, prepared with Counsel that morning, setting out their concerns.

[**15:13**] The Director of GCD informs the Director of Insurance that FSA's Chairman, having made some changes, agrees with the letter to be sent.

[**15:34**] FSA write to Equitable. FSA say that they did not disagree with the conclusions in relation to the first part of the opinion. However, FSA write:

> *We are concerned that the second part of the Opinion, which is in terms much more tentative, might nonetheless risk misleading both non-GAR and GAR policyholders as to the scope for non-GAR policyholders making claims against the Society. This might in turn lead to such policyholders making investment decisions on a false, or at least doubtful, basis.*

In particular, on the basis of our lawyers advice, we have considerable difficulty with [Counsel's] *conclusion that "there are arguments that the non-GAR policyholders have contractual rights to share in profits without the GARs being taken into account" ...*

One premise on which this part of the Opinion appears to be based is that the House of Lords decided that the terms that the article 65 discretion would not be used to undermine the right of policyholders was a term implied in the GAR policies ... As is recognised ... this is not the case, The term is to be implied in the Articles themselves.

Given that all policyholders are subject to the Articles, it seems to us highly improbable that the courts would find there to be any contractual provision inconsistent with, or that would neutralise the effect of, that implied term, whether by way of implied term in the non-GAR policies or by way of implied collateral warranty.

Secondly, another premise on which this part of the Opinion appears to rest is that the House of Lords have required the Society to act "unfairly" towards non-GAR policyholders ... We would be surprised if the courts would take the view that to give effect to policyholders contractual rights could properly be described as unfair. We are therefore concerned that a significant part of [Counsel's] *Opinion may be based on an assumption that is questionable.*

For the avoidance of doubt, I should make clear that we regard the matters raised by the Opinion as very weighty. Even if the particular issues in this letter can be resolved, we would need to term our own views on the approach canvassed by the second part of the Opinion as a whole.

FSA say that they would be happy for both Counsels to meet to discuss this.

[**15:44**] FSA forward a copy of the letter to Counsel saying that Counsel for Equitable might be in touch later that day.

11/05/2001 [15:30] PIA seek advice from FSA on closed funds and their investment proposition for clients. PIA enclose a copy of their '*Stage 1*' report (see 30/04/2001 [**20:42**]).

11/05/2001 [16:00] Equitable telephone FSA following receipt of their letter about the publication of Counsel's opinion. Equitable say that they could not provide FSA with the assurance that Equitable would not publish the opinion until both Counsel had discussed it and that their Chairman '*remained very firmly of the view that the Opinion should be published without delay*'.

11/05/2001 [16:30] FSA's Chairman, Director of Insurance and Director of GCD meet to consider how to respond to the prospect of Equitable publishing Counsel's opinion. FSA record:

In particular, consideration was given to whether the situation would justify the exercise of statutory powers to require them not to put the Opinion on to their website (or otherwise make it public) in its current form.

The statutory power was exercisable for the purpose of ensuring that a company conducts its business in a sound and prudent manner and that a company would not be regarded as conducting business in a sound and prudent manner if it failed to conduct its business with due regard to the interests of policyholders.

It was noted that:

- *the company had committed to publishing the Opinion, and had obtained views from leading and junior counsel;*

- *our concerns about the soundness of the Opinion had been made clear to the Company's counsel, who had an opportunity to revise their views;*
- *the relevant part of the Opinion was expressed to be preliminary and tentative, and there was material emphasising this in the Equitable's draft press release;*
- *if it was concluded that this preliminary and tentative Opinion gave a misleading impression, further clarity could be given through the further advice being sought from* [the Society's Counsel]*, or if necessary by a statement of our own views on the position;*
- *our consistent approach to the use of these legal powers was that they should be used to deal with serious concerns about a company's conduct of its affairs, but not to allow the regulator to micromanage those affairs.*

In these circumstances, it was concluded that it was not appropriate to prevent the Equitable publishing the Opinion in its current form.

However, it was noted that the circumstances did give [rise] *to concern on sound and prudent management grounds since:*

- *the Opinion dealt with issues of great significance for policyholders but was being published at a point when little reliance could be placed on its very tentative conclusions, and without, it seemed, readiness to postpone publication even for the short period necessary to allow Counsel for the Equitable and the FSA to consider the matter together over the weekend: (in the event, such discussions did take place because of a postponement to the publication timetable following an intervention by the Halifax);*
- *in the course of the discussions it had become apparent that this was being done notwithstanding the serious doubts of the company's chief executive;*
- *there was also concern that the Halifax had not been properly consulted about the publication, and that there was a lack of goodwill and mutual trust between the Halifax and the management of the Equitable.*

There were issues which would need to be closely monitored.

11/05/2001 [17:31] Halifax write to FSA about a concern they had regarding Equitable's proposal to publish their Counsel's opinion. Halifax enclose a copy of a letter sent that day to Equitable, which set out their concerns and state that their prior approval had not been obtained for publication. Halifax explain to FSA that the letter '*will give you a flavour of an issue which ..., if not handled properly, could have severe adverse implications for the health of the Closed Fund, and the interests of the Society's members*'. Halifax state that their concern was to ensure that the implications of the issue were considered fully before publication.

11/05/2001 [18:30] Equitable telephone FSA again to inform them that, having received further representations from Halifax, they would not now publish the Opinion before the following week. Equitable say that Halifax had formally notified them that they regarded the Opinion as a compromise scheme document, which required them to be consulted prior to publication. Equitable also say that their Counsel had now read FSA's letter of that day '*and thought* [the FSA's Counsel] *had "missed the point"*'.

14/05/2001 [09:26] Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

14/05/2001 [10:15]	FSA's Director of GCD advises the Head of Life Insurance that he believed FSA should not take part in any discussions between Equitable and Halifax in relation to the publication of Counsel's opinion. The Director of GCD does, however, advise that FSA should use this opportunity to reinforce their concerns with Equitable. The Director suggests that FSA should write to Equitable: *... indicating that we would find it helpful if:* • *we could understand what their position is on the issues raised by the* [Society's Counsel's] *opinion;* • *we could also understand how they proposed to deal with those issues, in the context of the planned 425 scheme, for example, whether they wished to have them resolved by separate court action, in advance of the 425 scheme; and* • *what they can do to explain publicly when they publish the* [Counsel for Equitable's] *opinion how the issues raised by the Opinion will be dealt with in the context of the s425 scheme.*
14/05/2001 [11:27]	FSA's Director of GCD informs Managing Director A of a conversation that he had had with Counsel over the weekend, in which Counsel had reported on his discussions with Counsel for Equitable.
14/05/2001 [11:29]	FSA write to Equitable about Counsel's opinion. FSA ask three questions on issues which they would find it helpful to have a clearer understanding of how Equitable proposed to proceed (in line with the Director of GCD's suggestion that morning). FSA write again to Equitable to request the bundle of factual material supplied to Counsel.
14/05/2001 [12:05]	FSA's Director of GCD writes to the Head of Life Insurance further to their conference with Counsel (see 11/05/2001 [**11:00**]), at which it had been said that Equitable were now attempting to take the view that the House of Lords' decision did not prevent the declaration of differential bonuses from year to year. [**12:33**] The Head of Life Insurance asks supervisors to report any cases of companies attempting to neutralise the effect of annuity guarantees, clarifying that: '*The idea is that all policies issued in a given year could form a distinct category for bonus purposes. This is an idea of* [Equitable's Chief Executive's]*, and I know of no evidence that it is more widely held*'.
14/05/2001 [13:41]	FSA's Director of GCD says that he agreed with the Head of Actuarial Support's comments of 10/05/2001 [**10:43**].
14/05/2001 [14:00]	FSA hold an Equitable Life Lawyers Group meeting. The issues discussed by the Group include: <u>Compensation</u> Chief Counsel B informs the Group that, in a meeting with FSA on 10 May 2001, Equitable had '*referred to Article 4 as enabling the capping of liabilities*'. Chief Counsel B expresses concern that the capping of liabilities had been emphasised rather than mutuality and the Group note that Equitable's comments had been made, despite the fact that their Counsel did not support that view. The Group discuss the possibility of common law claims and whether these would be covered by Article 4 and '*It was concluded that such claims would probably be met before payments were made under Article 4*'.

Market value adjuster
Chief Counsel B states that he had concerns in relation to the implications of Counsel for Equitable's opinion '*for the whole matter of the use of MVAs*'. The Group note that FSA had taken '*custody*' of the OFT work, although they were awaiting a note from the Head of Consumer Protection on this. It is agreed that FSA should seek the views of Counsel on this.

'*Legal action against FSA*'
Under the heading '*Legal action against FSA*', the minutes record: '[An FSA legal adviser] *advised the group that the 1st Life Directive imposed a duty on Member States to ensure that firms established adequate technical provisions.* [The adviser] *agreed to prepare a note on the implications of this provision and the nature of any consequential duties imposed upon a Member State*'.

The Group's 'legal issues' list is updated the following day and, under '*Issues arising from the Opinion of* [the Society's Counsel]', the following is included:

(a) Impact of section 425 compromise.

(b) Effect on IC Act reserving requirements.

(c) Companies Act solvency issues.

(d) Whether the opinion should be published.

(e) FSA response to the opinion.

14/05/2001 [15:40] FSA's Chief Counsel B seeks an update from the Head of Consumer Protection on the work that was being transferred from the OFT.

[**17:57**] The Department reports that the cases had not yet been received from the OFT.

14/05/2001 [15:59] Equitable send FSA a copy of the press notice to be issued at 16:30 that day about Counsel's opinion.

[**16:34**] Equitable's advisers also send FSA a copy of their question and answer briefing.

[**17:49**] Equitable also send FSA a copy of Counsel's opinion.

14/05/2001 [entry 10] FSA send HMT their recommendations that Equitable should be granted section 68 Orders for the value of Permanent Insurance and for the calculation of the rates of interest for fixed interest assets. FSA say that '*the valuation of Permanent* [Insurance] *is quite straight forward*'. FSA continue, saying:

The concession relating to rates of interest is more complex. We can provide a more detailed technical explanation if that would help. However, there are two further helpful points I can probably make. First, the concession was originally requested last November, at a time when the FSA, with GAD, had been carefully scrutinising the last returns. The examination identified a number of issues which have led to a modification of the valuation basis used, which overall leads to an increase in the reserving requirement. Second, you will also wish to be aware that because of the defects in Regulation 69, we are proposing that going forward, we should produce a requirement for firms generally to calculate the relevant rates of interest along the lines of [one of] the methodologies described in the paper.

I think it is important to remind you that a number of concessions have been granted to Equitable Life. Some have been fairly routine, such as the increase on the admissibility limits on certain shareholdings, including most notably those in [a named company] *following its merger last December. There are of course some others, including the order* *permitting Equitable to include among its assets an implicit item for future profits and that allowing it to count the subordinated loan. Inevitably, as concessions are disclosed in the annual returns, some commentators will suggest that while individually the concessions may seem reasonable, that collectively it could be argued that the Society has been permitted to elect the most favourable valuation basis on each occasion. Our view is that such criticism would be unfair because we have worked hard with the company to improve the reliability of its financial reporting; and the effect has sometimes been to increase the level of reserves required.*

FSA enclose a note on the two concessions, along with the papers that had been submitted to their Insurance Supervisory Committee and draft Orders to be sent to Equitable, if it were agreed that their applications should be granted.

14/05/2001 [entry 11] FSA's actuarial department provide PIA with advice on the performance of closed with-profit funds, in response to their request of 11/05/2001 [**15:30**]. FSA explain that: '*Closure of a with-profit fund could significantly impact on several factors that affect the level and volatility of maturity payouts. The most important impact is on future investment performance and bonus strategy. Closure can also affect staffing, expense levels and distribution of the estate*'.

One of the points stated is that: '*The initial loss of new business strain may result in a closed fund enjoying improved statutory solvency for the period soon after closure, although this may be partially offset by having to pay closure costs*'.

In conclusion, FSA say:

... it would be fair to say that for weak funds (such as the Equitable's after the House of Lords decision) closing to new business is unlikely to result in a lower level of payouts than remaining open. Payouts may even be higher. This is largely because weak funds would find that staying open to new business would severely affect their investment freedom.

Thus, the fact that policyholders have bought into a fund that subsequently closed would probably not have affected their expected payouts much per se. More importantly is the fact that they bought into a fund that had a weak underlying financial position.

Closure would also affect the pattern of payouts – possibly with more volatile payouts with higher terminal bonus content. The effect of payouts may be different for policies with different terms to maturity.

15/05/2001 [entry 1] Equitable notify FSA of the appointment of an authorised agent in the Republic of Ireland.

15/05/2001 [17:49] Following receipt of FSA's recommendations on Equitable's two section 68 Order applications, an HMT official explains that HMT usually approved such Orders at 'official' level but, given the potential for adverse reaction, questions whether '*we should do anything more formally on this occasion – eg telling Ministers what we plan to do?*'. The HMT official also asks another official to take the matter forward.

16/05/2001 [entry 1] Equitable send FSA notification in respect of their new Appointed Actuary.

16/05/2001 [15:46] FSA's Director of GCD informs the Head of Life Insurance of a conversation with Counsel the previous night, who had then read the final version of Counsel for Equitable's opinion. The Director says that Counsel '*was even more strongly of the opinion than before that it was wrong, and concerned about the society's conduct in publishing it*'. He also reports that Counsel had identified two issues, being:

> *The first was the oddity, as he saw it, of the Society effectively taking sides with the non GAR against the GAR policyholders in trying to neutralise the court decision. This seemed to him to reflect an ongoing unwillingness on the part of the company to accept the court decision. In his view, if the reality was that* [Counsel for Equitable] *had been asked to look after the interests of the non GAR, we should consider requiring the society to instruct someone to look after the interests of the GAR policyholders. Otherwise, the society's funds were being used to support the claims of one group of its members against those of another.*
>
> *The second issue was that he thought that close readers of paragraph 97 of the Opinion will detect in the reference there to resolving the dispute with a view to paying a dividend* [for] *the risk that the company might become insolvent. This suggests that GAR policyholders might wish to bail out.*

[**17:21**] The Head of Life Insurance says that FSA would pursue these points with Equitable at the meeting arranged for 21/05/2001.

16/05/2001 [16:42] An FSA Board member and Chairman of FSA's Pension Plan Trustee Limited informs Managing Director A and FSA's Chairman that the trustees of the scheme intended to cast their vote on the election of Equitable directors. The member says that neither they nor FSA's Company Secretary had taken any part in the discussion.

It was subsequently agreed that FSA should ask their pension scheme to confirm that they had reached their conclusions without input from any Board member or anyone involved in the supervision of Equitable, so as to close off one possible source of criticism.

16/05/2001 [17:03] FSA's Director of GCD writes further to his earlier advice to an official (see 10/05/2001 [**14:14**]), expanding upon the regulatory action FSA could take in this area. The Director says that he thought that FSA's existing strategy '*goes some considerable way in this respect*', which was to:

- *seek advice from* [Counsel] *on the extent of a firm's duties to make disclosures which would be relevant in these circumstances;*
- *with a view to possible publication either of his Opinion, or of an FSA document based on it; and*
- *consideration, on the back of that, and the* [FSA] *misselling review, as to whether, either at the Equitable or other companies, there is a need for a targeted endowment style review to ensure that redress is paid where due*'.

17/05/2001 [08:58] FSA's Chairman asks the Director of Insurance what level the FTSE 100 Index was at when Equitable had increased their market value adjuster to 15%. The Chairman also asks whether Equitable had any plans to reduce the market value adjuster if the stock market continued to rise.

17/05/2001 [11:48] Further to FSA's Director of GCD's note of 16/05/2001 [**15:46**], Chief Counsel A says that she believed Counsel was being '*overly harsh*'. The Chief Counsel says that, in her view: '*The Equitable ... are not taking the side of non-GARs as such, they are trying to get back to the pre-*[House of Lords] *situation which in their view is fairer to all policyholders. They are also trying to resolve all the issues in one "fell swoop" (and clearly there are mis-selling issues to be resolved)*'. Chief Counsel A also states, as she had done previously to the Head of Life Insurance and the Head of Actuarial Support, that she was '*uncomfortable with* [Equitable's] *confidence that the opinion does not (yet) raise significant reserving concerns (Co Act or ICA)*'. The Chief Counsel suggests that the reserving issue should be discussed with Counsel at a meeting '*the week after next*'.

17/05/2001 [14:58]	FSA's Chief Counsel B prepares a statement for possible issue about FSA's progress on their review of mis-selling by Equitable. The statement includes the following '*broad conclusions*' of the factual '*Stage 1*' PIA report: • *The Equitable did not identify a need to disclose directly to potential purchasers any specific risks associated with the outcome of the litigation.* • *The Equitable sales literature and written disclosures did not change materially during this period.* • *The potential uncertainties surrounding the sales process were not mentioned during the period after the company had put itself up for sale.* • *When responding to those few complaints about misselling which were made during this period, the Equitable stated that its communications with consumers had been based upon its best understanding of the position at the time.* [**18:33**] The Head of Life Insurance suggests that issuing such a statement was '*Difficult territory*'.
18/05/2001 [09:29]	FSA's Head of Actuarial Support asks Scrutinising Actuary F, in response to the Chairman's request of 17/05/2001 [**08:58**], to look back through their files for information about how the market value adjuster had been assessed. The Head of Actuarial Support comments: '*I think* [Equitable] *said at one point that in theory it should be around 12.5%*'. [**10:55**] Scrutinising Actuary F explains to the Head of Actuarial Support and the Head of Life Insurance that Equitable had applied a market value adjuster since the House of Lords' ruling in July 2000 and that it had been initially set at 5%, increasing to 10% when they closed to new business on 08/12/2000 and then to 15% on 16/03/2001. The Scrutinising Actuary goes on to say: *In a note dated 19.12.00,* [Equitable] *set out the rationale behind the application of the MVA, and its amount. He said that the level of 10% corresponded to a FTSE level of around 6300. There are three components of the MVA, of which investment market levels was the main factor. (The other factors were an adjustment to recoup the balance of initial expenses still outstanding, and a further adjustment to "protect the future solvency and investment freedom of the fund"). Of the 10% MVA, 7.5% related to the level of the markets.* *In the same note of 19.12.00,* [Equitable] *said that should the market fall to 6100, and stay there, a move in the MVA to 12.5% would be appropriate. (Of this, 10% would be the "investment related" part.)* *In an update from the Society dated 13.03.2001, they said that the theoretical levels of the investment related part of the MVA were 10% at 6100, increasing to 13% at 5700. (A further 2% on top is required in respect of recouping initial expenses.)* *At 13.03.01, when I believe the Society took the decision to increase the MVA to 15% (this was implemented on 16.03), the FTSE closed at 5720.* *If the market were now to stabilise at a FTSE level of around 5900, then the "theoretically correct" MVA would be 11.5% plus 2% expense adjustment = 13.5%.* *Whether the Society have any plans to reduce the MVA is a topic which I suggest is discussed with them at the next meeting on 21st May.* [**11:05**] The Head of Life Insurance forwards the note to FSA's Chairman.

[**12:38**] The Chairman comments: '*I don't think we need be pressing them to make an adjustment if the theoretically correct level is 13.5*[%]*. They've set some kind of precedent by moving in 5s, and I guess there's a greater risk of major outflows at 10*[%] *if they've once been to 15*[%]'.

18/05/2001 [14:02] FSA's Director of GCD responds to Chief Counsel A's note of 17/05/2001 [**11:48**], saying that he would be happier if FSA were to '*progress the reserving issue more rapidly*'.

18/05/2001 [14:41] Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

18/05/2001 [entry 4] The Chairman of the Financial Services Consumer Panel writes to Equitable (copied to FSA), in response to letters of 9 and 23 April 2001 about the arrangements for ensuring that policyholders were informed of developments. The Chairman suggests that they should arrange to meet again.

21/05/2001 [entry 1] FSA meet Equitable to get an update on preparation for their annual general meeting, to take place on 23/05/2001, and on the compromise scheme. FSA's note of the meeting records the discussion under the following headings.

Annual general meeting
Equitable explain the planned agenda for the meeting, which would include '*an outline, without much content, of the way forward through the 425 scheme*'. FSA note that the Chief Executive appeared slightly more comfortable about the vote for directors '*mainly because the action groups had diluted their campaign by submitting so many candidates*'. Equitable say that the results of their survey of policyholders' views on a compromise would be released at the meeting and they indicate to FSA that it would show there was an '*overwhelming consensus for a compromise* [but] *when it came down to sorting out the nature of an acceptable deal this consensus disappeared*'. Equitable agree that FSA could send an observer to the meeting.

Counsel for Equitable's opinion and the compromise scheme
Equitable say that Counsel needed to do further work on the rights of non-GAR policyholders and this would take a couple of months to complete. It was noted that a decision would need to be taken as to whether to include mis-selling claims in the compromise scheme and that this would be more likely if it were thought that any such liabilities were significant.

Equitable explain that '*generic mis-selling cases had been rejected by the Society and parked by the PIA Ombudsman pending FSA's exercise to examine generic mis-selling issues*'.

2000 annual return
FSA record that:

> [Equitable's Chief Executive] *and* [Appointed Actuary] *had given further thought to* [Counsel's opinion] *and did not believe that a provision for mis-selling was necessary for the year 2000 Annual Returns.* [The Chief Executive] *said that the 2000 Report and Accounts already referred to fundamental uncertainty which covered the potential legal risks and they were considering what equivalent provision was needed in the Returns.* [The Appointed Actuary] *suggested that they would look to see how much reserves could be released if they switched all their equities into* [fixed interest securities] *(which might indicate the maximum level of claim that could be sustained without them becoming insolvent).*

FSA confirm that they had recommended to HMT that the requested section 68 Orders should be granted, '*but this did not guarantee that they would be issued*'.

Market value adjuster
Equitable explain that the: '*estimate of the "realistic aggregate" MVA was a continually moving target and depended on market movements ... As things stood at FTSE c5900* [Equitable's Chief Executive] *thought an MVA of 15% was quite justifiable*'. Equitable say that, if the FTSE 100 Index settled at a level of around 6400, then they '*might need to consider dropping back to 10%*'.

Under '*Action Points*', Equitable agree to:

- produce the next set of actuarial papers on the compromise scheme by the end of May; and
- ask their solicitors to send the draft legal section of the compromise scheme to FSA.

FSA agree to:

- forward further feedback on the actuarial paper for the compromise scheme; and
- inform the Irish and German regulators about the compromise proposals.

21/05/2001 [14:00] FSA hold an Equitable Life Lawyers Group meeting. The Group discuss the latest positions on the various legal issues currently under consideration.

21/05/2001 [14:14] In response to Chief Counsel B's statement on FSA's progress of their review into mis-selling by Equitable (see 17/05/2001 [**14:58**]), the Director of GCD says that it looked odd to publish it without '*Stage 2*', which would state whether Equitable had been in compliance with PIA Rules. The Director of GCD also says that he would rather FSA wait for the second part of Counsel for Equitable's opinion to be published so that they could take that into account.

21/05/2001 [15:37] PIA circulate, including to FSA, a draft of their '*Stage 2*' report of their assessment of Equitable's disclosure of risks to potential investors after the Court of Appeal decision. They seek comments on it by 25 May 2001.

21/05/2001 [entry 5] In response to FSA's request, solicitors for Equitable send FSA copies of all the instructions and materials supplied to their Counsel, for use by FSA's Counsel.

21/05/2001 [entry 6] HMT reply to FSA's letter of 14/05/2001 about Equitable's applications for section 68 Orders. HMT say that the Order in relation to the valuation of Permanent Insurance is '*non-controversial*'. However, HMT say that the Order in relation to the valuation rates of interest '*raises a few more questions*'. HMT say that their:

> *... concerns centre on consistency and presentation. The* [Insurance Supervisory Committee] *paper you sent me says that you have made it clear to the Equitable "that a request for a concession would only be considered if the company would also use that valuation basis in future years, when it produced a less favourable result." Elsewhere you make the point that you "look to companies to maintain consistency of valuation methods from one year to the next." However, I understand that the Equitable has not used this concession before and is unlikely to be using it next year, since you will be reviewing the effects of Regulation 69 in general and will be developing a new methodology. So the Equitable will in fact use three different ways of calculating the valuation rate of interest in three years.*

HMT note that there were several ways in which they might seek to defend the Order, although:

The argument that this is a method which in future years might result in a less favourable result for the Equitable is weakened if the concession is only for one year and will be changed to a different basis for the 2001 return...

The argument that it is the same as concessions given to other insurers also falls if it is in fact different from the methods used by [the two insurance companies]. *Even if Equitable could conform to the same method of calculation, as they propose to do for future years, you make the point that the nature of these companies' business is different from Equitable's and more thought would be needed as to whether that approach was appropriate.*

HMT continue:

It is therefore not clear whether it would be better to refuse the concession to preserve consistency of valuation with past years, or to grant the concession to ease the pressure on the fund of confirming with the reserving requirements. What makes this particularly difficult of course is the perception that it was a lack of adequate reserves which contributed to the Equitable's closure to new business.

HMT suggest:

Might it not be preferable to develop the correct long-term approach first, and to change to it in 2001, instead of making a one-off concession this year that will then have to be changed in 2001 to a basis that can be sustained in the future?

HMT also note that:

Equitable estimated that not having this concession last year meant that their reserve was inflated by around £300 million. The estimate for the effect of the concession this year is of the order of £150-£200 million. How does this compare to the total value of reserves that they are required to hold?

HMT say that, given the sensitivities surrounding Equitable, they would want to '*inform Ministers that officials are granting these concessions*'. HMT ask for answers to their questions and details of the timetable that FSA were working to.

22/05/2001 [10:35] FSA's Scrutinising Actuary F provides the Head of Life Insurance with an update to his note of 18/05/2001 [**10:55**] about the market value adjuster applied by Equitable. He says:

At yesterday's meeting Equitable pointed out that the FTSE would need to move up to around 6400 before a reduction in the MVA to 10% could be justified. This contrasts with [Equitable] *saying back in December that a 10% MVA corresponded to a FTSE level of 6300. As they explained yesterday, this is because they have been adding interim bonus at the rate of 8% p.a. to policy values, and this requires an element of capital appreciation as well as investment income to support it. In other words, if markets stand still, then policy values – as measured by "smoothed asset shares" – get even further ahead of the value of the underlying investments, and a greater MVA is needed to compensate.*

They also reiterated that the MVA is doing no more than ensuring that outgoing policyholders take no more than their fair share of the fund on a non-contractual exit. (The fact remains that those taking contractual benefits – where no MVA applies – are getting more than their share of the cake. This is the concern I raised with them in an earlier meeting, which they conceded was true, but they reckoned they could live with so long as contractual termination rates did not increase unduly from current levels.)

22/05/2001 [11:23]	Equitable send FSA a copy of the terms of reference for the Independent Actuary in relation to the compromise scheme. [**12:37**] Line Manager E distributes the terms of reference, noting that FSA had decided not to approve them but had proposed to raise any concerns with Equitable. [**12:55**] The Head of Actuarial Support says that he thought the terms of reference were reasonable but notes that they did not cover the fairness within each policyholder class, '*particularly where there may be a separate offer made to different sub-classes within each class*'.
22/05/2001 [18:16]	FSA's Line Manager E circulates the notes of the meeting held on 09/05/2001 to discuss Equitable's section 68 Order applications. The Line Manager says that he saw HMT today and that they were still thinking about the '*more difficult*' concession. The Line Manager says that he thought that they now agreed that it was appropriate. He notes that HMT needed to alert their Ministers but did not expect to require ministerial approval.
23/05/2001 [08:59]	PIA send FSA a copy of their comments on their draft '*Stage 2*' report. [**14:53**] FSA (Head of Actuarial Support) provide some immediate comments on the points raised by PIA which included: 1) In response to a comment that '*Equitable was clearly weak and it knew it. This needs to be stressed*', FSA reply: *I am not at all sure that Equitable would have agreed that they were "weak". They took the view throughout that they were meeting all the requirements of the solvency regulations, and indeed that the thinness of their cover for the margin of solvency was a result of the conservativeness of the regulations rather than a reflection of their true strength. We also know that they persuaded* [Standard & Poor's] *until comparatively recently that they merited a AA rating.* 2) In response to the comment that '*the aim of* [a with-profits policy] *is to deliver asset share …*', it is said that that: '*needs explaining. A minimum expectation for investing in a with-profits policy should be that you can expect a return of premiums less expenses accumulated at the underlying asset performance. Thus getting less than this as a result of financing the GAR of others would not satisfy this. It should not consist of* [knowingly] *contributing to the "operating fortunes" of others*'. FSA reply: *I am not sure why there should be a minimum expectation that a policyholder would receive "asset share". Surely this depends on how this has been presented to policyholders. For example, if they have been told that they will also share in the operating profits or losses of the business, then they might well receive less than these basic asset shares (which would of course need to be defined in any event). This is of course likely to be one of the key issues here, namely whether this sharing in the operating profits and losses was explained sufficiently clearly to potential Equitable policyholders.* 3) In response to the comment that '*Equitable was right to regard the likelihood of not finding a suitable purchaser as unlikely*', it is said that: '*I would severely question this. The problem with the Equitable is that they had an arrogant view of their worth. They alone knew the true state. It was this state that shied off prospective purchasers*'. FSA reply: *There is still much debate over the exact reasons why potential purchasers declined to become involved with Equitable. In my view, the only "asset" of real potential interest which they had to sell was the "goodwill" of the business. In view of the state of*

dissatisfaction among members that had been reached following the [House of Lords'] *judgment, there were I believe significant misgivings among the bidders about the value of this "goodwill", though Equitable did eventually reach an agreement with Halifax. In addition, the fund had been destabilised by the judgment as both the balance sheet position and potential bonuses had become much more sensitive to changes in market fixed-interest yields. There was also the difficulty that the perception by many members, of the Equitable's worth to a purchaser, was probably too high.*

4) In response to the comment that '*with no purchaser it might be forced to close to new business*', it is noted that PIA's:

> *... contention* [is] *that they should have been aware that the only justification of continuing to write new business was that there would be a purchaser and that without one closure was inevitable. There were thus three options:*
>
> *1) close pending a purchaser*
>
> *2) keep open on the assumption of a purchaser, but keep silent of the risk*
>
> *3) keep open on the assumption of a purchaser but enclose a statement setting out the position*,

FSA reply: '*The Equitable was still just covering its margin of solvency following the* [House of Lords'] *judgment. However, the actuary had recognised that they were then unacceptably weak to continue as an ongoing operation. Accordingly, they sought a purchaser for the business. After failing to find a purchaser, they recognised that they had no realistic alternative but to close to new business*'.

5) In response to the comment that '*Equitable's analysis that it was likely to find a purchaser on the terms that it sought was reasonable*', it is said that: '*I am far from convinced that this was the case. What exactly do we know about the analysis? They had concluded that there was a very large hole. We must give evidence of why FSA believes this*'. FSA reply: '*I don't know where this suggestion of a "very large hole" is coming from. Potential purchasers were given a detailed report by* [auditors from the same firm as Equitable's auditors] *... on the prospects for the business. In addition, we know that their end-2000 report has now been signed off, with reference only to two areas of fundamental uncertainty, namely (a) the effect of the* [House of Lords] *judgment (on for example the propensity of GAR policyholders to pay additional premiums) and (b) the risk of further legal cases (eg in relation to mis-selling to Non-GAR policyholders)*'.

[**15:35**] The PIA official clarifies that he was talking in general terms but on the specific points, using the numbering above, he says that:

1) '*... my "weak" was referring to its position in attracting a bid. The strengths included the salesforce and its administration systems. Its main weakness were concerns about the state of the existing portfolio of policies. The fact that a* [House of Lords'] *ruling was immediately followed by putting up for sale meant that there was a real weakness in the perception of the Equitable's portfolio of policies.*'

2) '*An investor who enters a with-profits or mutual fund knows that they are subject to profits and losses but it is very difficult to justify buying a policy if a proportion of one's premiums are going to finance an existing known source of loss. Hence my view that there should be a minimum expectation as stated (without a bias towards financing losses).*'

3) '*... you state "unacceptably weak to continue as an ongoing operation." Closure meant that future potential customers avoid that weakness but while it was on offer, customers entered the fund.*'

4) '"hole" may not be the precise word but there was a very large problem which, I assume, they wanted solved by a purchaser putting money into the company. When this failed they closed.'

PIA conclude by saying: '*The fact remains that they did not attract a bidder. Why was this given the level of interest? Either there was not enough value or something frightened them. The relevant point is "How confident should the Equitable have been when they put themselves up for sale?" I am an outsider to this issue as I have no detailed knowledge of the state of the Equitable but I still, on reflection, state that I cannot recall another case with as high a risk as the Equitable. If anyone can hint a name, I would be pleased to know*'.

[**16:12**] FSA's Head of Actuarial Support concludes the exchange by saying, in relation to point 2) that:

> *I would say that* [Equitable] *introduced the cut in the first 7 months bonuses in 2000 so that new policyholders after the* [House of Lords'] *judgment would not be expected to contribute to the expected loss though they would of course participate in any profits or losses that might arise if the actual experience turned out differently.*
>
> *Before the* [House of Lords'] *judgment, they would no doubt say that they had no reason to believe that the non-GAR policies would be expected to incur significant profits or losses in respect of the GAR experience, and in particular there was not the expected loss of £1.5 billion that arose following that judgment.*
>
> *I should add of course that the above figure, and others in the note, relate of course to the financial position as shown in the company accounts rather than the FSA returns.*

23/05/2001 [09:47] FSA's Head of Life Insurance sends FSA's Chairman a copy of Scrutinising Actuary F's further note on the market value adjuster applied by Equitable (see 22/05/2001 [**10:35**]).

[**10:47**] In reply, the Chairman says: '*I do not recall them making the point about interim bonuses when they last moved the mva. I think they will have great difficultly explaining why they don't move down, if the market gets back to the point it was at before they changed. I'm afraid this is yet another example of their lack of candour*'.

[**11:31**] The Head of Actuarial Support comments:

> *A key problem at the moment for them is how to generate some realistic expectations about the levels of bonus and MVA that the fund can afford. In the last few years, they have been content to pay out higher levels of bonus than have been earned by the fund as part of their smoothing of investment returns. In addition, they paid out full policy values without any MVA to surrendering policyholders even when their actual assets were less than the aggregate of all these policy values.*
>
> *For example, they are currently increasing the policy values (on which both the retirement benefits and also the discretionary surrender values are based) by 8% per annum. This rate of increase is well in excess of the investment returns that they have earned since end-2000 or indeed during the year 2000 as well.*
>
> *Accordingly, they are incurring financial strains at present whenever benefits are taken on retirement. In addition, they believe that they have to set the MVA at 15% so that the departing policyholders do not take more than their fair share of the actual assets held by the Society.*
>
> *The reality therefore is that at present market levels they need to find some way of reducing this rate of interim bonus if they are to restore some measure of stability to the fund, and also to have a reasonable chance of reducing the MVA on surrender.*

If the market does manage to return to end-99 levels, then they may be able to rationalise this interim bonus rate in terms of their actual investment returns, and could even come under pressure to increase it. However, they would then still need to maintain a significant MVA to protect the fund against surrenders. They are caught therefore in [public relations] *terms between a rock and a hard place unless they can find some way of generating more realistic expectations of what the fund can afford.*

23/05/2001 [16:47]	FSA's Line Supervisor C reports on what had happened at Equitable's annual general meeting that day. The Line Supervisor says: '*I think* [the Society's Chairman] *handled it well and carried the meeting with him. Any hostility from the members was directed at other pedantic members hogging the microphone. Most importantly the Chairman's slate was elected with a sound majority*'.
24/05/2001 [11:21]	An HMT official sends a submission to the Economic Secretary to the Treasury, asking her to note that officials intended to approve, on the recommendation of FSA, section 68 Orders which would give two reporting concessions to Equitable for their 2000 returns. The concessions covered the valuation of the subsidiary company (Permanent Insurance), which had been sold on 16 February 2001, and the method of calculating the valuation rates of interest.
24/05/2001 [17:36]	FSA's Director of GCD writes to the Chairman and the Head of Actuarial Support saying that he agreed that the notes of 17/05/2001 [**08:58**], 18/05/2001 [**10:55**], 22/05/2001 [**10:35**] and 23/05/2001 [**11:31**] on the market value adjuster applied by Equitable raised serious concerns. The Director of GCD says: *The first is about PRE. Don't we need to consider whether, by meeting the unreasonable expectations of some policyholders they are depriving other policyholders of their reasonable ones? Is this a decision which has been taken by the Equitable at Board level?* *The second is about exposure to risk.* [Scrutinising Actuary F] *reports the* [Equitable] *as saying that they can live with people taking contractual benefits so long as contractual termination rates do not rise significantly. But what if they do? Is the suggestion that they would then introduce an MVA on contractual termination? But we have not seen an analysis which suggests that they are entitled to do so.* *The third is about the compromise. Has* [Counsel for Equitable] *been asked specifically to advise on how any liabilities should be brought into account in the compromise? Is he instructed for the Equitable on the compromise?* [**20:11**] Chief Counsel A suggests that the Head of Life Insurance should reply in the first instance to the points raised in the first two paragraphs above.
25/05/2001 [11:58]	PIA chase comments on their draft '*Stage 2*' report. PIA suggest getting together for a meeting to discuss. FSA send PIA a note of their comments, which included the following: • On the statement that PIA '*has established the following specific key risks Equitable did not disclose to clients*', FSA question whether '*we*' are only concerned about new policyholders and they ask '*What about people deciding whether to pay additional premiums? Or people who with "adequate" disclosure might have decided to quit the w/p fund while they were ahead?*'. • In response to a request within the draft report that FSA should provide details of where potential investors could find information on the financial strength of companies, FSA say: '*The key first hand data will* [be] *the company's annual report and accounts, the statutory returns and any formal statements issued ... In addition,*

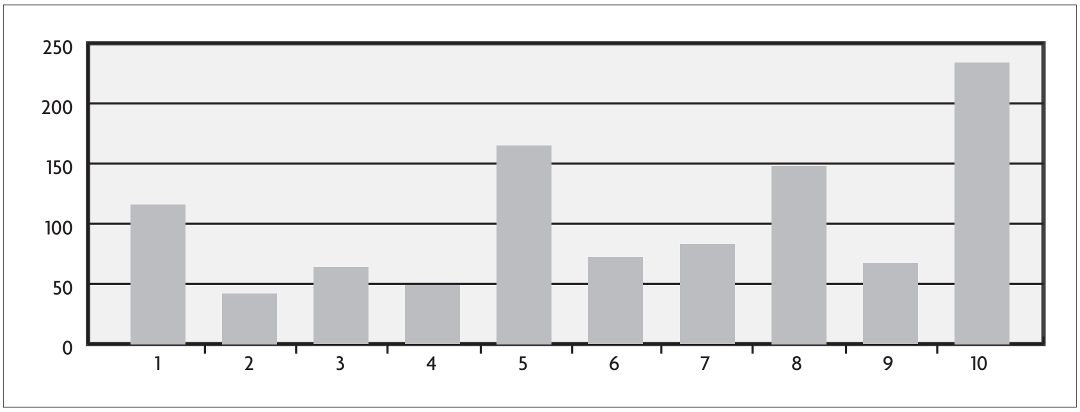
data is available from the rating agencies, which may or may not be based on access to privileged information, and commentaries in the business and trade press (eg Money Management, [the Financial Times]*)*'.

- In response to point 3) of PIA's comments of 23/05/2001 [**08:59**], about whether Equitable had been right to think that not finding a purchaser was unlikely, FSA say that '*... it rather seems to assume that the reason why the sale was not successful was the GAR exposure, but it is far from clear that that was the [main/only] reason. Neither of the two most persistent bidders specifically gave that as one of their reasons for dropping out (although it was clearly a factor in determining the amount they would offer if they went ahead)*'. FSA also state, in response to point 4) of the comments above, that:

  > *... it was likely that the fund would be closed whether a buyer was found or not. The distinction between the outcomes was therefore likely to be about the need to change investment strategy and the likely level of capital support available.*

29/05/2001 [entry 1]	FSA provide PIA with some legal comments on their draft '*Stage 2*' report.
29/05/2001 [entry 2]	FSA and PIA send instructions to Counsel to advise on the common law and regulatory issues raised by the opinion of Counsel for Equitable.
29/05/2001 [14:53]	FSA send Counsel a copy of the terms of reference for the Independent Actuary for the compromise scheme. FSA ask for any comments on it by 31 May 2001. Chief Counsel A notes that she believed it was '*important ... that the terms of reference (or a related letter) make clear that he is to report on the adequacy of the Equitable's actuarial work/conclusions on the impact on the various groups of policyholder in each class of accepting (or not accepting) the GAR compromise, in a way that will assist the Court and policyholders*'.
29/05/2001 [15:21]	FSA's Legal Adviser D provides the Head of Life Insurance with an eight-page paper entitled '*Section 425 – Companies Act 1985 Power to Compromise The Equitable Life Assurance Society Procedures*'.
29/05/2001 [17:41]	FSA's Line Manager E informs Equitable supervisors that the details of Equitable's policyholder survey were now on their website. The Line Manager comments: *Some of the findings are very predictable – younger GAR policyholders do not think that their older colleagues should get paid more; older GAR policyholders think they should. But there are also encouraging signs, such as 91% believe a compromise is important, compared with 3% who do not.* *It is also quite interesting to see the responses to questions such as how concerned are you – on a scale of 1 to 10 [highest] – about the safety of your savings, where it produces a graph something like a cross section of the Alps rather than an exponential curve (rising on the side of very) that you might expect. 10 was the most popular response numerically, followed by 5, 8 then 1.*

The results for all policyholder types to this question were as follows:



30/05/2001 [16:55] FSA's Director of GCD asks Legal Adviser D to clarify what constitutes a liability under a section 425 compromise scheme, explaining:

> *What I have in mind is the distinction that is sometimes drawn between the contractual or guaranteed liabilities of a company to its policyholders, and supposedly non contractual liabilities such as rights to a terminal bonus of a particular amount, or calculated on a particular basis.*
>
> *Am I right to think that this, and perhaps other expectations, do not constitute liabilities which would be brought into account into a section 425 scheme? If they are outside such a scheme, what is their status following the agreement of such a scheme?*

30/05/2001 [16:16] The Economic Secretary to the Treasury, having seen the note on Equitable's applications for the section 68 Orders of 24/05/2001 [**11:21**], asks whether the official was seeking Ministerial approval for the Orders. The Economic Secretary says that, if the official was, then she would need further details and would wish to discuss the matter before granting approval.

[**17:50**] HMT's Director of Financial Regulation and Industry advises an official to seek a clear explanation from FSA as to why they believed the adjustments to the rules would make Equitable's returns more accurate. HMT's Director explains:

> *As I understand it, adjustments (known in the trade as concessions) are regularly agreed by the FSA, and formally endorsed by HMT under current interim arrangements pending implementation of* [FSMA 2000]. *It is not our role to second guess the FSA's regulatory judgement. The only thing different about this case is that* [two HMT officials] *felt the process should be drawn to Ministers attention, for information, as it involved Equitable.*

[**18:06**] HMT ask FSA for a letter, '*in straightforward self-explanatory terms (that we can show the* [Economic Secretary to the Treasury]*)*', setting out: what they were proposing; why FSA believed the proposals to be justified; and some context which explained '*that this is a fairly straightforward procedure/many hundreds are made each year*'.

[**18:18**] In reply, on a question about timing, FSA's Line Manager E explains that things were getting tight, as companies had to go through a sign-off procedure before submitting their returns by the end of June 2001.

31/05/2001 [entry 1] FSA provide HMT with the letter requested about the section 68 Orders sought by Equitable for the value placed on Permanent Insurance and for the rates of interest used in their 2000 returns. FSA's letter includes the following explanation for the justification of granting the latter Order:

... Most companies live with the consequences of the regulation since the amounts involved are not sufficiently material to affect the overall financial position. However, some companies have sought, and been given, permission to calculate the relevant interest rates on a more reliable basis ... While the precise way in which the companies do the calculations varies slightly, they follow similar principles and all produce more reliable figures than the methodology set out in the regulations. For the future, the FSA will be looking to use its rule making powers to replace regulation 69 at an early stage.

The FSA has over the last year or so been looking closely at the way in which Equitable Life prepares its statutory returns and the valuation basis it has used. This has led to some refinements in the calculation of the company's reserves, most of which it should be said work against the company. The concession above, if granted, would work in the company's favour for the time being. The company estimates it will improve the presentation of its financial position by around £150 - 200 million. Once such a concession had been granted, we would not allow the company to switch between different methodologies from year to year. Therefore the company would not be able to opt for the methodology that would produce the most favourable result in any given year. For the longer term, we will be looking to impose appropriate requirements on Equitable Life to achieve this. Before doing so there are certain issues relating to consistency that we wish to explore. Those are not matters that are sufficiently material for us to need to hold off with the granting of a reporting concession for the 2000 year end, which would need to be in place in time for it to prepare its statutory returns that must be submitted in June.

[**17:32**] An HMT official forwards the letter to the Economic Secretary to the Treasury's office, explaining that the original referral had been for information only because of the '*general sensitivity of the Equitable case*'. She says '*... the attached note, as I say, seems to set out a pretty clear FSA view that these adjustments are in order. Indeed, it seems that – given the sorts of adjustments that the FSA regularly agree with a whole spectrum of insurance companies (at a rate of around 10 a week) – the FSA would find it very difficult to justify to the Equitable why the current requests should properly be refused*'.

31/05/2001 [entry 2] FSA write to the Chairman of the Financial Services Consumer Panel, in response to his letter of 18/05/2001 to Equitable. FSA explain the work that they have been doing to monitor the situation at Equitable.

31/05/2001 [19:20] FSA's Chief Counsel A informs Line Manager E that she had now discussed the terms of reference for the Independent Actuary for Equitable's compromise scheme with Counsel and she recommends that FSA should write to Equitable, saying:

> *We are concerned that the* [terms of reference] *for the* [Independent Actuary] *do not clearly spell out that he should consider the following:*
>
> > *1. the present value of GAR rights under policies (possibly by category of policy or policies);*
> >
> > *2. the value of GAR claims for the purposes of the compromise (which will presumably be different from 1);*
> >
> > *3. the value of policies for the purpose of voting;*
> >
> > *4. whether the actuarial work sets out sufficiently and accurately (so the Court can easily take a view) the impact that the acceptance (or non-acceptance) of the offer will have on the various relevant categories of policyholder <u>within</u> each class.*
>
> *While we recognise it is difficult at this early stage to set out with* [exactitude] *or in detail what the* [Independent Actuary] *should consider, not least because some of the actuarial work will be dependent on the legal conclusions on the classes etc, and there will no doubt need to be some adjustment and clarification as you go along, if you agree that the matters listed above are key issues to be addressed by the* [Independent Actuary], *we suggest a letter to the* [Independent Actuary] *supplementing or clarifying paragraph 3 of the* [terms of reference] *might helpfully be sent to him now.*

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01/06/2001 [entry 1]	FSA meet Equitable's Chairman to discuss general progress following Equitable's annual general meeting. The Chairman reports that the Society's meeting had gone well and all of his candidates for the Board had been elected. The compromise proposals are discussed and the Chairman tells FSA that the Board were going to discuss matters on 25 July 2001, by which time the second stage of their Counsel's opinion would have been delivered. Equitable's Chairman promises to provide FSA with the draft scheme documentation by 5 June 2001, which would give FSA three weeks to review it. FSA note that there had been no substantive discussion of the compromise scheme at the meeting. FSA inform Equitable that they had now taken on formal responsibility of the Unfair Terms in Consumer Contracts Regulations 1999 and would be taking over, from the OFT, the complaints regarding Equitable's application of the market value adjuster. FSA state their view that Equitable needed to make a fresh statement, explaining how the Society exercised its discretion. The Chairman says that he could see no difficulty in doing this.
01/06/2001 [entry 2]	FSA's Chairman thanks Legal Adviser D for her paper on section 425 schemes (see 29/05/2001 [**15:21**]). The Chairman asks whether FSA would see the work of the Independent Actuary, and: '*in addition to making representations in Court, will we send something to all policyholders? I assume there is no precedent for that, but that ELAS are unlikely to resist if we want to*'.
01/06/2001 [09:49]	FSA's Head of Life Insurance tells Chief Counsel A that he would like to discuss the issues raised in her note of 31/05/2001 [**19:20**] about the terms of reference for the Independent Actuary for the compromise scheme. The Head of Life Insurance says that he wondered: '*whether we are putting more weight on the* [Independent Actuary's] *report than it can reasonably bear. I think this report is not actually required under* [section 425 of the Companies Act 1985] *as distinct from a schedule 2c* [of ICA 1982]*? And we have agreed that the* [terms of reference] *should not be subject to our approval, so any suggestions we have need to be put forward in that light*'. [**12:18**] Line Manager E prepares a letter to be sent to Equitable. The Line Manager explains to the Head of Actuarial Support that he did not intend to raise his outstanding points at that time, but intended to do so when the next draft documentation was received. [**12:27**] The Head of Actuarial Support explains that his '*main worry about not including my list of questions at this stage is that there is not enough time to cover these properly at a later stage*'.
01/06/2001 [10:13]	Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches. Equitable note that they were '*blithely sending these to you on a weekly basis*' and ask if FSA still required this information. Line Manager E asks an official to telephone them to confirm whether FSA needed to continue to receive this type of information.
04/06/2001 [10:47]	FSA's Head of Consumer Protection informs Chief Counsel B and Line Manager E that the OFT had contacted them to say that they would be writing to all of their Equitable market value adjuster complainants that week to let them know that their cases were to be transferred to FSA. The Head of Consumer Protection says that the OFT hoped to provide FSA with the case papers later that week.
04/06/2001 [12:41]	FSA write to Equitable about the terms of reference of the Independent Actuary for the compromise scheme. FSA say they were likely to place considerable reliance on the views of

the Independent Actuary, when deciding whether or not to exercise their intervention powers in relation to the compromise scheme. FSA set out four areas of work that were not expressly referred to in the terms of reference, but which they believed should be specifically considered and reported on, those being:

a) the present value of GAR rights, with any appropriate breakdown by types of policy;

b) the basis of which any uplift would be calculated for the purposes of the compromise;

c) the basis on which policies will be valued for voting purposes; and

d) whether it will be sufficiently clear within the documentation to be put to the Court, what the impact of the scheme would be on various relevant categories of policyholder within each class.

04/06/2001 [15:20] PIA's Free-Standing AVC Review Team inform FSA of the provisional details of a visit to Equitable, planned for 29 and 30 August 2001.

04/06/2001 [16:00] FSA hold an Equitable Life Lawyers Group meeting. The Group note that there were no new developments on the compromise scheme. Chief Counsel B says that the OFT had informed FSA that they would be telling their complainants that their cases were being transferred to FSA and that they would pass over all correspondence when that had been done. The Group note that there was to be a lawyers only meeting on 14/06/2001 [**15:00**] to discuss what work needed to be done on the compromise scheme. Legal Adviser A says that there had been some changes to the reinsurance arrangements with Halifax for the unit-linked business and an up-to-date draft was to be sent to FSA. Under '*Issues arising from the* [Society's Counsel's] *Opinion*' the Group note that: '*Equitable had taken a robust view on* [ICA 1982] *reserving requirements.* [Equitable's Appointed Actuary] *and* [Chief Executive] *at their recent meeting with FSA had indicated that the company would not be increasing reserves although there is scope to increase reserves if necessary*'.

04/06/2001 [17:28] FSA's Line Manager E distributes two documents received from Equitable about the process and timetable for the compromise scheme.

05/06/2001 [15:59] FSA's Insolvency Practitioner attends a meeting of Equitable's Compromise Scheme Steering Group. According to the Insolvency Practitioner's report of the meeting, the items discussed include: the plans for the process of completing the scheme; progress to date on various issues, including that Equitable's actuarial report was not yet finished; and remaining legal issues. It is noted that written instruction had not yet been sent to Counsel but that he had been briefed orally on '*phase II*' of his opinion.

[**16:15**] The Head of Life Insurance says that he hoped FSA would receive the actuarial report within the next day or two and asks whether, in light of the slippage in the timetable, FSA's deadline for comments would be extended.

[**16:26**] FSA's Insolvency Practitioner says that: '[Equitable's Chief Executive] *acknowledges that our comments will be made on an ongoing, iterative, basis. Indeed, there are at least 4 documents to comment on: the actuarial report, the "launch" document, the full explanatory statement, and the legal contract. The last three will not be available until after 26 June. They hope to catch up the week lost in the two week's delay before the road-shows when* [the Chairman] *is away.* [The Chief Executive] *did not explicitly mention the 26 June as a deadline but I got no sense that we were being boxed in*'.

05/06/2001 [19:40] PIA send FSA a revised version of their draft '*Stage 2*' report into Equitable's disclosure to potential with-profits investors after the Court of Appeal decision. The executive summary and findings of the report are as follows:

> *2.1) This report concludes that Equitable's disclosure met regulatory requirements in that, given the nature of the risks it faced, it was not required by the Rules to disclose these risks to potential new investors.*
>
> *2.2) Equitable rightly regarded the* [House of Lords'] *ruling beyond the* [Court of Appeal] *decision as highly unlikely.*
>
> *2.3) The* [House of Lords'] *ruling, which created a population of GAR policyholders who, by investing further into their existing policies, might receive significantly more than asset share in return for their extra investment to the detriment of non-GAR with profits investors was again rightly regarded as highly unlikely.*
>
> *2.3.1) The impact of reserving for this liability was borne by those existing investors who had entered the with profits fund whilst the prospect of the eventual* [House of Lords'] *ruling was rightly regarded as remote.*
>
> *2.3.2) The impact of reserving for the increased GAR liability was not borne by new investors after the* [House of Lords'] *ruling.*
>
> *2.4) The possibility that a purchaser might not be found on the terms Equitable sought and that, without a purchaser, it might need to close to new business was rightly regarded as highly unlikely. It is not clear that the closure to new business will have a negative impact on future investment performance.*
>
> *2.5) The above are regarded as operational risks experienced by Equitable. PIA has no clearly established rules requiring the disclosure of operational risks to potential investors. Moreover, it is clear that PIA has not acted previously to discipline a firm for non-disclosure of such risks or that it has ever acted to force a firm to disclose such risks.*
>
> *2.6) This report recommends no further action to consider Equitable's disclosure to potential investors before or after the* [Court of Appeal] *decision.*

06/06/2001 [14:23] FSA's Legal Adviser D provides the Director of GCD with a note (dated 5 June 2001), in response to his query of 30/05/2001 [**16:55**] about what constitutes a liability under a section 425 scheme. The Legal Adviser says that she had not intended to mislead by using the word '*liability*', but was '*anxious to demonstrate how flexible a section 425 compromise can be*'. Legal Adviser D explains:

> *The word "liability" is not used in s.425 but I consider it right to stress the use of the word "compromise" throughout this section. I also consider it important to note the definition section in s.425(6) which provides:*
>
> > *(a) "company" means any company liable to be wound up under this Act, and*
> >
> > *(b) "arrangement" includes a reorganisation of the company's share capital by the consolidation of shares of different classes or by the division of shares in to shares of different classes, or by both of these methods.*
>
> *To my mind this definition section highlights that a s.425 compromise is a very different animal from a scheme of arrangement and can be a mechanism for achieving considerably more than just a compromise with creditors.*

Legal Adviser D provides some extracts from section 425 cases, in order to emphasise the flexibility of such schemes. The Legal Adviser concludes:

> *I realise I have not answered your question but I believe it to be inherent in the words "compromise" and "arrangement" that what can be compromised are not just contractual claims or guaranteed liabilities in the sense of the guaranteed annuity rates confirmed by the House of Lords in the* [Hyman] *case but could include rights to a terminal bonus both of a particular amount or calculated on a particular basis. Any compromise of these more ephemeral (as opposed to strictly contractual) rights would have to be one to which a reasonable policyholder would agree and thereafter be sanctioned by the court. This I believe to be the break on more fanciful claims or rights attempting to be compromised.*

Legal Adviser D stresses that she had no experience of section 425 schemes or pensions law and says that her note had been prepared simply to save the Director research time. She recommends that he should consult with Counsel on the issue.

06/06/2001 [14:38] FSA's Chief Counsel B circulates a copy of FSA's and PIA's instructions to Counsel, sent the previous week (see 29/05/2001 [**entry 2**]), ahead of a meeting the following day.

06/06/2001 [entry 3] In advance of a conference with Counsel the following day, FSA send Counsel a copy of the draft PIA Stage 2 report.

07/06/2001 [15:53] FSA meet the OFT to look through the complaints cases about Equitable's application of the market value adjuster. FSA explain:

> *In nearly all these cases there is a question or questions relating to the mva and unfair contracts, and for each of these cases OFT will send the standard letter which* [the OFT] *showed us.* [An OFT official] *will sign these letters, which he hopes to send out tomorrow. A copy of this letter will be attached to each file.*
>
> *Some of these cases also raised additional general questions about Equitable Life, for example, one asked about the rights of the GAR holders, another alleged mis-selling by Equitable Life. We will need to consider whether or how we will address these sorts of questions. From a practical point of view I did not feel we could ask OFT to add responses to these points to their standard responses, without considerably delaying the transfer.*
>
> *The cases not raising questions about* [unfair contract terms]*/mva raised issues of a more general nature. In these cases, OFT has already sent a full/final response. These cases are now closed, and probably should not have been in the same pile.* [An OFT official] *has agreed to ensure he does not send the standard letter in these cases, as this would obviously commit FSA to further action. However, OFT will send the files to us for completeness, but separately identified.*
>
> *OFT have already dealt with a number of more general enquiries/complaints about Equitable Life, as mentioned previously by* [the OFT]*, and they have answered these in full. As* [the OFT] *mentioned, they will copy these to us silently. There is no action for FSA.*

FSA take away with them the OFT's main Equitable file, which included their correspondence with the company.

07/06/2001 [18:36] Further to the conference with Counsel that morning (for a record of which see Chief Counsel B's note of 08/06/2001 [**17:19**]), Line Manager E lists some issues on which FSA needed to do some research, which were as follows:

1. [Counsel] *asked about the operation of group and occupational schemes, and* [were] *interested in how they worked. For example, where there were trustees, who had the membership and voting rights and who was the policyholder*[?] *In what circumstances did the employees of companies have direct rights against Equitable. Unless anyone knows the full details of the schemes Equitable runs, I might ask for a note from them.*

2. Did Equitable have any professional indemnity insurance for liabilities arising from mis-selling? (I am fairly sure they do not)

3. What assumptions are made for the purposes of the £1.5billion estimate of the GAR liability made post [House of Lords]*? How sensitive is it to factors such as increased propensity to top up and changes to interest rates?*

4. What kind of economic impacts can affect policyholders in different classes in different ways or by varying degrees Eg does a change in interest rate have the same impact on all policyholders? Are some advantaged/disadvantaged more than others? Does the benefit/detriment all go the same way?

5. What terms of with-profits policies can override other terms so that some policyholders have differential treatment to others? (The most obvious answer is that all contractual rights take precedence over discretionary benefits)

6. How ring fenced are subfunds? Do firms make a virtue of operating a number of subfunds, eg in their marketing? How do they treat subfunds for the purposes of the returns? How effectively are they ring-fenced for business and solvency purposes?

08/06/2001 [08:56]	FSA's Head of Actuarial Support tells Line Manager E that he had not been aware that the meeting with Counsel the previous day was taking place. He says that FSA were still waiting for the next version of the draft actuarial report and '*there are indeed numerous unanswered questions*'. In response to point 3 raised by the Line Manager, the Head of Actuarial Support explains that '*the assumptions are set out in the 2000 annual report and accounts but unfortunately there appears to be some unexplained inconsistency between the figures that we wish to raise with them*'. He also says that point 4 needed to be raised with Equitable and that points 5 and 6 were essentially legal questions.
08/06/2001 [11:08]	FSA's Line Manager E seeks clarification from Scrutinising Actuary F on his understanding of the position of group schemes and occupational pension schemes. [**16:42**] The Scrutinising Actuary explains that it was a complex question and FSA would need to ask Equitable who possessed the membership and voting rights in respect of various types of business, '*but it will be important to ask the right questions to increase the likelihood of getting helpful answers!*'. The Scrutinising Actuary gives an explanation of how group schemes would normally operate.
08/06/2001 [11:20]	Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.
08/06/2001 [11:21]	An HMT official informs HMT's Director of Financial Regulation and Industry that the Economic Secretary to the Treasury was now content with the recommendation in his note of 24/05/2001 that she should note HMT's intention to approve the section 68 Orders. [**11:39**] The Director confirms that HMT could now give FSA their formal approval.
08/06/2001 [14:11]	HMT grant Equitable the section 68 Order on the rates of interest used for fixed interest stocks and the Order on the value ascribed to Permanent Insurance.

HMT send copies of the Orders to FSA.

08/06/2001 [17:12] Equitable send FSA the latest version of the actuarial report for the compromise scheme (dated 7 June 2001). [**18:08**] Line Manager E circulates the draft to supervisory, legal and actuarial colleagues.

08/06/2001 [17:18] FSA's Line Manager E receives a copy of the earlier correspondence between FSA and the OFT in relation to the transfer of files about complaints made about Equitable's use of the market value adjuster. (See 07/06/2001 [**15:53**].)

08/06/2001 [entry 8] FSA's Chief Counsel B sends the Head of Life Insurance a copy of the note to PIA on the conference with Counsel the previous day, which concerns how PIA should take forward their work on their '*Stage 2*' report. The note records the following:

Chief Counsel B explains the context for PIA's report and notes that, alongside this, Counsel for Equitable had identified '*broader and more extensive issues*'. He notes that, in light of this, FSA and PIA had instructed Counsel to '*track the* [Counsel for Equitable] *issues under consideration and, if need be, to identify any further issues which may be relevant to the claims of GAR and non-GAR policyholders. We do so in order that the FSA can have a well formed view as to whether the Equitable's compromise proposals are appropriate and adequate. There is an expectation that* [Counsel] *will speak with* [Counsel for Equitable] *about how his views are developing*'.

Chief Counsel B continues that: '*Since there is obvious overlap between the issues under consideration by counsel (and by* [Counsel for Equitable]*) and the particular post-Court of Appeal misselling issues addressed in your draft report, we cannot move to finalise your report until the work with our external counsel is concluded*'.

Chief Counsel B says that the rest of his report sets out the points from the conference with Counsel the previous day, but that: '*Generally, counsel acknowledged that the supervisory judgments in the draft report had force. It would be reasonable for the regulator to take account of the extent to which Equitable had been at "fault" in deciding whether disciplinary action should be brought. It is however necessary to consider also whether Equitable has breached any non-fault-based obligations. In reaching a view on what Equitable considered were the risks at any time, the report relies on the firm's explanation as given to us. We should, however, try to look at the original evidence to get verification*'.

Chief Counsel B sets out Counsel's preliminary observations:

> *The starting point is the profound implication of the House of Lords judgment which must be assumed to have been the correct statement of law throughout. From the moment that GAR and non-GAR policyholders co-existed in the same fund the non-GAR policyholders were exposed to the risk that they might inevitably be exposed to disadvantage if the value of the fund had to be used to support the costs of meeting the GAR contracts. This can be expressed as a risk that the non-GAR policyholders would not get their "asset share" in circumstances where the GAR option became valuable. Counsel agreed that the concept of "asset share" is not necessarily something which can be translated into a contractual entitlement. It was also acknowledged that there are, for example, analogous risks, that a life office's mortality experience might be such as to impact upon the value of other classes of policy not affected by such experience, that a life office's exposure to common law misselling claims is an expense which may be wholly or substantially attributed to the fund. Distinctions may, however, be drawn between those risks about which a policyholder might reasonably be taken to be aware and others which should or need to be drawn to his attention.*

Chief Counsel B goes on to set out Counsel's preliminary views on the mis-selling issues identified by Counsel for Equitable, under the headings of '*Implied term*', '*Contractual warranty*', '*Good faith duty in insurance contracts*', '*Other common law actions*' and '*Breach of statutory duty – regulatory misconduct*'. Under the first heading, Chief Counsel B reports that Counsel is:

> *... deeply sceptical as to whether it is feasible, in the light of the House of Lords judgment, to mount a case that the non-GAR policies should be construed on the basis that they contained an implied term that the asset shares for such policies would not be prejudiced by virtue of the Society's exposure to GARs. This is because Lord Steyn held that the Articles of the Society should be read as subject to an implied term that the directors would not exercise the discretion to reduce bonuses for GAR policyholders opting for the guaranteed annuity. Once that is accepted it seems inconceivable that a Court would be persuaded to imply a further term into the Articles or policies which would not be reconcilable with the House of Lords ruling.*

Under '*Contractual warranty*', Chief Counsel B reports Counsel's view to be that:

> *It is possible that the Equitable, through the sales process, made promises to non-GAR policyholders which should be given contractual effect – a collateral promise or collateral warranty to the effect that non-GAR policyholders would not subsidise the costs of meeting the GAR policyholders. This would depend, however, upon the facts of each case. The preliminary reading of the sales literature supplied to counsel suggests that such warranties were not given but this needs to be further investigated particularly by reference to the briefing material given to Equitable salesmen. We should ask to see, if they are available, the records of training and sales briefing given to Equitable salesmen.*

Under '*Good faith duty in insurance contracts*', Chief Counsel B reports:

> *The insurance contracts sold by the Equitable attract the good faith duty of disclosure. This is a duty to disclose all such facts as would be relevant to a policyholder's decision to take out a policy and would include such facts as would have been known to the Equitable on reasonable enquiry. Clearly the Equitable could not have known, at least from 1988 until some stage in the litigation, that the Court would prohibit the exercise of discretion to reduce terminal bonuses for GAR policyholders. There will however be a subsidiary issue here, namely, whether the good faith duty of disclosure required the Equitable to disclose the risks presented by the litigation which the Society faced from 1998 onwards. A breach of the good faith duty of disclosure does <u>not</u> give rise to a claim for damages but merely for rescission of the contract. However, rescission of the contract, return of premiums plus interest, may be a valuable remedy for persons who bought Equitable policies at a late stage, particularly during the course of the litigation. The good faith duty, however, is one which is conditioned by fault i.e. it would be necessary to show that the Equitable knew of a particular risk, or ought reasonably to have known of such a risk, in order to succeed with the claim. On the fact of it, this may confine the issue to such time as the Equitable knew there was a material risk that the Court would condemn its practice of awarding a reduced GAO, or, alternatively, that it could not award a lower bonus to GAOs as a class.*

Under '*Other common law actions*', Chief Counsel B notes that Counsel said: '*It is conceivable that policyholders could seek to frame their claims in negligence or misrepresentation, again both <u>fault</u> based actions*'.

Under '*Breach of statutory duty – regulatory misconduct*', Chief Counsel B records:

This is relevant to the period from 1988 when the Lautro disclosure rules came into force (July 1988) and obviously requires an analysis to be undertaken as to what the rules at any time required. The central issue is whether the rules are to be construed as being fault based or whether they can be construed as giving rise to liability without proof of fault or negligence. Putting the question simply, was the Equitable under a regulatory obligation to provide information (as to the matters which might affect the ultimate value of a policy) which must be construed as including the disclosure of facts as subsequently substantiated by the House of Lords, or, only those matters which it would have been reasonable for the Equitable to have disclosed at the time.

The language of the Lautro rules does, superficially, appear capable of creating strict obligations. Counsel acknowledge however that a Court might be slow to reach such a conclusion if this were to produce extreme or absurd results. A Court might well be persuaded to read the rules subject to the necessary implication that any disclosures which they required were disclosures of matters which were known to the Lautro member or which, with reasonable diligence, could have been discovered by the firm. Persuading a Court that this is the right approach might require the regulators (and/or the Equitable) to show what consequences would follow if strict liability were to be applied. It would be helpful in this context if counsel could be provided with some analogies. At the conference we discussed, for example, the position of a life office which had written a book of policies which, unknown to it at the time, would be likely to expose it (and consequently other policyholders) to severe claims arising as a result of AIDS. Counsel is not suggesting that these questions need to be tested in Court – they are matters they will take into account in reaching a view.

If the regulatory rules (throughout the period) either expressly or, as a matter of construction, are not fault based then the Equitable's potential liability will turn upon whether it failed to disclose matters of which it had knowledge, or, which with reasonable diligence, it could have ascertained. This leads on to particular consideration as to whether the Equitable should have disclosed the risks presented by the litigation. This can be broken down into questions as to whether the Equitable should have disclosed to potential policyholders the fact that it was in litigation as to the treatment of GAR policyholders or more particularly whether there was a risk that it would be unable to meet its liabilities to GAR policyholders without drawing on the value of the fund supporting the entire population of policyholders. At this point it will be necessary for counsel to advise on the extent to which it was reasonable for the Equitable to rely upon their legal advice as to the nature and severity of the risks which were being faced. There is a particular point here in relation to the "ring-fencing" issue. [This] *arises from the Equitable's apparent position, post-Court of Appeal, that the option of treating GAR policyholders as a class and thus ring-fencing the costs of the GARs to that class nevertheless remained open to them.*

It is not clear from the Court of Appeal judgment whether there was argument on this particular point. At what point did the Equitable receive advice that this form of ring-fencing might be challenged and, as it was, struck down in the litigation? Counsel want to see the skeleton arguments presented to the Court of Appeal and the lower Court and, if possible, transcripts of both of those proceedings.

There is a more general point relating to the Equitable's assessment of the risks which it was facing. The [PIA] *report is based upon the Equitable's account of the legal advice which it received and the decisions which it subsequently took. However, in answering questions about the Equitable's state of knowledge and what it would have been reasonable for it to disclose it will be necessary to look further and in particular at the legal advice which it received and the decisions which its board took over the period in question. We cannot* *simply rely upon what the Equitable has told us about this. Accordingly, counsel would like the FSA to examine the Equitable's legal advice in its entirety starting from the point in 1998 when the complaints from GAR policyholders began to emerge and including the advice which it received during the course of the litigation.*

Next steps

Chief Counsel B lists the further material that needed to be sent to Counsel, along with a list of the officials responsible for collation of it. Chief Counsel B also states that Counsel had made it clear that he would not wish to complete his opinion until he had seen at least a draft of Counsel for Equitable's opinion.

[**17:19**] Chief Counsel B also sends a copy of the note to FSA's Chairman, as he understood that he was going to read PIA's report over the coming weekend.

[**17:54**] An official from the Chairman's office notes that, at a meeting with the Chairman earlier that day, it had been agreed that an FSA director would take forward this work. That director had in turn said that he would hold a meeting on it early the following week, to which he would invite Managing Director A and the FSA's Managing Director and Head of Consumer, Investment and Insurance Directorate (Managing Director B).

10/06/2001 FSA's Equitable supervision file includes an article from a newspaper in which FSA's Chairman is quoted as saying, in relation to the compromise scheme, that: '*We certainly think this is the best hope for policyholders. This is not a zero-sum game*'; and '*Halifax will put in additional funds and, if members cap the liabilities through the compromise, there is no reason to think that, going forward, investors in the Equitable Life will do any worse than any others*'.

The Chairman explains that the Tripartite Standing Committee had considered whether there was a case for the government to '*step in and prop up the company*'. FSA's Chairman says: '*We didn't think the case was made for a government bail-out. There are plenty of investors whose investments do not return what they had hoped. Despite everything, Equitable Life has been quite a good performer. There will be other companies where investors have had lower returns*'.

11/06/2001 [15:42] FSA's Head of Actuarial Support sends Scrutinising Actuary F a list of fifteen issues from Equitable's draft actuarial report for the compromise scheme (dated 7 June 2001) which he had identified required clarification.

12/06/2001 [entry 1] FSA's Financial Services Consumer Panel secretariat write to Managing Director B, in advance of a meeting the following day with the Chairman of the Panel. The Panel's secretariat explain the background to the Panel, its membership and processes, along with providing a list of issues that it currently had an interest in, which included Equitable.

12/06/2001 [08:30] FSA's Legal Adviser D replies to the Chairman's questions of 01/06/2001. She says that FSA would see the Independent Actuary's report for the compromise scheme. On the second question about whether FSA would send something to policyholders, the Legal Adviser answers that: '*it depends on whether the FSA broadly approves/agrees with the proposed compromise and how clearly it is explained. The FSA can send out its own missive to policyholders if it was not happy with the substance of the scheme and/or considered that it was not explained sufficiently clearly ... At the moment it is impossible to say whether the FSA will do so or not*'.

The Director of GCD later (on 15 June 2001) advises Legal Adviser D that she should work on the basis that FSA would want to write to policyholders.

12/06/2001 [12:38]	FSA's Line Manager E writes to Chief Counsel B about some remaining legal issues in relation to Equitable's Rectification Scheme.
12/06/2001 [12:41]	FSA's Chief Counsel B sends the Head of Life Insurance, Chief Counsel A and the Director of GCD and PIA a note on '*Equitable – Standards of Disclosure in Product Particulars and Advertising*'. Chief Counsel B says that, at the conference with Counsel the previous week (see 08/06/2001 [**17:19**]), they had discussed '*the nature of the obligations created by the Lautro rules, on product particulars, and whether they were such as to create what counsel referred to as "non-fault based" obligations*'. He explains that such obligations '*might require the disclosure of matters even if they were unknown to the firm at the time or could not, at the time, have been discovered with reasonable diligence*'. Chief Counsel B's note goes on to set out the case for his view that '*the correct approach is to start from the presumption that the earlier Lautro rules were intended to be fault-based*'. The Chief Counsel seeks comments on that stance.
12/06/2001 [18:26]	FSA's Scrutinising Actuary F sends the Head of Actuarial Support some comments on his note of the previous day, along with a further eight issues from the draft actuarial report that needed to be clarified.
13/06/2001 [11:33]	Having seen a copy of Chief Counsel B's note of 08/06/2001 [**17:19**], the Head of Actuarial Support provides an outline of some other types of risk that could be disclosed to potential policyholders. Those being investment risk, mortality risk, expense risk, taxation risk and operational risk. [**11:38**] Line Manager E forwards the note to PIA.
13/06/2001 [13:00]	FSA's Director of GCD is sent a copy of FSA's note of the meeting with Equitable's Chairman of 01/06/2001, as requested. [**15:37**] Having seen the note, the Director of GCD expresses his concern to the Director of Insurance that, as FSA had not yet received the legal documentation for the compromise scheme which had been promised by 5 June 2001, Equitable's Chairman might mistakenly believe that everything was running to time and that FSA would have reviewed the draft documents in time for Equitable's Board meeting on 25 July 2001. The Director of GCD asks the Director of Insurance if he could find out what was going on. [**16:17**] The Head of Life Insurance says that FSA had received Equitable's actuarial paper and suggests that this might have been what their Chairman was referring to. The Head of Life Insurance also informs the Director of GCD that he had spoken to Equitable's Chief Executive, who had admitted that the timetable had slipped but had said that he believed that Equitable had met their target by sending the actuarial paper. The Head of Life Insurance also reports that the Chief Executive had said that the Society's solicitors were concerned that changes to the actuarial paper would have dramatic effects on the legal paper. The Head of Life Insurance tells the Director of GCD, however, that '*our separate requests to see legal advice in relation to potential misselling has made* [Equitable's Chief Executive's] *task more difficult, because their lawyers are now even more nervous about what they show us on the compromise*'. [**17:06**] The Director of Insurance informs the Director of GCD that he too had spoken to Equitable's Chief Executive that day, on other business (see 13/06/2001 [**17:17**]), and had been told that he was not yet satisfied that the actuarial paper was adequate. The Chief Executive had said that Equitable's Chairman was under no illusion on the extent of progress.
13/06/2001 [14:47]	FSA's Director of GCD comments on Chief Counsel B's note of 12/06/2001 [**12:41**] that there appeared to him to be a distinction to be made between two issues:

The first is about the standard of conduct which a rule requires. Does it require an absolute standard, or only that reasonable steps should be taken ...

The second is about how a particular rule should be construed. I believe that it is a principle of interpretation that a rule should be construed in such a way that it is possible to comply with it. The Lautro disclosure rules can be complied with if they are construed to require disclosure of information [which] *the firm knew or could with diligence have known. They cannot be complied with if they are construed to require disclosure of information where this is not the case. Therefore that cannot be the proper construction.*

13/06/2001 [17:17] FSA's Director of Insurance informs Line Manager E that he had telephoned Equitable's Chief Executive earlier that day to find out what he wanted to discuss at a meeting that had been arranged for 19 June 2001. The Director says that the Chief Executive wanted to discuss the extent to which Equitable would need to submit '*non-standard*' returns. The Society's Chief Executive had explained that he thought that there would be a need to refer to '*fundamental uncertainty*' and he would like to follow the formula used in the Companies Act reports and accounts. The Chief Executive had also expressed concern that the new directors '*will need to indicate that the matters which they certify are certified "to the best of their knowledge and belief"*'. The Director of Insurance says that he knew the Chief Executive had raised this issue previously with the Head of Life Insurance and he asks Line Manager E to find out if FSA had reached a view on it or had found any precedents.

[**17:30**] Line Manager E says that FSA were not clear what changes Equitable had in mind but '*as a matter of policy we are inclined to think that honesty is the best policy*'.

[**19:15**] The Head of Life Insurance says that he would let Line Manager E have the responses to his trawl of supervisors for qualifications that had been made to certificates.

14/06/2001 [12:02] FSA's Director of GCD sends Chief Counsel B and Counsel a draft of the proposed section 379 of the Insurers (Winding Up) Rules 2001 which he says is '*Relevant as background to the Equitable accommodation*'.

14/06/2001 [15:00] FSA and their legal advisers hold a conference with Counsel to discuss various issues about the compromise scheme. According to a draft FSA note of the meeting, Counsel advised on the following issues:

<u>Actuarial report</u>
Counsel states: '*that the reasons for the Actuary making a distinction between premium-paying and non-premium paying policyholders and a further distinction between those who paid premium in 2000 were not stated/unclear*'.

It is agreed that the alternatives to a compromise scheme should be spelt out and it is noted that: '*Such explanation might elucidate whether the compromise proposed was fair or not*'. It is recorded that the actuarial report, as drafted, did not do this, nor had it been intended to do so.

It is agreed that the 60% take-up rate for individual and group scheme policyholders required justification and it is queried why the proposed uplifts differed for the two types of policyholder (the uplifts being 23% and 20%, respectively).

FSA note that there was '*general concern because the actuary had first worked out the total cost of paying all GAR policy holders in full, then looked at sharing out the available pot according to the GAR rights, rather than taking as the starting point the value of the GAR rights.* [Chief Counsel A] *noted that Equitable might have no alternative to this approach and if so, the FSA would need to ensure that policyholders were given a very clear explanation of it*'.

Counsel queries whether Equitable's £1.5bn GAR provision had already been discounted by 60% (reflecting the Actuary's take-up rate assumption). Counsel says that, if this was the case, then GAR policyholders were getting less than the full value of their rights. Counsel asks whether this could be justified as being fair. Chief Counsel A notes that there could be a misunderstanding on this point, due to the differences between reserving requirements for the ICA 1982 returns and the Companies Act reports and accounts.

Counsel says that it seems '*non-GARs money was being used to "buy-off" the 700 pre-1975 GAR policyholders*'.

It is agreed that fuller information was needed about group schemes and the role of the actuary in appearing to determine the policyholder voting classes is queried.

<u>Role of FSA</u>
The note records:

> [Counsel] *suggested the FSA's role in a s.425 compromise was to ensure that it was fair to policy holders, to ensure that the voting was fair and that the explanatory statement was clearly written.* [Counsel] *explained that the Court will look to both the independent actuary and the FSA for help.* [Chief Counsel A] *responded that the FSA is also guardian of policyholders' interests and would intervene to protect them.* [Counsel] *stated that maybe Equitable policyholders' reasonable expectations were for full GAR rights.*

<u>Solvent entity</u>
Counsel states that '*the oddity of this proposed compromise was that an apparently solvent insurer was requiring policyholders to give up 40%* [of] *the value of their rights*'. The discussion continues:

> *It was noted that* [the report] *appeared to suggest that those who retired now could do so taking full GAR benefits and thus get £1 in the £1 at the expense of those who had to wait for the compromise who would not get more* [than] *60p in the £1. When was the clock going to stop – a cut-off date be established.* [Chief Counsel A] *replied that there was always an inherent unfairness in such compromises and there had been a similar difficulty in the ... scheme* [of a named company]. *Many policyholders would prefer to get 60% (eg, those who preferred the cash option, those who risked losing all GAR value if the market improved and so on).*
>
> [Counsel] *suggested that if the Equitable was solvent why is the Equitable not treating the with-profits fund as a closed fund and simply waiting to see if all policyholders take up their GAR rights. It was explained that this left open the possibility of top-ups and a deterioration in the market. In addition, investment freedom would continue to be restricted. If this paragraph suggested it was beneficial for some policyholders to retire now on full GAR benefits ahead of the scheme,* [Counsel] *queried whether the FSA should take steps now to ensure policyholders were informed.* [Chief Counsel A] *agreed it would be important to ensure that policyholders were made aware of the options available to them.*
>
> [Counsel] *also queried whether GAR policyholders should simply be required to stop paying further premiums. Surely one solution was to persuade GAR policyholders to give-up their "right" to pay further premiums now.* [Chief Counsel A] *noted that this would still leave Equitable's investment freedom constrained.*

<u>Involvement of the Policyholders Protection Board</u>
FSA's legal advisers query whether the Policyholders Protection Board '*should be invited to pay-in money to Equitable now as they had done in* [a previous] *case. Those present stated that this option was very unlikely to be favoured by the* [Policyholders Protection Board] *in the case of a solvent company*'. Chief Counsel A agrees to inform the Policyholders Protection Board so that they could take their own view.

Under '*<u>Next Steps</u>*', Chief Counsel A states '*on several occasions during the meeting that the FSA had regularly asked for a draft scheme from* [Equitable's solicitors] *and draft explanatory statement without success*'. Counsel note that '*the threat of the FSA being unable to approve the proposed scheme was now real given the short timetable and should be made clear to both Equitable and* [their solicitors]'. Chief Counsel A says that this had been done and would continue to be done.

14/06/2001 [15:14] FSA write to Equitable ahead of the meeting the following day. FSA set out the queries they had identified with the actuarial paper (see 11/06/2001 [**15:42**] and 12/06/2001 [**18:26**]), those being:

> *1) ... does the increase of £1.3 billion in the Society's free assets, if a scheme is adopted, arise from the combined effect of releasing the prudential margins in the GAO reserve (compared with the "best estimate") and also a lower resilience reserve?*
>
> *2) ... one of the assumptions is a smoothing adjustment of 0.55% p.a., compared with 0.3% p.a. previously. Why has this value been increased when the philosophy has not changed? That paragraph also refers to policy values being significantly "less" than asset values but should it not say "more"?*
>
> *3) ... we note that you say that age is not a material factor in the cost and yet this appears to be inconsistent with the figures shown in the table in section 4.4. Are you able to explain the comment?*
>
> *4) There is a reference ... to the Board considering several alternative schemes. This sits rather uneasily with the concept that the present draft represents a fair best estimate of the value of the GAR benefits, that are then apportioned fairly by the scheme as an uplift of benefits across all the relevant policyholders. Can you clarify what elements may be subject to review?*
>
> *5) ... you mention that the benefits under pre 1975 policies are less valuable than those under post 1975 policies. However, is it not also the case that in recent times there will have been a more significant number of people taking retirement benefits from pre 1975 policies than post 1975 policies and that the balance will shift as the older people retire? How have you allowed for this in calculating the GAR value for post 1975 policyholders?*
>
> *6) The report indicates that it is now intended that the scheme should differentiate between premium and non-premium paying policyholders. How will you operate this distinction when in practice all policyholders appear to retain the right to pay additional premiums at any time?*
>
> *7) There is no differentiation made between males and females in the proposed uplift in benefits. From the figures ... this appears plausible for most groups of policyholder, but for retirement annuitants, there might be a differential here of around 2 - 2.5% to consider. A similar (and possibly slightly higher) differential might also appear if we had regard to the present annuity rates available in the market for males and females ...*
>
> *8) The GAR/CAR ratios ... have fallen compared with the figures in the 30 April draft. E.g. for post-1975 Retirement annuities, the ratio for a male retiring at 65 has fallen from 1.436 to 1.377, and for females at 65 from 1.417 to 1.352. Does this reflect an improvement in Equitable's CAR's in the meantime?*
>
> *9) Can you clarify why those examples ... for current annuity rates were selected? For example is there an objective reason why you quote figures for Sun Life annuities for males and Norwich Union annuities for females? Is it your expectation that once the uplift has happened, people taking retirement would or should take an annuity from another provider on the open market? Are you currently encouraging people to do this anyway?*

10) You now appear to be treating group policies in broadly the same way as individual policies. In particular you are now assuming a take-up rate of 60% for both and the proposed enhancement for group policies has increased to 20%. However the figures ... show a lower actual take up rate for group business. This is clearly a difficult issue as your paper acknowledges. However, it seems to us that the group schemes may provide benefits that are more valuable than the GAR which means that the scheme members could benefit twice over – by an enhanced policy value from which they would take further enhanced benefits.

11) You are assuming a long-term interest rate of 5.5% for valuing annuity benefits. This is slightly higher than the current risk-free rate on gilts (on which market rates for this type of swap are likely to be based) but slightly lower than the rate of interest underlying the current annuity rates offered by other insurers as tabulated ... Is your assumption intended to be an average of the implied rates of interest from these two sources? More generally, it would be helpful to have some further description of the sources of material available for the different approaches indicated ... and an explanation of how these approaches have been reconciled.

12) How do you justify the assumed 60% take-up proportion in the calculation of a "fair" offer for a policyholder wishing to take all the annuity benefit in GAR form (and either maximum cash or no cash benefit)? Would this involve having regard at that stage to the difference between current annuity rates in the market, and annuity rates derived from the assumed 5.5% long-term rate of return?

13) Have you considered the application of financial option theory to the value of a GAR benefit that only becomes exercisable after a deferment period (generally equal to the number of years before the policyholder attains age 60)? This might well have an effect on the assessed value of GAR benefits by present age.

14) There is little variation in the value of GAR benefits by age for individual policies ... However, there is considerable variation for group policies. Can you provide further explanation.

15) We shall need to see separate tables for paid-up and premium paying policies, especially if you intend to distinguish the uplifts between these. In particular we would want to see adequate justification for the uplifts of 20 and 24 per cent respectively for non paying and premium paying policyholders with Retirement Annuities.

16) We are having some difficulty in reconciling all these figures for the aggregate value of GAR benefits, and their potential sensitivity to changes in the assumptions with those shown in the annual returns.

17) Paragraph 9.1.3 in appendix E comments on communications with policyholders. It is unlikely that many will understand the benefits of a percentage uplift combined with enhanced investment freedom compared with retaining the GAR. It seems to us vital that some modelling is done to show what the effects are likely to be for real typical policyholders. In any event, we are likely to want to see some information of that kind before taking a final view on the scheme.

18) Some other miscellaneous points are as follows;

> *(a) As indicated at paragraph 12 above, have you considered applying financial option theory to value (1) the GAR option available at retirement and (2) the 3.5% guaranteed accumulation rate that policyholders are also being asked to renounce?*
>
> *(b) Will the overall package be affected by movements in the value of equity (and other) investments covering the GAR liability?*

(c) What is the reason for the strange pattern of figures (moving up and down) in the table in Section 4.4?

(d) Appendix C shows some policyholders aged 83 and 80 who have not yet taken benefits. Is this an error?

(e) On a point of detail, what is the origin of the factor of "ten" for valuing each with-profits annuity in Appendix D? And if that factor is used both to determine the value of the [with-profits] *annuity and the number of votes for* [with-profits] *annuitants, does that not give a disproportionate share of the vote to* [with-profits] *annuitants.*

(f) Similarly, why are you applying the "[Minimum Funding Requirement] *liability" to derive the value of certain pension plans on pages 48, 49 and 53 of Appendix D?*

(g) Appendix E uses uplift figures of 20 and 25 per cent which is inconsistent with the information on page 5.

(h) We could not understand the calculation, or the rationale for the calculation set out for "replacement benefits" in Appendix I. We were also unclear about the calculation of the replacement benefits (page 63), and the interaction between "x %" in those calculations and enhancements of 3, 20, 23 and 24 per cent. mentioned on page 5.

(i) We noted that there was a comment that for 20% of group schemes, data could not be split by age. This seems a significant proportion of missing data and we wondered if you would be looking to fill the gap.

(j) Section 3.3.10 says that the assumptions are that for individual pension benefits are taken at 60 or 65 and that for group schemes that you assume a pattern based around the normal retirement age. Can you explain and justify the differences (if any) in the assumptions?

(k) On page 32 there is a list of GAR policies that are not to be included in the scheme. That is clearly a matter for Equitable Life. However, we would be interested to know why you have proposed excluding those policies. It would also be useful to us to know what implications that has for future reserving since presumably not buying out those guarantees leaves a degree of uncertainty going forward.

14/06/2001 [19:53] FSA's Managing Director A writes to the Director of Insurance about a letter to a Member of Parliament. The Member had written to FSA regarding correspondence that he had received from several of his constituents, who felt that they were not receiving the necessary information to make an informed decision about the proposed reorganisation of the Society. The Member had said that Equitable had not provided an illustration of the value of the GAR in respect of particular policies, but had instead enclosed a table so that clients could calculate this for themselves.

The Managing Director attaches a draft reply to the MP and invites comments. He writes further:

But he raises a perfectly fair question and I think we need to be on the front foot in responding. Personally (though I haven't said this in the letter) I feel that what would be reasonable information to give a GAR holder before he/she votes on the compromise would be either a personalised quote or generic information that was accurate to within a small margin or – a poor third – a self-calculation aid to "do it yourself". The trouble with this is that if it is simple enough for someone to do it themselves, why can't the Society do it? If on the other hand it is too difficult for the Society to do itself how can it produce a comprehensive ready-reckoner?

14/06/2001 [entry 5]	PIA send FSA a copy of their comments on Chief Counsel B's note of 12/06/2001 [**12:41**] on the standards of disclosure expected and the relevant LAUTRO and PIA rules.
15/06/2001 [entry 1]	Equitable send FSA a copy of their draft 2000 returns, ahead of a meeting on 19/06/2001. Equitable say that they would like to consult FSA on the Directors' and Appointed Actuary's certificates '*and in particular the matters to which the reader's attention are drawn in the separate statement preceding these certificates*'.
15/06/2001 [09:08]	FSA's Director of Insurance sends a copy of the draft reply to Chief Counsel A saying: '*... I wonder if saying that we "will need to define and defend" what is reasonable may go a bit too far given the fact that we have no formal locus in s425 schemes. It seems to me that our role is to ensure that what the company proposes is not unreasonable and to stand ready to intervene if we think it is. In practice we will need to explain our role and our views. But this is perhaps a little less onerous than* [the Managing Director] *suggests?*'.
15/06/2001 [10:51]	FSA's Director of GCD reports to Chief Counsel B on a conversation with Managing Director A about FSA's Chairman's concerns about the mis-selling review. Those being: '*Effectively ... he is keen to ensure that no one can say that the report is a white wash. So, for example, even if the conclusion is that there has been no general* [mis-selling], *it will be odd for the report not to recognise the possibility that some individuals might have been* [mis-sold]'.
15/06/2001 [10:55]	FSA's Legal Adviser D prepares some further questions about the compromise scheme to be put to Equitable at their meeting that afternoon. These reflect the points raised by Counsel on 14/06/2001 [**15:00**].
15/06/2001 [11:02]	FSA's Legal Adviser D asks the Insolvency Practitioner for a copy of his paper on '*counterfactuals/worst case scenario*' in the event that a compromise is not achieved. [**11:06**] The Insolvency Practitioner sends her a copy of his paper of 19/03/2001 explaining that it sets out the consequences for Equitable of a liquidation, '*although there are many alternative and better options to consider before liquidation is reached*'. [**12:59**] Line Manager E sets out the possibilities other than the compromise scheme open to Equitable as being: *a) they could go for a winding up, which for reasons established by the paper will have terrible consequences and we would expect to need to intervene to stop it happening; or* *b) they would have to soldier on and look at a much more cautious investment strategy as time goes on with bonus levels getting less and less generous, or even reduced to nil.* The Line Manager does, however, note that there were some other potential '*ways forward*', including that it '*might be possible to do some restricted insurance business transfers to other life offices (assuming there were any prepared to take it on), but (i) that could cause problems about frustrating the GARs and (ii) may not be possible because of the terms of the Halifax deal ... But those are too remote and hypothetical for us to assess at this stage*'. [**13:19**] Chief Counsel A suggests that FSA should hold a short meeting to discuss counterfactuals, as she thought that FSA '*may wish to do a bit more eg on how we might react should the solvency margin be breached*'.
15/06/2001 [11:03]	Equitable send FSA information on the calls to Equitable's helpline and on the value of transfers, surrenders and switches.

15/06/2001 [13:09] FSA's Director of GCD writes to Chief Counsel A (copied to other officials), ahead of the meeting with Equitable that afternoon which she was attending, saying that he was rather worried about the current state of play on the compromise scheme. The Director of GCD says that Equitable's draft actuarial report on the scheme did not make a convincing case for people to give up their GAR rights. The Director says that he believed that a case could be made for this, but it would need to explain that the alternative would be far worse. He says that the report apparently proceeds on the basis that there had been an actuarial valuation of the rights of the GAR holders, and that they were being offered the value of those rights. The Director of GCD says that this might not be a convincing argument. He notes that the amount available to uplift policy values was the required reserve for the guarantees, which was the £1.5bn that Equitable had based on a likely take-up rate in GAR rights of 60%. The Director of GCD says:

> *The difficulty is that the actual value of the rights to each policyholder is not the same as his proportionate share of the expected aggregate take-up. For those policyholders who would have exercised the right, their uplift is worth only 60% of the value of those rights.*
>
> *As far as I can see, there is no way of avoiding this, because the company has no other resources to provide for the uplift. But it is highly relevant to the basis on which the scheme is justified.*

(Note: the Director of GCD had prepared a draft that was to be sent to Managing Director B but the recipient appears to have been changed after comments on it from Chief Counsel B.)

15/06/2001 [13:18] FSA's Chief Counsel B sends the Head of Life Insurance, Chief Counsel A and Director of GCD a copy of his reply to PIA's note of 14/06/2001.

15/06/2001 [15:00] FSA meet Equitable and their solicitors to get an update on the compromise scheme.

<u>Timetable for the compromise scheme</u>
Equitable set out the timetable and having done so: '*it was impressed upon the visitors that this meant that the FSA had to be effectively satisfied that it had no fundamental objections to the 425 scheme by 25th July. There would be little point in the Board sanctioning an approach and consulting members more widely if we were minded to object.* [FSA's Head of Life Insurance] *stressed that the 25 July date was very close and expressed concern that we did not have enough material at this stage to come to a view. Furthermore if more material is forthcoming we needed sufficient time to consider this*'.

In order to be able to give their '*blessing*' for the scheme, FSA explain that they would '*wish to be content that the process was thoroughly prepared and appeared adequate and transparent and that we had no reason to object to it in substance*'. Equitable say they are confident that they will be able to give FSA the reassurance required.

FSA note that '*When pressed as to what "the test" should be on ... deciding whether this scheme was better than other options* [Equitable's Appointed Actuary] *confirmed that ELAS were still grappling with this*'.

FSA highlight that they '*may face difficulties with the scheme if certain groups or even individuals are significantly adversely effected.* [Equitable's Appointed Actuary] *argued that the most extreme group effected would be GAR policyholders past retirement age, however, these policyholders would still have the right to take ... up their full GAR pension provided they did this before the effective date of the compromise. Otherwise* [Equitable's Appointed Actuary] *thought that appropriate differentiation of value issues had been considered and were broadly fair. They did, however, agree to do more analysis on pre 1975 policies*'.

Discussion of FSA's letter dated 14 June 2001
The discussion includes answers to the following questions (following the numbering in FSA's letter):

1) Equitable confirm that the '*bulk*' of the £1.3bn increase in their free assets resulted from the release related to the resilience reserve, but also '*a slightly higher valuation rate of interest could be justified in view of the shorter duration of liabilities*'.

2) On the changes to the '*smoothing adjustment*', Equitable explain that the change '*was deemed necessary because policy values and asset shares moved apart last year (because 2000 was a poor year for investment returns) and needed to be updated. The change will lead to a claw back on smoothing*'.

4) FSA record:

> *It was confirmed that the ability for GAR policyholders to top up policies (at GAR rates) would be curtailed for those policyholders that had not previously topped up their policies in the last 12 months. This change of policy would be made at a Board meeting on 27 June and would be effective from 1 July. FSA thought that the Society had previously received legal advice that they were not able to halt top ups of this nature, since it had been thought that notice needed to be given before making such a change (and the very act of Notice may encourage policyholders unaware of their GAR benefit, to top up). However, ELAS now believed that they were able to do this and will make some kind of public statement relating to the change in policy. ELAS agreed to give us advance copy of any public statement made. It was also possible that a similar benefit available in Final Salary Schemes would also be cut off on this date. Subsequently, we have learned that they are intending to give notice to policyholders of this change, though they may not be aware that the "offer" in the compromise will depend on whether or not they are paying premiums. GCD have flagged this as a potential issue of concern that needs to be understood and addressed.*

5) For the pre-1975 GAR policies, Equitable confirm that '*benefits were much less generous than after this date but because the number of pre 1975 policyholders of this class were so few (about 700, less than 0.5% of GAR policyholders) there was less of a need to consider balancing considerations*'. FSA tell Equitable that they were not yet persuaded that the 3% uplift for these policies was a fair offer.

10) Equitable state '*the GAR option had now been given broadly the same value for groups as it had for individuals*'. FSA say they had not received sufficient justification for the take-up rates used and go on to record:

> *It was still not currently known why Group schemes had a lower level of take up. Anecdotal evidence pointed to many of the policy values being small (and not worth the hassle of taking out the GAR). Furthermore other in house schemes have higher mortality and good investment performance which might make their schemes more attractive, and group policyholders seem more inclined to take cash.*
>
> *The general principle of the scheme is to take into account the economic cost based on the current levels of take up and then divide this up between the GAR policyholders.* [FSA's Chief Counsel A] *expressed some concern that the scheme was based on costs rather than focussing on the value of the individual rights. It was also possible that a Judge might want to focus on compensation for the value of the individual's GAR rights.* [Chief Counsel A] *thought that it would be crucial to be very transparent about how this issue was being dealt with so that policyholders were aware of how much they were being asked to give up.*

> [Equitable's Appointed Actuary] *thought that these type of arguments went to the core of what the scheme was about and it was important to note that the scheme was a compromise. He added that currently there was no certain outcome for GAR policyholders. For example an important variant was interest rates. If they rose significantly the GAR policyholders could be seen to be getting something for nothing (as the GAOs lost value) to the detriment of the non GARs.* [Chief Counsel A] *noted that GAR policyholders who did not intend to take the GAR would also be better off.*

Many of the other points are agreed or further information promised.

Under '*Action Points*', Equitable agree to:

- formally respond to FSA's letter of 14/06/2001;
- complete the actuarial part of the scheme and send it to FSA the following week;
- provide a roadmap or justification for the scheme;
- provide a statement on revoking the guaranteed annuity rates from applying on further premiums paid;
- provide details on the principles for uplift;
- clarify the materiality on pre-1975 policies;
- provide a definition of a group scheme;
- provide an explanation of how certain approaches in one part of the actuarial paper would be reconciled;
- expand a table within the scheme document;
- provide an update on their solicitors' work on policy classes; and
- provide a reconciliation of the different GAR values given in various documents.

FSA agree to give Equitable an indication of what their '*no objection*' or '*fair and reasonable*' test would be.

On a version of the note of the meeting, FSA's Chairman comments to the Director of GCD that: '*Since they expect to go to court on 5/10, and there is a risk that our review may not be published before then, we need to consider just how material non-publication will be to those who face a choice*'.

15/06/2001 [15:41] FSA's Chief Counsel B seeks help from the Head of Actuarial Support in relation to his work on Counsel for Equitable's opinion and PIA's enquiry into mis-selling by Equitable. The Chief Counsel explains that Counsel had advised that '*even if the Equitable has been guilty of a breach of duty of proper disclosure it would need to be established whether or not policyholders have suffered any financial loss as a result of that* [non] *disclosure. It is on that question that I would welcome some information which I can pass on to Counsel*'.

[**17:39**] The Head of Actuarial Support advises Scrutinising Actuary F that they would need to think carefully about how FSA approach this, as FSA had information about conventional regular premium endowment policies but probably did not have readily available information on with-profits bonds or pensions policies.

15/06/2001 [entry 11] The OFT send FSA a copy of a letter that they had sent that day to Equitable about the transfer of their enforcement action under the Unfair Terms in Consumer Contracts Regulations 1999 to FSA. The OFT's letter says:

We have agreed that the FSA is best-placed to take effective industry-wide action in the interests of all investors. It gained powers to enforce the Regulations on 1 May and began the wide-ranging review of with-profits policies. The review includes scrutiny of the fairness of the terms and conditions which concerned us. Moreover, the FSA's review covers the whole industry and not just Equitable Life. Today we transferred the numerous complaints we have received about Equitable Life including those relating to allegations of mis-selling and other matters.

18/06/2001 [09:48] FSA's Chief Counsel B sends the Head of Life Insurance and the Head of Actuarial Support copies of further instructions which had been sent to Counsel on 15 June 2001 as they had, at the conference on 14/06/2001 [**15:00**], asked for '*some clearer indication for the regulator's policy in this area; for background information about the policy intentions which informed conduct of business rules; for a clearer explanation of what rules applied at what time, counsel observed that the rules referred to in the addendum to* [Counsel for Equitable's] *opinion appeared to be very different from those cited by the PIA in their draft report*'. The further instructions contain the information requested and are drawn from the views set out previously at 12/06/2001 [**12:41**] and 13/06/2001 [**14:47**].

18/06/2001 [11:40] Further to Chief Counsel B's request of 15/06/2001 [**15:41**], FSA's Head of Actuarial Support asks an FSA actuary to find out how much information FSA possessed about the market performance of with-profit companies in terms of payouts at both maturity and surrender for different types of contract.

18/06/2001 [15:29] FSA's Line Manager E writes to Scrutinising Actuary F about the draft certificates to the returns supplied by Equitable, having compared them to the requirements of Regulations 28 and 29 of the ICAS Regulations 1996 and to Equitable's previous returns. He explains that there were two changes to the proposed returns, with Equitable making additional statements on '*the historical position of the* [House of Lords'] *judgment and its consequences, including the uncertainty on future GAR take up (and cost), the payment of further consideration by Halifax Group plc and the fact that no-one other than* [Equitable's auditors] *who has to sign a certificate was appointed to the relevant position during that period to which the certificate relates*'. Line Manager E says that the information seemed helpful, was not misleading and its inclusion should be welcomed.

18/06/2001 [16:00] FSA hold an Equitable Life Lawyers Group meeting. Chief Counsel B gives a summary of the discussion with Counsel for FSA about Counsel for Equitable's Opinion on mis-selling of 7 June 2001. He reports that the advice of Counsel was that there needed to be significantly more work done before advice could be given.

Chief Counsel B reports that, at the meeting on 14/06/2001 [**15:00**], only Equitable's draft actuarial report had been discussed, as there had been no update from Equitable's solicitors on the proposals for the different policyholder classes. Chief Counsel B also informs the group of the discussions that had taken place with Equitable and their advisers on 15/06/2001 [**15:00**]. He notes it was clear that Equitable considered their current compromise proposals to be final. Chief Counsel B notes that the Director of GCD had expressed his concerns to the Director of Insurance and Managing Director A (see 15/06/2001 [**13:09**]) and had advised that the case for the compromise scheme had not been made.

18/06/2001 [17:37] FSA's Head of Actuarial Support informs the Head of Life Insurance, Line Manager E and the Director of Insurance of an informal meeting that afternoon with the Independent Actuary for the compromise scheme. The Head of Actuarial Support reports that the Independent Actuary had expressed some concerns about the scheme and had indicated that he was far from being happy with it. In particular, he was not convinced that the deal was reasonable for non-GAR

	policyholders. The Independent Actuary had also mentioned that he had not seen FSA's letter of 14/06/2001 or their comments on the actuarial paper. The Head of Actuarial Support suggests that there was a strong chance that the Independent Actuary would not give his approval to the scheme unless Equitable were able to provide a more substantive rationale for the details of it. [**18:21**] Chief Counsel A suggests to the Director of Insurance that he should ask Equitable's Chief Executive, when they met the following day, whether FSA's letter of 04/06/2001 [**12:41**], (about defects in the Independent Actuary's terms of reference), had been discussed with the Independent Actuary.
18/06/2001 [17:54]	The Personal Investment Authority Ombudsman send FSA a copy of a letter they had sent to Equitable on 15 March 2001 about the Society's Rectification Scheme.
18/06/2001 [18:08]	FSA's Chief Counsel B provides advice to Line Manager E on the Rectification Scheme, in response to his note of 12/06/2001 [**12:38**]. The Chief Counsel explains that his earlier advice '*suggested that it would be inappropriate to agree to an arrangement which effectively deprives the policyholder access to* [the Personal Investment Authority Ombudsman], *but as I see it this is precisely what the scheme will do*'. The Chief Counsel advises that Equitable's explanations '*are very unclear about how they will inform policyholders about the availability of the Ombudsman – I think they should be pressed to make the position clear, and for our part we should make clear the limits we think should be observed in terms of the Equitable's ability to exclude jurisdiction*'. Chief Counsel B also provides some advice in relation to the LAUTRO/PIA Rules on advertising and on '*Product Particulars*' and 'Key Features' documents. [**18:16**] Line Manager E says that he shares Chief Counsel B's '*unease over* [Equitable's] *interpretation of what had been said previously. Intuitively it seemed odd to say "If you disagree with our view you may have it reviewed by one third party. You may choose whether to opt for a third party under our direct control or one who is independent".*' [**21:32**] PIA inform FSA that Equitable had told them that, due to the concerns expressed by PIA and the Personal Investment Authority Ombudsman, the Society now proposed that the arbitrator should act as an adviser and mediator and to permit policyholders who had used this avenue to refer the matter to the Personal Investment Authority Ombudsman, should they remain dissatisfied.
18/06/2001 [19:31]	Equitable's solicitors send FSA a copy of a paper they had prepared on 6 March 2001 on the determination of voting classes.
19/06/2001 [09:54]	FSA's Chief Counsel B informs Managing Director A and the Director of Insurance that he agreed with the thrust of the proposed reply to the Member (see 14/06/2001 [**19:53**]) and that there was no regulatory reason why Equitable should not provide personalised valuations of GAR policies. The Chief Counsel says that he assumed that FSA '*would be concerned if the Table were to give discounted values based upon the actuarial assessment of the take up rate for GARs – or at least if they do so without informing policyholders that this is the case*'.
19/06/2001 [10:01]	FSA's Head of Actuarial Support comments on Equitable's solicitors' paper that he sees: '*very little match between this note (evidently produced in March!) and the recent draft actuarial report. This note suggests that* [Equitable's solicitors] *are looking for a sophisticated distribution of the "substitute benefits" that reflects the different potential interests of policyholders holding around 58 (or more) different types of policy. The actuarial report (dated 7 June) has identified at present less than 10 such sub-groups, I believe, for which different levels or types of benefits might be given*'.

19/06/2001 [16:22]	FSA thank the Personal Investment Authority Ombudsman for the copy of their letter (see 18/06/2001 [**17:54**]) and note that they understood (from Line Manager E) that Equitable might now be '*shifting back to using an independent "assessor" not arbitrator, and acknowledging that policyholders should not be deprived of their right to pursue a complaint with the Ombudsman*'. FSA comment that they thought that was the correct approach.
19/06/2001 [16:28]	Further to 18/06/2001 [**18:08**], Chief Counsel B queries with Line Manager E how the Rectification Scheme fitted with the compromise scheme. [**17:45**] Line Manager E explains that the compromise scheme would buy out GAR rights that had not yet been exercised, rather than the Rectification Scheme which was relevant to GAR policyholders who had not taken an annuity at their guaranteed rate before the House of Lords' decision.
20/06/2001 [09:55]	Following further discussion of the proposed reply to the Member of 14/06/2001 [**19:53**], FSA's Head of Actuarial Support says that he felt '*apprehensive about placing too much emphasis on these "policy values"*'. The Head of Actuarial Support explains that such policy values '*are intended only to be an illustration of the amount that may be available to meet any claim. Indeed, we know from our meeting yesterday that* [Equitable] *are becoming increasingly concerned about the widening gap between these policy values and the actual investments held to cover them. Accordingly, they are looking at contingency plans to cut the final bonuses that have been previously added to these illustrated policy values in the event of any significant fall in equity values, and would also like to be able to make further significant switches in their investments. In particular, they are worried about the possibility of a 10-15% fall in the markets which could leave them technically insolvent on the statutory basis (and could also cause problems then with their financial reinsurance)*'.
20/06/2001 [entry 2]	Equitable send FSA copies of correspondence that they had had with the Guernsey Financial Services Commission about the differential treatment of international policyholders. Equitable's reply to the Commission states: *I'm not sure that I agree that a new angle has been reopened up by the* [Society's Counsel's] *Opinion. The issue of ring fencing was clearly before the House of Lords and, while it is undoubtedly extremely difficult to discern their intentions, there is no doubt whatever that they were aware of the existence of non UK business, and that they appeared content to allow a measure of ring fencing in that case. Whether or not this is consistent with the remainder of their judgement is virtually impossible to say ...* *We are in regular dialogue with the FSA as you may imagine, and we will raise this issue specifically at our next visit ... We have asked* [Counsel] *to undertake further work to see if clarification of some of the more obscure implications of the judgement is achievable.* FSA's Line Supervisor C notes: '*I don't remember this point, do Guernsey want their policies ring fenced and excluded from GAR exposure? Or are they concerned about being ring fenced in some other way?*'.
20/06/2001 [entry 3]	FSA inform Counsel of developments on Equitable, providing copies of the material that Equitable had provided to their Counsel. FSA also refer to other issues.
21/06/2001 [17:40]	Equitable send FSA a copy of a report entitled '*Management Report on the Compromise Scheme Strategic Decisions Group*'. Equitable explain that it detailed the compromise scheme, its principles and the arguments in favour of it. Equitable ask for comments on the paper by 26 June 2001.

21/06/2001 [17:56]	Equitable send FSA written answers to the questions raised in their letter of 14/06/2001. In relation to question 10, Equitable say that:

This is a difficult issue. Our current thinking subsequent to the 7 June Actuarial Report is that the calculation of enhancements should be in two stages.

In the first stage, the total costs of GARs would be calculated on a "best estimate" basis using assumptions based largely on previous experience (other than the interest rate assumption, of course). For Group Pensions business that would mean basing the costs of GARs based on a take-up rate which was closer to 40% rather than being 60% (as in the 7 June report). That would establish a value for the costs of GARs which would be met by non-GAR policyholders.

In the second stage, that calculated total cost of GARs would be allocated on the basis of the relative potential values of the GAR options (by assuming a 100% take-up rate by all policyholders). The enhancements for Group Pensions would be exactly the same as for Individual Pension Plans and would take no account of the fact that the take-up rates for the two groups of policy were significantly different.

This approach is illustrated by the following example calculation using the values tabulated in section 4.4 of the 7 June Actuarial Report. The first column shows the first stage calculation of the total amount to be distributed assuming a 40% take-up rate for Group Pensions and 60% for all other groups of GAR business, which is £1,363m. The second column shows the second stage calculation based on a 100% take-up rate (and the same GAR annuity format for both Group Pensions and Individual Pensions business) to determine the allocation percentages shown in brackets. Those percentages are applied to the £1,363m total value from the first column to calculate the value allocated to each of the three groups of GAR policy which is shown in the third column.

	GAR value – experience	*GAR value – potential*	*GAR value – allocated*
Retirement Annuities	*£939m*	*£1,565m (62%)*	*£845m (62%)*
Individual Pensions	*£217m*	*£362m (14%)*	*£196m (14%)*
Group Pensions	*£207m*	*£597m (24%)*	*£322m (24%)*
Total	*£1,363m*	*£2,525m (100%)*	*£1,363m (100%)*

	Policy Value	*GAR value allocated / Policy Value*
Retirement Annuities	*£4,395m*	*19.2%*
Individual Pensions	*£929m*	*21.0%*
Group Pensions	*£1,532m*	*21.0%*
Total	*£6,856m*	*19.9%*

The fact that members of some group pension schemes can receive very generous annuity rates from their schemes is not the concern of the Society and is something that cannot be measured (i.e. because the Society has no details).

22/06/2001 [10:41]	FSA's Chief Counsel B informs the Head of Actuarial Support that Counsel would like to meet him the following week to discuss the impact of the House of Lords' decision and what Equitable would have done had they previously acted in accordance with it.

22/06/2001 [12:14] FSA's Line Supervisor C informs the Head of Life Insurance and Line Manager E that, in relation to the note of the meeting with Equitable on 15/06/2001, Chief Counsel A: '*felt uncomfortable with subsequent developments relating to the change of policy re top ups. In sum, when relinquishing the right to top up are GAR policyholders going to be made aware that if they have not topped up their policy in the last 12 months they will not fare as well as GAR policyholders that have*'.

25/06/2001 [09:07] Equitable send FSA a summary of the key points and action arising from their meeting about the compromise scheme on 15/06/2001.

25/06/2001 [10:17] Equitable send FSA weekly customer servicing information, which no longer includes data on the amounts leaving the with-profits fund.

25/06/2001 [13:16] Commenting on Equitable's response of 21/06/2001 [**17:56**] to FSA's questions about the compromise scheme, FSA's Head of Actuarial Support says that it was largely as expected but notes that not all the information had been provided. He also says that the answer to a question about how the scheme intended to deal with group scheme policyholders looked '*dubious*' and should be referred to FSA's legal advisers.

25/06/2001 [15:27] FSA's Line Manager E reports on a conference call that he had just had with Equitable about the compromise scheme and the work that Equitable needed to do before a meeting of their Board on 25 July 2001. The Line Manager says that he had agreed to '*come up with a list of* [FSA's] *key criteria for judging the proposals*' and to provide comments on the management paper. Line Manager E had also informed Equitable of the need for a '*properly argued and supported package*' of materials for FSA to consider, which was presently missing.

25/06/2001 [16:00] FSA hold an Equitable Life Lawyers Group meeting. Chief Counsel B notes that, in relation to the compromise scheme, Counsel had expressed the view that '*FSA's interest lay in the fairness of the scheme proposed by Equitable*' and that '*it was probably inappropriate for the FSA to form a view as to the number and make up of the classes of policy holder as this was a matter to be determined at the final hearing and not at interlocutory stage*'.

Chief Counsel B informs the group that a lawyer had been appointed on secondment to look at the complaints under the Unfair Terms in Consumer Contracts Regulations 1999 about Equitable's application of the market value adjuster.

Under '*Any Other Business*', Chief Counsel A notes that Equitable's Board was due to consider the compromise scheme proposals on 25 July 2001 and that this date: '*was now quite close and as yet the FSA had not received fundamental GAR and non-GAR material and some that had been received was not in the correct form …* [Chief Counsel A] *stated that no draft scheme had yet been seen only internal uncompleted actuarial reports plus various pieces of oral information provided at weekly meetings*'.

Chief Counsel B informs the group that: '*it had still not been resolved as to whether the Equitable's legal advice and board minutes could be shown to the FSA. Whilst the company had not yet refused access they probably would do so on the basis of legal advice. It was generally felt that we could not demand the advice as there was no relevant power in* [ICA 1982]'. Legal Adviser A undertakes to confirm the position.

25/06/2001 [16:46] FSA's Line Manager E prepares '*some fairly general propositions*' on the tests that FSA might apply for evaluating the compromise scheme, which are set out under the following headings:

Is it better than any alternatives?
Line Manager E notes that the compromise scheme, by its very nature, involved some kind of loss of rights, and that: '*It would ... seem likely that were the offer a more attractive proposition for policyholders than the rights they currently enjoy, that the Society would not need to go through this process to achieve its objectives*'. He says that, therefore, FSA:

> *... need to consider whether the alternatives are any better. The alternatives appear to be a sale of the business to achieve new capital support (ruled out), a winding up (or similar) process under the Insolvency Act 1986 (undesirable consequences) or continuing without the benefit of the compromise.*

Is it fair?
Line Manager E notes that it would be difficult to achieve fairness to all policyholders where they did not all have the same kind of rights that were being given up, and that FSA:

> *... need also to recognise that may be difficult where there are a range of uncertainties that make it ... impossible to establish the future worth of the rights in any particular case. By implication this means that an averaging process must be used. Our analysis must therefore consider whether the basis for the averaging is fair, so that it does not aim or have the effect of treating one group materially, and deliberately, worse than another.*

Is it reasonable?
Line Manager E notes that the answers to the first two questions were important elements in deciding whether the scheme was reasonable.

What are the justifications?
Line Manager E explains: '*In order to reach a view on these things, we will require some explanation of why a particular methodology was used to decide between different potential choices. This includes having an understanding of the underlying assumptions made to decide on the variables to be used for the calculations, and having evidence to justify those choices*'.

Burden of proof
Line Manager E says: '*Notwithstanding the above, there are difficult choices about the severity of the test. For example, do we have to be satisfied that the scheme is "fair" or "not unfair". To the extent that there is likely to be a material difference between the two, it seems to me that "not unfair" is the more appropriate test on the basis that if there is a grey area, the voting and court process provide adequate additional safeguards to ensure that an unfair (etc) is not adopted, without the FSA needing to be interventionist to the point of preventing individuals exercising their own reasoned choices*'.

26/06/2001 [11:44] FSA's Head of Life Insurance sends Line Manager E a note on the '*Development of FSA's Position*' with regard to the compromise scheme, further to a brief discussion about the issue that morning between the Head of Life Insurance, the Director of Insurance and the Director of GCD. The Head of Life Insurance explains that it had been agreed that it would help to '*concentrate our minds*' to focus on two practical aspects, with the first being:

> *Our response to Equitable's request for an indication of the criteria against which we would judge their compromise. You have already set some work in hand on this. I set out below my attempt at some criteria, taking account of the discussion with* [the Director of Insurance] *and* [the Director of GCD]*:*
>
> *1. The compromise should be as fair as possible to all policyholders, bearing in mind the practical constraints (including the timing constraint imposed by Halifax's deadline for further financial support);*

2. The proposal should leave no policyholder worse off than he or she would be in the absence of a compromise, bearing in mind the likely alternative scenarios;

3. The compromise should be fair enough to enable the Court to enforce it on all policyholders.

The Head of Life Insurance asks Line Manager E for comments on this '*first shot*'. Secondly:

We agreed that it was not too soon to begin to consider what we would wish to put in an FSA information sheet to policyholders, assuming that we decide in due course to issue one. It is likely that there would need to be at least two elements to this:

1. Our comments on the compromise scheme (which we cannot draft yet, as we do not have enough information from Equitable);

2. A description of the alternatives if the scheme is rejected. These would include:

(a) Winding up

(b) The company staggering on. This scenario should be broken down into at least two alternatives, representing "best" and "worst" scenarios. The "best" scenario would be a fund which was still exposed to GAO liabilities, including the risk of further top ups; the "worst" scenario would envisage in-fighting between different groups of policyholders, costly litigation draining the fund, and the departure of the current chairman and chief executive, and possibly other members of the board and management.

The Head of Life Insurance asks Line Manager E to prepare a draft, with contributions from others, including their Insolvency Practitioner, on the winding up alternative, and from their actuaries, on the financial implications of the various scenarios, '*which ... should be quantified as far as possible*'.

[**14:15**] FSA's Managing Director A says that this was going to be '*a hugely important piece of work ...* [and] *it is vital that we get the whole of the FSA's relevant resources in on this*'. On the substance of what FSA needed to do, he writes that he was not clear whether Equitable's proposals involved non-GAR policyholders giving up any rights ('*misselling or whatever*'), and:

... This seems to me to matter enormously, because it will affect what we are able to say. Personally, I hope the compromise covers everything, as I see no other way to clear the ground and let the Society make a fresh start; but if it is to do that, there are more issues for us to cover. What are we to say about the worth of the possible claims for mis-selling especially given the potential conflict seeing that we are one of the parties who would almost certainly be involved in a dispute over whether or not mis-selling had occurred.

FSA's Managing Director raises a second point, that he believed:

... [the Head of Life Insurance's] *criterion "no-one should be worse off than they would be under no compromise" is a highly debateable one. First, is it tenable? It would seem to mean current GAR holders probably being offered more than a compromise in aggregate can "afford" (the capital uplift in return for loss of the income guarantee is obviously pretty unattractive for some sub-sets of the GARs). The only way it might be tenable would be if the compromise were all-inclusive and if the non-GAR holders' chances of undermining the* [House of Lords'] *judgement seemed pretty high (that might be enough to frighten the GAR holders into accepting less) and/?or if the compromise were much more complex than hitherto anticipated. [This would allow a closer correlation between current value of individuals' guarantees and what was offered in the compromise; its great drawback is the likelihood that it would proliferate the number of classes and render acceptance very unlikely].*

Second, there must be other versions of the criterion that might attract more support [in economic jargon this is a welfare maximisation problem and there are numerous different optima that can be postulated. If so we need to have fleshed out how the compromise would look on these different criteria].

Managing Director A raises a final point which is his '*biggest worry (on which we have touched on several times in recent weeks)*', that is:

> ... *what information can reasonably be provided to policyholders.* [The Head of Life Insurance] *has clearly picked up the need to address the counterfactuals – they will be difficult. Where I have* [no] *real feel is over information on the compromise itself.* [Briefly], *most policyholders ... probably feel they are owed nothing less than a "market valuation" – of undoubted veracity (and thus preferably not provided by Equitable) for their own personal situation (in some cases with bells and whistles e.g. "what would my market valuation be if there is no compromise and I put in £x a year for the next 5 years?") Can such things be provided? I rather doubt it. Can people be given a "do-it-yourself" pack? If yes then why can't the Society do it for them? And so on.*
>
> *What I fear we are going to get is some kind of generic representation of the "typical policies for a man aged 40 who has been contributing for 10 years" variety. Surely we are going to have to satisfy ourselves that what is proposed is the best that can reasonably be done in the circumstances.*

FSA's Managing Director A concludes by saying: '*I also fear (I hope someone can prove me wrong) that a terrible* [public relations]*/real quagmire exists for us over the whole issue of the subtle tradeoffs there will be between overall cost, fairness to the individual, simplicity of the scheme, and information that is needed for a proper assessment by the individual*'.

[**16:34**] The Head of Life Insurance says that FSA would involve their Consumer Relations Directorate and others. He says that FSA were pressing ahead with the aspects of the scheme that were not dependent on issues that Equitable were yet to make decisions on.

[**16:58**] Line Manager E provides some further information in response to the Managing Director's comments. On Equitable's timetable, he says that Equitable were expecting FSA to give a '*no fundamental objection clearance*' before their Board meeting on 25 July 2001. On his first point, Line Manager E explains that Equitable's current proposals were for a compromise of GAR rights only but: '[Counsel] *has been commissioned* [by Equitable] *to report back in time to inform the final design, and decisions on what should be done about possible miss-selling claims will be taken once they have received his report. At the moment they are working on the basis that there is no grounds for action, or that if there were the cost would be minimal*'.

On his second point, Line Manager E writes:

> *That "No-one" should be "worse off" is clearly a very high hurdle to clear, and in its strictest terms would make any scheme unattractive because of its cost. I suspect we need to think of people not being worse off in aggregate (against some benchmark yet to be determined – but presumably centred around current experience about the variables on interest rates, annuity rates, mortality, retirement patterns and so on), and that within that generality, no one is being treated in an especially discriminatory and disadvantageous way.*

Line Manager E says that he shared the Managing Director's initial thoughts on the information to be provided to policyholders and that:

> *... I think to the extent our powers (including those of persuasion) allow, we will need to ensure that the Society takes this very seriously ... Presumably the court will not accept the scheme unless it clearly specifies what people will get (and people can be*

demonstrated to have known this at the time they voted). Given the discretionary nature of the benefits under a with-profits contract, there must be a process that will lead to GAR policyholders being given some kind of statement. What is possible or desirable needs thinking through very carefully since, among other things, there will be a trade off between the amount of information and consumer friendly presentation. I had proposed to bring [FSA's Consumer Relations Directorate] *more directly into the loop once the package had been settled sufficiently for us to work up some ideas. That detailed information probably needs to* [be] *ready for the end of the summer when the offer is formally made, but there is clearly a communications job to be done before then.*

26/06/2001 [13:17] FSA's Head of Actuarial Support tells Chief Counsel A that he was uncomfortable with Equitable's response to question 10 raised on 14/06/2001 [**15:14**] and he suggests that FSA should seek the advice of Counsel on it. The Head of Actuarial Support also says that FSA did not yet have enough information '*to feel comfortable with the level of uplift to be offered to each possible sub-group of policyholders, and in particular the extent to which this might vary by age*'.

27/06/2001 [08:56] FSA's Managing Director A thanks Line Manager E for his comments of 26/06/2001 [**16:58**], adding that his own feeling '*is that it is quite impossible for us before 25 July to give them the "no objection in principle" reply that they seek*'.

27/06/2001 [14:30 - 18:30] FSA hold a conference with Counsel with the purpose '*to discuss/decide whether the FSA could approve in principle Equitable's proposal to base s.425 Compromise on a value of GARs discounted by 60%*'. FSA record that:

> [Counsel] *pointed out that if the Equitable was insolvent then there would be a calculation of the just estimate of the full GAR rights.*
>
> *It was agreed that unless the threat of insolvency was more real than presently indicated in Equitable's documents to-date, a s.425 Compromise could not be justified ... the Actuarial Report dated 7 June 2001 did not indicate that the With-profits fund was under any threat of potential insolvency.*
>
> [Chief Counsel A and Scrutinising Actuary F] *explained that Equitable's statutory returns as of 31.12.2000 showed assets of approximately £400m only ie the Equitable was holding £1.6bn to cover £1.2bn for a total fund of approximately £34bn.* [Chief Counsel A] *said that the FSA was satisfied that the Equitable's financial situation was sufficiently uncertain to justify a s.425 Compromise.*
>
> ... [Counsel] *warned that a court would be unlikely to sanction a s.425 Compromise which required policyholders to give up valuable legal rights if it was solvent.* [Counsel] *queried whether a regulator should permit such a use of the s.425 procedure. Further there was some doubt in legal circles as to whether it should be used by solvent insurance companies.* [Chief Counsel A] *said in* [the case of another company] *that s.425 Compromise policyholders were giving-up only the potential right to a future distribution of assets.*

Counsel states that '*FSA could only provide the indicative approval the Equitable sought by its 25th July Board Meeting if it was satisfied that the s.425 Compromise was better than any other alternatives*'.

Counsel agrees that Equitable's answer, in response to question 10 in FSA's letter of 14/06/2001, that '*Equitable would calculate the cost of the GAR at 40% and then distribute on the basis of 60% take-up was highly questionable*'.

Chief Counsel A says that an option that had not yet been explored by Equitable was to buy out GAR top up rights only. It is noted that this would '*deal with the supposed instability of the With-profits fund but would leave the Equitable with the problem of reserving on a prudent basis of full take-up of GAR rights*'. Counsel suggests that FSA might need to require an explanation for why Equitable had based the compromise scheme on a 60% take-up rate of GARs when they had been required to set their reserves on a 90% take-up rate.

Chief Counsel A also reports that Equitable's Board were that day considering whether to '*exercise its contractual right not to allow policyholders to top-up where no premium had been paid in the previous year*'. FSA note that it had been agreed that '*notice to policyholders was an essential requirement*' and that '*Counsel queried whether the Equitable could now enforce this right having not done so for 20 years*'.

Under '*Conclusion*', it is recorded that '*Counsel advised that if s.425 was properly reasoned then there was no legal reason why the Equitable should not put forward a compromise based on the cost of the GARs rather than value and that FSA could properly indicate its approval to such an approach*'.

Under '*Action Points*' it is agreed:

- *GAD to do further work on the value of GAR rights as opposed to the cost.*
- *Equitable to be asked to consider valuing GAR rights by the Financial Option Theory method.*
- *Equitable to be asked to do further work and provide an explanation for the lower take-up rates of GAR rights by group schemes.*
- [Chief Counsel A] *to raise with Equitable/*[their solicitors] *the need for proposed Pre-Directions Hearing on voting classes.*
- *FSA to send a letter to Equitable supporting in principle the cost as opposed to value approach in calculating GAR rights.*

Submission of the 2000 regulatory returns

28/06/2001 [entry 1] **Equitable submit their 2000 regulatory returns to FSA**. Accompanying those returns are copies of the Society's annual report and accounts for 2000, prepared in accordance with the Companies Act 1985 and dated 11 April 2001. (See 30/04/2001 [**17:13**].)

The returns include the following information about Equitable's business and financial position as at 31 December 2000.

The returns
Equitable's returns are submitted in one part covering Schedules 1, 3, 4 and 6 to the ICAS Regulations 1996.

Schedule 1 (Balance sheet and profit and loss account)
Schedule 1 of Equitable's returns consists of Forms 9, 10, 13, 14, 15 and 17. Form 9 summarises the Society's financial position at 31 December 2000 as follows:

Long term business admissible assets	*£34,257,185,000*
Total mathematical reserves (after distribution of surplus)	*£32,894,405,000*
Other insurance and non-insurance liabilities	*£730,961,000*
Available assets for long term business required minimum margin	*£631,819,000*
Future profits	*£1,000,000,000*
Total of available assets and implicit items	*£1,631,819,000*
Required minimum margin for long term business	*£1,220,923,000*
Explicit required minimum margin	*£203,487,000*
Excess (deficiency) of available assets over explicit required minimum margin	*£428,332,000*
Excess (deficiency) of available assets and implicit items over the required minimum margin	*£410,896,000*

In Form 13, Equitable set out their admissible assets.

In Form 14, Equitable set out their long term business liabilities and margins.

Schedule 3 (Long term business: revenue account and additional information)
As in previous years, Schedule 3 consists of Forms 40 to 45.

In Form 40, Equitable provide a revenue account.

In Form 41, Equitable provide an analysis of premiums and expenses.

Schedule 4 (Abstract of valuation report prepared by the Appointed Actuary)
In the 2000 returns, Equitable change the presentation of the report of the valuation of their long term liabilities. Instead of presenting a gross premium valuation in the main part of Schedule 4 and a net premium valuation as an appendix, Equitable present a gross premium valuation only.

As in previous years, the results of the valuation are carried forward, unadjusted, from Form 58 to Form 14 and on to Form 9.

Schedule 4 of Equitable's returns provide the information required by paragraphs 1 to 23 of Schedule 4 to the ICAS Regulations 1996 and includes Forms 46 to 49, 51 to 58, 60 and 61.

Schedule 4 (text)
Equitable state that the valuation is made in conformity with Regulation 64 of ICR 1994.

In response to paragraph 4, Equitable provide 11 pages of information about their non-linked contracts. Most of the description provided is identical to that supplied in the previous returns.

In relation to all accumulating with-profits contracts, in paragraph 4(1)(a)(i) Equitable include a slightly expanded description from the previous returns of the circumstances in which – and the methods by which – adjustments could be made to surrender payments. The explanation provided says that:

> *The purpose of the financial adjustment is to protect the interests of policyholders who are not choosing to surrender policies early while still providing those who are surrendering policies with a fair and reasonable value. The current method of adjustment is to pay a proportion of the full policy value but there is no guarantee that that method will be used in future. In particular the Society has set the financial adjustment at a proportion of the final bonus in the past and may do so in the future or may introduce another method.*

In response to paragraph 5 of Schedule 4, Equitable provide 74 pages of information about their linked contracts.

In paragraph 6, Equitable set out the general principles and methods adopted in their main valuation.

Following amendments made to Regulation 72 of ICR 1994, Equitable include a new paragraph in this section on their approach to reserving for surrender values to reflect those amendments. They state:

> *For accumulating with-profits business the reserve for the amount of a cash payment secured by the exercise of an option to surrender the policy has been calculated as the discounted value of future guaranteed benefits. That amount is consistent with that which could reasonably be expected to be paid if the option were exercised having regard to representations to policyholders, in the event of a significant level of policy discontinuances. The bases to be used in the event of surrender or transfer are not guaranteed and, the primary objective when setting the basis is to protect the interests of the continuing with-profits policyholders.*

For with-profit retirement annuity contracts, as in previous years, Equitable state that '*benefits have been valued on the basis that the benefits will be taken at age 60 or, if that age has been attained, at the valuation date*'.

For with-profit personal pension plan contracts, Equitable state that '*benefits have been valued on the basis that the benefits will be taken at age 50 or, if that age has been attained, at the valuation date*'. This is a change from the previous year, where a retirement age of 55 had been assumed (which was itself a change from an assumed age of 60 within the 1998 returns).

Equitable state that a general reserve of £150m was held '*as a provision to ensure that the valuation is, in aggregate, prudent as required by Regulation 64 and includes consideration of issues such as managed pensions review and possible future improvements in mortality*'.

As in previous years, Equitable disclose:

> *The valuation method makes specific allowance for rates of future reversionary bonus additions, the levels of which are consistent with the valuation interest rates employed having regard to the reasonable expectations of policyholders and the Society's established practices for the determination of declared bonus rates. The balance of the total policy proceeds, consistent with policyholders' reasonable expectations, will be met*

> *by final bonus additions at the time of claim. Such additions are not explicitly reserved for in advance but are implicitly covered by the excess of admissible assets over mathematical reserves.*

Unlike in previous years, the paragraph continues:

> *It is assumed that adjustments will be made to final bonus to ensure that this remains the case in the future.*

Equitable state that they have made an explicit provision for their liability for tax on unrealised capital gains (in relation to business other than that linked to their internal funds), which they now estimate as not exceeding £100.6m. The provision made is £110m, which they say is shown in the Appointed Actuary's certificate in Schedule 6 of the returns.

In paragraph 6(1)(g) relating to investment performance guarantees, as in previous years Equitable state that they do not consider it necessary, in current conditions, to hold a reserve for the guarantee they offer on a unit-linked annuity.

In paragraph 6(1)(h), Equitable disclose that they had set up reserves for the annuity guarantees on their '*Pension contracts – old series*' business. They explain the assumptions used in establishing those reserves concerning the take-up rate of the annuity at a guaranteed rate and cash commutations. As in the previous returns, Equitable state that the '*combined effect of the allowances made is that of these policies which survive to retirement date ... the gross reserves are reduced by less than 5%*'.

Equitable strengthen the mortality assumptions used when estimating the expected future annuity rates for males that are used to value the GAR liabilities. Equitable also change the valuation rate of interest for the expected future annuity rates to 5¼% for annuities expected to be taken out in the year following the valuation (from 5¾%), with lower future rates for annuities expected to be taken out in later years. This takes account of Regulation 69(9)(a) of ICR 1994.

As in previous years, in paragraph 6(2) Equitable state that, in determining the provision needed for resilience reserves, they have taken account of the fact that the long term fund has been valued at book value.

In paragraph 7(5), Equitable explain that they consider the reserves for future bonus within the valuation to be fully able to withstand any future strains which would arise if there were significant changes in mortality or morbidity experience. They say that, accordingly, the Society does not consider it necessary to establish any additional reserves in this respect.

In paragraph 7(6), Equitable provide a description of the scenarios that have been tested in order to determine the requirement to hold resilience reserves. They state which of the three scenarios tested produces the most onerous result.

Equitable disclose that a resilience reserve of £1,390m was provided for.

In paragraph 7(8)(a), Equitable disclose the changes made to the valuation assumptions and methods in the resilience scenarios. They explain:

> *It was assumed that the valuation has been undertaken using the gross premium method as described in section 6(1) for all business except that for with profits business where the benefits are determined from outset in relation to the total premiums payable where a net premium method has been used. The following changes have been made:*
>
> > *(i) the interest rates are as stated in Form 57.*
> >
> > *(ii) for all accumulating with profits business, an annual loading of 1.5‰ increasing by 4% per annum compound of the basic benefit was reserved. That is considered to be a prudent allowance for ongoing expenses.*

(iii) the mortality table used for accumulating with-profits pensions business was adjusted to AM80 ult- 5 years.

(iv) the reserve in respect of the potential liability to tax on capital gains was reduced to £18.1m.

(v) no future bonus was assumed which is consistent with the reasonable expectations of policyholders having regard to the current rate of bonus and in the event that experience were to follow the valuation basis.

As Equitable have no longer presented a main and an alternative appendix valuation of their long term liabilities, their response to paragraph 8(d) is different to that provided in previous returns.

Paragraph 8(d) of Schedule 4 to the ICAS Regulations 1996 requires, in respect of non-linked contracts: '*where, in valuing contracts falling within the circumstances described in regulation 67(1) of the Insurance Companies Regulations, future premiums brought into account are not in accordance with that regulation, such additional information as is necessary to demonstrate whether the mathematical reserves determined in the aggregate for each of the main categories of contract are greater than an amount for each such category calculated in accordance with regulations 66 to 75 of those Regulations*'.

Instead of the 112 pages of information that made up the appendix valuation report in the last returns, in the 2000 returns Equitable include one page of information in which they disclose:

For with profits contracts where the benefits are determined from the outset in relation to the total premiums payable a further valuation has been undertaken using the net premium valuation method. The bases employed are in accordance with Regulations 66 to 75 of the Insurance Companies Regulations 1994. The mathematical reserves for that business are lower than those calculated on the methods and bases described in this report and are given below:

Life assurance and general annuity business:

Type of insurance or name of contract	*Amount of Mathematical Reserves (£000)*
With Profits	
Whole Life Assurance	*38,010*
Endowment Assurance	*153,619*
Endowment Assurance with guaranteed minimum death benefit	*128,662*
Flexible Savings Plan	*12,151*
Deferred Annuity	*5,525*
Miscellaneous (assurances)	*1,848*
With Minor Profits	
Whole Life Assurance	*142*
Endowment Assurance	*81*
Miscellaneous (deferred annuities)	*6*

Pension business:

Type of insurance or name of contract	*Amount of Mathematical Reserves (£000)*
With Profits	
Endowment Assurance	*108,499*
Deferred annuity with return of premium on death	*62,942*

Equitable go on to state:

> *The mathematical reserves determined in the aggregate for all categories of contracts referred to in sub-paragraph (d) above represent less than 5% of the total mathematical reserves (after deduction of reassurance cessions) for all non-linked contracts. The mathematical reserves for each category of contracts are greater than the mathematical reserves that would be determined on a net premium reserving basis.*

In paragraph 12, Equitable describe the IRECO reinsurance treaty. Equitable disclose that the treaty now comes into effect where the proportion of policyholders taking an annuity at their guaranteed rate exceeds 60% (previously 25%) of total retirements in that year. They also disclose that the premium payable since the last set of returns was £797,675 (previously £850,000).

In paragraph 13, Equitable disclose: '*The Society has no business where the rights of policyholders to participate in profits relates to profits from particular parts of the long term business fund*'.

In paragraph 14, Equitable set out a statement of their aims with regard to bonus distribution and of how they maintain equity between different generations of policyholders. The information provided on the stated principles underlying their approach is the same as that provided in the 1998 and 1999 returns, with the addition of the following paragraph:

> *... following the House of Lords' judgment guaranteed annuity rates (where applicable) are applied to the full policy value (including any final bonus element). Where those guarantees mean that the value of benefits taken is greater than the asset share then this additional value is paid for by a reduction in the asset share for all with-profit policyholders.*

In paragraph 15, Equitable disclose that (except for German policies) no bonuses have been declared for 2000. They also state that:

> *Although the valuation allows for the declaration of bonuses as set out in 6(1)(e) no declared bonus is currently being declared, and this position is likely to continue throughout 2001 and for some period thereafter.*

In paragraph 16, Equitable set out final bonus rates. Under the heading '*Maintenance of Final Bonus Rates*', Equitable disclose:

> *The directors reserve the right to reconsider the rates of final bonus at any time. In particular directors will need to ensure that the final bonus policy and the level of any financial adjustment are such as to allow the Society to maintain its solvency.*

In paragraph 21(2), Equitable disclose:

> *The rates of interest on fixed interest securities have been determined using the aggregate yield basis, i.e. by calculating the rate of interest as the rate which equates the discounted value of the aggregate cash flows. The fixed interest portfolio (excluding convertible fixed interest securities) has been separated into two segments of securities which have like attributes (being the categories on Forms 48 and 49), i.e.*

- *approved fixed interest securities, and*
- *other fixed interest securities.*

In explaining the description of the method by which the yield on assets other than equity shares and land was adjusted in accordance with regulation 69(7) of ICR 1994, unlike in previous years, when the maximum yield was given, Equitable state:

> *The yields on non-approved fixed interest securities have been reduced having regard to the credit rating of each security. The reduction in yield is calculated according to the following table:*

Credit Rating	*Yield Reduction*
AAA	*0.12%*
AA	*0.19%*
A	*0.34%*
BBB	*0.80%*
BB	*1.50%*
B or less	*4.00%*

> *Where stocks are unrated an appropriate rating was ascribed.*

Schedule 4 (forms)
In Form 46, Equitable provide information on changes to their ordinary long term business.

In Form 47, Equitable provide an analysis of their new ordinary long term business.

Form 48 shows that 51% of Equitable's non-linked assets are invested in equities, 7% in land, 34% in fixed and variable interest securities and the remaining 8% in a variety of other assets.

In Form 51, Equitable set out the mathematical reserves held for various types of non-linked contracts (excluding accumulating with profits contracts) along with information on the number of contracts in force, the benefits valued, and the rates of interest and mortality assumptions used.

In Form 52, Equitable set out the mathematical reserves held for accumulating with-profits policies, along with information on the number of contracts in force, the benefits guaranteed, and the rates of interest and mortality assumptions used in valuing them. The mathematical reserves are not discounted from the current benefit value. The Form 52 for '*Pension business*' discloses that the gross total reserve for '*Options and guarantees other than investment performance guarantees*' (i.e. the reserve for annuity guarantees) is £2,631m. The form also shows that this reserve has been reduced by reinsurance of £808m to a net total reserve of £1,823m.

In Form 53, Equitable set out the mathematical reserves held for the various types of property-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death, and the rates of interest and mortality assumptions used in valuing them. They again disclose that they hold reserves for non-investment options and other guarantees for many of their unit-linked policies.

In Form 54, Equitable set out the mathematical reserves held for the various types of index-linked contracts, along with information on the number of contracts in force, the value of current benefits, the level of benefits guaranteed on death or maturity, and the rates of interest and mortality assumptions used in valuing them.

In Form 57, Equitable provide matching rectangles, illustrating the notional allocation of assets to each category of liabilities, showing the valuation rates of interest supported, and the ability of the matching assets to cover the reserves in the resilience scenarios.

In Form 58, Equitable set out the valuation result and composition and distribution of fund surplus.

Supplementary notes to the returns
In the notes to the returns, set out at the end of Schedule 4, Equitable disclose that they have been granted a section 68 Order, which permits them to include in aggregate form details of their '*Personalised Funds*' in Forms 43, 45 and 55.

Equitable disclose that they have been granted a section 68 Order which permits them to take into account a future profits implicit item. The Society states that it had included an item of £1bn and that this was within the maximum amount permitted by the Order.

Equitable disclose that they have been granted a section 68 Order, enabling them to disregard amounts owing under the subordinated loan up to an amount not exceeding 50% of the required solvency margin.

In relation to the admissible assets disclosed in Form 13, Equitable state:

> *The Treasury, on the application of the Society, issued to the Society in February 2001 an Order under section 68 of the Insurance Companies Act 1982. The effect of the Order was to enable the Society to complete Form 13 as if the permitted asset exposure limit for shares and hybrid securities issued by* [a named company] *was 3.25% of the long term business amount.*

Also in relation to Form 13, Equitable state:

> *The Treasury, on the application of the Society, made in June 2001 an Order under Section 68 of the Insurance Companies Act 1982. The effect of the Order was to provide that the value to be ascribed to the Society's holding of shares in Permanent Insurance Company Limited was to be the amount agreed to be paid for the shares by Liverpool Victoria Friendly Society Limited.*

In relation to Form 14 and '*Charges, Contingent Liabilities, Guarantees, Indemnities and Contractual Commitments*', Equitable disclose that they are to undertake a review into whether there had been any mis-selling of Managed Pension policies. They say that, should the review find that mis-selling occurred in all cases, the liability would be up to £200m. Equitable state that any costs would be met from their general expense reserve of £150m.

Also in this section of the returns, Equitable state:

> *Subsequent to the House of Lords' decision in the case of Equitable vs Hyman in July 2000, a number of enquiries by various regulatory and professional bodies and other parties have been instigated including the Treasury Committee of the House of Commons. In those proceedings and elsewhere, certain policyholders have indicated they believe that they have grounds for an action against the Society for mis-selling of business due to the non-disclosure of the guarantees to GAR policyholders. There is the further possibility that other causes of action may arise. It is not possible to assess the impact of the outcome of these matters, if any, on the financial position of the Society and no provisions for contingent liabilities have been made.*
>
> *A fundamental uncertainty exists in respect of the outcome of any actions that may be initiated against the Society as a consequence of matters emerging from the various regulatory and other enquiries in progress, which are noted above.*

Equitable also disclose that:

> *In respect of policies with guaranteed annuity rate options, the House of Lords' decision will have an impact on the decisions of policyholders in the future as to the extent to which they continue to pay future contributions. The reserves have been calculated based on the limited experience to date but are substantially more prudent than this experience would indicate. There is fundamental uncertainty as to whether the future decisions of policyholders will conform to the assumptions made. As a result, the reserves could be either overstated or understated with a corresponding effect on the excess of available assets, and implicit items, over the required minimum margin.*

As in the previous year, Equitable disclose:

> *Under the Society's recurrent single premium contracts, the amount and frequency of contributions can be changed at any time without penalty, including ceasing future contributions completely. Most policyholders take advantage of this flexibility and there is consequently no precisely identifiable annual premium on recurrent single premium contracts. On Form 46 the annual premiums shown for recurrent single premium contracts are those which are not specifically identified as single premiums.*

In relation to the Form 57 matching rectangles and the determination of the rates of interest on fixed interest securities, Equitable provide a supplementary note that:

> *The Treasury, on the application of the Society, made in June 2001 an Order under section 68 of the Insurance Companies Act 1982. The effect of the Order was to require the Society to calculate the rates of interest to be used in determining the present value of future payments for approved fixed interest securities and other fixed interest securities (other than convertible fixed interest securities) on an aggregate yield basis. The aggregate yield equates the discounted value of the aggregate cash flows on such fixed interest securities with the total market value of such securities.*

<u>Schedule 6 (Certificates by directors, actuary and auditors)</u>
Equitable provide an additional statement in the returns on matters relating to the certificates of the Directors and Appointed Actuary. They say:

> *The decision of the House of Lords on 20 July 2000 relating to Guaranteed Annuity Rate policies, had a material impact on the Society's financial position. It substantially reduced the level of free assets held in excess of the margin of solvency required by section 32 of the Insurance Companies Act and led to the closure of the fund to new business.*
>
> *The certificates on the following pages, which should be read in conjunction with this statement, report on the position of the Society following the House of Lords' judgement using the actuarial bases and economic assumptions disclosed in Schedule 4. The bases carry margins of prudence beyond the Society's relevant experience. However, attention is drawn to the fundamental uncertainties in relation to the Guaranteed Annuity Rate "GAR" options and contingent liabilities that may arise from any actions that may be initiated against the Society as a consequence of matters emerging from the various regulatory and other enquiries in progress. These matters are described in supplementary note 1402 to these returns.*
>
> *The closure of the Society to new business will result in an altered pattern of maturity and other claims which will require active management of the assets and liabilities. The successful implementation of the proposed compromise scheme in relation to GAR obligations and the possibility of further payment of consideration by Halifax Plc would also affect this future position.*

Equitable explain that the signatories to the certificates did not work for the Society during any part of the year 2000. Therefore, the certification had been made to their best knowledge and belief.

Three Equitable Directors provide the certification required by Regulation 28(a) of the ICAS Regulations 1996. Equitable's Appointed Actuary provides the certification required by Regulation 28(b) of the ICAS Regulations 1996. Equitable's Auditors provide their opinion that Schedules 1, 3 and 6 of the returns have been properly prepared.

28/06/2001 [entry 2] Equitable apply to FSA for a section 68 Order in respect of a future profits implicit item of £1,100m, for possible use in their 2001 returns. Equitable provide the Appointed Actuary's certificate in support of the application, along with an appendix to their letter containing details of some supporting calculations.

28/06/2001 [11:16] FSA's Legal Adviser D asks Scrutinising Actuary F whether Equitable's reserving requirement is based on the assumption of a 90%, 95% or 97% take-up of GARs.

[**11:33**] The Actuary advises that Equitable had assumed an 85% take-up rate in their 1999 returns, which had been increased to 90% for the 2000 returns, following challenge from GAD.

28/06/2001 [11:29] Equitable's Chief Executive writes to FSA about the current level of policy values to available assets. The Chief Executive says:

> *On page 323 of the returns ... there is disclosure of the need for active management of the assets and liabilities of the Society as a result of its closure to new business.*
>
> *The Board recognises that there was an excess of policy values over available assets of approximately 10% at 31 December 2000. In accordance with valuation regulations no allowance is made for final bonus within the mathematical reserves.*
>
> *In 2001 the Society has benefited from the sale proceeds for the partial disposal of its business to Halifax PLC, but investment returns have been poor due to market conditions. When combined with the continued accumulation of bonus at 8% p.a. during the current year, the excess of policy values over available assets has increased. In normal investment conditions the Society intended to reduce the excess over a reasonably short period of time. However, in view of market conditions, and the relatively high level of claims that have been experienced since the Society closed to new business, the Board considers that a more immediate reduction in this excess is required.*
>
> *Further work is being carried out to enable the Board to decide upon the appropriate action in the very near future. We will keep you advised of decisions in relation to this issue.*

On a copy of the letter sent to Legal Adviser A by Chief Counsel A, the 8% bonus rate has been underlined and marked with '*!*'.

In an undated note, Legal Adviser A provides Chief Counsel A with his understanding of what this means, that being:

> *... as far as I can sort out is that the value of the policies exceeds the assets ie they would be insolvent on a realistic basis. However, they would be solvent under the ICA because they do not have to reserve for terminal bonuses.*
>
> *As they* [are] *increasing the value of policies by 8% which is above the investment return the position is worsening. They then have to reduce this 8% but in a way in line with PRE.*
>
> *I don't* [think] *this requires immediate action on our part (they have not reached the* [required minimum margin]*) but we need to know what they are going to do. So yes I think it does sound O.K.*

28/06/2001 [17:41]	FSA's Line Manager E circulates a note on the position that has been reached following '*a number of parallel discussions*' about Equitable's letter and their 2000 returns. The Line Manager says that:

> *Paragraph 16 of Schedule 4 to the Accounts and Statements regs require the returns to include*
>
> > *"a statement of the practice regarding any bonus payments ... to be made on claims arising in the period up to the next investigation ..."*
>
> *From discussions with* [the Head of Actuarial Support] *and* [Scrutinising Actuary F]*, we all think that there is a case for arguing that the drafting of the returns as they stand (ie referring to the interim rate of return at 8%) on the basis that was the rate that applied at the time of the submission and no formal decision to amend the rate had been taken. It is implicit that by being an interim rate, it is subject to revision at any time.*
>
> *That said, we are all of the view that it would be preferable, if it were not logistically difficult to do so, if the wording of the statement could be amended slightly to say something along the lines that "the rate is currently 8% but that it is regularly reviewed to take account of external factors such as market conditions." None of us think there is any need for the returns to be any more explicit about the current position. By extension, I assume that* [FSA's actuarial department] *would share my view that against that background a statement of the kind proposed submitted around the same time as the returns would not cause us difficulty.*
>
> *Perhaps* [Legal Adviser A] *or* [Chief Counsel A] *could let us know before the meeting if they take a different view on any of the above conclusions.*

[**23:03**] In response to this, Chief Counsel A says to Line Manager E: '*We discussed.* [Legal Adviser A] *and I think something should be said about a review. Mentioning external review might be misleading as might a reference to a "regular" review*'.

29/06/2001 [10:19]	Further to Line Manager E's note of 25/06/2001 [**16:46**] and the Head of Life Insurance's note of 26/06/2001 [**11:44**], FSA's Insolvency Practitioner puts forward his thoughts (under the title '*Basis for the FSA's Intervention in Equitable Life's Scheme*') on the test that FSA ought to apply in assessing the compromise scheme. The Head of Life Insurance explains his view that:

> *... it is important to focus on what the FSA's role is in this situation. It is not to decide whether the scheme is fair or unfair, reasonable or unreasonable. The scheme is a compromise between groups of creditors and the company. It is not for the FSA to say that an uplift of 20% or 30% is a fair value of creditors' rights. There are unquantifiable benefits of the scheme that will sway creditors and different creditors will perceive different factors as important. It is therefore futile to try to arrive at a judgement of overall fairness for the scheme. Following this, I believe that the FSA should not be concerned with whether policies are valued in the scheme on the basis that each policyholder will exercise his GAR options so as to maximise the value of the policy in actuarial terms, or whether the policies are valued after making an assumption about the realistic take-up rate of GAR benefits. (The exception to this is the value for voting purposes, which I come to later.)*

The Insolvency Practitioner suggests that there are two parts to FSA's role '*which derive from the principles of consumer protection and treating customers fairly*'. First:

> *The scheme promoted by the directors should have a reasonable prospect of being approved.*

The scheme offers overall benefits in the Halifax consideration and investment freedom. It is right that these benefits are not lost by the directors promoting a scheme so skewed as to stand no chance of general acceptance or so late as to miss the March 2002 deadline. In my view, this is the limit of the "reasonableness test".

The second part suggested by the Insolvency Practitioner is that:

The information available to creditors and the High Court should be adequate to enable each to assess the effect of the scheme on his rights and compare this to the alternatives to the scheme. Because of the safeguards mentioned below, I think this is all that is required for the company to "deal fairly" with policyholders.

The Insolvency Practitioner sets out the aspects of this in relation to policyholders and to the High Court. On the former, he says:

(a) The scheme explanatory statement should state what the alternatives to the scheme are and what the board intends to do if the scheme is not approved. The next best alternative is clearly to continue to run off the closed fund for so long as it is solvent (and also if it is marginally insolvent). The explanatory statement should illustrate (and try to quantify) the benefits which flow from greater investment freedom. The explanatory statement should explain the consequences of liquidation and attempt to quantify this. There should also be a statement as to the prospects of transferring the business to another fund or obtaining other capital support (presumably nil, unless Halifax has a change of heart).

(b) Each policyholder should have a personalised statement showing the value of his policy: for voting purposes, if the scheme is not approved, and if the scheme is approved. This should take into account the benefits of the Halifax consideration and greater investment freedom, and it should give a range of values to illustrate the sensitivity to interest rate assumptions.

We need to specify now for the Society the minimum standard of personalised information we think a policyholder should receive, since it will take time to build the systems to produce the calculations. I think we could accept some generalised illustrations, but there must be enough examples for there to be one appropriate to each policyholders' circumstances, in particular, there must be one for policyholders for whom the scheme is not advantageous compared to carrying on without the scheme.

Under the heading '*Can no-one be worse off than they would be under no compromise?*', the Insolvency Practitioner writes:

It is possible for the scheme to be a win-win for GARs and non-GARs compared to no scheme if the non-GAR's share of the Halifax consideration conditional on the scheme being approved and the greater investment returns possible after removing the uncertainty over the quantum of GAR options is removed exceeds the compensation paid to GAR policyholders for removing the maximum value of their options. However, I think that the sums do not quite work.

Halifax contribution	*= £500m*
Extra, say 1/2 % return on £30bn of funds for, say 7 years	*= £1,050m*
Non-GAR share	*= 80%*
Amount paid to buy-out GARs	*= £1,500m*

80% x {£500m + £1,050m} = £1,240m < £1,500m

A crude calculation obviously, but I think that the Society should make some attempt at quantifying the benefits of increased investment freedom.

[**14:23**] Line Manager E notes the Insolvency Practitioner's views:

> *... on the rigour (or lack of it) with which we should test the proposals and I can see that is justifiable on the basis of our specific statutory role in a case such as this. However, we are empowered more generally to act if we consider there is a reasonable expectation that policyholders reasonable expectations may not be met.*

However, Line Manager E believes that FSA should recognise that '*many policyholders will be either unwilling or unable to* ['*reach a view on the acceptability or otherwise of the proposals*'] *and that they will be expecting some guidance about whether they should sign up, or at least whether it would be reasonable for them to contemplate doing so*'. Line Manager E says that FSA '*must be reasonably testing*' of Equitable's proposals and that their tests should be:

- *a vertical test, comparing the outcome after a scheme with the other possibilities (of which winding up and continuation of the status quo are the most relevant);*
- *a horizontal test, to see how the treatment of groups of policyholders compares and also how the scheme would impact on policyholders within those groups (insofar as that can be predicted);*
- *a general "is it a reasonable scheme for someone to come up with?" test.*

Line Manager E seeks comments on these proposed criteria and asks whether he could give Equitable a general idea of FSA's thinking.

29/06/2001 [10:26] Equitable send FSA a timetable for the sign-off programme to prepare the compromise scheme documentation ready for presentation to Equitable's Board at a meeting on 25 July 2001.

29/06/2001 [before 12:03] FSA meet Equitable to discuss their letter of 28/06/2001. According to FSA's note, Equitable's Chief Executive:

> *... explained that terminal bonus rates were not currently sustainable. The problems in part stemmed from the nature of the society's business which, because it had only a relatively small proportion of annual premium business, meant that putting the business in run off meant that the long term fund went rapidly into decline. (Normally a life office would expect the fund to continue to grow for a period before starting to decline, which enables it to cope better in difficult market conditions.) There was also a problem because of the flexibility in many contracts that meant that pension contracts allowed people to take out their funds during a wide window of opportunity.*

Equitable's Appointed Actuary:

> *... said that they would need an investment return of 2% for the year as a whole (it is currently negative) just to keep their heads above water. They had thought that they would elect for a material reduction in the rates of interim bonus for the time being, but the position was now such that that did not deliver what was needed. Policy values have grown by about 10% too much compared with the underlying assets.*

Equitable inform FSA that their:

> *... Board discussed the issues on Wednesday (27/6) and has resolved to take action. A further board meeting has been called for Monday 2/7 at which a range of options will be considered. As noted above, at one stage, the solution was thought to be ... to cut interim bonus rates from 1 August 2000 onwards, although that was now unlikely to be enough as it would simply produce a cut of about 7% and further action would be needed. Realistically therefore, it was thought that more drastic steps would be needed. One option being considered would be to remove some of the transparency*

from the process by which terminal bonus is added to pension plans from year to year. Effectively the proposition was that they would cease to show the rate of accrual of the non-guaranteed terminal bonus. This would be consistent with the practice for much of the industry and some other types of Equitable Life policy, but it was a clear step back into opacity which would not go down well. It could be seen as a mechanism for frustrating the GAR. The alternative would be to deliver a cut to policy values by some means to bring them more closely back into line with the underlying assets. This could be done by reducing the amount of accrued terminal bonus, or by making a reduction in the overall policy value, but so as not to take the value below the guaranteed value in any individual case. Either approach would be difficult, and in order to sell this course of action they thought that they would have to be explicit that they would look to restore the bonuses if and when financial markets improve.

Equitable's Chief Executive confirms that '*if there were a significant rebalancing of policy values, they would expect to reduce the financial adjuster on non-contractual terminations, perhaps to 5%*'.

How this impacted on Equitable's 2000 returns is discussed and FSA say that they:

... thought some disclosure would be needed because of the requirements under the regulations for the actuary to comment on bonus rates for the current year. We thought that avoiding the issue would be particularly difficult if the board might have met and decided on a course of action by the time the statutory returns were in the public domain. Equitable did not disagree with our view and it was concluded that this could best be dealt by a modification of the appointed actuary's report. However, they did believe that there was a need for some caution if the information was not to be misinterpreted since this could cause panic and simply make the position worse. We agreed to acknowledge receipt of the letter, so that [Equitable's auditors] *could be clear that we had been notified of the position ... Equitable agreed to show us a form of words that might go in the report.*

FSA record that they:

... also discussed briefly the issue of the term in GAR pension plans that allowed the Society to determine the terms on which future premiums would be accepted if a policyholder ceased to pay premiums in a policy year. Previously the Society had allowed policyholders to continue to enjoy GAR benefits for future premiums. However, they took the view that they were now obliged to enforce the contract terms and that this should include not allowing those who had missed premiums to continue to benefit from the GAR in future. We noted our concerns about whether there would be PRE issues. [Equitable's Appointed Actuary] *noted that there were the interests of non-GAR policyholders that needed to be respected. He also noted that there had been no reason for the Society to apply different terms to subsequent premiums prior to the House of Lords judgment. The situation had now changed, so he argued it was acceptable for such steps to be taken. Equitable agreed to provide a copy of their legal advice on the issue. They indicated that any change of this kind would take a couple of months to implement.*

29/06/2001 [entry 4]	As agreed at the meeting that morning, FSA write to Equitable in reply to their letter of 28/06/2001. FSA say: *You explained to us that the Board has resolved to take action to address the position at a very early stage and that it is due to meet again early next week to consider the courses of action available. I should be grateful if we could meet again as soon as your Board is clearer about the precise action it intends to take so that the FSA may satisfy itself that there is no regulatory obstacle to, or indeed need for modification to, that action. In the meantime, we concluded that appropriate disclosure of the position, and of the need for action to address it, ought to be made in the statutory returns that are due to be submitted by 30 June 2001. We agreed that this should be done by way of a statement to be included in the report of the appointed actuary. Since the meeting you have provided a copy of the form of words he proposes to use and I can confirm that the FSA considers that wording acceptable.*
29/06/2001 [entry 5]	Line Manager E informs FSA's Chairman of Equitable's letter of 28/06/2001, the meeting with them that morning, and the subsequent correspondence.
29/06/2001 [16:00]	FSA send Counsel the notes of the meeting with Equitable earlier that day. FSA say that they have been '*nudging* [Equitable] *towards the "adjustment" ... (to bring policy values into line with assets) for some months*'. FSA also inform Counsel that Equitable's Board had approved a decision to prevent GAR policyholders from topping up their policies immediately and without notice. FSA explain that they had been startled to discover this on 28 June 2001, as it had been contrary to what they had been led to believe that the Society's approach would be.
29/06/2001 [19:40]	Equitable's auditors for the 2000 returns write to FSA, stating that they '*consider that in accordance with the Auditors (Insurance Companies Act 1982) Regulations as amended by the Financial Institutions (Prudential Supervision) Regulations 1996 and Statement of Auditing Standards 620, we are obliged to specifically draw to your attention the contents of* [Equitable's letter of 28/06/2001] *in the context of Regulation 22 Schedule 4 Para 5(4)(a)(iv)*'.

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02/07/2001 [07:35] Equitable send FSA an outline of a paper entitled '*The Business Case for the Section 425 Scheme*' for FSA comment. The content of the paper is set out under six main headings:

1. *Problem*
2. *Options*
3. *Appraisal of the options*
4. *Proposed Solutions*
5. *Details*
6. *Appendix*

[**09:47**] Line Manager E circulates the document within FSA and recipients comment upon it.

[**12:16**] The Head of Life Insurance says that the list of issues looked comprehensive and suggests that the possibility that FSA might produce an information sheet could be flagged under a heading in the '*Details*' section entitled '*What will policyholders receive?*'.

[**14:59**] The Head of Actuarial Support says that he remained unconvinced by the steps set out in the '*Details*' section of the paper, which included the further headings:

5.1 How do we achieve a Section 425 Compromise Scheme?
5.2 Why is the value discounted to [£]*1.37 billion?*
5.3 Why are we allocating the [£]*1.37 billion in the proposed way?*
5.4 Why did we use these factors and not others?
5.5 The scheme
5.6 The scheme procedure
5.7 What will policyholders receive?
5.8 What is the role of the independent actuary?
5.9 What will happen if the scheme is effective?

However, the Head of Actuarial Support recognises that this would be an issue for lawyers to resolve.

[**15:54**] Legal Adviser D raises a number of points, including that made by Counsel on 27/06/2001 [**14:30**] that the use of a section 425 scheme for a solvent insurance company was unusual and '*arguably a questionable use of s.425 at all if the Equitable is solvent*'. The Legal Adviser explains that the Court '*will be required to be satisfied that there is no better alternative to the proposed s.425 compromise since GAR policyholders are being asked to give up valuable legal rights. Unpalatable though it might be for the Equitable it will need to have a section in paragraph 1.2 "What is the problem?" a heading such as Unable to maintain Required Solvency Margin and give an indication of how likely and/or how soon it might breach* [that margin] *without the compromise being approved*'. Legal Adviser D also says that, as Counsel had advised, the proposed scheme should first calculate the value of GAR rights and then decide on the amount to be allocated, rather than the other way round.

[**16:10**] The Insolvency Practitioner advises that there were a reasonable number of solvent section 425 schemes and that he did not think this was questionable as '*after all, it is a Companies Act procedure not an Insolvency Act one*'. The Insolvency Practitioner also comments that he '[does] *think that there is a question whether the scheme should provide for the run-off of the fund on an insolvent basis should the solvency decline further (increase in mis-selling claims or stock market falls). ie it would be drafted with* [a named company] *type provisions which kick in when it becomes insolvent in someone's view. I had assumed that the scheme would not have such provisions because it would be scare-mongering, but perhaps the board should explicitly consider this option*'.

[**16:43**] The Insolvency Practitioner provides some further comments on the detail of the outline paper, including that Equitable could provide policyholders with updated financial statements.

[**19:56**] The Director of Insurance agrees with his view on the use of such a scheme by a solvent company.

02/07/2001 [09:40] FSA's Line Manager E seeks advice from the Director of Insurance on how to acknowledge Equitable's former auditors' letter of 29/06/2001 [**19:40**]. [**13:59**] Line Manager E later suggests some wording, which includes the following:

> *I confirm that the Society had already been in touch with the FSA about the matters raised in your letter. As you say, it has been agreed that the Appointed Actuary's certificate, which forms part of the regulatory returns, would disclose the matters in terms that are acceptable to the FSA. On the basis that* [Equitable's auditors] *have been able to report on the statutory returns for the period ended 31 December 2001, we assume that you also find disclosure in those terms acceptable as the Society's auditors.*

The Line Manager says that the wording was deliberately cautious about what was said in Equitable's Appointed Actuary's certificate as FSA were yet to locate the Society's returns among those received.

02/07/2001 [10:15] FSA's Director of Insurance responds to the Insolvency Practitioner's paper on the tests that FSA ought to apply to the compromise scheme (see 29/06/2001 [**10:19**]). The Director of Insurance says that the paper was helpful, particularly in relation to the possible approaches to quantification. The Director continues: '*However my instinct is that the hurdles which the FSA will wish to see cleared are a little higher than you suggest, given our responsibilities to consider whether "sound and prudent" is met*'. The Director of Insurance suggests meeting to discuss this test before they considered the actual proposals in detail.

[**13:08**] Scrutinising Actuary F provides some thoughts in advance of a meeting the following day to consider the issue. The Scrutinising Actuary says:

> *One of the key issues is whether it is acceptable for any individual to be any worse off under the Scheme.*
>
> *Notes of our meeting with Counsel last Wednesday are awaited, but this was a topic we discussed at length. My understanding is that Counsel's view was that, since the company is not insolvent, no GAR policyholder should be offered less than the value of his/her GAR rights. This is particularly important for those policyholders just coming up to retirement, who in the absence of the Scheme would have the option to exercise their GAR in full.*
>
> *Counsel's view appeared to be that for those about to retire the value of these rights should not be influenced by the behaviour of other policyholders, i.e. the assumed take-up rate. However, for those retiring in 30 years' time, it may be acceptable to incorporate the take-up rate in the calculations. This suggests the need for an age-related scale.*
>
> *The value of these GAR rights changes as interest rates move and the shape of the yield curve changes. I would suggest an appropriate way of determining these rights at a particular point in time is to use financial option theory – as used by those who price derivatives. We asked Equitable whether they had considered this as one of our long list of questions on the S425 Actuarial Report (*[Line Manager E's] *letter of 14 June). Their answer was that they had not considered this yet, but they were "looking at what can be done". Time is running out.*

[**13:41**] Line Manager E says that FSA: '*need to be clear of the basis and reasons for our acting here. It seems to me that we have general powers and we have the ability to put a case before the court at the hearing. However, as* [the Insolvency Practitioner] *has pointed out, we must not forget that the policyholders concerned are being given the opportunity to vote on whether or not they are prepared to accept a deal. If they do so willingly, then it is not, I think, for us to intervene provided we can be clear that the proposals are not totally unreasonable and that we believe that they have voted on the basis of a reasonable understanding of what is on offer. I think our role is to provide suitable safeguards and ensure that the basis on which the scheme is developed is sound, and that people are not asked to sign up to something that is demonstrably unfair or unreasonable*'.

[**15:26**] The Head of Actuarial Support also comments on the Insolvency Practitioner's note, saying that he would: '*doubt the practicality of some of this. In particular, I cannot see how you can provide meaningful information to inform a policyholder about the choice he should make through a single "policy value". Similarly, quantification of "investment freedom" is highly speculative and I would be very dubious about making some arbitrary assumption for this purpose about (a) the future investment policy and (b) the outperformance of equities over gifts. The latter will be very dependent on both the term of the policy and actual market events that may transpire*'.

02/07/2001 [14:32] The Director of GCD provides Chief Counsel A and Counsel with his views in response to Chief Counsel A's note to Counsel of 29/06/2001 [**15:59/16:00**]. The Director of GCD says:

I think they need to consider whether a package along the following lines would be sustainable:

- *make clear this needed for reasons actually needed*
- *point out that existing approach misleading – as per* [the Baird Report]
- *ensure no loss of transparency by establishing a clear policy for future determination of bonus levels*
- *demonstrate fairness by making clear will apply to GAR + non GAR alike*
- *confirm that as per* [House of Lords]*, once declared, terminal bonus benefits from GAR*
- *make clear that cannot affect shares in accommodation, which will abate rateably*
- *note that financial condition is relevant to compromise*
- *make a virtue of MVA reduction.*

02/07/2001 [16:00] FSA hold an Equitable Life Lawyers Group meeting. The minutes of the meeting record discussion on significant developments during the previous week (the Baird review) and progress on outstanding items. Under '*other items*', it is agreed that Chief Counsel B would prepare a note of the issues discussed with Counsel, those being: failure to meet policyholders' reasonable expectations; misrepresentation by Equitable; and application of the Unfair Terms in Consumer Contracts Regulations 1999 to policy values.

02/07/2001 [18:06] Equitable send FSA a suggested agenda for a meeting arranged for 04/07/2001 [**18:30**] on the compromise scheme.

03/07/2001 [entry 1] Equitable send FSA an extract from Counsel's opinion dated 29 June 2000 on the company's ability to refuse to accept further premiums on terms which included guaranteed annuity rates.

03/07/2001 [morning] FSA meet to discuss the criteria by which FSA should judge the compromise scheme.

[**15:53**] Following the meeting, the Director of Insurance sends Chief Counsel A (and others) a note which records that they had agreed to seek Counsel's advice on the issue and which sets out the '*policy instructions*' they had discussed.

[**17:50**] Following the meeting, Scrutinising Actuary F confirms the two issues on which actuarial input was to be sought and discusses how FSA could undertake the necessary work. The first of these is to '*verify that FSA are satisfied with Equitable's statement that their statutory solvency position would improve by £1.3bn. should a Scheme of comparable cost to that currently proposed be implemented*'.

The Actuary sets out a suggested approach that FSA could take to this work:

> *1. We understand that the figure of £1.3bn. represents the difference between (a) the GAR reserve held in the regulatory Returns (after reinsurance) and that part of the resilience reserve which relates to the GAR liabilities, and (b) the value to be ascribed in the regulatory Returns to the uplift to be granted to the GAR policyholders (plus any associated resilience reserve).*
>
> *2. We expect that the Society will already have performed their own calculations which have come to the conclusion above. To gain full comfort as to the reliability of these results, we recommend that it would be necessary to undertake an audit of this work. This would entail sending a team of actuaries to the Society's Offices to review the calculations which have been done, the systems which were used, and the data which was processed. This approach allows a more in-depth analysis than can be achieved by our reviewing a Report from the Society on the subject – although they could no doubt furnish us with this.*
>
> *3. In particular, the audit would need to pay attention to the following aspects:*
>
> - *a breakdown by major groups of the Society's business to which GAR's attach. This would show the amount of the benefits under these policies, the amount of the GAR's attaching, selected retirement dates under the contracts, and the liabilities in respect of both the main benefits and the attaching GAR's;*
> - *details of how the above liabilities would alter as a result of the Scheme – from the release of the GAR reserve & the addition of the uplift on those same policies;*
> - *a sensitivity analysis showing how the results vary (primarily) under different economic conditions, but also on different assumptions re future mortality;*
> - *the results of the resilience tests, how the most onerous resilience scenario was determined, and the amount of the resilience reserve thereby held. The impact of buying out the GAR benefits on the resilience tests. Note that the resilience tests are applied to the total portfolio of the company – a possible consequence of removing the GAR liabilities is that a different resilience test becomes the most onerous.*

Scrutinising Actuary F then explains that the impact of this would be:

> *The benefit of the release of £1.3bn. from the statutory liabilities is an immediate improvement in the free assets of the Society. This permits the adoption of a higher equity backing ratio (EBR) for the with profits business. The Society have reduced this EBR post-*[House of Lords] *from c.72% to c.61% of with profits liabilities. They would be unlikely to want to increase it beyond 75%. Even were they to do this, assuming equities out-perform gilts by 3% p.a. (a typical long term assumption), the impact on the investment return of the fund would be an increase of 14% of 3%, i.e. 0.42%, or say 0.5% p.a. This is*

only a modest improvement on the current position, especially for those close to retirement. There is however a reduced risk of statutory insolvency going forwards. Additionally, of course, the fund would benefit from the further injection of £250m.-£500m. from the Halifax – this though is to be used to benefit investment performance, rather than being credited directly to policy values.

On the second issue that FSA '*assess the value of the GAR rights enjoyed by GAR policyholders (whether individually or collectively). What is the "market value" of these rights?*', the Actuary suggest that FSA's approach should be that:

... these rights be valued by the use of financial option theory, as used in derivative pricing. However, in addition to the economic elements of the calculations (e.g. the assumed 15 year gilt yield 10 years hence), other assumptions would need to be made regarding e.g. the dates on which policyholders choose to exercise their options, the extent to which they would pay future premiums into their contracts, together with actuarial/demographic assumptions regarding the future mortality experience, and so on. The situation is effectively the opposite of that in [a friendly society]*, who you will recall last year invested in a range of swaptions to hedge their GAO liabilities over the next 30 years. Here the GAR policyholders are being asked to swap their future (variable) rights for a fixed amount.*

Scrutinising Actuary F says that, in view of the '*complex and specialist nature of this work*', he had passed it to another actuary at FSA.

[**19:06**] After receiving comments on the note, the Director of Insurance asks Line Manager E to translate the material into a draft letter to Equitable, setting out FSA's views on the relevant criteria.

04/07/2001 [10:48] FSA's Head of Actuarial Support replies to Scrutinising Actuary F's note, advising:

The audit of the resilience reserve suggested here would be very resource intensive and I am not sure of the value that we would obtain from this very detailed examination of this one point. In particular, the release of reserve will improve the statutory solvency position, but it does not affect either the Companies Act solvency position or the aggregate policy values.

We also need to be very cautious about assuming that increased investment in equities will necessarily provide greater value for policyholders (even if we were confident that they would change their investment policy in this fashion). This increased return is in effect the equity risk premium that is "earned" to cover the risk that equities could fall significantly in value. This risk will though be borne entirely by the members of the society. Moreover, many economists would question whether such a "risk premium" exists at all. Accordingly, I would not place any long-term value to policyholders on this potential change in investment policy. In the short term (which will affect those near retirement), the level of investment returns on equities relative to fixed-interest must be quite uncertain.

Regarding the value of the GAR options, we have already requested [Equitable's Appointed Actuary] *to provide some results using financial option theory. When we receive these, we shall need to review this information with the assistance of the Traded Investment team at FSA.*

[**12:42**] FSA's Insolvency Practitioner adds that he is '*very concerned about whether the Equitable can meet the tests if we disregard improved investment returns*'. The Insolvency Practitioner explains:

As I understand [the Director of Insurance's] *first test for GAR policyholders (in aggregate, as a class, are they better off under the scheme than without it?), the calculation we are proposing is:*

	£bn
Maximum value of GAR options	*2.6*
discount for Equitable uncertainty, say 5%	*(0.1)*
Market value of GAR options	*2.5*
Transfer value/policy uplift	*1.3*
GAR share of Halifax consideration 20%x£0.5bn	*0.1*
GAR share of the Increased investment return	*nil*
Total (must be more than 2.5bn)	*1.4*

If I understand [the Head of Actuarial Support's] *first paragraph correctly, I agree with it. The reserving requirements in the FSA returns are irrelevant to policyholders – it does not result in a penny more being paid to policyholders in aggregate. It might allow higher terminal bonuses to be paid to those retiring soon but at the expense of paying lower terminal bonuses to those retiring later unless investment returns also improve to enable later terminal bonuses to be increased.*

If the improved investment return for the Society as a whole amounts to more than £1.1bn (on the above figures) then the scheme works, otherwise it will not pass our tests. Without improved investment returns being taken into account the scope to increase the transfer value is limited to about £1.7bn because of the second test (are non-GAR's better off with the scheme than without):

	£bn
Realistic cost of meeting GAR rights (60% take up)	*1.3*
non-GAR share of Halifax consideration 80%x£0.5bn	*0.4*
non-GAR share of improved investment return	*nil*
Maximum transfer value without the non-GAR being worse off:	*1.7*

One final thought on how the market value of the GAR's should be calculated. These policies are not transferable. There is no open market on which they can be sold or priced. Should therefore the market value be the actual value which could be obtained if GAR's exercised all their rights now – ie a liquidation value?

[**16:06**] The Director of Insurance agrees with the Insolvency Practitioner and, while noting the Head of Actuarial Support's concerns, says that he was '*still firmly of the view that we must be able to assess, and the Society must be able to demonstrate, the fairness of the exchanges which will be involved in the s425 scheme*'. The Director of Insurance continues:

Thus we need something which will give us some measure of the "GAR Value" and the value of the positive gains and the negatives avoided through the scheme.

Against that background, and the background of what we and the company have said about the disbenefits of an unstable fund in which GARs and non GARs are still opposed, and the investment constraints that that imposes, then we surely must believe that resolving that uncertainty is beneficial. If that is so we must find some sort of proxy for the value of that benefit.

But I am, of course, open to suggestions on how we might approach that assessment, recognising always that we will need to reach some sort of publicly defensible view (and methodology) very quickly. In all the circumstances I don't think that cash resource constraints ought to deter us from action which, while it might not strictly add value, could be essential if we are to be able credibly to claim that we have reached a wholly objective and independent view.

[**18:26**] FSA's Head of Actuarial Support responds that he thinks:

... what we are really looking for here is some measure of the reduced probability of insolvency ensuing (as a result of the scheme) to which we shall give some further thought. This will though be quite different from the £1.3Bn resilience test figure to which you referred earlier. A detailed audit of this single figure is not going to help us to resolve that issue, but I shall try to think further about where we could focus our efforts.

As I indicated earlier, I would be very sceptical about placing some assumed value on the ability to invest more heavily in equities. Indeed, the latest informal comments suggest that they are likely to have to move more heavily towards fixed-interest in any event.

The Head of Actuarial Support adds that FSA had also discussed briefly with Equitable's Appointed Actuary the use of financial options. He reports that the Appointed Actuary '*has discussed this with his firm's experts and they are of the view that this is not likely to give us much more insight, given that these options are now so far into the money*'.

04/07/2001 [morning] FSA meet Equitable to discuss the outcome of Equitable's Board meeting the previous day and to get an update on '*a range of issues related to the current situation*'. FSA make a note of the meeting.

<u>Equitable Board meeting</u>
Equitable report that their Board had recognised that there was no easy way to implement the change in bonus policy which would provide financial stability to the with-profits fund. Equitable say that they had identified two realistic options: reducing final bonus or reducing total policy values, and had decided on the latter. Equitable add that there would be serious practical difficulties in implementing the decision.

Equitable's Chief Executive says that, following the Board meeting he had met with Counsel, who had '*radically changed the position*'. FSA's note records:

While [Counsel] *was not yet ready to produce his opinion he was indicating that the chance of successful action for mis-selling from '88 onwards was not negligible (although not probable). On that basis* [Counsel] *had asked whether, given no reserve has been set up for possible compensation costs, the Society were confident that they should make any payments beyond those to which they were contractually committed ...* [Equitable's Chief Executive] *had reflected further on this and considered that the Society now had to consider an alternative to the Board decision. This was to suspend all final bonus, pending resolution of the current uncertainties. In addition, he was considering refusing to allow any surrenders until the position was clearer.*

FSA say that they had made it clear to Equitable that FSA had serious reservations about the reasonableness of refusing surrenders and, subject to further consideration, would be minded to take formal action to prevent Equitable from doing so. FSA's note goes on to record that Equitable had come back to them after the meeting and that Equitable now believed that:

... provided the board decision reported above is implemented, the risks of the [Counsel for Equitable] *opinion can be contained without raising solvency concerns by carefully managing the Society's investments, particularly by moving further into gilts. This will avoid the risk of the more extreme adverse publicity.*

This part of FSA's note is amended by the Director of Insurance the following day to read:

> [Equitable's Chief Executive] *recognised that there were serious problems with this more radical approach. The company would be asked why it had not taken this decision earlier, and might be accused of seeking to bring pressure on policyholders to accept the compromise. The answer to this would be that the new Board had needed time to take a fresh and thorough look at the whole problem. A second difficulty was that this response might be regarded as implying rather greater recognition of possible mis-selling claims than was the case; the decision would have to be presented very carefully to make clear that this was not so.* [The Chief Executive] *planned to keep both options open until the Board could be convened on 12-13th July. (Subsequently the Appointed Actuary told us that he was not convinced that the more radical option was necessary, and that he is in further discussions with* [the Chief Executive]*. We will be seeking further clarification as a matter of urgency). Meanwhile, at our request,* [the Chief Executive] *promised to send us a copy of the Board paper setting out the options for the 3rd July Board meeting together with a copy of the relevant part of the Board Minutes. Although this was now somewhat overtaken, it helpfully sets out the thinking behind the options considered at the 3rd July meeting.*

Subordinated debt
Equitable's right to buy back their subordinated debt is discussed and the Society says that, from its point of view, there were strong reasons for buying back some of the debt now.

Counsel's opinion on mis-selling
It is noted that Counsel for Equitable had advised that the proposed change to bonuses would not undermine the House of Lords' decision. Counsel had raised questions about whether Equitable could afford to meet the costs of any mis-selling claims. FSA's note records:

> [Equitable's Chief Executive] *expressed frustration at the fact that the likely "damage" in respect of which mis-selling damage might be claimed was likely to be, on average, about 5% of policy value; and this was well within the normal variance of returns in a with-profits fund. It was agreed that the likely outcome of the second* [Counsel for Equitable] *Opinion strengthened the argument for seeking to bind the potential for mis-selling claims into a compromise scheme under Section 425 ...*

The compromise scheme
FSA explain that the criteria for them to decide whether the scheme was one to which they should not object was still being worked on but that FSA would send it to Equitable when those criteria were ready.

Top ups
FSA remind Equitable that FSA had significant reservations about the proposal to withdraw GAR top-up rights and that FSA's tentative legal advice was that this might be improper. Equitable agree to send FSA their latest legal advice on this and to give FSA 24 hours' notice of any decision to implement such a change.

[**20:36**] Chief Counsel A sends a copy of the note of the meeting to Counsel.

04/07/2001 [14:00] FSA and their Counsel meet with Equitable and the Independent Actuary to get an update on preparation and progress for the proposed compromise scheme. Equitable provide a pack of documents which forms the basis of the discussion. This includes: a presentation which focuses on the scheme methodology; Equitable's '*The Business Case for the Section 425 Scheme*' paper; an undated paper entitled '*Determining the proposed enhancements to GAR total policy values*'; a note on the calculation of with-profits immediate annuity voting values; further responses to the questions raised in FSA's letter of 14/06/2001; and an initial draft of Equitable's scheme launch letter. FSA explain in principle the two-part test which was likely to form the basis for the criteria on which FSA would judge the compromise scheme.

04/07/2001 [18:30]	FSA's Line Manager E provides an initial brief report on the second meeting with Equitable and records that '*Progress is being made but (for the benefit of those with a wider issue) there are still some fairly fundamental issues that need to be resolved*'. The Line Manager also distributes a copy of a letter for policyholders about the scheme which they aimed to send out in August 2001, which Equitable had provided.
04/07/2001 [entry 5]	FSA's Returns Reception & Validation Unit carry out initial checks of Equitable's 2000 returns.
05/07/2001 [09:57]	In response to Line Manager E's brief report of the meeting with Equitable on the compromise scheme, FSA's Managing Director A asks '*what chance do our lawyers rate a scheme like this being acceptable to the Courts <u>on the basis of there being only 2 classes of policy-holder?</u> It seems to me that there are a lot of interests being lumped into the GAR class?*'. Managing Director A also makes two comments: > *... I can't believe that Equitable believe they can get away with the mickey mouse style of "consider the cases of Jane and Bill and see how their guarantees grow". I still therefore do not see what policy-holder advice it would be reasonable for us to expect to be provided.* > *... the draft currently has nothing about misselling/giving up of other rights etc. While that may be understandable ahead of* [Counsel's opinion] *we all need to remember that in reality the issues and the balancing act for the 2 classes of policyholder will be considerably more complex than suggested in the present draft*. [**10:37**] In response to the question, Chief Counsel A advises that FSA's legal advisers share the Managing Director's concern and that: '*Counsel have not been asked yet what chances they would give this scheme because we are all agreed that two classes will probably not be accepted unless the Equitable can make the uplift (ie, how the pot/cake is to be spread within the GAR class) work more fairly. The two issues (classes and uplift) cannot be viewed separately. If there are more classes, then what happens within each class matters less (for these purposes), but we are all keen to see the number of classes kept to a minimum. To the extent the classes multiply, the scheme will become horribly complex and difficult for policyholders to understand*'. Chief Counsel A also agrees with the Managing Director's comments.
05/07/2001 [10:30]	Further to the discussion the previous day (see 04/07/2001 [**10:48**]), the Director of Insurance says that he: > ... [finds] *it difficult to believe that it is simply reduced chance of insolvency that is the issue: this was certainly not the way the Society themselves have presented it in the past. I recognise however that putting firm quantification on the value of a better* [equity backing ratio] *is difficult and possibly spurious. But we are surely in no doubt that it is better to be in a fund which has greater investment freedom than one which is more constrained. The trick will be to demonstrate that and to include it (however quantified or qualitatively described) in the assessment of the "fair exchange" to be presented to GAR and non GAR policyholders.* > *Again on the "GAR Value" I recognise that this is a complex issue and I do not pretend to know how to go about assessing it. But the plain fact is that GAR policyholders perceive that they have something of value (they may overestimate it since it is currently in the money but won't necessarily be so for ever). They are being asked to give it up. They will surely expect us to have made some assessment of how what they are giving up stacks up with what they are gaining by way of uplift and other less quantifiable aspects of the scheme. And I can't see how the court can be expected to approve it (assuming the necessary majority of policyholders have voted for it) unless it too can get some feel for the "fairness" of the exchange since it is asked to bind in dissenting members who have voted against it.*

The Director of Insurance says that this is '*clearly very complex stuff*' and he suggests that officials should meet to discuss the matter. He also asks whether FSA needed to involve an economist in the discussion.

[**10:46**] Chief Counsel A agrees with the Director's comments.

[**10:53**] FSA's Insolvency Practitioner says that this would mean FSA:

> *... end up quantifying benefits of the scheme which are quite subjective. This makes it difficult for the detailed rationale to be made public, but I suspect we must make an attempt internally.*
>
> *The credit risk factor presumably works along the lines:*
>
> > *Probability of insolvency if there is a scheme = 10%*
> > *Probability of insolvency if there is no scheme = 30%*
> > *Incremental costs of insolvency = £3bn*
> >
> > *Value in having the scheme = (30%-10%)x£3bn = £0.6bn*
>
> *In the same ball-park as the £1.3bn, but numbers I have plucked out of the air. The probability of insolvency is also age-related (the longer someone is tied into the Equitable, the greater the probability that it will go bust whilst they are still in).*
>
> *If we are to be this subjective we might as well make an estimate of the litigation costs avoided through the scheme as well (the benefit of which would be greater if the scheme bought out potential mis-selling claims).*
>
> *I tend to agree that we cannot put too much weight on a better equity return, but I think that we can attach some value given the fund has 20+ years to run.*
>
> *I am not sure* [Equitable's Appointed Actuary's] *idea works. If you offer those of retirement age 60% of full GAR entitlements under the scheme with the option (expectation) that they can retire before the scheme becomes effective and take 100% of their GAR rights, then you may find that many more take up their 100% GAR rights than the 60% assumed so far. There is a risk that the fund will be depleted by more than it can afford if it is to uplift the value to younger policyholders by the amounts promised. How much risk can be taken?*
>
> *I think we must have a sliding scale based on age to retirement with something very close to 100% of GAR value at the top end. There probably cannot be too much science to the shape of the curve given the intangible benefits we are asking younger policyholders to contribute towards older policyholders. All that we need is a credible stab at getting the balance right, and one which policyholders can understand.*

[**11:50**] FSA's Head of Actuarial Support says that he:

> ... [agrees] *with* [the Director of Insurance's] *suggestion that a meeting to discuss this would be useful, and we would certainly welcome some input from an economist about the likely value of the equity risk premium at present (ie by how much equity returns may reasonably be expected to exceed fixed interest returns over the next 10-20 years). I can see that it may be easier presentationally to use this as the proxy for the reduced risk of insolvency, even if we are not convinced that they will actually change their investment policy.*
>
> *I also agree with your penultimate paragraph about the risks from* [the Appointed Actuary's] *proposal. I see that their draft letter to policyholders suggests that they are attempting to offer an uplift that will "ensure" that a GAR policyholder could obtain the same annual income as if they elected to apply 75% of the fund at GAR rates. If we replace the word 'ensure' with something less definite, and then adopt this test with the uplifted*

fund applied on the best current annuity rate in the market, then we might have a suitable benchmark for the level of percentage uplift to offer those at or close to retirement.

It also occurs to me that the proposed cut in policy values will in itself very likely lead to a 1.5-2% increase in the uplift factors. In addition, it might be possible to allocate a part of the £250 million Halifax contribution specifically for the purpose of this uplift, as is half suggested in the draft letter. This combination of devices might well lead us to an uplift that meets the test that I outlined above for those close to retirement.

At younger ages, then I would agree with your point that the "credit risk" must be larger and this would seem to justify some discount factor to be applied to the uplift factor, albeit that this might be offset against the increasing value of the GAR attributable to potential further increases in longevity for younger individuals.

05/07/2001 [13:26] FSA speak to Equitable to clarify their latest thinking on how they would deal with an adverse opinion on mis-selling claims. Equitable confirm they have not reached a firm view on how they would act but had concluded that they could maintain solvency by switching almost the entire fund from equities to bonds.

Equitable also give notice to FSA that they intended not to accept any further premiums on existing terms that included guaranteed annuity rates from policyholders who had not paid premiums in the last policy year. FSA note that Equitable: '*are well aware of the concerns we have raised about them acting on the basis of their current legal advice. On the other hand, the position is very difficult at a time when the Society is concerned about potential challenges from non-GAR policyholders, whose position is further threatened by the current practice, and also because they are increasingly concerned about statutory solvency going forward given current conditions*'.

[**15:26**] FSA's Director of Insurance comments that it is '*intolerable that the Society should be left effectively rudderless* [as the Chief Executive and Chairman are out of the country] *with, it appears, major unresolved differences between the Appointed Actuary and the Chief Executive*'. The Director of Insurance also says that FSA needed to get a better '*handle*' on Counsel for Equitable's opinion on mis-selling compensation and that the sums mentioned of £1bn to £1.5bn sounded very alarmist.

[**16:07**] The Director of GCD reports that he had spoken to Counsel, who would try to find out what Counsel for Equitable's views were and says that the Director had told Counsel that FSA might need to be able to publish his opinion on 20 July 2001.

05/07/2001 [14:47] Equitable send FSA a note prepared by their Appointed Actuary on the terms for premiums paid on policies which included guaranteed annuity rates but where premiums had not been paid for at least one policy year. The Appointed Actuary recommends that revised terms should be offered.

Line Manager E circulates the note, commenting that it showed approximately one third of GAR policyholders still had the contractual right to obtain GAR terms on future premiums, while half had not paid any premiums in the last five years. The Line Manager says: '*Before deciding what we should do, we need to recognise that Equitable are proposing to close the door because they believe it necessary, both for the protection of the vast majority of their policyholders, and as part of a programme of maintaining statutory solvency. We need also to recognise that they do not have much time for the concerns we have expressed and that they are likely to go ahead on some basis, unless we forcefully intervene to stop them*'.

[**15:04**] Chief Counsel A expresses the doubts that she and Counsel shared about the validity of what Equitable were intending.

[**15:16**] The Head of Actuarial Support agrees that this needed careful consideration in the context of the Unfair Terms in Consumer Contracts Regulations and, [**15:28**] in response to a query from the Director of GCD, [**15:50**] clarifies that '*While the contract (at least the example I have seen) says that if a premium is missed, then the Society may accept a subsequent premium at its absolute discretion, an associated leaflet says in effect that policyholders may follow whatever premium pattern they choose, with no mention of the Society's discretion either not to accept premiums or to vary their terms. In addition, I am not sure about the implications of Schedule 3, paragraph 2 of the Unfair Contract Terms Regulations which could be read as requiring reasonable notice to be given of a change in the terms for accepting new premiums*'. He suggests that the answer may be to wait for any complaints and then to examine their merits.

05/07/2001 [14:55] FSA's Head of Actuarial Support writes to Chief Counsel B, further to the meeting with Counsel the previous week, at which:

> *... they asked us whether we could provide an estimate of the reserves that might have been set up by Equitable for guaranteed annuity options at end-93 and end-94. This estimate will of course depend on how we interpret the applicable regulations, in the absence of any specific guidance at that time.*
>
> *I believe that we can make appropriate assumptions for this purpose about both the assumed mortality rates (deemed appropriate at that time) and the assumed long-term rate which is spelt out in some detail in the regulations. However, the main area of doubt would be over the level of take-up of the option that should be assumed for the purpose of determining the reserve to be made for this option.*
>
> *We had a discussion on this latter point with Counsel earlier in the year, albeit in a slightly different context. His view was that we could not insist on an assumption of 100% take-up, but would have to rely on our interpretation of the word "prudent" in Regulation 72 of Insurance Companies Regulations 1994 (and of course this word does not appear at all in the corresponding regulation that applied in 1993).*
>
> *If we were to assume that a take-up rate of somewhere between 10 and 40% would have met this criterion in 1993/4, in an environment where the GAR's were only just better than CAR's (or actually still worse than CAR's in most of 1994), then the mathematical reserve might have been between 0.5 and 2% of total funds (or equivalently around 5 – 25% of published free reserves).*
>
> *I would not have expected this to have had a material impact on bonus declarations at that time, given that they would have had various means to improve their statutory free asset ratios, and were most likely at that time expecting interest rates to remain at moderately high levels.*

05/07/2001 [15:29] FSA's Director of GCD writes to Counsel to express concern about an aspect of the emerging line of thinking on mis-selling.

05/07/2001 [19:12] FSA send Counsel their draft letter to Equitable on FSA's criteria for assessing the compromise scheme.

05/07/2001 [20:51] FSA send Counsel instructions to advise FSA on four issues relating to Equitable's decision, without prior notice, to no longer allow the application of GAR terms to top-ups made from 16 July 2001. Those issues are:

1) the quality of the legal advice on which the Board had based its decision;

2) whether Equitable could validly withdraw the ability to top-up a policy with or without notice;

3) whether GAR policyholders had, in addition to any legal rights, a reasonable expectation that they would continue to have the ability to top-up their policy; and

4) if top-up rights could validly be withdrawn without notice and there was no reasonable expectation, were there nevertheless any implications for the compromise scheme flowing from the withdrawal of such rights.

Chief Counsel A sends a copy of the instructions to other officials at FSA, for information.

06/07/2001 [10:23] FSA's Chief Counsel B thanks the Head of Actuarial Support for his note of the previous day on the estimate of reserves that Equitable would have had to set up for annuity guarantees. The Chief Counsel says that FSA would also '*need to ascertain when the reserving for GARs would have had a material impact on bonus declarations, presumably some time between end 94 and 98?*'. The Chief Counsel asks if the Head of Actuarial Support could give Counsel a view on this, noting that '*time is of course pressing*'.

[**10:55**] The Head of Actuarial Support replies:

> *The issue of when and by how much they might have adjusted bonus rates is very judgmental. We know that they cut the declared bonus in 1998 (from 6.5% to 5% for most pension policies) to reflect current and prospective financial conditions, but it is not clear whether they would have done this anyway even if we had not pressed them to establish a sizeable provision for GAO's at that time.*
>
> *The provision required for GAO's at end-97 and earlier would have been significantly lower than at end-98, since a major fall in interest rates occurred during the course of 1998. In my view, it is doubtful therefore that they would have made a cut in their declared bonuses prior to end-98.*
>
> *Regarding the final bonus rates, we know that they continued until end-99 to base these on smoothed investment returns with no apparent adjustment for the cost of GAO's (as they considered the economic value of these GAO's to be of the order of only around £100-200M). Following the* [House of Lords'] *judgment in mid-2000, the economic cost of the GAO's rose to around* [£1.5] *billion and they therefore decided to eliminate any final bonus for the first 7 months of 2000 in order to offset this cost.*
>
> *If they had followed the* [House of Lords'] *judgment from the start, then they would very probably in my view have reduced final bonuses at an earlier stage. This becomes very judgmental indeed, but this could conceivably have involved a reduction of 1 months final bonus in 1995, a further 2 months final bonus in 1997 and another 3-4 months final bonus in 1998.*

06/07/2001 [11:07] FSA's Line Manager E seeks an update on what was happening with PIA's contribution on mis-selling issues to a report to the FSA Board. The Line Manager asks for confirmation of where things stood, saying that he had been asked to provide a short note about what Equitable would do to cope with any mis-selling liabilities.

[**13:24**] Chief Counsel B replies: '*The position is that I am tasked to review and revise the PIA report on Equitable misselling which has looked at the history post-Court of Appeal. I am also tasked to ensure our counsel deliver a view on the misselling issues as identified by* [the Society's Counsel] *and as we anticipate that will emerge in* [the further opinion that Counsel is to provide to the Society]. *Both these pieces of work are closely related. I think we are now aiming to have counsel's opinion on the ... issues* [identified by the Society's Counsel] *ready by 20 July and I am aiming to have the PIA part of this completed by then also*'.

06/07/2001 [12:33]	FSA's Director of GCD thanks Chief Counsel A for sending instructions to Counsel on the top-ups issue. He suggests two further points to pursue with Counsel.
06/07/2001 [afternoon]	FSA have a conversation with Equitable. According to the Director of Insurance's note: [Equitable's Chief Executive] *called me in response to the message we relayed to him through* [Equitable's Appointed Actuary] *... whom we had met at lunchtime that day. He confirmed that he had discussed matters with* [the Appointed Actuary]*, and was aware of his view (and ours) that the Society should not take precipitate action in response to what it expected* [Counsel] *to advise on misselling. He said that he had been keen that the potential need to take "extreme and radical action" should be recognised, and his purpose in raising this in the terms he had had been to ensure that planning for the eventual arrival of the* [Counsel] *opinion should not be on too optimistic a basis, and also that the Board, in taking decisions on the policy value adjustment we had discussed earlier should do in the clear knowledge that* [Counsel's opinion] *might well lead to the need for further action in fairly short order. However he was clear that there was no question of the Board taking any decision on action that the* [Counsel for Equitable] *opinion might necessitate this week. He confirmed that the Society would discuss with us what such further action might involve before they committed to it.* *We discussed briefly the situation that might arise if the* [Counsel for Equitable's opinion] *meant establishing a provision which meant that Society was unable to meet its* [required minimum margin]*. I said that, if this were to occur we would, of course, look to the Society to bring forward proposals to address the situation. This might well involve a substantial further rebalancing of the Society's funds. But we would not necessarily expect (and might not permit) this to be done over a very short period. The test for us would, of course be, whether the action and its timing was best designed to protect policyholders' interests.* [Equitable's Chief Executive] *said he was reassured that this was likely to be our approach.*
06/07/2001 [18:22]	Having received Counsel's input, Chief Counsel A seeks urgent comments on the amended draft letter to Equitable on FSA's criteria for assessing the compromise scheme. Chief Counsel A highlights the addition, under matters of particular concern to FSA, of '*The risk of insolvency if the scheme does not go ahead (or if the scheme does go ahead without including mis-selling claims)*'. She says '*Everyone will know why I am uncomfortable with it*'. [**18:59**] Chief Counsel A later sends an amended version of the letter back to Counsel to consider over the weekend. She says that FSA were '*uncomfortable only about referring to insolvency as you suggested in a letter which may become public*'.
06/07/2001 [19:35]	Equitable's new auditors telephone FSA to discuss Counsel's opinion given to Equitable, which had suggested that Equitable could face significant mis-selling claims. Equitable were present during the call. According to FSA's note of the conversation: *He said that he felt that the Society were in an extremely invidious position in that they were now aware of this possibility but had received no indication of the basis on which claims might be made or of the classes or cohorts of policies that might be involved. It was accordingly quite impossible to form any view on possible amounts. In these circumstances he thought that it was inappropriate to try to reach a view on the level* [of] *provision that might need to be established or to take precipitate action based on inadequate information. Accordingly his view, which was also the view of the Society, was that the Board at its meeting next week, should address the known problems (ie the fact that notified policy values exceeded available assets, and the need to address "top ups with GARs attached" which were still being accepted in circumstances where there*

appeared to be no contractual obligation to do so). Further action, if it was necessary, to deal with possible misselling should be taken in a considered fashion after full consideration of all the implications and such quantification as was possible.

The auditors say that Equitable were not expecting to receive anything further from Counsel before their next Board meeting. The note continues:

> [The auditors] *told me that the Society were taking legal advice to confirm that this "process" in respect of an opinion of which they had, somewhat oddly, been given a foretaste but not the full details was sound. He asked for my view. I said that we very much agreed that it was important to avoid over-hasty or precipitate action which might damage policyholders. We would, of course, expect to be kept very closely in touch with developments and to be given reasonable opportunity to comment on (and if necessary intervene in) any major decisions. But our basic approach would be to try to work in such a way as to best protect policyholders' interests. Thus, if setting up an appropriate provision to cover possible misselling costs meant that the* [required minimum margin] *was uncovered we would not expect the Society to correct the position overnight (eg by some sudden and major switch from equities to bonds) if a more measured and progressive approach would produce a better result, albeit at the cost of leaving the margin uncovered for a longer period.*

The implications for the compromise scheme are discussed and FSA suggest that Equitable '*could scarcely go forward with the scheme with so much uncertainty*'.

06/07/2001 [entry 7] Counsel telephone FSA to inform them of a three-hour conversation that he had had with Counsel for Equitable about possible mis-selling liabilities and the compromise scheme. FSA's Director of GCD records:

> *Points made* [were] *that:*
>
> - [The Society's Counsel's] *opinion would continue to mention almost all the claims identified in the original, and indicate that they were all possible source of claim, in the sense that they were not negligible;*
> - *the exception was pre-1988 claims, which he could not currently say were not negligible, though he was looking at this further;*
> - [The FSA's Counsel's] *view was that* [Counsel for Equitable] *and his junior did not see themselves as advising Equitable, but as "free spirits giving independent advice";*
> - *it was said to be clear that any figures that had been supplied to us as to the value of the misselling claims had not come from* [Counsel for Equitable], *who had been extremely cagey about what the claims were worth;*
> - *it appeared that* [Counsel for Equitable] *and* [his junior Counsel] *were now less bullish on contractual claims for breach of collateral warranties, but would still not dismiss them out of hand;*
> - *in order to make such a claim work, it would be necessary for the court to imply contrary terms into the contracts of GAR and non-GAR policyholders, and the effect of this would be to increase the overall liabilities of the Equitable, rather than simply to require a different sharing of the same pot;*
> - *there was a stark contrast between the approach which* [Counsel who was advising the Society on mis-selling issues] *was taking and the approach which had been taken by* [junior Counsel], *who was advising the Equitable on the GAR scheme along with* [Counsel]*;*

- *this was because* [the Society's Counsel] *had been under the clear impression that his work was going to be factored into the 425 scheme, while those who were working on the 425 scheme were clearly of the view that misselling would be kept out of it;*
- *in particular, the draft board paper on the 425 scheme had referred to misselling only as a procedural point, indicating that the scheme would not affect misselling claims;*
- *it was clear that* [Counsel for Equitable] *had been surprised at the idea that the misselling claims would not be included in the scheme;*
- *our own Counsel expressed doubt that tortious misselling could be included, given that its value will vary from person to person: on any basis, the effect would need to be explained very carefully;*
- [The Society's Counsel] *and his junior take a more absolute approach to the construction of the regulatory rules than* [Counsel for the FSA] *and* [his junior Counsel]*, but consider that even if some fault on the part of Equitable were required in order to show liability, that fault could be established on the basis of the paper* [*With Profits Without Mystery*] *produced by* [Equitable] *in 1988 and 1989, which in* [Counsel for Equitable's] *view showed that they knew that they had a problem, but ran away from it;*
- *accordingly if it were concluded that the rules simply required disclosure of that risk,* [Counsel for Equitable's] *view would be that there had been a material risk from the time policies had been issued, because he had been told that if the true position had been given, no one would have bought these policies rather than those from another provider;*
- *the view that* [Equitable] *knew the true position in 1988 and 1989 is based both on his published actuarial paper "With Profits Without Mystery" and on a meeting note from that date;*
- *it was clear that* [the Society's Counsel] *was not going to be dissuaded from saying that there had been misselling back to 1988 and 1989;*
- *it was clear that the Equitable had not taken legal advice at the time they introduced their differential bonus policy about the validity of such a policy;*
- *it could not be assumed that if they had taken advice before they had introduced the policy, it would have been the advice given by* [Counsel] *when he was consulted;*
- *in* [Counsel for the FSA's] *view, it was difficult to imagine that the 425 scheme would be sellable without including misselling in the accommodation;*
- *this was because the GAR holders would be asked to give up all their rights, but would know that the rights of the non-GAR would be maintained, and this could only* [lead] *to smaller bonuses for the GAR holders, undermining the value to them of the deal they had accepted;*
- *there were, however, two counter arguments to the view that misselling claims had to be included in the 425 scheme;*
- *the first was that the Halifax deal was conditional only on the compromise of the GAR rights, not on compromise of the misselling claims, which could complicate the deal;*
- *the second was that if* [Counsel for Equitable] *was right to believe that there were contractual claims, their scale might be such that it was practicable for them to be adjustable only by a liquidator or administrator.*

06/07/2001 [entry 8] FSA's Head of Actuarial Support meets with the Independent Actuary for the compromise scheme. Included in the issues arising from the meeting and under the heading '*Principles of Financial Management*', the Head of Actuarial Support records:

> *The scheme should result in an improvement to the Companies Act balance sheet of around £500-600M from removing the value of the GAR and replacing this by an uplift of 17-22% to the guaranteed fund; plus also the Halifax contribution of between £250M and £500M.*
>
> *This will reduce the risk of insolvency, thereby allowing Equitable slightly more investment freedom and the possibility of a slightly higher ratio of guaranteed to non-guaranteed bonuses in the future.*
>
> *There is though no indication as yet by Equitable of how this scheme is expected to affect their investment policy, bonus philosophy (including smoothing), MVAs on surrenders (for both GAR and non-GAR policies) and current annuity rates (the latter may not be too important as long as policyholders retain the right to take the funds elsewhere on retirement without penalty).*
>
> *This information will be important to both a qualitative and quantitative assessment of the scheme by policyholders, the independent actuary (if this is within his terms of reference) and FSA.*
>
> *For example, some assurance is needed that the uplift provided to the non-guaranteed element of policy values for GAR policies cannot be unilaterally removed, other than in the context of some equivalent reduction of final bonus for all policyholders.*
>
> *We would also expect to see both GAR and non-GAR policyholders treated similarly in the event of early surrender.*

09/07/2001 [10:27] FSA's Head of Actuarial Support asks the Director of Insurance if Equitable's auditors or their Appointed Actuary had expressed a view on 06/07/2001 as to whether the company was still solvent, as: '*It is not at all clear to me from the limited information provided at present that there is much margin at all on a Companies Act basis, particularly if they have in due course to make any material provision for mis-selling claims*'.

[**10:31**] The Director of Insurance says that Equitable had told them that they were solvent as at end-June but '*that, I am pretty clear, was before any provision for misselling claims*'. The Director concludes: '*At this stage, before either their counsel or ours has opined, it is very difficult to see on what basis such a provision could be made. But the fact that the Society's auditors are (now) being fully involved gives me some comfort*'.

09/07/2001 [11:45] FSA's Head of Actuarial Support circulates a note of his meeting on 06/07/2001 with the Independent Actuary about the compromise scheme. [**12:05**] The Director of Insurance and [**14:13**] the Insolvency Practitioner comment on some of the scheme issues.

09/07/2001 [13:08] FSA's Insolvency Practitioner prepares a paper entitled '*Equitable Life Counter-factuals/Contingency Planning*', which sets out eight scenarios where difficulties might arise for Equitable policyholders. The scenarios are:

1) Solvency deteriorates.

2) Policyholder petitions for winding up.

3) Society becomes insolvent.

4) Society announces that terminal bonuses are not sustainable.

5) Society removes rights to top-up GAR contracts.

	6) Counsel for Equitable's final opinion supports mis-selling actions. 7) Timetable slips – Scheme cannot be sanctioned before 1 March 2002. 8) Scheme is rejected by creditors or not sanctioned by the Court.
09/07/2001 [15:30]	FSA hold a conference with Counsel on the rights of Equitable policyholders to pay top ups and on Counsel for Equitable's opinion in relation to mis-selling liabilities. Counsel advise that Equitable could seek not to allow further top ups only if they gave notice of this to policyholders, but there was also an argument that they could not now do so at all. On mis-selling, Counsel agrees to provide a '*bullet type opinion*' in response to Counsel for Equitable's '*Stage 2*' opinion. The note records: '*This short opinion was likely to indicate that any claim based on contractual rights by non GARs was weak/unsustainable and that mis-selling was from 1995 and not 1988*'.
09/07/2001 [17:04]	An FSA actuary provides the Director of Insurance and the Head of Actuarial Support with a '*Scoping Paper for GAR Value*'.
09/07/2001 [entry 6]	Equitable's solicitors confirm with FSA the arrangements for a conference with Counsel to take place on 13 July 2001. The agenda items are the termination of top-up rights and the significance of this for the determination of classes in the compromise scheme of premium paying and non-premium paying policyholders.
10/07/2001 [09:24]	FSA's Director of GCD suggests that FSA should consider whether Equitable should soon be seeking advice on trading while insolvent. [**13:43**] The Director of Insurance replies: *Do you mean legal advice? If so I am not entirely sure what value it would add. If you mean advice as to what provision might be required in these circumstances (which is essentially a matter I think of "accepted accounting practice") the advice might best come from their auditors, to whom they are already talking (see my note of my conversation with* [Equitable's new auditors]*).* *Where lawyers might really help would be in advising on the nature of any misselling claims that might arise, what form of compensation might be appropriate, whether the causes of action are broadly similar (so that they might stand or fall together) or whether they are various and dissimilar. It is precisely on these points that the auditors feel the Society are being ill-served by* [Counsel]*. Given this information the company could make a reasonable attempt at deciding what should be provided. But for the present the advice the auditors are giving is that the contingent liability appears to be too difficult to quantify to make it appropriate to provision.* *I think we have to bear in mind that what trading means in the case of the Society is paying out money; annuities, maturity payments, surrenders etc. Deciding to stop trading would mean, in practice, stopping all payments. Is this what you have in mind?*
10/07/2001 [10:00]	HMT and FSA hold their tenth quarterly meeting on insurance regulation issues. FSA update HMT on current issues concerning Equitable, including the planned policy value cuts.
10/07/2001 [12:32]	FSA's Line Manager E seeks comments on a further draft of a letter to be sent to Equitable about FSA's criteria for assessing the compromise scheme. Following comments by Chief Counsel B, the Head of Life Insurance and Line Manager E, [**15:35**] the Director of Insurance says that the letter must be issued by 12 July 2001, and should be again checked by Counsel and shown to FSA's Chairman and Managing Director B immediately for their sign off.

[**16:26**] Line Manager E circulates a revised draft of the letter and says that he would prepare a note to the Chairman and Managing Director B.

10/07/2001 [12:42] Further to the discussion on 29/06/2001 [**10:19**] about the basis for intervention by FSA in relation to the compromise scheme, the Director of GCD asks Line Manager E to put together a draft letter to Equitable on the test that FSA would apply, so that they could seek Counsel's views on it.

10/07/2001 [14:01] Following some of the initial discussion that morning about the draft letter to Equitable on FSA's assessment criteria, in which Chief Counsel B had suggested that FSA should ask for urgent clarification on whether Equitable intended to include mis-selling claims in the compromise scheme, Line Manager E says that Equitable have been:

> *... fairly clear with us that they will take a view on whether mis-selling claims can and should be caught up in the scheme when they have a better idea about the scope, scale and likelihood they have of success. Understandably, Equitable does not want to try and deal with a problem that has yet to prove it exists (though clearly we are getting closer to reaching a view that it probably does to some degree). Accordingly, I would rather put that question once the legal advice has been given, and ideally when we have reached a view, as promised in our memorandum to the Select Committee.*

He also queries a point made in a note from the Director of GCD that both Counsel for Equitable and for FSA did not know how the mis-selling issue was being taken forward by Equitable.

[**15:07**] The Head of Actuarial Support says that his understanding was that:

> [Counsel] *is looking at possible mis-selling claims for all with-profit policies sold from around 1996 as being a possibility (though his view may well differ from* [Counsel for Equitable] *who has so far come at this from a rather different angle). The present policy values in respect of this business are likely to be of the order of £10 Bn, so that if the quantum of claim were say 15% of policy value (and it could be higher on the approach he is looking at), we could have mis-selling liabilities of £1.5 bn or more.*
>
> *In present investment market conditions, this would very likely mean that the company was insolvent. Therefore, the Section 425 Scheme would take on quite a different flavour, as it would be the means to restore overall solvency. I am not sure that it is practicable for us to expect the Society to modify the scheme so fundamentally at this stage unless or until we receive confirmation that there are likely to be mis-selling claims of this magnitude.*

[**15:13**] The Director of GCD suggests that '*the alternative* [is] *even more unattractive – that* [Counsel] *gives his advice and there is no plan to deal with it*'.

[**15:16**] The Director of Insurance says that he thinks FSA '*really do need some harder information before we try to take a firm position. There is a danger that too much speculation (which is all it can be at this stage) however well informed will lead to precipitate action which will not best serve policyholders*'.

[**15:18**] The Director of Insurance says that FSA needed some scenario planning and asks that the Insolvency Practitioner's work (see 09/07/2001 [**13:08**]) should be expanded.

[**15:32**] FSA's Insolvency Practitioner circulates his work to a wider audience in FSA.

[**16:00**] The Head of Actuarial Support comments:

> *In this context, it would be very useful to have a figure from them for the total statutory value of the Society's tangible assets as at 30/6/01 (any admissibility percentage limits could be ignored for this purpose). In one board paper, these are estimated on the assumption of a 0% rate of investment return for 2001, while a second Board paper*

assumes a -4% rate of return. Even this small difference could affect their present solvency and resilience to further market changes.

Another point to consider in this note would be the effect on the society's reinsurance arrangements, and in particular the liabilities that were reinsured to Halifax ... I am not sure what would happen to these in the event of a liquidation.

The value to be placed on the GARs in a liquidation is another area of uncertainty that would need to be raised with Counsel in that event.

In Appendix B, I don't understand how implicit items such as future profits could be included in a test of solvency.

10/07/2001 [14:09] FSA's Director of GCD circulates the key points arising from the conference with Counsel the previous day.

10/07/2001 [17:32] FSA's Head of Actuarial Support prepares an analysis of the two Board papers on bonus declarations supplied by Equitable. This comprises two lists of the advantages and disadvantages of option 1 (reduction of policy values by 15%) and option 2 (eliminate interim bonus from 1 August 2000 (i.e. a reduction of 7.3% in policy value)).

On option 1, the Head of Actuarial Support states:

Advantages

- *Preferred option of management/chief executive*
- *Achieves near balance of Aggregate Assets with Policy Values at present time*
- *Avoids potential losses if large number of policyholders opt to retire now*
- *Financial adjuster on surrenders reduced to 5% (but overall they become 5% worse off?)*

Disadvantages

- *Systems problems with implementation*
- *Possible inconsistency with PRE*
- *Concerns that payouts should be smoothed (why has Board not acted before now?)*
- *Revised policy value is around 5% lower than value shown to policyholders as available for transfer as at 31/12/00*
- *Possible unfairness for policies written since around 1990 relative to others*
- *Adverse PR for society*
- *Loss of confidence in board*
- *Difficulty in getting acceptance by policyholders for S425 scheme*
- *Increased likelihood of mis-selling claims*

On option 2, he states:

Advantages

- *Preferred option of appointed actuary in 21 June Board paper*
- *Looks more plausible in terms of investment returns since January 2000*
- *Allows some degree of smoothing in payouts*

- *Administratively less costly*
- *Policy values still higher than amount shown as available for transfer at 31/12/00*

Disadvantages

- *Society still vulnerable to sudden increase in numbers of retirements (though a cut in final bonus as in option 1 could be implemented at a later date)*
- *Financial adjuster on surrenders likely to remain at significant level, (though probably reduced to around 7.5%)*
- *Some adverse PR though less than for Option 1*
- *Imbalance remains between Aggregate Assets and Policy Values (though may not be necessary to disclose this previously unpublished figure with S425 scheme)*

The Head of Actuarial Support says that he was '*somewhat concerned*' about some significant discrepancies in the figures in the papers. He notes that Equitable's Appointed Actuary had recommended a relatively modest reduction in bonus, whereas the Chief Executive had recommended a '*much more drastic*' cut in bonuses. The Head of Actuarial Support suggests that FSA should talk to the Appointed Actuary in order better to understand the situation and to ascertain whether the Appointed Actuary was content with the more drastic option that was being considered.

[**18:21**] Line Manager E responds:

> *I have had some difficulty getting to grips with the relevant papers, but are the numbers so different? Both the management paper and the appointed actuary's report indicate that policy values exceed asset shares by 15-16%. One paper does not contemplate cutting terminal bonus going other than by a further adjustment of the interim rate of return for the recent past. The other is more radical in that it proposes cutting policy values back to match the assets. But equally, the less radical option acknowledges that it does not actually solve the problem – it just means that ... ongoing it would not be quite as bad as it might otherwise have been and that further measures will be needed over time to keep things under control.*
>
> *Would it help if I asked* [Equitable's Appointed Actuary] *to clarify why/when the relevant papers were prepared and considered? It may be that they were produced for different purposes that is not immediately apparent. For example, we know that before the returns were submitted the board considered the issues but failed to decide how to act. There was then a further paper that we were told contained more analysis on the basis of which the board later took its view. It could be that the* [Appointed Actuary] *signed paper was their first shot, and that it had then to be developed into the more radical option (though less radical than some others that* [the Chief Executive] *has come up with, and which* [the Appointed Actuary] *had been unhappy about!).*

10/07/2001 [entry 8] FSA write to Counsel following the conference held the previous day. FSA say that their Counsel had reported that the Opinion given to Equitable by their Counsel considered that there might have been mis-selling by the Society of non-GAR policies from as early as 1988. FSA set out their understanding of the basis for this view and provide their comments on this.

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c10/07/2001 Equitable send FSA copies of four papers discussed at their Board meeting held on 3 July 2001, as requested by FSA on 04/07/2001. The four papers are:

- *FSA Returns, Policy Values and Bonus Rates*, dated 21 June 2001, prepared by the Appointed Actuary.

- *Note on Solvency Position at 2000 and Prospects in 2001*, dated 21 June 2001, prepared by the Appointed Actuary.
- *Note on Society's terms for premiums paid into policies which have GAR benefits, but where premiums have not been paid for at least one full policy year*, dated 21 June 2001, prepared by the Appointed Actuary.
- *Bonus Declaration*, dated 29 June 2001, prepared by the Chief Executive.

1) *FSA Returns, Policy Values and Bonus Rates*
In this paper, the Society's Appointed Actuary sets out the broad position as would be revealed by the returns for the year 2000, once submitted, and highlights some issues which arise. The Appointed Actuary says that he believes that:

> *... it is only appropriate to present these Returns in their present form if the Directors address urgent issues, and that the Society is run with tight control. The urgent issues are bonuses credited on with profits policies for 2001, and changing the terms for new premiums on GAR policies where premiums have not been paid in the previous policy year.*

The paper includes the following presentation of Equitable's financial position at the year-ends 1999 and 2000:

> *Form 9 reveals the following position (*[figures] *in £m)*

	2000	*1999*
Long Term Business Admissible Assets	*34257*	*33111*
Mathematical Reserves	*(32894)*	*(29933)*
Other Liabilities	*(731)*	*(241)*
Available Assets	*632*	*(936)*
Future Profits	*1000*	*925*
	1632	*3861*
Required Solvency Margin	*1221*	*1114*
Free Assets	*411*	*2747*

Equitable's Appointed Actuary notes that the Society's financial position had deteriorated over the year, despite no '*significant*' declared bonus being added. He also says:

> *It should be noted the £411m of free assets is after taking credit for the reinsurance benefit (£808m) and future profits (£1000m). It also ignores the value of the subordinated debt liability of £346m.*
>
> *These are all permissible and previously agreed with the FSA. However, their use clearly eats into any conservatism in the basic valuation regulations.*

The Appointed Actuary goes on to explain:

> *In setting and reviewing each element of the valuation basis I have endeavoured to ensure that each assumption is at least prudent and is backed up by a suitable analysis of experience.*
>
> *Compared with the valuation assumptions used at the time of the Report and Accounts the only significant change is to add an additional reserve of £150m. This is in respect of adding some margin to the mortality assumption and also to provide for possible costs and payments on the Managed Pension Review. In addition a resilience reserve is included and the treatment of the GAR reserve is different using conservative assumptions but including the reinsurance.*

In arriving at the valuation, specific assets are hypothecated to particular liabilities, and reallocated in the resilience scenarios. I believe that the process we used is close to the best achievable.

Overall I think that whilst prudent in all respects according to the valuation regulations the Directors should be aware that it would, in my view, not be possible to produce a satisfactory valuation which produced a materially higher net asset position at 31/12/2000.

Under the heading 'Managing the Society in 2001', the Appointed Actuary reports:

In the first 6 months of 2001 investment returns to mid June were broadly zero (or slightly negative). This was particularly true of UK equities (FTSE 100 index at 31/12/2000 was 6222). This will have adversely affected solvency. The passage of time will also have increased guaranteed liabilities where there is a 3½% interest rate guarantee. Against this the Society received £500m (or say £300m net) from Halifax. (The Permanent sale value was already credited in the 2000 returns). The Society also sold some more equities, although the impact of this has been eroded by claims outflow.

Claims (both surrenders and maturity) are running at a much higher level this year compared with last year and with profit premiums are very modest.

When with profits policies mature the final bonus (which is not reserved for) crystallises. On the other hand, resilience reserves are released and unless an annuity is taken with the Society the 4% solvency margin is released. In the case of surrenders the 15% financial adjustment comes off the final bonus.

In the first 3 months of 2001 £1290m of with profit policy value matured or surrendered with a final bonus of £328m. The financial adjuster saved £29m and hence actual payouts were £1261m with a final bonus element of £299m.

The Society's Appointed Actuary continues:

If first quarter experience were repeated then total claims would be £5.0bn with final bonuses of £1.2bn and therefore a release of guaranteed fund of £3.8bn. The release of resilience reserve on the £3.8bn guaranteed fund might be anywhere between say 6% and 33% of the guaranteed fund. The 33% assumes that we are hypothecating 100% equities to the business going off the books. 6% assumes that the resilience reserve reduces pro rata to the with profits fund. This produces a range of resilience reserve release of between £0.2bn and £1.3bn. Therefore, at best the only addition to free assets would be say 4% of £3.8bn or £152m. At worst, there would be a deterioration of around £850m.

In order to mitigate the adverse effect we could reduce the equity backing ratio.

Under the heading '*Policy Values and Asset Shares*', the Appointed Actuary says that '[as] *well as considering the statutory position the realistic position also needs attention*'. He reports:

At this moment (FTSE 1000 at 5700) policy values are around 16% above asset shares. The interim final bonus rate we are using is 8% per annum for 2001. The financial adjuster we are using (of 15%) means that surrenders are at around 99% of asset shares. The figure clearly fluctuates from day to day with investment markets, but policy values are increasing by 8 % p.a. relentlessly.

Given the tight financial position of the Society it seems perverse to be paying out 16% more than asset shares. In addition this rate of increase of 8% is higher than we would reasonably expect the Society to be able to earn net of management expenses, and recouping present overpayments.

An indication of a sustainable rate would be

	%
40% fixed interest @ 5.5%	*2.2*
60% Equity @ 8.0%	*4.8*
less management and smoothing cost	*(1.0)*
	6.0

In practical terms the most we can do in cutting policy values today is to eliminate any interim bonus additions for the year 2001 in effect reducing calculated policy values today by 4%.

Going back further would effectively go back on what was said in respect of 2000. Going forward we do not wish to set the interim rate below a reasonable gross return on a balanced portfolio, as this would encourage people to retire/surrender immediately. Therefore a 6% rate seems appropriate.

The Society's Appointed Actuary goes on to say that:

The effect of 4% reduction would be to "save" some £200m in policy value payment in a full year which is entirely from the final bonus.

This is clearly a modest step but combined with the reduced accumulation rate would reduce the problem, and stop it "running away" on business that remains in force. Incidentally the policy value overpayments are ultimately paid for by continuing policyholders in extra "smoothing" charges.

There is clearly a risk that this move will be seen as a further sign of weakness of the Society. However, it is interesting that S&P are concerned about this issue and think we will not address it.

The Appointed Actuary's paper concludes with the following recommendation:

As a result of the above analysis, I recommend that the Directors reduce the increase in policy values since 31/12/2000 to zero (where possible) and that from 30/6/2001 the interim rate should accrue at 6% per annum. A formal resolution will be tabled which gives details of the proposed changes.

It was agreed at the Investment Committee that the equity backing ratio (including relevant commitments) should be a maximum of 61½% of the with profits fund.

As illustrated above, this may be insufficient to maintain the solvency margin on its own, particularly if investment markets remain depressed. The Society should therefore monitor the position closely and if necessary reduce the equity backing ratio to improve solvency.

In any event it will be essential to ensure that cash movements and asset exposure are tightly controlled in order to avoid "accidental" exposure to falling markets.

I have stated in the FSA returns that I do not believe that it is appropriate for the Society to contemplate any additional reversionary bonuses until the Society's solvency position is significantly stronger. This might be if investment markets have risen significantly and the compromise scheme is concluded. Such a rise in markets would also be the opportunity to eliminate the gap between policy values and asset shares.

Given that even with the 4% interim policy value increase removed the Financial Adjuster only reduces surrender values to 95% of ongoing asset shares I recommend that no change is made to the financial adjuster.

2) *Note on Solvency Position at 2000 and Prospects in 2001*
In his second paper, the Society's Appointed Actuary sets out the principal reasons for the change in Equitable's statutory solvency position during 2000. The Society's solvency position is set out in greater detail than in his first paper (see above), and is as follows:

		31/12/2000		31/12/1999
		£m		£m
Statutory value of assets		*33,526*		*32,870*
Future profits implicit item		*1,000*		*925*
		34,526		*33,795*
– Mathematical reserves				
– basic reserves	*29,371*		*27,869*	
gross GAR reserve	*2,631*		*1,663*	
rectification	*200*		*–*	
reassured GAR reserve	*-808*		*-1,098*	
– net GAR reserve		*2,023*		*565*
– resilience reserve		*1,500*		*1,500*
		32,894		*29,934*
Available assets		*1,632*		*3,861*
– minimum statutory solvency margin		*-1,221*		*-1,114*
"Free assets"		*411*		*2,747*
Available assets/minimum, margin		*1.3*		*3.5*

The Appointed Actuary points out that the largest single factor that had caused the deterioration in the Society's free assets was the impact of the changes in the reserves established in respect of annuity guarantees. He explains that the main changes to the level of these reserves were due to:

> *i. GAD guidance expects the reserves to assume that almost all policyholders exercise their GAR options. In the 1999 returns it was assumed that 85% of policyholders took GARs. With the House of Lords' judgment that has been increased to 90%.*
>
> *ii. ... the reinsurance treaty had to be renegotiated following the House of Lords' judgment and now allows the Society to assume a net take-up rate of 60% (25% at 31 December 1999).*
>
> *iii. Interest rates at the end of 2000 were generally at a lower level than at the end of 1999. That leads to a higher reserve as does the strengthening of the annuitant mortality basis.*
>
> *iv. The assumptions for the level of future premiums to be assumed have been increased.*
>
> *v. New valuation regulations were introduced during the year which reduced the rate of interest for future cashflows again leading to higher reserves.*

The paper sets out an analysis of the changes in the reserves in respect of annuity guarantees. The Appointed Actuary reports that:

> *The above analysis "explains" some £1.7bn of the £2.2bn change in free assets (increase in GAR related reserves of £1.5bn and additional reserves etc of £0.2bn). The rest of the change is for a wide variety of reasons. However, in the rest of this note the impact of the crystallisation of final bonus is highlighted alongside the change in respect of basic liability values.*

The Appointed Actuary's paper then addresses the changes in the value of the Society's assets over the year (which had increased by 3.1%), along with the changes in the basic mathematical reserves (which had increased by 5.3% or, if premiums received in the year less claims made and expenses incurred were taken into account, by 6.7%). He explains:

Essentially therefore, if we assume that the 3.1% asset increase looks reasonable we need to explain why liabilities (including payouts during the year), increased by 6.7% (i.e. 3.6% more than "expected" or £1bn).

This amount could be partly explained by:

- *additional reserve £150m*
- *crystallised final bonus £545m (from Form 58 of the FSA Returns)*

This would leave miscellaneous strengthening etc of £300m. That would be plausible based on mortality changes and possible losses on non profit liabilities.

Broadly we would expect that as basic liabilities (including the GAR reserves) increased compared with assets the resilience reserve would increase. However, this is not the case.

It is believed that this is explained by the s68 order allowing a "pooling" of the fixed income return on the fixed interest holdings and the more sophisticated allocation and reallocation process used at 31/12/2000 but also and importantly, because the release of reserves through maturity payments can have an opposite effect to the final bonus payment.

FSA sideline the final part of the last sentence and mark it with '?'.

In the remainder of his paper, the Appointed Actuary provides estimates of the possible position of the Society as at 30 June 2001 and 31 December 2001. These estimates, based on certain assumptions, showed free assets at those dates of £338m and £511m, respectively.

<u>3) *Note on Society's terms for premiums paid into policies which have GAR benefits, but where premiums have not been paid for at least one full policy year*</u>
The third paper prepared by the Appointed Actuary considers the issue of the contract terms for GAR policyholders. He explains:

Most of the GAR policies clearly state that if premiums are not paid in any policy year future premiums are accepted by the Society on terms which it decides. Until now the Society chose to allow such premiums to be on GAR terms. Prior to the House of Lords Judgment this seemed fairly neutral, and was administratively convenient. Any "anti selection" was, I believe, minimal.

Since the Judgment this ceases to be the case. In view of the Society's position it is clearly important to avoid any unnecessary further liabilities. I therefore recommend that we offer revised terms for new premiums on such policies with immediate effect and reflect this in the Section 425 Scheme.

The Society's Appointed Actuary provides an analysis of the premium paying characteristics of policyholders, which shows the following:

	Retirement Annuity		*Individual Pension*	
	No	*%*	*No*	*%*
Premium Paying in 2000	*37,772*	*35*	*3,259*	*28*
No premium for 1 year	*5,295*	*5*	*635*	*6*
2 years	*4,894*	*4*	*499*	*4*
3 years	*4,493*	*4*	*380*	*3*
4 years	*3,084*	*3*	*261*	*2*
5 years	*52,709*	*49*	*6,566*	*57*
	108,247	*100*	*11,600*	*100*

4) *Bonus Declaration*

The fourth paper considered by the Society's Board, prepared by the Chief Executive, considers the issues of bonus methodology, the relationship between policy values and asset shares, and the Society's smoothing assumptions.

By way of introduction, the Chief Executive says:

> *Policyholders are sent an annual statement ... and accompanying leaflet ... which sets out the guaranteed fund at a certain date, and the policy value at that date. From this and the With Profits Guide it can be seen that it is clear that "maturity" payments are targeted to be asset share (subject to being not less than the guaranteed amount). Whilst it is not specifically stated that maturity payments can be less than a recent policy value quoted on an annual statement, the statement makes it clear Final Bonus is not guaranteed and may vary. It is stated that the actual amount payable will be determined when benefits are taken. This clearly means that the final maturity payment can be less than the amount quoted on the annual statement.*

FSA underline the words '*Whilst it is not specifically stated that maturity payments can be less than a recent policy value quoted on an annual statement*' and write next to them: '*PRE?*'. FSA also underline the final sentence and mark it with '*?*'.

Equitable's Chief Executive highlights the differences between the Society's approach and that of other companies, explaining that:

> *The Society's approach is different to other with profits offices for pensions business (but similar for life business). Typically bonuses are declared in two forms, a reversionary bonus which adds to the guaranteed fund (or sum assured). The Society's declared bonus (nil for the 2000 year) is similar to this reversionary bonus. However nearly all other offices show a "terminal bonus for policies becoming claims in 20XX". No comparative figure is shown for the previous year, and there is no explicit way of finding out how this has been calculated for any particular policy. The policyholder can compare the terminal bonus with the previous years statement and can read the With Profits Guide if he requests such a guide.*

The Chief Executive then explains to the Board the operation of with-profits business and the smoothing of returns. He reports:

> *With-profits business tries to smooth by holding back investment returns when they are very high in order to subsidise them when they are low ... For smoothing to work, there should be at least as much flowing in by holding back investment returns as flows out. The free assets cannot be allowed to run out during the bad times so either smoothing*

must be more tightly controlled (i.e. a trend line which follows the market more closely) or there must be large free assets.

Most companies now express their total payout policy in terms of asset share. Therefore terminal bonus is essentially aimed at paying out asset share. Typically an office would wish to avoid paying out less this year than last year on the same policy, but provided there is sufficient terminal bonus there is no reason why this should not happen ...

The Chief Executive continues:

The difference between payout and guaranteed amount is stated as the terminal bonus applicable to that policy for maturity or claim that year.

The key difference compared with the Society is that the terminal bonus has no "history" of build up over the years and clearly only applies to that year. For all companies however final or terminal bonuses can be reduced and changes can generally be made at any time.

The Board paper then turns to the current position of the Society compared with smoothing assumptions. The Chief Executive reports:

A summary of the position at 31 December 2000 and an estimate of the 30 June 2001 position are shown below. This assumes that the return over the 1st half of 2000 has been about -4% and policy values (PV) have increased by 4%.

	31.12.00		30.06.01 (estimate)
Market value of with-profits fund	25,333		
New business loan	510		
Asset value	25,843	A	24,400
Guaranteed with-profits benefits	21,468		21,350
Final bonus	5,933	a	6,650
Total policy value	27,401	b	28,000
Best estimate GAR cost	1,500		1,500
PV + GAR	28,901	B	29,500
PV + GAR as a% of asset value (A/B)	111.8%		120.7%
Average final bonus as a% of policy value (a/b)	22%		24%

[Note: The usual annual updates of policy values to 31 December 2000 have not yet occurred as the declaration was deferred. Therefore there are more estimates than usual in the policy value totals above which may be up to 2% overstated.]

The Society's Chief Executive advises that:

The worsening of the ratio of policy values to asset shares from 31 December 2000 to 30 June 2001 of 120.7% is due to the continuing roll-up of total policy values at the interim rate of return at 8% p.a. (4% for the year-to-date) and due to the total return on with-profits assets of around -4%.

In another office it would not be surprising to see some payouts compared with asset shares at up to 120% of asset shares, especially for very long policies but the average would be much lower. Also other offices would tend to have more regular premium business and also new business to "dilute" the effect over time.

Lastly they would have an "estate" or excess capital so that this overpayment was, if it came to it, covered by assets. The Society currently represents to policyholders that their *aggregate interest is £30bn when in fact it is only £25bn. Clearly for the Society to be able to smooth returns at all there needs to be some ability to have policy values above the available assets but the amount of the excess seems too great in present conditions.*

Under the heading '*Policyholder options against smoothing*', he also advises the Board that: '*The Society is also unique in having such a large proportion of its liabilities in the form of pension policies where policyholders can retire immediately (and hence take full benefit (in many cases with GAR benefits.)). It is estimated that £6.7bn (40%) of the guaranteed with profit liability is in this position*'.

The paper then covers the discussion that had taken place at a meeting of Equitable's Board on 27 June 2001. At this meeting, the Appointed Actuary had presented his paper '*FSA Returns, Policy Values and Bonus Rates*' (see above). The Chief Executive records the following from that meeting:

> *The Board agreed that the current position was not sustainable. In particular the matters that the Board were concerned about are:*
>
> 1. *Policy values exceeded asset shares by approximately 10% at 31 December, and the position has deteriorated to approximately 20% currently. Although these values include "indicative" final bonuses which are not included for the purpose of FSA returns, the excess needs active management (for the reasons given ... above).*
> 2. *Policyholders who are electing to retire and invoke a maturity claim are generally withdrawing cash in excess of asset shares even before allowing for the cost of any GAR. This results from over allocation of bonuses in the period before 1991 as well as from the poor returns of the past 18 months. Subsequent reductions in bonuses have affected younger policies as well and have not addressed the over allocation to older policies.*
> 3. *The Board believes some disclosure to policyholders of the financial position of the Society will be necessary at the time of launching a* [compromise] *scheme, and disclosure of the current excess would not be acceptable to the Board or to policyholders.*

The Chief Executive notes that no conclusions had been reached by the Board at that time. The paper then sets out some possible alternative bonus declarations in order to correct the problem, those being:

- a change in the interim rate;
- a percentage change in policy values;
- a percentage change in final bonus; or
- to move to a policy value which reflected the asset share build up on a year-by-year basis.

Under the heading '*Financial Impact of Bonus Changes on the Society*', the Chief Executive says:

> *It is helpful to consider the impact on premiums paid at different durations to assess how "fair" any particular basis is to individual policyholders. Due to the flexible nature of the Society's recurrent single premium contracts it is not possible to look at the position of policies taken out in any one year as each policyholder will have paid a completely different pattern of premiums but we can look at the position of a single premium paid in a particular year. A policy will be made up of a series of such premiums.*

The paper continues:

> *The table below shows an estimate of how policy values and asset share (after deduction of the best estimate cost of GARs) compare for premiums paid of a £1,000 investment content on 1 January 1980 through to January 2000. The asset shares calculated here ... do not take account of any profits or losses from running the business including from past smoothing of with-profits payouts. They can therefore only give an indication of the "true" underlying position and the pattern year by year.*

	(A) Estimate of asset share after GAR costs	(B) Guaranteed Fund	(C) Final Bonus	(D) (B) + (C) Policy Value	(E) (C)/(D) Final Bonus %	(F) (D)/(A) PV as % of AS
Single premium paid on						
01.01.00	*926*	*1053*	*21*	*1074*	*2%*	*116%*
01.01.99	*1070*	*1106*	*96*	*1203*	*8%*	*112%*
01.01.98	*1207*	*1162*	*161*	*1323*	*12%*	*110%*
01.01.97	*1409*	*1239*	*256*	*1495*	*17%*	*106%*
01.01.96	*1552*	*1334*	*311*	*1645*	*19%*	*106%*
01.01.95	*1802*	*1436*	*373*	*1809*	*21%*	*100%*
01.01.94	*1717*	*1545*	*445*	*1990*	*22%*	*116%*
01.01.93	*2203*	*1663*	*585*	*2249*	*26%*	*102%*
01.01.92	*2598*	*1808*	*711*	*2519*	*28%*	*97%*
01.01.91	*2959*	*1993*	*778*	*2770*	*28%*	*94%*
01.01.90	*2636*	*2217*	*886*	*3103*	*29%*	*118%*
01.01.89	*3309*	*2467*	*1257*	*3724*	*34%*	*113%*
01.01.88	*3792*	*2745*	*1471*	*4215*	*35%*	*111%*
01.01.87	*4110*	*3054*	*2099*	*5153*	*41%*	*125%*
01.01.86	*4936*	*3429*	*2731*	*6160*	*44%*	*125%*
01.01.85	*5598*	*3877*	*3439*	*7316*	*47%*	*131%*
01.01.84	*6572*	*4384*	*4418*	*8802*	*50%*	*134%*
01.01.83	*7991*	*4958*	*5669*	*10627*	*53%*	*133%*
01.01.82	*10565*	*5606*	*7087*	*12693*	*56%*	*120%*
01.01.81	*11653*	*6339*	*9162*	*15500*	*59%*	*133%*
01.01.80	*14228*	*7167*	*11442*	*18609*	*61%*	*131%*

The Chief Executive's paper sets out the potential financial impact of the four options for changes to the bonus declaration, as well as the likely impact of each change on: policyholder behaviour; public relations for the Society; and, the Compromise Scheme.

The paper addresses the practical implications of implementing each of the options, before going on to consider '*Consistency with past statements*'. In this section, the Chief Executive explains:

> *The Society has always made it clear that final bonus is not guaranteed and is only finally set when a policy matures. The Society has had a policy of transparency and policyholders are shown the total accumulating value (including final bonus) on the annual statements. An example annual statement is attached ... with some key paragraphs highlighted. All the options for reducing final bonuses are therefore possible in that final bonus is not guaranteed and may be removed but some options are less consistent with other statements which have been made to policyholders which will have set their expectations.*

For the option of making a change in the interim rate, the Chief Executive says:

> *... the ratio of policy values over asset shares has increased by 10% since 31 December 2000 as there has been a gap of 10% between growth allocated to policies and the returns earned. A change to interim growth rates from either 1 January 2001 or 1 August 2001 should be justifiable to policyholders as they will reduce policy values by 4% and 7.3% respectively.*
>
> *As part of the consultation on the* [compromise] *scheme, we have commented that the fund is now more unstable and so more erratic changes are likely and should be expected.*

For the option of making a change as a proportion of policy value, the Chief Executive says:

> *A deduction from the policy value (at 31 December 2000 or at a later date) of much more than the 10% would be difficult to defend in terms of policyholders' reasonable expectations as the leaflet which accompanied the annual statements ... and the Report and Accounts made no explicit mention of the overdistribution at 31 December 2000. However, the financial adjuster of 10% was clearly explained including reference to the market level of assets.*
>
> [The Society's Chairman and Chief Executive] *have also made strong arguments in defence of the Financial Adjuster to the OFT, FSA, and policyholders. Those arguments have stressed that continuing policyholders are being protected by the Financial Adjuster and that it is possible to pay a smoothed value to maturing policies but not to those surrendering ... To now argue that smoothing on maturity is not possible would put the Chief Executive and Chairman in an extremely vulnerable position.*
>
> *A more drastic cut in policy values should the* [compromise] *scheme fail would be much more consistent with policyholders expectations as the management team has been consistently saying that the* [compromise] *scheme is needed to allow the fund to be run in a less volatile - manner without the scheme the fund is fundamentally unstable. If the scheme was not voted through the policyholders should expect much more drastic action.*

For the option of making a change as a proportion of final bonus, the Chief Executive says that:

> *The method that has been used to produce the current policy values has been in place since 1989 and policyholders have consistently been told that the Society has passed across fair and reasonable values within the constraints of smoothing. As we have made no reference to over distribution by duration, to hit some policies by a much greater proportionate cut in payout values and justify it by saying they had been given too much compared with younger policies would be open to criticism that it was inconsistent with PRE. Although smoothing always means that some cases will be over and some under distributed, past statements have not indicated that this will need to be "corrected".*
>
> *GAR policies have final bonus proportions greater than the average across all policies ... and the lack of past statements that such a change may be introduced would leave the Society open to challenge that the House of Lords' was being undermined.*

For the option of making a change to using a duration related scale, the Chief Executive says that this could appear to run counter to the House of Lords' decision. He also says that to move to a less transparent method of allocating bonuses would be inconsistent with policyholder expectations.

The Chief Executive's paper concludes with the following '*Management Proposal*':

On the basis of the foregoing, and the need to get all the bad news out, the "best financial option" seems to be a cut in policy values of 15%. This is based on a FTSE 100 level of 5600. The interim bonus rate would be set at 6% p.a. ongoing with a clear message to policyholders that the position will be kept under review. On that basis, a 5% financial adjuster would seem to be appropriate. Clearly major policyholder and PR issues need to be overcome but we believe that this is the fairest option in the interest of all policyholders.

11/07/2001 [08:41] FSA's Director of GCD responds to the Head of Actuarial Support's note of 10/07/2001 on the Board papers supplied by Equitable. The Director of GCD says:

This is reassuring if it means that, on likely position as to misselling these two options are still available – less so if not. My only other point relates to PRE. We need to recognise, as [the Director of Insurance] *has recently pointed out, that PRE is not a legal entitlement to a particular asset share, or method of calculation. It is a trigger for regulatory action. May be more helpful to consider interests of policyholders.*

[**11:13**] The Head of Actuarial Support comments:

If a significant liability or contingent liability falls to be recognised on the balance sheet for mis-selling, then this is likely to increase the necessity for such action on bonus rates, and most likely push them towards the more drastic option (for which they could then use the mis-selling issue as part of the rationale for this cut in bonuses).

However, I don't think that potential mis-selling is mentioned as one of the factors to be considered in either of these two papers. Therefore, they would no doubt need to prepare a further paper to look at the wider implications. This would also need to consider the potential impact on their immediate solvency which would not be resolved by simply cutting final bonus rates.

On PRE, I seem to recall that the Scott judgment said that this was a factor but not necessarily the only factor that a company should take into account when exercising its discretion. In this present context, I can well see that there would be a range of issues to weigh up in terms of protecting consumer interests, and that these could also influence FSA when considering the possibility of any regulatory action.

[**12:55**] The Head of Actuarial Support also comments on Line Manager E's response of 10/07/2001, saying:

I think it would be helpful to have a chat with [Equitable's Appointed Actuary] *when he comes here tomorrow, after the S.425 meeting, about the content of these papers, some of which (eg the 40% proportion mentioned in paragraph 1.5, and the table in Section 4) look quite surprising.*

His paper says that policy values exceed assets by around 15-16% but the later [Chief Executive] *paper quotes a figure for this ratio of 21% (which would indicate that the 15% financial adjuster on surrenders is now out of line with underlying asset values). The key difference appears to be in the assumed investment return for the year to date.*

At one stage, I know that Equitable were on monthly financial reporting to us but I have not seen one of these reports for a while. It would certainly be very helpful to have a figure from them for the aggregate value of tangible assets as at 30 June this year.

[**13:01**] Line Manager E adds:

That sounds sensible to me. I think the monthly reporting was an informally agreed arrangement. However they have been falling down on that and if they do not pull their socks up and get back into the habit of providing the information on a timely basis, I *think we should consider exercising formal powers. We will put together a short letter asking for the missing information –* [Line Supervisor C] *can you (get* [another FSA official] *to) check when the last report was received and the period it related to.*

11/07/2001 [10:12] In response to 10/07/2001 [**14:09**], the Director of Insurance says that this did not seem to provide the advice promised and, to save time, he sets out what he imagined the advice should be:

As I understand it FSA may intervene where the criterion of sound and prudent management is not met, and in particular in this case, if it appears that the company is not being managed with "due regard" to policyholder interests. Additionally the FSA may be able to act if it appears to it that the company may be acting in a way inconsistent with fulfilling PRE. These are discretionary powers and we have always taken the view that the test to be applied before using them is quite a high one. They are not designed simply to allow us to substitute our judgement for that of the company (whether on policy or legal matters). In that respect they are to be distinguished from the more absolute requirements of the Act, and the related regulations (eg on reserving standards), where we are entitled (indeed possibly bound) to act if <u>in our opinion</u> a company is not meeting the specific requirements imposed on it.

In the present case it appears that the company take a different view of the risk of legal challenge than we do. We know that, at our insistence, they are going back to counsel to test their original view of the legal position (as we ourselves have done). If their new opinion coincides with our own, and the directors follow it, then the problem disappears. But if counsel for the company take a different view we should not necessarily insist on the company acting on the basis of the advice provided to us rather than on their own. The advice we have been given, and the company's intention to follow their own, and contrary, advice, would not <u>of themselves</u> constitute grounds for intervention action.

However there are a number of things we should do immediately. We should:

a) ensure that the [company] *are aware of the views of our counsel – as a matter of urgency;*

b) draw their attention, in particular, to the dangers we envisage arising in relation to the 425 scheme;

c) ask to see the Society's opinion so that we may satisfy ourselves that it addresses the right questions, and is not obviously defective (as it might be if the instructions on which it was based were inadequate);

d) tell the company that we are reviewing the question of whether we should intervene to prevent them acting as they currently intend, and that we will decide on, and if necessary take, formal action, before their decision is due to be announced on 16 July.

Subject to a), b) and c), and provided we are satisfied that the Board has properly considered the issues in the light of (adequate) advice provided to it, and the full knowledge of our views, my firm view is that we should not insist on taking the decision for the company (which would be the effect of intervention action).

[**10:48**] Chief Counsel B says to the Director of GCD, Chief Counsel A and Legal Adviser D that: '*I think that if an insurance company were to act on the basis of a legal view which we think is wrong, then the ICA intervention powers would be available. I think, however, it would be a reasonable <u>policy</u> decision not to do so*'.

	[**12:04**] The Head of Life Insurance agrees with the steps outlined by the Director and: '*If we are satisfied with the steps they have taken to obtain legal advice, and in the light of all legal advice the company decide to cease applying the GAR rate to top-ups, I agree that we should not intervene to prevent that*'. [**13:06**] Chief Counsel A agrees.
11/07/2001 [10:29]	FSA's Chief Counsel B sends the Insolvency Practitioner a note entitled '*Criteria – Equitable Life Scheme*', which provides some initial thoughts on his scenarios paper (see 09/07/2001 [**13:08**]).
11/07/2001 [14:00]	FSA hold a conference with Counsel to discuss the draft letter circulated by Line Manager E on 10/07/2001. FSA's note of the meeting records that discussion had focused on the detail of the letter and: the FSA's role under ICA 1982; the criteria for how FSA would evaluate the scheme; the extent to which benefits and disbenefits should include elements whose value was difficult to quantify; the role of the independent actuary; and the information to be provided to policyholders. It is agreed that the letter should leave open the possibility of FSA appearing in court and communicating its view on the compromise scheme to policyholders. The letter is to be revised and passed to FSA's Chairman for approval before being sent to Equitable for their comments.
11/07/2001 [15:00]	FSA meet again with Counsel. According to Chief Counsel A's note prepared that evening [**21:22**], the Director of Insurance agrees that FSA should leave until later the decision as to whether they should intervene on Equitable's proposed approach on top-ups. In the meantime, FSA are to ask Equitable for their instructions and advice, which was to be sent to their Counsel, and to inform them of the advice received by FSA.
11/07/2001 [15:33]	Further to the Head of Actuarial Support's comments of 10/07/2001 [**16:00**], FSA's Insolvency Practitioner writes: *I think that we may need to develop our views on when Equitable might become insolvent in Insolvency Act terms and what action the FSA might take at that point (if it arises) and how the FSA might respond if the directors became uncertain about the Society's solvency and whether they were wrongfully trading.* *We might need the Society to report regularly and frequently the "fair" values of assets and liabilities (rather than prudent values as in the FSA returns).* *However, we should not jump to the conclusion that liquidation is in any policyholder's best interests even if the Society were marginally insolvent: ie in the short term, policyholders with benefits falling due some way in the future may be worse off in a liquidation compared to permitting the Society to pay in full benefits now falling due for payment.* *Unfortunately a lot hinges on what value is given to PRE in any solvency test. As bonus rates are cut, policyholders' expectations diminish and the excess of asset shares over guaranteed benefits becomes available to meet other liabilities (eg mis-selling claims). If I understand the latest Equitable board papers correctly there is £1,550m headroom available, after GAR provisions, to meet mis-selling claims on the 30 June 2001 worst-case projected balance sheet. We might need Counsel's help with this issue.* The Insolvency Practitioner goes on to set out the key differences between solvency under ICA 1982 and under the Insolvency Act, these being: • *Policyholders reasonable expectations can be included in the Society's liabilities (the court can require them to be valued in a liquidation) – this would probably result* [in] *policies being valued at the asset share values published to policyholders.*

- *Liabilities could be discounted at a fair estimate of the rate of return on all assets available to meet those liabilities: eg assumed returns on equities need not be limited to the dividend rate.*
- *All assets of the society can be taken into account: not just "admissible" assets.*
- *Resilience reserves are not liabilities which need to be taken into account.*
- *Implicit items in the FSA return are not taken into account, but the key test is whether the total projected cash flows from all assets and liabilities is positive at the end of the projections. These projections can take into account the profit element in gross premiums due to the society – to this extent future profits could be taken into account.*
- *Subordinated loan guarantees are liabilities which need to be included.*
- *Reinsurance cover must be included only at a realistic value (but can assume business continues)*
- *Liabilities arising from top-ups to GAR policies need to be included.*
- *Sales proceeds (the Halifax consideration) can be taken into account if there is a realistic prospect of their being received).*

On liquidation other factors arise (but these need not be taken into account in any going concern solvency test – they do need to be taken into account if the society wished to be pass a members (ie solvent) voluntary winding up resolution (permissible with FSA consent after N2 [i.e. 1 December 2001, when the new regulatory regime came into force]*).*

- *The GAR reinsurance contract terminates.*
- *Administration agreements with Halifax become terminable.*
- *Liquidation costs arise.*
- *Unit linked liabilities are paid by Equitable at the same dividend rate as all Equitable's other creditors face unless (as is likely) Halifax make cut-through payments direct to unit liked policyholders and take an assignment of their rights against Equitable.*
- *GAR options are valued in a liquidation (and need to be similarly valued in the above solvency test).*

[**16:06**] FSA's Head of Actuarial Support responds:

> *The exact solvency margin on a Companies Act accounts basis is unclear at present (the figures in the two recent board papers being rather different). Hence, my recommendation that we should indeed request some up-to-date information on the fair value of (tangible) assets as at 30 June. However, you need to be aware that the Companies Act accounts do not include any provision for final bonuses, so that any cuts in those bonuses will not directly impact on this balance sheet.*
>
> *I think we may need to discuss further the basis on which the liabilities would be determined for the purposes of testing insolvency. In particular, I am not sure about your first 2 indents on this topic. If the liabilities are taken to be the underlying policy values (without allowing for the financial adjuster that may be applied on surrenders), then we would indeed have a problem now. However, the Companies Act basis liabilities would be rather lower, and at end-2000 were I believe essentially taken as equal to the guaranteed fund (plus best estimate value of GAR's) for most of their policies.*

Arguably, as I think you indicate in your second indent, these liabilities might be discounted further at some assumed long-term rate of return (net of the 3.5% guaranteed future investment returns on most GAR policies), but then with the addition presumably of some allowance for PRE (all on the lines I think of the 1985 Winding Up Rules).

11/07/2001 [16:48]	Equitable send FSA a draft of their paper '*The Business Case for the Section 425 Scheme*'. Equitable ask for a response by 16 July 2001 and say: '*Given the tight timescales no response by that date will be taken as acceptance of the content and you have no issues with regards sign off of this document by the 20 July*'. [**16:59**] Line Manager E distributes the paper, commenting that he did not think that it was for FSA to '*sign off*' Equitable's document. He suggests that FSA should make this clear to them at their meeting the following day.
11/07/2001 [20:02]	Equitable send FSA the latest draft of the actuarial report for the compromise scheme business case paper.
12/07/2001 [08:51]	Equitable send FSA a copy of their minutes of the meeting on 04/07/2001 [**14:00**].
12/07/2001 [11:59]	FSA write to Equitable to set out their position on the company's plans to cease to apply annuity rate guarantees on top-ups. FSA explain that they had identified four potential problems, those being: • *There is real ... difficulty in the way of trying to prevent people who have not paid or recently paid a premium from exercising top up "rights", because of representations made when policies were sold (and possibly later);* • *However, these "rights" do not have contractual force, and can be removed or changed by notice indicating that the Society is adopting a different policy, thus allowing those who have been given representations that they can top up at any time to consider whether they wish to top up now, before the policy is changed (taking into account the effect this will have on their possible rights under the GAR/non-GAR scheme);* • *It might not be particularly effective in practice to make this change, because it is possible that the reason for the annual percentage reduction in exercise of top up rights is accounted for by people moving out of self employment and so losing their eligibility to participate under Inland Revenue rules;* • *It is extremely important for eligibility for top up to be got right, because it could affect the votes which could be cast in the 425 scheme, and a mistaken basis for calculating these votes could allow this scheme to be set aside.* FSA say that, in the light of this, they believed that there were significant risks to Equitable in proceeding as planned without providing adequate notice to policyholders.
12/07/2001 [12:54]	FSA's Line Manager E says that he had asked Equitable for copies of their further legal advice on the top up issue. He also reports that Equitable had asked for sight of the marketing information on which FSA's legal advice had been based.
12/07/2001 [13:54]	FSA's Insolvency Practitioner comments on Equitable's business case paper for the compromise scheme. The Insolvency Practitioner makes several points of detail on the '*liquidation option*', along with the following '*General/actuarial*' comments: *The reservations we expressed to the Equitable's project team last week remain: the cost has to be higher than the £1.3bn best estimate if policyholders able to retire now or shortly are not to be worse off.*

We need to know what sort of bonus policy will be followed after the scheme becomes effective; particularly how the £250m to £500m consideration from the Halifax will be distributed in terminal bonuses.

We also need to know what investment strategy the Society will follow after the scheme is effective.

We need also to ask the Society to report monthly their financial position on both an FSA return basis and a realistic basis (policy values vs asset shares). We also need to know about assets and liabilities other than those associated with the with-profits fund and perhaps we should also ask for monthly balance sheets or management accounts prepared on a Companies Act basis.

There has been (or shortly will be) a substantial change in the Society's financial position. The scheme must therefore include an up-to-date revised balance sheet, and I think that it should be audited. I believe that the impact of the scheme on policyholders will be clearest if such a balance sheet is presented in a way which shows aggregate asset-share policy values.

The paper needs to specify how the value of policies will be calculated for voting purposes: eg guaranteed values, asset share values, full rights to GAR options, or something less? What is [Equitable's solicitors'] *advice on this?*

I see a scheme adjudicator has crept in (5.15). Who is this proposed to be? Will he adjudicate mis-selling claims? Are we comfortable with policyholders' recourse to the courts being curtailed?

12/07/2001 [14:56]	Line Manager E circulates a revised list of FSA's comments on Equitable's business case paper, taking account of the Insolvency Practitioner's comments given earlier that day.
12/07/2001 [15:30]	FSA and Counsel for FSA meet Equitable, Equitable's solicitors and Equitable's actuarial advisers to discuss the compromise scheme. According to FSA's minutes, the purpose of the meeting was to: review and comment on Equitable's business case paper; identify any changes to the scheme methodology; and inform Equitable of the final criteria against which FSA would judge the fairness of the scheme. Under '*Action points*', Equitable are to provide FSA with any comments on their assessment criteria. FSA are to identify any further information required to assess the fairness of the scheme and Chief Counsel A is to revert to Equitable's solicitors on the question of privilege. (Note: the minutes of the meeting do not record that there was any discussion of policy value cuts, as suggested on 11/07/2001.)
13/07/2001 [12:37]	FSA's Director of GCD seeks confirmation from the Director of Insurance that a letter could be sent to Counsel, which sets out the results of the work commissioned by FSA (from an actuarial firm) on assessing the relative performance of Equitable with-profits policies and other comparable policies.
13/07/2001 [12:39]	FSA's Director of Insurance informs Managing Director B (copied to others) of a telephone call that he had received from Equitable following a meeting of the Society's Board that morning. The Director of Insurance says that the decision taken by the Board was as they had expected and that Equitable were going to announce on 16/07/2001 that they were adjusting policy values, the interim bonus declared and the market value adjuster. The Director says that he had asked to see the press lines prepared by the Society.

13/07/2001 [15:56] FSA's Insolvency Practitioner sends Chief Counsel A and the Director of Insurance a revised version of his paper entitled '*Equitable Life Counter-factuals/Contingency Planning*'. The paper now includes a ninth scenario: '*The executive directors resign*'.

13/07/2001 [17:21] The Financial Services Consumer Panel send FSA their final brief for their Equitable policyholder research. The Panel explain that '*It is now far less about assessing consumer detriment as a result of lack of information and understanding about Equitable Life and much more about getting a better grasp on consumers' experiences to help inform general work on getting information to consumers*'.

13/07/2001 [17:57] Equitable send FSA a solvency matrix that was part of a paper, dated 11 July 2001, for Equitable's Board.

The matrix sets out the ratios of available assets to minimum required solvency margin in changed conditions. (Note: 'MV' refers to 'market value').

Based on 31.05.01 data but allowing for changes in equity values and fixed interest yields from 31.05.01 to 30.06.01	*Yield on fixed interest decreases by 1.0%*	*Yield on fixed interest decreases by 0.5%*	*Yield on fixed interest as at 30 June 2001*	*Yield on fixed interest increases by 0.5%*	*Yield on fixed interest increases by 1.0%*
MV of equities as at 30/06/01	*2.6*	*1.7*	*1.6*	*1.9*	*2.2*
MV of equities falls by 5%	*2.1*	*1.7*	*1.2*	*1.5*	*1.7*
MV of equities falls by 10%	*1.6*	*1.5*	*0.9*	*0.9*	*1.1*
MV of equities falls by 15%		*1.1*	*0.7*	*0.8*	*0.8*

The notes to the matrix say:

> *The ratio of 1.6 at 30.06.01 is after allowing for the sales of equities during June. It is also unlikely that the Society's assets will have performed exactly in line with the indices.*
>
> *The figures take account of additional reserves in respect of guaranteed annuity rate options at the level which reflects the financial reassurance arrangement and assumes the bringing into account of a "future profits" implicit item equal to 5/6ths of the minimum solvency margin. Such additional reserves will increase as interest rates decrease and so the cover ratio reduces with a fall in yields although the effect is partly offset by the corresponding increase in market values.*

13/07/2001 [entry 6] **FSA complete the A1 Initial Scrutiny check on the Society's 2000 regulatory returns**.

13/07/2001 [entry 7] Equitable send FSA a copy of their press notice, for release on 16/07/2001, which states that they had decided to reduce final bonus, along with a copy of an open letter to all policyholders.

13/07/2001 [entry 8] FSA and their Counsel meet Equitable's solicitors and their Counsel for the compromise scheme to discuss issues of common interest relating to the formulation of the compromise scheme.

16/07/2001 [09:04] FSA's Head of Life Insurance provides their Press Office with two amendments to FSA's public statements:

1. <u>Is the company still solvent?</u>
Yes. We are satisfied, on the basis of the latest figures supplied by the company, that it continues to meet its solvency margin requirements. As the company has made clear in its Annual Report and in its regulatory returns, it continues to face some fundamental uncertainties.

(The point here is that we must put the confirmation of solvency in the context of the fundamental uncertainties – the company themselves do this, but far less clearly)

2. (Supplementary point on the Financial Adjuster):

<u>Is the 7.5% level fair?</u>
As explained above, it is perfectly reasonable to apply a financial adjuster in circumstances such as the Equitable now face. The precise level at any given time is a matter of judgement for the company. We continue to monitor the position closely, and will not [hesitate] *to intervene if this would be justified.*

[**09:25**] The Head of Actuarial Support advises:

Regarding the second point below on the financial adjuster, I believe that the position we reached with [Equitable's Appointed Actuary] *over the weekend (not for publication I would suggest) is that the 7.5% adjuster is an arbitrarily calculated adjuster that is designed to protect the fund against the effect of surrenders. As such though, it has not been reviewed against either the representations made to policyholders at point of sale or the provisions of the Unfair Contract Terms rules. [He also mentioned I believe that his own preference was for a 5% figure while* [Equitable's Chief Executive] *sought 10% and they compromised on 7.5%].*

The qualitative reasons stated for this adjuster (which he said were not for publication) were as follows

(1) To allow some room for manoeuvre in volatile investment conditions (i.e. to avoid frequent changes in this adjuster)

(2) To recover all their initial expenses (i.e. deferred acquisition costs)

(3) To allow for the increase in marginal costs for the remaining policies in the fund as a result of the decline in fund size

(4) To build up a reserve for the fundamental uncertainties (i.e. principally the potential mis-selling costs)

(5) General protection of the fund for remaining policyholders

My understanding is that Items (1) and (2) had previously been allowed for in the 15% MVA, but Items (3) to (5) appear to be new.

I think they will have considerable difficulty in explaining to policyholders the reason for the sharp increase in the financial adjuster from 15% to an effective 27.5% for most policies, even if they do choose to publicise the above factors.

In particular, I am conscious from figures they produced earlier that the payouts in respect of many recent policies are now likely to be less than asset shares, even without the 7.5% financial adjuster, thereby exacerbating potential mis-selling claims.

[**10:05**] The Director of GCD states that the advice already given by FSA's legal department was that, from the viewpoint of the Unfair Terms in Consumer Contracts Regulations 1999, it was necessary for Equitable to establish clear binding public criteria for the level of market value adjuster applied, so that policyholders could not be subject to arbitrary and unilateral changes of approach. The Director of GCD says: '*My worry about these new criteria would be that 5 is* *completely open ended and that the changes in the criteria do not seem to justify the new values given*'.

[**10:30**] The Head of Life Insurance informs the Director of GCD, the Head of Actuarial Support and the Head of Press Office that he had received a separate explanation from Equitable, being:

1. Overarching point; fairness between leavers and stayers. But with the benefit of any doubt ("priority in fairness") given to stayers;

2. Market values; when markets are volatile, there is a need to have bases for both maturity and surrender which can be set for a reasonable period; and a fair level for "market value" should be more conservative for surrenders than for maturities;

3. Expenses; recovery from early surrenders;

4. Uncertainties: Uncertainties have to be allowed for, but should be allowed for on a more conservative basis for surrenders than for maturities (comment; this can perhaps be justified on the basis that surrenderers have discretion over timing of withdrawal, whereas maturing policies do not. This is I think a bit less open ended than point 5 below).

[**10:40**] FSA's Head of Actuarial Support notes that Equitable still had the difficulty of explaining why surrender values had decreased so sharply and suddenly, while FSA had the difficult question to consider as to whether the Society's policy was fair to departing policyholders and consistent with the representations which had been made to them.

16/07/2001 [09:24] Further to the discussion on 11/07/2001 [**15:33**], the Director of GCD tells the Head of Actuarial Support and the Insolvency Practitioner to have regard to his forthcoming note on Counsel's advice on mis-selling liabilities and the relevance of the market value adjuster.

16/07/2001 [09:29] FSA's Head of Life Insurance circulates the lines to take in response to questions about the policy value cuts. The issue of whether a statement should be made on the level of benefits that could be payable in the event of winding up is discussed at length between the Head of Actuarial Support and FSA's Insolvency Practitioner.

16/07/2001 [10:58] FSA's Director of GCD provides the Director of Insurance with details of a discussion that had taken place on 13 July 2001 with Counsel about mis-selling liabilities. This had followed a discussion earlier that day between FSA and Equitable's lawyers.

The Director of GCD reports: '*In short, their view was that the relevant Lautro rule required disclosure of the GAR liabilities from the point at which a policyholder might reasonably expect that they would affect the amount available for distribution by way of bonus*'.

The Director of GCD says that Counsel had considered whether any action by Equitable to mitigate the impact of annuity guarantees (for example by using reinsurance, financial hedging instruments or the differential terminal bonus policy) would affect policyholder expectations. Counsel's view was '*that policyholders would indeed expect that liabilities which should be disclosable, but for mitigation of this kind, would remain disclosable*'.

The Director of GCD says:

The effect of this was that:

- *the GAR liabilities were disclosable from the point at which their size, having regard to the company's assets, were such that policyholders might reasonably expect that they would affect the amount available for distribution by way of bonus;*

- *in determining this, the society's arrangements for mitigation of the size of the liabilities by way of the differential bonus policy should be left out of account;*
- *there was no sense in which this involved interpreting the rule to require people to disclose, retrospectively, what the court subsequently decided.*

My view is that this is a sustainable interpretation of the Lautro rules, and the one which the courts are most likely to adopt.

It remains possible that the actual liabilities of the Equitable for misselling are greater than those which would be produced on this basis. We understand that [Counsel for Equitable] *takes the view that the GAR liabilities were disclosable from the late 1980s, on the basis that the society was aware, even then, of their potential impact. Though we do not accept this as the correct interpretation of the Lautro rule, we cannot discount it without seeing his opinion and the facts on which it is based.*

16/07/2001 [entry 5] Equitable announce that they had decided to cut policy values by 16%; to reduce the interim bonus rate for the period from 1 January to 30 June 2001 from 8% to zero and to set the rate of bonus from 1 July 2001 at 6%; and to reduce the market value adjuster from 15% to 7.5%.

16/07/2001 [14:45] FSA's Chief Counsel B and Legal Adviser C provide advice on the operation of the compensation scheme under the Policyholder Protection Act and under the new rules to come into force on 1 December 2001 with the commencement of the majority of FSMA 2000.

[**15:15**] The Director of Insurance asks whether the position outlined was '*a little more definite than is justified as regards the Equitable*', saying that he was not sure, given the advice they had received, that compensation from the Policyholder Protection Board would be payable. The Director says that FSA should be pretty circumspect in what they said, as he '*would not wish to get into a position where it might be thought that we had promised more than could be delivered*'.

[**15:18**] The Director of GCD agrees with the Director of Insurance's comments.

[**15:35**] FSA's Press Office circulates the advice and [**15:59**] later confirms that the Director of GCD had since clarified that FSA: '*can be quite firm on the negative aspects of the* [Policyholder Protection Board]. *The compensation scheme would not cover terminal bonuses before the company has formally decided to award them, so there can be no question of policyholders being worse off now than if the company had been wound up in December – contrary to what some of the policyholders' groups are suggesting*'.

16/07/2001 [14:49] FSA's Chief Counsel B asks Line Manager E what was happening with regard to correspondence about the market value adjuster issue.

[**16:15**] Line Manager E replies:

At some point I think I will mention to Equitable that we have taken over the files and that as they are aware of our corporate view, which we have exposed publicly (eg via the website), we are not proposing to take the matter further [for the time being]. But I will remind them it is something we are looking at mvas generally in the context of the with profits review. I reached the view that if I tried to press the [unfair terms in consumer contracts] *team to write in response to the Equitable offer to OFT, there was a chance it would reopen the substantive debate.*

Chief Counsel B later forwards the correspondence to the Director of GCD, who comments: '*Not sure this decision will prove to be sustainable*'.

16/07/2001 [15:05] FSA's Scrutinising Actuary F advises Line Manager E that FSA should request from Equitable the details of the Appointed Actuary's prospective calculation for their application for a section 68 Order for a future profits implicit item for possible use in the 2001 returns (see 28/06/2001 [**entry 2**]). The Scrutinising Actuary says that they would need to see details of:

- *the method and the actuarial basis he has used for the prospective calculation, including in particular the assumed rate of future investment return, and*
- *the allocation of the anticipated future profits as between the implicit item sought, any obligations the Society will have under the GAO reassurance treaty with Irish European, its ability in respect of the subordinated loan, and any other call on these monies which is envisaged.*

Scrutinising Actuary F also says that it would be helpful to see these details in respect of the '*number of other calculations*' referred to in Equitable's application. He goes on to say: '*We recall that the Society were asked to supply this information in respect of the implicit item used in the 2000 Returns – we do not recall ever seeing this information, and suggest it is requested again. We can then review both sets of calculations together*'.

16/07/2001 [16:00] FSA hold an Equitable Life Lawyers Group meeting. The Insolvency Practitioner attends. They discuss the Practitioner's counterfactuals report and the list of legal issues.

16/07/2001 [16:20] FSA's Head of Actuarial Support circulates a note on his thoughts on Equitable's draft actuarial report, which he says had been presented to FSA on 8 July 2001.

16/07/2001 [18:03] FSA's Chief Counsel A provides the Director of GCD with a list of the '*big areas*' for the compromise scheme proposals where FSA could not yet be satisfied due to insufficient information or justification, or because they did not believe it to be fair. She states:

> *1. I think we are agreed that the proposed treatment of those reaching retirement age within (say) 3-5 years from the effective date of the scheme is not fair. We might be able to agree to a proposed taper up to 75% of the economic value of the GAR rights (in the case of those reaching 50 very soon after the effective date) on the basis that almost everyone in practice takes the 25% cash lump sum. This is a little uncomfortable because it is to insert into an evaluation of individual rights a value based on the experience of the group, but it is a rough and ready "justice" which we might consider acceptable.*
>
> *2. The calculation of the up-lift for premium and non-premium is still a mess. Some improvement may follow on from whatever the Equitable decides to do on receipt of its legal advice on top-ups. At the moment, apart from the issue of whether the Equitable can include as non-premium paying those whom it is planning to cut off without notice, there is an issue as to whether Equitable can treat as premium paying those whom it has not cut off whom it could have cut off. I am also concerned that the Equitable is valuing top-up rights on the basis of historical experience. This is the accepted actuarial method (as we heard from* [Counsel for Equitable] *on Friday), but I remain to be convinced that we should not be using a different methodology to calculate economic value (and one that does not rely on the experience of the group).*
>
> *3. Finally, although the figures may be around now (and I have just not caught up with them), we have some concerns that the 3% up-lift for pre-1975 policies may be operating unfairly within the group.*

Chief Counsel A concludes that she thinks FSA '*can say now that subject to the up-lift operating fairly (on the basis, mainly, of the value of individual rights, not the experience of the group, and other caveats like misselling and the possibility of submissions from* *policyholders in due course which may cause us to change our mind), calculating the pot on the basis of the cost of the GARs appears to be reasonable. On the up-lift, however, while I think we are heading in the right direction and we have no reason to think Equitable will not find a solution which we can accept, we are not there yet. This message may still be positive enough for the Equitable to be getting on with*'.

17/07/2001 [entry 1]	FSA's Director of Insurance writes to the Director of GCD (copied to others) suggesting that a '*core group*' is established to co-ordinate work on Equitable. The Director identifies a number of issues that FSA needed to address in the following areas: • compromise scheme; • financial position; • mis-selling; • availability of compensation; • contingency planning; and • FSA decision making.
17/07/2001 [entry 2]	HMT ask FSA for answers to some questions raised by the Economic Secretary to the Treasury. The questions are: *1. What did the FSA say at the time the Halifax deal was announced? How did you frame your comments on the wisdom of staying in or leaving the fund? Have you said anything since? What was the basis for commenting on the deal at all?* *2. Do you consider saying anything about yesterday's announcement? Did you consider urging* [Equitable] *to make it sooner, or saying something yourselves beforehand?* *3. What is the basis for your current assessment that* [Equitable] *is solvent? Does yesterday's announcement have any bearing on this? Does it increase the risk of members leaving and thus worsen solvency? And what about the likely publication of Counsel advice on misselling? How great is the risk of insolvency, and what do we do then?* *4. Had Equitable's funds been revalued between December and yesterday's announcement?* *5. How does the size of yesterday's revaluation compare with market movements generally over a directly comparable period?*
17/07/2001 [entry 3]	FSA's Chief Counsel B seeks advice from the Head of Actuarial Support on three issues from a report by an actuarial firm, dated 13 July 2001, on the quantum of mis-selling liabilities.
17/07/2001 [10:00 and 15:12]	Chief Counsel B asks the Director of GCD to confirm his view on the Policyholder Protection Board, as, if that view was as described by FSA's Press Office the previous day, '*it conflicts with the advice I had previously given*'.
17/07/2001 [11:09]	FSA's Scrutinising Actuary F draws the attention of the Director of Insurance, the Head of Life Insurance, Line Manager E, the Head of Actuarial Support, Chief Actuary C and Chief Counsel A to commentary that had appeared in a national newspaper that day which was '*highly critical of the role of FSA in apparently doing nothing in recent months while Equitable behaved "recklessly" in overpaying outgoing policyholders*'. He refers them to the note of the meeting with Equitable on 04/04/2001 '*when I raised these very concerns*' and continues: '*As most of*

you will know, despite the Society's lack of action at that point, my concerns on this continued'.

17/07/2001 [12:17]	Following the Equitable Life Lawyers Group meeting the previous day, Legal Adviser A asks Line Manager E and the Head of Life Insurance whether FSA should impose a notice of requirements on Equitable for the provision of regular updates of their financial position, verified by their auditors. He says that he understood that FSA currently received monthly updates. [**12:50**] Line Manager E says that he was not sure that the monthly reports were '*capable of audit*'. The Line Manager also confirms that FSA '*are supposed to get monthly reports, but they have not been doing very well of late – the last we had was as at end March. I have it on my to-do list to raise this with* [Equitable's Appointed Actuary]'.
17/07/2001 [13:30]	Equitable send FSA a copy of their questions and answers on the policy value cuts.
17/07/2001 [18:21]	FSA's Press Office asks the Head of Life Insurance whether someone had already suggested to Equitable and/or the Society's Chairman that they did not make misleading statements '*such as that their cut in policy values was not done for solvency reasons? Obviously this is stretching the truth somewhat, and* [although] *we can't take away the fact that he said it, he presumably shouldn't be saying it again given what we know is in their annual return? If we say nothing they will probably treat it as acquiescence?*'. The Press Office also suggest that Equitable might be misleading people about the benefits of switching from equities to bonds. The following day, the Head of Life Insurance says that the Press Office's first point was well taken but that he was not sure about the second.
18/07/2001 [09:52]	FSA's Director of GCD replies to Chief Counsel B's note of 17/07/2001 [**15:12**], saying: *I misread your note and believed we were in agreement. As I understand it you conclude that the* [Policyholders Protection Board] *can pay compensation on an amount which includes PRE. If this is right, it applies to the future as well as the past and means that people might indeed be better off on a liquidation than accepting what the* [Equitable] *offers them. It also suggests that this is the answer on* [Article] *4 – ie that you can get back not only the reduced value of your* [liabilities]*, but also 90% of* [policyholders' reasonable expectations] *so perhaps in some scenarios liquidation would give people more back ... we need to evaluate this.* (Note: the Director of GCD replies again to this query on 24/07/2001 [**11:33**].) [**13:04**] The Director of Insurance writes to the Director of GCD and Chief Counsel B saying that, as they had agreed that morning, '*this is of potentially very great significance*'. FSA are to commission advice on how a court might determine policy values having regard to bonus expectations. [**14:12**] FSA's Insolvency Practitioner informs the Director of Insurance, the Director of GCD and Chief Counsel B that the case of another company that had gone into liquidation was not particularly helpful. [**14:18**] The Director of Insurance thanks him and says: '*So at least we know that we are in uncharted waters*'.
18/07/2001 [10:00]	FSA and PIA meet to discuss the regulatory control of Equitable following the Director of Insurance's note of 17/07/2001. FSA's note of the meeting records that no meetings were to take place without the prior knowledge of the supervisory team and, whenever possible, supervisors should be invited to attend. The note summarises the discussions on a number of issues.

Financial position
FSA say that Equitable's Chairman's most recent statement regarding the solvency of Equitable was arguably misleading. It is agreed that FSA should issue a Notice under section 44 of ICA 1982 requiring the Society to provide monthly financial information and to demonstrate that it was solvent under the requirements of both ICA 1982 and the Companies Act 1985. It is also agreed that there should be an independent review of Equitable's financial condition within three to four weeks.

(Note: on this last point, the draft minutes of the meeting read: '*It was agreed to appoint an independent auditor (probably* [Equitable's new auditors]*) to report to the FSA on the solvency of the Equitable within 3-4 weeks*'. On 19 July 2001 (at 15:14), Managing Director B writes that he '*thought we agreed that the independent audit should not be done by the Society's auditors (i.e not* [Equitable's auditors]*)*'. The final minutes are amended to read: '*It was agreed that there should be an independent review of Equitable's financial condition within 3-4 weeks*'.)

Mis-selling
The note records that the following actions were agreed:

- that Counsel should be asked to produce provisional advice on mis-selling.
- that FSA should ask Equitable formally about their strategy for pensions mis-selling claims on publication of their Counsel's opinion.
- that FSA did have powers to stop Equitable publishing their Counsel's opinion but that it was unlikely to be in the interests of policyholders to exercise those powers.
- that FSA should ask Equitable about their ability to reserve for mis-selling claims. It is noted that work would be needed to quantify claims and that Equitable would need adequate contingency planning to cope with a range of possible outcomes.

Compensation – Policyholders Protection Board
FSA note that the Court would probably include policyholders' expectations in calculating policy values in the event of liquidation and the Policyholders Protection Board would pay 90% of policy values after determination by the Court.

Compromise scheme
It is agreed that FSA could not sign off the current proposed compromise scheme until it was clear how those proposals '*measured up*' to their criteria. FSA record that the scheme would be '*arguably unfair ... if it did not include pensions misselling claims*'. FSA also record that Equitable should be asked to justify the advantages of a compromise scheme over the status quo and formal Insolvency Act procedures.

Contingency planning
FSA record that administration, if it were extended to insurance companies, would be preferable to provisional liquidation. The Director of Insurance agrees to talk to HMT about the possibility of an Order being made under section 360 of the FSMA 2000 (Note: this was commenced on 20 July 2001 and gave HMT the power to make an order to allow insurance companies to be placed into administration).

Further action points
The following items were noted for further consideration:

(a) The FSA to require Equitable to freeze payments of terminal bonuses.

(b) The FSA to require the Equitable to move further funds from Equities to Gilts. The ratio was currently 61.5%. (We have now been advised that equity proportion is 48%, 12% property and 40% bonds.)

(c) The FSA to require the Equitable to apply the MVA to terminal bonuses and not guaranteed bonuses.

(d) The FSA to seek Equitable's confirmation that those policyholders who withdrew shortly before the announcement of 16% reduction in terminal bonuses would allow such policyholders to withdraw at the old values.

Of these (a) to (c) should be kept under review. (d) should be actioned.

18/07/2001 [10:07] FSA provide HMT with answers to the questions they had raised the previous day. FSA state:

1. Since the announcement of the closure of Equitable Life to new business, the FSA has been careful in its information to policyholders not to give them encouragement to stay with Equitable Life or to transfer to another provider. We have however encouraged people to consider any action they propose to take carefully and encouraged them to take proper advice where appropriate. We also sought to alert people to the fact that there might be downsides to their transferring, for example because of taxation or if they had GAR policies. Our position has been reflected on the website (copies of the relevant pages attached) and that neutrality has not fundamentally changed in the period since December 2000.

2. We considered carefully whether it would be helpful for the FSA to make an announcement in parallel with that from Equitable Life. We concluded that there was nothing that we wished to say proactively since this was an announcement by the company. However, we prepared lines to take in response to enquiries and were in close touch with the company to review the proposed terms of its statement to ensure that it was appropriately expressed. The announcement was made as soon as practicable after the board had decided on its course of action, so an earlier announcement was never a possibility. It should also be remembered that part of the reason for the need for such extreme action was the continuing decline in the financial markets at a time when Equitable Life policies were continuing to attract notional annual growth of 8 per cent taking the value of the policies and the assets further out of line.

3. We are satisfied, on the basis of the latest figures supplied by the company, that it continues to meet its solvency margin requirements. As the company has made clear in its Annual Report and in its regulatory returns, it continues to face some fundamental uncertainties. It is difficult to judge whether this will increase policyholders propensity to leave. The opportunity of suffering the financial adjuster at the lower rate of 7½ per cent will probably be attractive to some, but others may consider that the damage has already been done and that they would do better sitting tight. There is the likelihood of further announcements about the performance of life funds in the near future and this may discourage people for the time being.

There are however uncertainties, including in relation to the opinion on mis-selling which is due shortly (the FSA is also doing work on this topic). Subject to those uncertainties, at this stage, we do not think insolvency likely and we have been assured by the appointed actuary that there are further steps the company can take to avoid that, such as by cutting terminal bonus further. This is something that the FSA will be investigating further with the appointed actuary as a matter of urgency. If however insolvency was unavoidable, this would trigger the operation of the Policyholders Protection Act where the Policyholders Protection Board would in the first instance seek to secure a transfer of policies to another insurer. It would be able to provide financial assistance to achieve that. Alternatively, the business could be placed in liquidation and policyholders would be paid compensation up to 90 per cent of the guaranteed value of their policy at the point of liquidation.

4. The Regulations require the assets and liabilities of an insurance company to be under constant review. The movement of the value of the assets and liabilities over the first six months of the year has therefore been fairly clear and was reported by Equitable Life to the FSA on a regular basis.

5. The adjustment to policy values, as compared with the year end position, was of 16 per cent. The FTSE 100 closed at about 6220 on 31 December 2000; on 17 July 2001 it closed at 5430, a fall of about 13-14 per cent. However, at the year end, policy values were already some way ahead of the value of the underlying assets because of the continued application of an 8 per cent interim rate of return. The overall effect is to reduce policy values to close to the value of the underlying assets at the present time.

18/07/2001 [14:36] Equitable inform FSA that they were going to look at their Companies Act valuation to see what margin might exist to accommodate a provision for mis-selling. FSA note: '*He seems to think that they might be able in theory to discount their liabilities by up to another £4 billion but I believe this would only be possible in the context of a further substantial increase in the MVA (which could in turn increase the mis-selling costs, and also would bring the surrender values well below the guaranteed fund on retirement) and possibly a further reduction in the final bonus (which would now principally affect GAR policies –* [there] *being little if any potential final bonus remaining now for post-88 policies)*'. Equitable ask whether FSA might be willing to '*offer*' them a further section 68 concession to further discount their liabilities. FSA indicate that they would be quite sceptical about this.

18/07/2001 [entry 5] FSA's Chairman, Managing Director B, Managing Director A, Director of Insurance, Director of GCD, Head of Life Insurance and Head of Press Office meet and agree:

- *That the Society's Board should consider* [Counsel's] *opinion and the strategy for the section 425 compromise before publishing the opinion.*
- *That the FSA should commission a comparison by consulting actuaries of the value of Equitable policies (by type and by year) and the average value of comparable products available from other providers. This would provide, very roughly expressed, the test we anticipate will be proposed by our Counsel to establish loss where misselling is established. The quantums should be calculated against both the* [Counsel for Equitable's] *and* [Counsel for FSA's] *opinions.*
- *That the FSA should require the Society to commission an independent review of its financial position with terms of reference to be agreed with us.*
- *That this work should be taken forward in as timely fashion as possible to minimise further delay to the Society's section 425 proposal (it was noted that the original immediate timetable was clearly now unrealistic). It was further noted that we would find it difficult to advise on the fairness of any section 425 scheme absent this information.*
- *That these points should be communicated to* [Equitable's Chairman] *at a meeting the following morning.*

18/07/2001 [20:21] The Head of Life Insurance provides FSA's Chairman with a speaking note ahead of the meeting with Equitable's Chairman.

19/07/2001 [08:30] FSA meet Equitable's Chairman to discuss their position on mis-selling claims and Counsel for Equitable's opinion, which was to be provided to FSA shortly. The meeting is held at FSA's request. FSA's note of the meeting records that discussion took place on the differences of the provisional views of Counsel for Equitable and Counsel for FSA and the immediate issues that needed to be addressed as a result of the views expressed by Counsel, those issues being:

i. *Should these liabilities be brought within the ambit of the s425 scheme (our current understanding was that the Equitable and its advisers did not plan this)?*

ii. *Did the Society remain solvent so that it was proper for it to continue in operation?*

iii. *Was there a danger that the liabilities attributable to mis-selling might outweigh the value of the GARs and, if so, how did that impact on the proposed scheme?*

It is noted that Equitable were to receive Counsel's draft opinion the following day and that it would be considered by the Board on 25 July 2001. The Director of GCD informs Equitable's Chairman that Counsel's advice on the compromise scheme now suggested that it would be possible to include mis-selling liabilities within the scheme.

FSA anticipate:

a) *That we should commission a report by consulting actuaries which would seek to establish the range of prudent liabilities* [for mis-selling costs] *to which the company might be exposed. This would need to involve, on the basis of what we expected our Counsel to advise, comparison of the value of Equitable policies (by type and by year) against the industry average for comparable products.*

b) *That there should be a rapid independent review of the financial condition of the Society. I explained the basis on which we envisaged this would be carried out – essentially that the emphasis would change from a statutory value under the Insurance Companies Act which was the focus of our normal supervisory attention, to one based more directly on Companies Act requirements.*

It is agreed that there should be further discussion over these two financial reviews.

Equitable's Chairman is '*non-committal*' about the implications of possible mis-selling claims on the stability of the fund. FSA's note records:

> *There must be some danger that policyholders – particularly non GARs – might conclude they had had enough and should leave. But there would be substantial costs to them in this (and to the Society which would need to liquidate assets to meet surrender payments further reducing the value of the Society's assets). Much would depend on the Society's success in marketing the proposed scheme.*

Equitable's Chairman, in response to FSA's Chairman, says that there was no sign that the directors might be unwilling to continue.

19/07/2001 [10:36]	FSA prepare a draft proforma for the financial information that they might ask Equitable to produce each month.
19/07/2001 [12:58]	PIA report to FSA that their Enforcement Department had had no direct contact with Equitable at the time of the Halifax deal and disciplinary action on Pension Fund Withdrawals and pension review failings.
19/07/2001 [14:09]	FSA's Line Supervisor C sends the Director of GCD copies of FSA's letter to Halifax of 31/01/2001 and PIA's letter to Equitable of 31/01/2001. The Line Supervisor says: '*I got this message second hand so I hope this is what you need. I don't think we gave a positive undertaking not to reveal this – but I presume it was implicit that this was confidential communication between the regulator and a regulated firm*'.

[**14:41**] Line Manager E comments: '*I think it was understood that the fact of possible disciplinary action being dropped, and the reasons why it happened, would at some point become known. I think there was also, however, an understanding that we would not reveal the information just for the sake of it. If the reason for the question is connected to the Review, I think that that is precisely the kind of situation where it was envisaged that some form of disclosure would happen*'.

19/07/2001 [15:11] FSA meet Equitable's Appointed Actuary to set out what financial information they would want to receive on a regular basis to enable them to monitor effectively Equitable's ongoing financial position. FSA's Head of Life Insurance's note of the meeting does not state what information was required; however, it does state that Equitable's Appointed Actuary had no problems with the request and that FSA had explained to him that they would want to translate the request into a formal requirement.

FSA also outline the '*additional steps*' they were minded to take (i.e. an independent review of the financial position of the Society), as discussed with Equitable's Chairman that morning. In response to this, the Appointed Actuary says that if this were to happen his position would become untenable and that he would have to resign. The Head of Life Insurance's note goes on: '[The Appointed Actuary] *already has plans to call on the resources of* [his company] *to undertake work to validate the financial position. He would not want to commit to this if FSA were to require another firm to be brought in*'.

The Head of Life Insurance comments:

> *I think this puts a different perspective on our discussions yesterday about the identity of a firm to carry out the work envisaged. For the Society to lose another Appointed Actuary at this delicate stage would be a very serious, and potentially fatal, blow. As regards independence, I think it should be acceptable for the Equitable to commission* [the Appointed Actuary's company]*, if it was made clear that the commission was to the firm, as distinct from* [Equitable's Appointed Actuary]*, and that* [the company] *would have a duty of care to FSA as well as to the Equitable.*

[**15:16**] The Director of Insurance responds to the note of the meeting, saying that he agreed with the Head of Life Insurance that there could be '*awkwardness*' if Equitable's Appointed Actuary resigned, but adds '*I am not sure we should let him use this to prevent us from doing what we think is necessary*'.

[**19:23**] The Head of Life Insurance replies to those comments, reporting that he had received a telephone call from the Appointed Actuary's company and one from Equitable's Chief Executive. The company had expressed concern at what the Appointed Actuary had reported to them and stressed that: '[The company] *had recognised the risks to them as well as to* [the Appointed Actuary] *personally in agreeing to make him available as the Appointed Actuary of the Equitable and saw themselves as standing behind* [the Appointed Actuary] *to provide additional resource and expertise, and independent and objective review of his actions and assessments*'. The Head of Life Insurance says that he explained FSA's reasoning that '*in the special circumstances of the Equitable, it was reasonable for the regulator to take additional steps to satisfy itself about the financial position, including commissioning (or asking the Society to commission) independent work*'. In response to the Appointed Actuary's company arguing that they should be considered as being independent, the Head of Life Insurance states that FSA '*were likely to take the view that these advantages* [regarding efficiency and minimising the strain on Equitable's resources] *were outweighed by the extra independence that would be provided by involving a third party*'.

On the conversation with Equitable's Chief Executive, FSA's Head of Life Insurance says that the Chief Executive had been in an '*emotional mood*' and had said that '*if the FSA wanted to run the Equitable, then they were welcome to do so, and he would join* [Equitable's Appointed

Actuary] *in resigning*'. The Head of Life Insurance says that he had stressed that '*although what we were proposing was unusual by the traditions of DTI/HMT insurance regulation, it was perfectly normal in the context of banking supervision, and as an integrated regulator, it was natural for the FSA to review the full range of supervisory tools available (and familiar) to it*'.

[**15:44**] The Head of Actuarial Support writes separately to the attendees of the meeting, pointing out that the Appointed Actuary was a consultant from an actuarial firm rather than an Equitable employee. The Head of Actuarial Support provides eight key points from the meeting, those being:

1) For the Companies Act accounts at 30 June 2001, Equitable's Appointed Actuary believed assets exceeded liabilities by £1.6bn, '*Therefore, a provision for mis-selling would take them right up to the line*'. He says that he believes that Equitable might be able to justify reducing their liabilities by £400m to £800m but that the Head of Actuarial Support had reminded him of the '*professional responsibility to take particular care in selecting an appropriate actuarial basis when the solvency of an insurer is in doubt*'.

2) Equitable do not appear to have considered the possibility that redress for mis-selling might need to be calculated on the basis suggested by Counsel for FSA.

3) In the event of a provision for mis-selling of £1.5bn being required, the Appointed Actuary's view was that the Board would wish to consider freezing all final bonus payments and further increase the financial adjuster applied to surrenders.

4) Equitable's asset mix is currently 48% equities, 12% property and 40% bonds. They were trying to sell around £600m to £800m of equities each month in order to fund cash outflows and to reduce their holding in equities by 5% over the next three months.

5) Equitable's Appointed Actuary says that he believes that there would be no scope to increase the proportion of assets held in equities as a result of the compromise scheme and '*Accordingly, any such references were being removed from the documentation*'.

6) Work on the compromise scheme was continuing without any modifications to allow for Counsel's opinion on mis-selling.

7) The Appointed Actuary confirms that recent policies where policy value was less than the guaranteed fund would not receive any final bonus. The Head of Actuarial Support asks him to consider '*whether the policyholders were sufficiently aware now of the society's present investment policy and how this might affect their future bonuses in variable investment conditions*'.

8) FSA present the Appointed Actuary with their draft proforma for monthly financial reporting that FSA were likely to make into a formal requirement.

19/07/2001 [17:59] FSA's Head of Actuarial Support sends Chief Counsel B a note summarising his research on the claim values currently being paid by Equitable for pension policies written in 1996, hoping that it would be helpful to Counsel's analysis. The Head of Actuarial Support notes that, while some further work would need to be done to determine the potential redress for individual policyholders, '*we should be able to make some broad estimate of the potential provision that may be required if this is the likely approach, once we have some idea of which generations of policies are likely to be affected. For example, if this were to include all policies written since 1988, then we could be looking at a provision of around £4-5 billion*'.

[**18:26**] The Head of Life Insurance questions why Counsel needed this information.

[**18:42**] FSA's Director of Insurance suggests that it is needed not for quantification, but to form a view of the date from which mis-selling occurred.

19/07/2001 [entry 7] **FSA complete their Initial Scrutiny of the Society's 2000 regulatory returns**.

FSA complete Form A2, which follows a similar format to that used for the 1996 to 1999 returns and includes the following:

Strength of valuation basis
FSA note that the rates of interest used for with-profits business do not appear to make provision for policyholders' reasonable expectations and comment: '*Form 57 @ 4% used in respect of* [pension business] *valued at 3¾%*'. FSA note that other management expenses, at £80m, are material. FSA confirm that Equitable have applied the resilience test in accordance with the latest published guidance (see 15/05/2000). FSA judge the overall interest basis and, taken overall, the valuation basis appears to be '*adequate*' to '*weak*'.

Solvency position
FSA judge the absolute level of cover for the required minimum margin to be '*of concern*'. FSA observe that the trend in the level of cover over recent years has been '*down*' and that the slope of the decline is steepening.

Suitability of assets
FSA note that the level of mismatching by currency is material and comment that there were insufficient sterling assets. FSA also note that linked asset surpluses/deficits were material but were less than 1% of unit values in aggregate.

Operating results
FSA answer '*yes*' to the question '*Is either the absolute level of surplus/deficit emerging or its trend over recent years such as to give current cause for concern?*'. They again note that the amount of reinsurance is material and that there was a material exposure to non-UK authorised reinsurers without deposit back.

PRE issues
FSA identify no issues of concern.

Current issues
FSA note that Equitable have set up an identifiable reserve of £130m (£132m in the 1999 returns) in respect of pensions mis-selling. FSA again state that Equitable were known to have material exposure to annuity guarantees and that either the amount of the additional reserve, or any aspect of the basis used to calculate it, was a cause for concern.

FSA do not make any '*General comments*' and they maintain the priority rating at 2.

FSA also prepare a five-page report on their initial scrutiny.

FSA state that Equitable's solvency position was very weak and, despite strengthening of the valuation basis in the 1999 returns, '*areas of weakness appear still to remain*'. FSA say that the position is obfuscated by Equitable reporting only a bonus reserve valuation without the appendix net premium valuation. Their primary concerns relate to the adequacy of the reserves for accumulating with-profits business and of the provision for future expenses.

FSA produce a table of Equitable's financial position which shows that available assets have fallen from £3.86m for the 1999 returns to £1.63m for the 2000 returns, resulting in a fall in their cover for the required minimum margin from 3.46 to 1.34. FSA say that available assets have fallen dramatically as a result of:

- *increased reserving for GAO's,*
- *changes made to the valuation bases as a result of correspondence with GAD in late* [2000] *following our scrutiny of the 1999 Returns,*
- *the impact of the 2000 (Amendment) Regulations introduced in May 2000, and*

- *the poor investment returns experienced by the fund over the year 2000. (The Report & Accounts quote a total return of +2.7% on the fund over the year, which was in fact quite good relative to the performance of the markets, and the results achieved by competitors.)*

FSA note that the solvency position improved in March 2001 with the sale to Halifax '*although the position remains tight*'.

FSA explain why the reserve for annuity guarantees had increased from the previous year. They set out the level of reserve as being:

(£'000s)	*31.12.2000*	*31.12.1999*
Gross	*2,631,000*	*1,663,000*
(Reassured)	*(808,000)*	*(1,098,000)*
Net	*1,823,000*	*565,000*

FSA say that the higher gross reserve reflects: reductions in the yield on fixed interest securities; the impact of the 2000 (Amendment) Regulations; and a strengthening of the assumed future mortality assumption. FSA explain that the reinsurance offset was lower due to renegotiation of the treaty following the House of Lords' decision.

FSA set out the changes to the valuation basis resulting from their scrutiny of the 1999 returns, which were:

- An increase in the assumed GAR take-up rate from 85% to 90%. (FSA note that information on the assumed take-up rate had not been specified in the returns but had been advised in Equitable's letter of 16/11/2000.)
- A reduction in the rate of decrement assumed for future premiums paid on policies containing guaranteed annuity rates.
- A reduction in the assumed retirement age from 55 to 50.
- The effects of the synthetic bond which required Equitable to aggregate the rates of interest on fixed interest securities.
- Discontinuation of the use by Equitable of a zillmer type adjustment in the resilience scenario. FSA note that, while this issue appeared to have been resolved, '*the overall approach to reserving in the resilience scenario at this valuation appears to be weak, and we are questioning this in our letter*'.

FSA highlight the additional statements of uncertainties included in the 2000 returns. Those were made regarding:

- The review of the sale of Managed Pension policies; the unknown outcome of enquiries by regulatory and professional bodies and any actions which might result from these; no provisions for contingent liabilities had been made; and the future premium pattern of in-force policies.
- Matters relating to the certificates of the Directors and Appointed Actuary.
- The Appointed Actuary's certificate which had been signed '*subject to the uncertainties and limitation set out*' and which mentioned the need to adjust policy values and '*take action on*' bonus policy.
- The Auditors' report, which also mentioned the '*fundamental uncertainties*'. FSA note: '*although their opinion is "not qualified in respect of the above matters"*'.

FSA explain that Equitable had on this occasion only presented a bonus reserve valuation but had (at paragraph 8(d) of the returns) demonstrated that the reserves held were at least as great as a net premium valuation would require.

FSA note that the resilience reserve required had increased from £1,350m for the 1999 returns to £1,390m for the 2000 returns.

FSA explain that the amount of resilience reserve held in this set of returns is not directly comparable to the reserve held last year in either the gross premium or net premium valuations. They state: '*This is because the underlying valuation this year is a bonus reserve valuation, but the resilience reserve held in last year's* [bonus reserve valuation] *was a balancing item such that the total reserves held in both the* [bonus reserve valuation] *and the* [net premium valuation] *were the same*'. They go on to say that the resilience reserve '*looks low*' and '*an initial examination of Forms 57 in the 2000 Return indicates that on some of the classes of accumulating with profits business, reserves are being released in the resilience scenario, and this suggests that reserves in that scenario may be less than PRE surrender values*'.

FSA note that reserves for expenses were up sharply but that it was not clear that the total reserve would be sufficient.

FSA state that Equitable's sterling denominated assets were now less than their sterling denominated liabilities, by around £2.5bn.

FSA say that it was not clear where the reserves for the rectification scheme were held.

FSA say that an area of strength in the valuation was the general reserve of £150m, but FSA add that: '*Whether this is sufficient remains to be seen!*'.

FSA attach a copy of their letter to Equitable (see below).

19/07/2001 [entry 8] FSA write to Equitable's Appointed Actuary with some questions about their 2000 returns which had arisen as a result of FSA's initial scrutiny of those returns. They ask:

1) How the reserves held for accumulating with-profits contracts compared with the smoothed asset shares. They ask for separate figures for products with and without guarantees (being both guaranteed investment returns and guaranteed annuity rates).

2) What amounts were generated by the valuation to cover expenses for future years.

3) To advise on any allowance made for mismatching by currency.

4) To confirm the provision held in respect of the GAR rectification scheme.

5) To provide details of the calculations to support the use of the section 68 Order for a future profits implicit item. FSA note that they did not appear to have received a reply to their letter of 12/03/2001 on this issue.

6) To explain their preferred approach to dealing with the synthetic bond, as: '*It seems to us that there is a choice for the future – either to proceed on a basis that is consistent with the year end 2000 or to move to the alternative method you had proposed in your application that would bring Equitable into line with other companies*'.

19/07/2001 [entry 9] FSA seek advice from the Policyholder Protection Board's solicitors about the Policyholder Protection Act 1975.

20/07/2001 [13:53] FSA's Insolvency Practitioner asks Legal Adviser A and the Head of Actuarial Support to check two draft letters concerning requiring Equitable to commission investigating accountants to quantify potential mis-selling liabilities.

20/07/2001 [14:28]	FSA's Press Office writes to the Director of Insurance and Managing Director B, saying: '*Apparently, the Equitable Policyholders' Action Group is asking HMT for £2.6bn to compensate them for regulatory failures re Equitable. HMT are trying to work out how to* [pour] *cold water on this without pre-empting our review etc. They will let us know what they come up with – unless anyone would like to offer suggestions?*'.
20/07/2001 [14:44]	FSA's Chief Counsel B sends the Insolvency Practitioner a note of the advice on policyholders' reasonable expectations, insolvency and the market value adjuster that he and the Head of Press Office had given orally. The Chief Counsel advises that they had thought that it would not be possible for a court to grant a winding up petition where the evidence of insolvency rested in part on the insufficiency of assets to meet non-contractual benefits to which policyholders' reasonable expectations attached.
20/07/2001 [15:51]	Counsel send FSA a copy of their draft opinion, saying that they look forward to receiving comments on it next week.

20/07/2001 [17:46] Equitable reply to FSA's letter of 19/07/2001 about their 2000 returns. Equitable provide the following responses, as per the numbering used by FSA:

1) Equitable attach a table setting out the data on the reserves held for accumulating with-profits business (in the base and resilience scenario) and the smoothed asset share as at 31 December 2000.

	Mathematical reserves, normal conditions	*Smoothed asset share*	*Mathematical reserves in changed conditions*
	£m	*£m*	*£m*
UK Life and General Annuity	*2,198*	*2,664*	*2,031*
UK Pensions 0% guarantee	*2,660*	*3,071*	*2,415*
UK Pensions 3.5% guarantee (including GAR reserve)	*14,882*	*18,276*	*13,476*
Overseas	*567*	*649*	*531*
Total	*20,307*	*24,660*	*18,456*

Equitable say that there had been a degree of estimation in the figures for smoothed asset shares and that they would supply a breakdown of those with and without annuity guarantees next week.

2) Equitable explain their approach to the reserves established for expenses.

3) Equitable say that they had assumed that the fall in value of equities in the resilience test contained an element for mismatching by currency.

4) They provide information about where in the returns they had made provision for the rectification scheme.

5) Equitable enclose a copy of their letter and calculations dated 28/06/2001 for the future profits implicit item.

6) Equitable say that this needed to be discussed and some further work carried out. They ask to defer this item for a short period.

Equitable enclose their estimated solvency positions for April, May and June 2001 and apologise for not sending them earlier. These show:

Solvency position at 30 April 2001

	£m	£m
Value of non-linked assets		*28,350*
Future Profits Implicit Item		*1,000*
		29,350
Mathematical Reserves		
– Basic (including GAR)	*26,405*	
– resilience	*940*	
		27,345
		2,005
Required Minimum Margin		*1,155*
Excess Assets		*850*

Solvency position at 31 May 2001

	£m	£m
Value of non-linked assets		*27,780*
Future Profits Implicit Item		*1,000*
		28,780
Mathematical Reserves		
– Basic (including GAR)	*26,200*	
– resilience	*790*	
		26,990
		1,790
Required Minimum Margin		*1,140*
Excess Assets		*650*

Solvency position at 30 June 2001

	£m	£m
Value of non-linked assets		*27,255*
Future Profits Implicit Item		*1,000*
		28,255
Mathematical Reserves		
– Basic (including GAR)	*26,030*	
– resilience	*445*	
		26,475
		1,780
Required Minimum Margin		*1,120*
Excess Assets		*660*

Equitable conclude by saying:

> *Last week I sent you our "ready reckoner solvency" matrix. Using this type of methodology we estimate the statutory solvency position daily and at the low point of*

the market at around lunchtime on 19 July 2001 when the FTSE 100 stood at 5320 it is likely that the cover ratio was about 1.0, i.e. just covering the required minimum margin. As discussed, and is clear from the matrix further equity market falls could lead to the required minimum margin being breached.

20/07/2001 [18:16] Following a request from the Chancellor, FSA send HMT a note on Equitable, which reads:

1. Since the House of Lords' judgement and the Equitable's decision to put itself up for sale, the FSA's aim has been to achieve the best result for Equitable policyholders in a difficult set of circumstances.

2. Following the Society's failure to find a buyer and the closure to new business in December 2000, our strategy has been to:

- *assist the sale of the underlying business to secure the highest possible value for policyholders;*
- *see new directors and new management in place;*
- *ensure that the Society remains solvent;*
- *ensure that policyholders were kept informed, both by encouraging the Society to improve its communication and by putting out our own messages through the press and on our website;*
- *promote a resolution of the outstanding difficulties through a compromise between the various groups of policyholders which would cap the outstanding GAR liabilities, and allow the Society to revert to a more normal investment strategy going forward; and*
- *address potential regulatory issues, principally whether there was mis-selling which might require compensation.*

3. This strategy remains in place. The Halifax deal produced additional funds of £500m with a further £500m potentially available in the event of a successful resolution of the GAR/non GAR problem. A strong new Board is in place – albeit with thin management support. The Society continues just – to meet its margin requirements but has had to take and announce difficult decisions on the adjustment of policy values. Policyholders have been provided with relevant information, although the Society struggles to deal with the volume of enquiries and its handling of public communications has failed to win policyholders' confidence.

4. However, the future remains uncertain.

- *The Society's solvency position remains tight and current market conditions are unhelpful.*
- *The compromise scheme is being worked on; the main outstanding issue is whether and if so how to incorporate the potential liability for mis-selling. Equitable have commissioned* [Counsel] *to advise them; his opinion is likely to be that mis-selling took place from 1988 onwards. The FSA has commissioned its own advice which is not so extreme, but is expected to be that there are significant liabilities for mis-selling, dating broadly from the point at which the annuity rate guarantees became valuable, as long term interest rates fell.*

5. Against this background, the strategy is still feasible, but will be difficult to achieve. [Counsel] *is briefing the Society's directors today but his final Opinion is two weeks away. Meanwhile the Board will consider its response, and the implications for a compromise scheme. We are liaising closely with the Society over this. We believe that the best* *solution would be to include any mis-selling liabilities within the compromise. This will be a complex task. It may not be possible to meet the 1st March 2002 deadline set by the Halifax as a condition for putting up to £500m extra into the Equitable's fund.*

6. It is for the Society to bring forward proposals for a compromise; but the FSA needs to be in a position to take its own view on the fairness of any proposal (we need to satisfy ourselves that we should not intervene to prevent it on the grounds that the Society is not acting in the interests of policyholders) and we will wish to make our position clear to the Court, which will have to decide on the acceptability of the proposal.

7. We have therefore set in hand some contingency planning. We plan to:

- *Commission consulting actuaries to quantify the probable liability for mis-selling, by comparing the value of Equitable's policies with the average value of comparable products from other providers (this is the test which we anticipate Counsel will propose to quantify the loss to policyholders of mis-selling);*
- *Commission an independent review of its financial position.*

8. In the worst case scenario, we may need to consider liquidation of the Society. This could take a number of forms but each of them would involve the Policyholders Protection Board becoming involved, either to seek a transfer of the business to new ownership (highly unlikely, given the history), or to pay out to policyholders 90% of their benefits. Putting the company into administration, which would be a preferable alternative, is currently not permitted by law. We understand that the relevant provisions of [FSMA 2000] *which enable appropriate regulations to be made which would allow this have been commenced, but the regulations themselves (which will be complex) have not yet been drafted.*

9. A further factor in all this is the outcome of the Review of the FSA's supervision of the Equitable since 1 January 1999. The report is almost complete, but some maxwellisation of former members of the Equitable is still required. Our best estimate is that the report will be ready for publication by the Treasury in September or October.

23/07/2001 [entry 1] Equitable return to FSA their completed response to a survey on the tax treatment of derivative assets.

23/07/2001 [entry 2] FSA meet the National Association of Pension Funds, at their request, to discuss the position regarding Equitable.

23/07/2001 [11:34] Counsel send FSA their thoughts on the second draft of Counsel for Equitable's opinion.

23/07/2001 [12:24] FSA's Head of Actuarial Support writes to Chief Counsel B about Counsel's opinion (received on 20/07/2001 [**15:51**]). The Head of Actuarial Support writes:

This draft appears to say that all policies sold since 1988 (and any pre-88 policies on which premiums have increased by 10% since 1995?) may have been mis-sold, and that the quantum of any loss may have to be determined by comparison with a similar policy sold by a "median" insurer.

However, there is some suggestion, which seems quite surprising really given that policyholders would only recently have been aware of this omission by Equitable (perhaps in 1998), that the Limitations Act could rule out claims for policies sold more than 6 years ago (or perhaps only in respect of premiums paid more than 6 years ago).

Nevertheless, even if claims could only be submitted for premiums paid on non-GAR policies since mid-1995, the potential liability could still be around £2-3 billion.

> *Do we know if* [Counsel for Equitable] *is likely to reach a similar view?*

23/07/2001 [14:28] Equitable send FSA a note entitled '*A Comparison for Retirement Annuity of proposed policy enhancements with the value of GARs using Open Market CARs*'.

23/07/2001 [16:00] FSA hold an Equitable Life Lawyers Group meeting.

23/07/2001 [16:47] An official from FSA's Press Office informs the Head of Life Insurance that Equitable's website says: '*The FSA is responsible for safeguarding the interests of policyholders*'. The official says: '*I'm not at all sure that's right. Are they over-promising what a regulator can deliver as much as they over-promised their fund?*'.

The following day [**at 09:15**], the Head of Life Insurance says that he did not have any problems with the wording as '*it is what we aim to do*'.

On 25 July 2001 [**16:21**], the Director of GCD agrees with the Head of Life Insurance's comments.

[**16:37**] The official explains that her concern was that '*it implies a guarantee that we can always safeguard their interests – which many consumers would no doubt take to mean that we are safeguarding the value of their investments ...*'.

23/07/2001 [17:31] FSA's Director of GCD circulates copies of the two Counsel's opinions on mis-selling. The Director later circulates a note summarising the opinions.

[**17:54**] The Head of Actuarial Support says that the financial implications look quite bleak:

> *If, for example, they are likely to incur mis-selling claims on all post-1993 policies, then the liability could be around £3–4 billion, which would be well beyond their current free reserves on a Companies Act basis of around £1½ billion. If the potential claims extend back to 1988 or even earlier, then the situation is clearly even worse.*
>
> *Even if the Limitations Act applies (which seems very odd to me as a layman given that it was not the fault of the policyholders that they could only have been likely to have become aware of the alleged non-disclosure in 1998 or even later), then the liability could be around £2½ to £3½ billion, assuming that there would be a liability in respect of all premiums paid in the last 6 years. The result is still then likely to be insolvency.*

Managing Director B, the Director of Insurance and the Director of GCD meet to discuss the position and to agree the immediate action to be taken.

[**20:23**] Following the meeting, the Director of Insurance comments:

> *It seems to me that the analysis in the two opinions raises the possibility that other companies which wrote GAR business might face similar claims. This might arise where Companies are paying GAR liabilities but their ability to do so (as falls in equity markets reduce their free assets) comes to be at the expense of asset shares for policyholders generally. In such cases it seems possible, at least in theory, that the "*[Counsel for FSA] *test" of the quantum to be attached to any misselling claims, as the difference in value between affected policies and policies issued by companies which did not sell GAR policies, could potentially produce substantial additional liabilities.*
>
> *The work I have asked* [the Head of Actuarial Support] *to do, in fairly rough form, is to look at the companies which we know have written significant volumes of GAR business, and to provide such assessment as he can, by reference to what we know of their free asset position, of the point at which they would be likely to deliver (or may already be delivering) less than asset shares to policyholders because of the need to meet GAR liabilities.*

When we have this assessment, I think we will need to take a view on:

a) whether such misselling claims, if they are likely to arise, could imperil further companies.

b) whether it is possible to make any assessment of the possible impact on the industry generally through the compensation schemes and of the ability of the industry to absorb this impact.

Depending on the results of this work we may need to consider briefing the Bank/HMT/FSA standing committee. I am mindful that we have said publicly that we briefed the committee in December on the Equitable situation, and that at that time the Committee's view was that there was no threat to financial stability. While this may still be, and probably is, the correct view it might do no harm to reconsider the position.

23/07/2001 [18:11] FSA's Chief Counsel B distributes a note confirming the position of policyholders who had mis-selling claims.

23/07/2001 [19:17] FSA's Chairman asks for a meeting on 26 July 2001 to discuss '*the interplay between solvency and the GAR scheme and raise the issue (even if only to dismiss it) of whether policy-holders would be best served by activating the compensation scheme now*'. The Chairman says that he also thinks that FSA needed to think through their rationale for:

- *Why we did not do anything about the misselling liability at the time?*
- *What, if anything, should we do about it now?*

23/07/2001 [22:04] FSA's Insolvency Practitioner circulates two draft letters, the first to Equitable requiring them to instruct investigating accountants and the second to the investigating accountants. He comments that he thinks Counsel's advice to FSA becomes discoverable if they shared it with the investigating accountants '*unless* [the Director of GCD] *can find a way around this*'.

The following morning, Managing Director B circulates an amended version of one of the letters.

24/07/2001 [09:17] FSA's Chief Counsel B advises that there might be two issues relating to tax on any mis-selling compensation.

24/07/2001 [11:25] FSA's Insolvency Practitioner sends the Director of Insurance, the Director of GCD and an FSA Legal Adviser (Legal Adviser E), copies of correspondence between FSA and HMT on the difficulties with making administration available to insurance companies, so that they were aware of those difficulties.

24/07/2001 [11:33] Further to Chief Counsel B's query of 17/07/2001 [**10:00 and 15:12**], the Director of GCD replies again (see 18/07/2001 [**09:52**]), confirming his understanding of the advice to be that '*compensation could be paid on an amount set by the court to represent undeclared terminal bonus*'. The Director of GCD continues:

I think there's a difference between this and paying compensation on what a company itself estimates as intended future bonus. But is the conclusion that policyholders would have been better putting the company into liquidation before? Or would the same exercise take place whenever the company went into liquidation? And if so, isn't that the answer to our article 4 concerns? And surely this could mean that liquidation could be better than a 425 scheme, depending on the impact of that scheme on PRE? We also need to consider whether we should be advising policyholders to stay in rather than go, because PRE will be compensatable – subject only to a 10% penalty – on liquidation.

24/07/2001 [15:30] FSA meet Equitable to review the position of the Society. FSA's note of the meeting records discussion on the following issues:

<u>Independent review of Equitable's financial position and likely mis-selling costs</u>
FSA explain why they thought the reviews were necessary and hand over draft instructions for investigating accountants and investigating actuaries. Equitable's Chief Executive accepts the reasoning behind the review of the financial position but '*was less sure*' about the review of mis-selling costs. The note records: '*In this context, the impact of Article 4 of Equitable's Articles became important. We reminded him that both FSA and the Society had legal opinions which suggested that Article 4 would not protect the Society from insolvency*'. It is agreed that both sides would revisit the issue.

<u>Subordinated loan</u>
Equitable's Chief Executive reports that the annual payment on the subordinated loan, of about £28m, becomes due on 6 August 2001. The Chief Executive notes that, if the required minimum margin were not met, then the payment could be passed, but this could lead to policyholder panic and a run on the fund. He confirms that bondholders could not petition for winding up. However, FSA comment that they thought any six policyholders could petition for winding up on just and equitable grounds. FSA agree to research the position further.

<u>Top-ups to GAR policies</u>
Equitable hand over Counsel's further opinion, which advised that four weeks' notice should be given of any cancellation of top-up rights. FSA and Equitable agree to consider how much notice would be required.

<u>Press criticism</u>
FSA ask for Equitable's Chief Executive's reaction to press criticism that policy values had exceeded fund value for an excessive period. The note records:

> [The Chief Executive] *said that his view was that at the end of 1999, policy values were too high and could have been corrected by a 1% reduction of bonus rates in at least some years during the 1990s. The divergence had become significant over the last eighteen months, with the emergence of the GAR problems. For a normal fund, even this divergence need not have been a problem; but the Equitable had an unusually high proportion of policyholders approaching maturity, so that the over payments were particularly costly. Nevertheless, the company's policy had been reasonable; it was* [defensible] *to regard the divergence as consistent with normal smoothing as* [late as] *spring 2001, when the new board undertook its financial review.*

On 27 July 2001, Equitable send FSA a copy of their notes of the meeting. FSA provide their comments on the notes on 3 August 2001. According to Equitable's notes of the meeting, on the proposed reviews:

> [Equitable's Chief Executive] *commented that solvency in general tends not to be a concern, however, meeting* [the required minimum margin of solvency] *is an issue particularly given the well-known fundamental uncertainties faced by the Society. He was happy for investigations to be undertaken. The range of numbers regarding the quantum of mis-selling claims is potentially very large, including values higher than the cost of the House of Lords' ruling which would threaten the solvency.*

FSA change the final word '*solvency*' to '*RMM*', (i.e. required minimum margin).

24/07/2001 [16:16] Equitable's solicitors telephone FSA to ask whether they planned to publish their Counsel's opinion and, if so, to request sight of it. FSA say that, if they were to publish anything at all, then it would be after Equitable had published their own opinion and that FSA would give Equitable notice.

[**16:23**] Line Manager E says that it would be unusual for FSA to publish their opinion but says that FSA might want to draw upon it in any report on mis-selling.

[**21:26**] The Director of Insurance agrees and informs them that FSA's Chairman's view was that FSA should express their view on mis-selling at the same time as Equitable.

The following morning (at 08:29), the Director of GCD also informs them that FSA's Chairman had made it clear to Equitable's Chairman that FSA would not want a gap between publications.

24/07/2001 [16:23] FSA thank Counsel for sending them the latest version of Counsel for Equitable's opinion and FSA send them a copy of their summary of the opinions (see 23/07/2001 [**17:31**]). FSA say that, from a preliminary review of the latest version of the opinion, they did not believe that the summary needed to be changed but ask for Counsel's views on this.

24/07/2001 [16:53] FSA's Director of GCD suggests to Chief Counsel B that FSA should determine what approach they would take if FSA were to set up a redress mechanism to require Equitable to provide redress for generic mis-selling. The Director sets out his view of the position that FSA should take on the information and advice that policyholders were entitled to receive from Equitable and as to what they had actually been told.

24/07/2001 [17:35] FSA's Director of GCD sends the Insolvency Practitioner the comments of Counsel on draft letters to Equitable requiring them to commission independent reports into their financial position and estimate of mis-selling liabilities.

[**17:41**] The Head of Actuarial Support queries two points.

25/07/2001 [09:42] FSA's Director of GCD provides revised advice to the Director of Insurance on the weight that could be attached to Article 4 of Equitable's Articles of Association.

25/07/2001 [10:31] FSA's Insolvency Practitioner sends the Director of Insurance the final version of the letter to Equitable requiring them, pursuant to sections 44(2)(B) and 45(1) of ICA 1982, to commission a report from their Appointed Actuary's company providing an analysis of Equitable's financial position as at 30 June 2001.

The Insolvency Practitioner also sends a further draft of a letter to a different firm of actuarial consultants, commissioning an estimate of the extent of mis-selling liabilities.

25/07/2001 [12:26] FSA's Director of GCD writes to his Chairman, in response to a request for advice on how FSA might respond to queries about their role in relation to mis-selling. The Director of GCD provides the following draft questions and answers, highlighting that the material would need to be checked before finalisation:

Q *You tell us now that your rules mean that the Equitable has been required, since at least 1993, to disclose to potential policyholders the existence of the GARs. What disclosure should the company have made?*

A

- *The advice we have had is that the company should have disclosed the fact that it had GAR liabilities which a reasonable policyholder could think might affect the amount available for distribution by way of bonus.*
- *These liabilities would not have been disclosable if the company had put in place arrangements to mitigate them, for example by reinsuring them, or taking out an interest rate swap.*

- *Nor would they have been disclosable while the company had robust and unchallenged legal advice that its differential bonus policy was valid.*
- *But in fact it never had such advice. From 1988 to 1998, it was operating without the benefit of legal advice. The advice it received in 1998 was only given in the context of the challenge made, which the company concluded needed to be taken to court in order to provide clarification of the position.*

Q Why was no action taken about it at the time?

A Determining whether to make this disclosure was, in the first instance, a judgement for the company to make, with its own knowledge of its commitments, and the assets available to meet them.

- *This issue first came to the attention of the FSA at the beginning of 1999. [Is this true?] By that stage, the company had had legal advice that its bonus policy was valid, but had also decided that the issue needed to be tested through the courts.*
- *In the circumstances, no action was taken to insist on a disclosure, given that the true position remained a matter of dispute before the courts. That is not to say that we now take the view that no appropriate disclosure could have been made.*

Q What action will you now take on the basis of this conclusion?

A We will:

- *ensure that proper redress is provided from the assets of Equitable Life either by requiring Equitable Life to pay redress to these policyholders, or by satisfying ourselves that proper provision is made for credit to be given through the proposed compromise between the different class of policyholders;*
- *consider whether any action is required personally against those at Equitable Life responsible for its action;*
- *consider whether there are other companies in a similar position, where similar action is required.*

But we do not intend to take action to fine the Equitable Life itself. This would only penalise the policyholders, by reducing the assets available to them.

Q Can policyholders sue you for failing to ensure that proper disclosure was made?

A We believe that we have acted reasonably throughout. The proper source of redress for misselling is the company which missold the investments concerned.

25/07/2001 [12:40] FSA's Director of GCD provides advice to the Director of Insurance on Counsel's opinion on top-up rights and on '*whether it would be possible for FSA to express the view to the society that we would not take action against it on PRE grounds if it were to give 6 weeks notice, instead of 4 months*'. The Director of GCD advises that this would depend on whether, in all the relevant circumstances, six weeks would be sufficient to enable policyholders to determine whether or not to make a top up.

25/07/2001 [14:30] A PIA legal file on Equitable includes a '*Note for Record*' of a meeting of FSA (Managing Director B, Director of Insurance, Chief Counsel B, Legal Adviser D, Head of Actuarial Support, Head of Life Insurance, Insolvency Practitioner, Line Manager E and another official) and Counsel to discuss the draft opinions of both Counsels. (Note: a copy of this note does not appear to be held on any of FSA's files.)

The two-page note records:

Key Points

1. [Counsel] *agreed that the FSA could send* [Equitable] *a copy of his draft opinion with the caveat that it was likely to change significantly before being finalised and also that it was provided in confidence and therefore should not be published. Final version of opinion expected to be delivered* [by close of business on] *30/7.*

2. [Counsel's] *draft opinion implied that* [Equitable] *was insolvent (and had been for some years). This conclusion was based on three points (require clarification!)*

- *If full disclosure had been required non-GAR policies would have been unsaleable.*
- *? s459 of Act – limitation period?*
- *Non-GAR contracts prevent* [Equitable] *using profits to discharge GAR liabilities.*

3. If, as expected, [Equitable] *publish* [Counsel's] *opinion, others would be free to draw the same conclusions.*

4. [Counsel] *noted that* [the Counsel for Equitable] *opinion requires an initial judgement that the policy documentation effectively promised non-GAR policy holders "fair" share of the profits. It is, however, very improbable that* [Equitable] *believed that they were operating under such an arrangement.* [Counsel] *thought it arguable that, on the basis of the documentation, non-GAR policy-holders were unlikely to expect a smoothed share of profits. Indeed, the policy documentation makes no reference to asset sharing.*

5. [Counsel] *noted that the 1994 Lautro rules required disclosure of any risk which may have had an adverse effect on performance or was otherwise material to an investors decision to invest. Attendees discussed whether it was reasonable to assume that the GAR risk should have been disclosed to non-GAR policyholders.*

6. It was agreed that if the GAR risk had been recognised by [Equitable] *management it potentially should have been disclosed to policyholders. However, given the economic environment during the late 80s/early 90s, the probability of the GAR risk materialising was minimal. In addition, because* [Equitable] *did not take legal advice on whether they were mis-selling the non-GAR policies at the time, they were unable to form a view of the probability and impact of the risk materialising. Ultimately* [Equitable's] *management had failed to consider the implications of what was then a highly improbable potential risk, but they should have recognised the potential legal uncertainty and sought a legal opinion.*

7. [Managing Director B] *noted that the policies included options which were at the time so far out of the money that* [Equitable] *may not have ... considered* [them to be] *a disclosable risk. However, the inclusion of the options could reasonably have been expected to be disclosed in the product literature.*

8. Attendees then discussed at what point [Equitable's] *management could have reasonably anticipated the full impact of the risk materialising.* [Paragraph] *3 of the* [Counsel for FSA's] *opinion noted that it was unclear when the full implications of the risks were appreciated.*

9. It was noted that the regulatory implication of the [Counsel for Equitable's] *opinion was that mis-selling liabilities across the insurance industry could amount to a systemic level.*

10. [The Director of Insurance] *asked* [Counsel] *to consider the arguments about likely quantum (noting that as late as 1999,* [Equitable's] *auditors considered the quantum of the potential risk to be much smaller than current estimates) and materiality factors in his final opinion.*

11. [The Director of Insurance] *asked whether Article 4 of* [Equitable's] *constitution could be interpreted as enabling liabilities to be reduced proportionately to assets available to meet them, thereby reducing both GAR and mis-selling claims. If so it would, in effect, transform these liabilities from cumulative liabilities to offsetting liabilities which could be reduced/compromised without threatening solvency.* [Counsel] *confirmed that he thought this interpretation was unlikely:*

- *his interpretation of the principle aim of the provision was to ensure that members could not sue other individual members of the society;*
- *Article 4 refers only to policy claims and is therefore not applicable to mis-selling claims.*

[Counsel] *concluded that Article 4 offered no comfort to* [Equitable's] *Directors in relation to wrongful trading (whilst insolvent).*

12. All parties agreed that a s425 scheme achieved through administration, rather than liquidation, was the most sensible way forward. This would enable [Equitable] *to continue operating but provide Directors with the protection of the courts. The alternative of liquidation would be very disruptive. Another option was for the Board to seek financial assistance from the industry. It was agreed that the FSA should raise this issue with the* [Investors Compensation Scheme].

13. [Line Manager E] *noted that* [Equitable] *had received advice that mis-selling claims should be included in the 425 scheme. However, there were obvious doubts over the extent to which claims could be accurately estimated within the tight timescale dictated by the Halifax deal. A pragmatic solution would need to be agreed.*

25/07/2001 [15:04] Ahead of a meeting the following day with the Association of British Insurers, FSA's Director of GCD provides FSA's Chairman with his immediate views on the financial limits which might apply to compensation. The Director of GCD notes that the maximum amount that could be levied on the insurance industry in any one year was 1% of the previous year's premium income from long term business and the Policyholder Protection Board's borrowing powers were limited to £10m.

25/07/2001 [entry 7] FSA meet with HMT and the Bank of England to discuss Equitable before attending an emergency meeting of the Tripartite Standing Committee (Deputies). HMT's note records the discussion that took place under the following headings:

<u>Latest situation</u>
FSA's Chairman reports that Equitable's Board had met earlier that day and had decided that it was possible for the company to carry on for a short period '*although it was not clear how long that would be*'. It was assumed that the Board had concluded that they were still solvent in Companies Act terms.

It is noted that Equitable had to make an interest payment on the subordinated loan of £30m, due on 3 August 2001 (rather than on 6 August 2001, as had been previously thought). Equitable thought they could meet the payment, if FSA granted a waiver in respect of regulatory capital requirements. It is noted that FSA were yet to decide whether they would grant this.

FSA's Chairman explains that he had had discussions with the industry, without the knowledge of Equitable or HMT, about possible support for the company. He says that the industry would require a lot of persuasion to make any contribution and, even if they would be willing to do so, '*would say that this could not be organised in the time available before Equitable had to go into provisional liquidation*'. FSA note that they consider that the best way forward was to make administration available for insurance companies.

Statutory compensation schemes
The operation of the Policyholder Protection Act 1975 and the Investor Compensation Scheme are explained by FSA.

Liquidation vs. S.425 scheme
The different features of provisional and full liquidation and schemes under section 425 of the Companies Act 1985 are considered.

Administration
The possibility of introducing an administration procedure for insurance companies is discussed but: '*It was uncertain if everything could be done before the end of next week*'. FSA's chairman acknowledges the constraints of getting this in place but says FSA would want HMT to see if a scheme could be brought in within the time available. It is noted that administration '*represented the best current card in a weak hand*'.

In concluding the discussion: '[An HMT Director] *noted that perceptional factors together with the likely availability of the Halifax funding favoured administration over provisional liquidation. However, the feasibility and safety of getting the necessary legislation to provide for administration for insurance companies through in the required timescale needed further consideration*'. It is agreed that '*experts*' should meet on 26 July 2001 to discuss this further.

25/07/2001 [entry 8] All of the same officials from FSA, HMT and the Bank of England then attend an emergency meeting of the Tripartite Standing Committee (Deputies) '*to consider whether Equitable Life's difficulties represented any systemic risk and, if so, what the response might be*'. HMT's note records the discussion that took place *inter alia* under the following headings.

Misselling
The Bank of England say that Counsel's opinion seems very important. The note records:

> [FSA's Director of GCD] *said that* [Counsel] *had been appointed by* [Equitable] *to investigate the extent of their policyholders claims against them, and to produce an opinion for publication. An initial opinion had been produced in May and a final opinion was expected to be published at the end of July. The opinion looked at* [Equitable] *contracts both against background of the ordinary laws on mis-statement and the LAUTRO and PIA rules. These rules required disclosure of any information that would affect the amount available for distribution to policy holders. There were three relevant factors: the size of the GAR liabilities; the size of the company's overall assets; and the existence or not of hedging contracts. In* [Equitable's] *case there were low assets, high liabilities and lack of hedging.*

Case for Intervention by the Authorities
The issue of whether there were arguments for an injection of public funds into Equitable is discussed. The note records:

> [FSA's Chairman] *said that something between £3*[bn] *and £5bn would make* [Equitable] *solvent.* [FSA's Director of Insurance] *said that it was difficult to assess what additional contribution to the pot might be necessary to make a s.425 scheme attractive to* [Equitable] *policyholders. But while the insurance industry would probably not be keen on a rescue, it might be readier to consider this if the government was involved.* [FSA's Chairman] *said that if the government put money into the company, it would be interpreted as a problem with the past regulatory regime.*

Moral Hazard
Moral hazard issues are also discussed:

> [FSA's Chairman] *said that it was possible to contemplate basing support on a change in the environment. This kind of intervention would fall somewhere in between ameliorating systemic risk and admitting that the regulatory system had not worked perfectly. He thought this circumstance could be distinguished from regulatory negligence.*

Next Steps
It is noted that FSA were to review the situation with Equitable on 27 July 2001 and that there was an Equitable Board meeting planned for 30 July 2001 (Note: this was later brought forward to 29/07/2001). Discussion goes on to note:

> *The* [Equitable] *were due to make a payment on 3 August that would focus their attention on Insurance Act solvency requirements. They could only make the payment if their required margin was intact or if they received consent from the regulator. It would be difficult for the FSA to consent to this if there were no clear way forward for the company but permission could be given if FSA were satisfied the company did have a good plan in place. It was noted that, if* [Equitable] *failed to make the interest payment, it would be recognised that it could not meet its commitments and liquidation of the company would be precipitated.*
>
> [An HMT Director] *asked whether the company should be allowed to continue in business until Friday on the basis of what was known now.* [FSA's Director of Insurance] *said ... that there were high hurdles for FSA intervention. It was also the case that the misselling liabilities had not been quantified and might possibly be small.* [FSA's Director of GCD] *said the legal position was that the FSA could intervene if they thought* [Equitable] *was insolvent or if they thought that they could not meet the reasonable expectations of their policy holders. They believed the right course at this stage was to get more information.*
>
> [FSA's Chairman] *said that the FSA did not have grounds to overturn the Board's view that* [Equitable] *was still solvent in Companies Act terms. But the FSA would only consider granting* [Equitable] *the waiver for regulatory capital purposes that would be necessary to pay the interest on their debt if they could see a plan for putting the policy holders in a better position than they would be if* [Equitable] *was liquidated immediately. The FSA would need to able to see that by next Friday when the payment was due to be made. The Treasury would have to make a judgement about the probability of an administration scheme's being in place in time. If the Treasury felt that the necessary steps could be taken to allow the* [Equitable] *to go into administration, the FSA would feel comfortable about advising Ministers that they should be allowed to make the payment. If administration was not likely, then it would be better to move to liquidation quickly rather than waiting until after the interest payment had been made.*

In summing up: '[HMT] *said that the FSA should put advice to Ministers on the issue of what should be done in respect of the interest payment if* [Equitable] *fell below its regulatory capital requirements. Treasury officials would advise on the administration scheme issue ...* [HMT] *would brief the Chancellor*'.

On 30 July 2001, the Director of Insurance sends HMT's notes of the meetings to Line Manager E, copied to the Head of Life Insurance and the Insolvency Practitioner. He says to them: '*I think we should keep only one file copy of this. I should be grateful if* [the Insolvency Practitioner] *could destroy his copy when read*'.

25/07/2001 [entry 9] FSA's Insolvency Practitioner writes to the Director of Insurance following the meeting of the Tripartite Standing Committee. He says that he had three points to add to what had been discussed. First, that it was important to involve the people who might be asked to act in the event of liquidation/administration. Secondly, he sets out the timing and funding of potential mis-selling compensation from a liquidator and the Investor Compensation Scheme. Thirdly, reiterating a point he had made outside the meeting, he says that he believed '*the best way for the directors to be comforted that they may continue trading and paying claims in full whilst the GAR and misselling liabilities are uncertain, might be if they receive a written undertaking from the* [Investor's Compensation Scheme] *that the* [Investor's Compensation Scheme] *will contribute to a s.425 scheme up to the amount that it would have to pay by way of compensation in a liquidation*'.

He continues:

> *This does not necessarily mean that creditors will be no worse* [off] *if the scheme fails and liquidation ensues; and therefore the directors remain exposed for wrongful trading liabilities to the extent that the society pays terminal bonuses and subordinated debt interest meanwhile. However, the test the directors face is whether there was no reasonable prospect that the society would avoid going into insolvent liquidation* [under section 214 of the Insolvency Act 1986]. *If the scheme could be sweetened by up to £5bn (say) then there remains a realistic prospect of such a scheme succeeding.*
>
> - *this does not mean that a view need be taken now on whether £5bn is indeed the amount of the misselling liabilities.*
> - *The* [Investor's Compensation Scheme], *I presume, has power to provide "financial assistance" along the lines of the* [Policyholders Protection Board], *but extended to situations where there is merely a prospect of the society being unable to pay its debts.* [Chief Counsel B] *should advise.*
> - *If so, this commitment can be made immediately (if* [the Investor Compensation Scheme] *board concur) without the need to obtain agreement from the* [Association of British Insurers] *or industry generally.*
>
> *The directors will still need to be robust and have robust advice, but I believe that such an arrangement will strengthen their position significantly.*
>
> *I think the FSA could apply the same criteria when considering whether to intervene in policyholders' interests.*

The Insolvency Practitioner also prepares an '*Illustration of the possible cost to the industry of funding compensation through the Policyholders Protection Board and the Investors Compensation Scheme*'. The illustration is presented as follows:

Present financial position of the Society's with-profit fund		*Reduction by 16%*	*Position on liquidation*		*Compensation*	
	30-Jun-01	*15-Jul-01*				
	£'m	*£'m*	*£'m*	*Note*		*£'m*
Assets in the fund						
(current market value)	*24,400*	*24,400*	*23,668*	*a*		
			(500)	*b*		
			23,168			
Liabilities of the fund						
Guaranteed benefits	*21,350*	*21,350*	*21,350*		*90%*	*19,215*
Best estimate GAR cost	*1,256*	*1,055*	*2,400*	*c*	*90%*	*2,160*
Possible mis-selling liability	*?*	*?*	*5,000*	*d*		*4,987*
Total liabilities	*22,606*	*22,405*	*28,750*			*26,362*
Contractual surplus/(deficit)	*1,794*	*1,995*	*(5,082)*			
Non-contractual expected terminal bonus	*6,650*	*2,170*	*2,170*		*90%*	*1,953*
Compensation schemes will be able to recover from the liquidation (23,168)						
Net cost to the industry						*5,147*

The notes to the illustration are:

It is assumed that the Society would go into liquidation and a stop order made since a transfer of the business to another insurer could not be achieved. Only on such a liquidation would policyholders have any prospect of the [Policyholder Protection Board] *paying compensation in respect of undeclared terminal bonuses.*

The obligations of the Halifax to the Society in respect of unit linked business and of the Society to unit linked policyholders have been ignored on the assumption that Halifax would pay such policyholders directly and assume their rights against the Society.

a It is assumed that the market value of the Society's investments have fallen in proportion to the FTSE 100 between 5,700 at 30 June and as at 24 July 5,320 with an asset backing 45%.

b Liquidation costs are estimated to comprise:

	£m
Liquidators professional fees	*10*
Legal and litigation costs	*10*
Halifax penalties capable of arising	*250*
ISA fees	*230*
	500

c On liquidation a policyholder can prove for the full value of his GAR rights irrespective of whether he would actually have exercised them: £2,400m.

d The [Investor's Compensation Scheme] *limits compensation to £48,000 for each claimant.*

- *Assume that the total misselling claims are tortious and total £5,000m.*
- *Assume that there are 300,000 non-GAR policyholders who were sold policies after 1988 and who are eligible for compensation.*

- *Assume that the damages each policyholder is entitled to claim falls in a normal distribution about the average of £16,667 per policyholder with a standard deviation of £10,000.*
- *Then only 0.086% of policyholders will have their claims capped.*
- *Thus, compensation payable by the* [Investor's Compensation Scheme] *will be approximately £4,987m.*

25/07/2001 [entry 10] FSA's Chief Counsel B circulates a draft report entitled '*PIA misselling report*'. The Chief Counsel explains:

> *The report adopts and explains the reasons behind the conclusions reached by counsel about the nature and the extent of misselling by the Equitable; it also deals with an issue not currently in the draft* [counsel] *opinion, namely, the sale of new policies after the Court of Appeal judgement and following the House of Lords ruling. My conclusion is that the disclosures given by the Equitable during both of these periods were inadequate but I hope that I have dealt with* [the] *closure to new business point in a way which colleagues will find comfortable.*

The report states:

> *The basic proposition underlying the regulatory requirements which apply to the Equitable throughout the period is that potential policyholders were entitled to:*
>
> - *be told the nature of investments they are being sold;*
> - *have proper care taken in the information and advice given to them;*
> - *be given information about any special features of the liabilities of the Society which a reasonable policyholder would expect might affect that amount available (then or in the future) for distribution by way of bonus.*

and goes on to find that:

> *... no policyholder could have been reasonably satisfied that the GAR risk was immaterial and therefore something which did not need to be disclosed as part of a process by which potential policyholders were able to take informed decisions. On this basis the regulators agree with the conclusion reached by counsel ... that the Equitable failed, in a generic way, to comply with the disclosure requirements to which it was subject both under the initial Lautro rules and the later PIA Key Features rules. This was a failure which commenced when, on an objective basis, an investor would have reasonably concluded that the Equitable's exposure to GARs was a material risk. Given the Equitable's own assessment that, on a proper assessment of the GAR contracts, non-GAR policies supported in the same with profits fund were un-saleable, the risk to policyholders was material from the out set – [July 1988] – and hence the Equitable breached the disclosure rules from that date.*
>
> *This conclusion is one which, on the basis of the material considered by the regulators and by counsel, affects the sale of all Equitable policies up to the publication of the House of Lords decision on 20 July 2000.*

The report discusses the sales of policies during the Hyman litigation finding that correspondence from Equitable to policyholders during that period had not properly reflected the range of possible outcomes. However, it concludes: '*The Equitable's failure to properly disclose the range of outcomes presented by the litigation is however of secondary significance given the more fundamental failure identified in relation to the sale of Equitable policies from July 1988*'.

On the sale of policies after the House of Lords' decision, the report states:

> *The material on which sales representatives were encouraged to answer questions lacked balance and in the regulators view does not conform with the duty to provide investors with adequate information. This therefore gives rise to a further category of potential missales.*

25/07/2001 [18:32]	FSA's Line Manager E sends Managing Director B a short note summarising the points they had discussed about arrangements for financial support from the industry. The note covers how the Policyholders Protection Act 1975, the Policyholders Protection Board and voluntary arrangements might work.
25/07/2001 [19:54]	Equitable inform FSA that the Board had decided that it would not be irresponsible for them to continue on the current basis for a brief period.
26/07/2001 [10:20]	PIA inform FSA of the steps that Equitable were taking to address the Pensions Review implications of the 16 July policy value cuts.

26/07/2001 [morning] FSA meet the Association of British Insurers to discuss a possible industry response to the Equitable situation. FSA's '*Note for File*' records that:

> *The position of the Society was very delicate. A leak could prove extremely damaging. The company's financial position was finely balanced.* [FSA's Chairman] *explained the legal opinions which the Society and the FSA expected to receive shortly in respect of possible mis-selling. It was clear that these opinions had potential consequences for a number of companies but these could be very variable. The test which Counsel were likely to suggest for quantifying possible losses arising from mis-selling was essentially that where a policyholder, properly informed of relevant and material risks would not have bought a policy from the company but would have bought one from another provider, then the measure of damage was the difference between the value of the policy actually bought and the industry average for comparable products supplied by other providers. In the case of the Equitable the consequences looked severe, although no systematic quantification had yet been done.*

FSA inform the Association that '*while the* [Society's] *directors had concluded that they could properly continue the operation for the time being the situation might change very quickly*'.

The possibility of industry support for the compromise scheme is discussed. FSA record that their Chairman had explained:

> *In our view such a compromise still offered the best prospects of a reasonable outcome for policyholders and was still achievable if the Society was in administration or provisional liquidation. However, it now seemed likely that for it to be attractive to policyholders it would need to be "sweetened" with some additional finance.*

FSA's note continues:

> [FSA's Chairman] *explained that on the basis of some initial and somewhat tentative calculations, it seemed to the FSA that the amount needed to make such a compromise attractive to policyholders (and thus likely to succeed) would be considerably smaller than the cost that the industry would be likely to incur if the company went into full liquidation with compensation being payable to policyholders both through the Policyholders Protection Board (in respect of policy liabilities) and through the investors compensation scheme (in relation to mis-selling claims). He suggested that further discussions might take place, without commitment on the part of the industry, between*

technical experts to explore both the relative costs and the processes that would be involved.

The response of the Association to FSA's suggestion is recorded by FSA, as follows:

> *The* [Association of British Insurers'] *representatives expressed considerable doubts about the proposition. It was not clear why policyholders who had chosen to invest in well managed companies should be expected to bail out those who had invested in a company which was less prudently managed. They were concerned too that the legal opinion seemed unbalanced and potentially hugely damaging. They were concerned that the reasoning might extend not only to guaranteed annuity rates but to all forms of guarantee and potentially to all risks inherent in with-profits policies. Publication of these opinions could lead to a clamour for a major review of mis-selling beyond even the size and scale of the pensions review.*

FSA also record that the Association of British Insurers were:

> *... concerned in particular about the quantification test likely to be suggested by Counsel. This raised the spectre that any policyholder in a fund performing below the industry average would be given an incentive to complain that he had been exposed to some undisclosed risk and to insist that his policy value was brought up to the industry average.*

FSA's Chairman expressed the hope that the Association would not take an immediate decision not to explore the possibilities. The Association of British Insurers' representatives '*reluctantly agreed that some initial work should be done*'.

26/07/2001 [11:33] FSA's Director of GCD reports to Managing Director B on his discussion with Counsel for FSA about the appropriateness of the measure of mis-selling liabilities identified in the two Counsels' opinions. This discussion had followed comments made by FSA's Chairman the previous day. FSA suggest to their Counsel that it might be possible to conclude that the usual tortious measure of damages was not appropriate in this case. The Director of GCD explains:

> *This is on the basis that it would produce an over recovery, by compensating people not only for what they have lost as a result of the effect of the GARs on bonus distributions, but also because of the fact that, coincidentally, particular Equitable policies may have under performed the market.*

[**12:53**] Managing Director B thinks that this is a logical approach and '*avoids the concerns discussed at this mornings meeting with the* [Association of British Insurers] *about averaging-up and the potentially very damaging consequences for the industry as a whole*'.

[**13:12**] The Head of Actuarial Support adds that this would tie in better with Counsel for Equitable's opinion, which had said that the mis-selling liabilities would have to be met from the fund prior to establishing the surplus available for distribution as bonus. The Head of Actuarial Support continues: '*It could therefore achieve the outcome that they were seeking, namely to restore the balance between GAR and non-GAR to roughly where it was prior to the* [House of Lords'] *judgment*'.

On the commissioning of an independent assessment of Equitable's potential mis-selling liabilities, the Head of Actuarial Support goes on to say:

> *Meanwhile,* [a firm of actuarial consultants] *have declined to take on the assignment that we offered them as they did not wish to be associated with the view that mis-selling had taken place (when this could have implications for other insurers) and would therefore be not in their commercial interests (on which we may have our own private views!). I can try to talk with* [another actuarial consultancy] *(or failing them some other smaller firms) to*

see whether they would take on this assignment, but if [the Director of GCD] *is right, this may not be quite so pressing now.*

[**14:10**] The Head of Life Insurance says that he thought FSA still need an independent assessment of quantum '*so as we agreed, please contact* [the actuarial consultancy] *to explore the position*'.

[**15:03**] The Director of GCD provides some further comments following an update from Counsel.

26/07/2001 [15:58] Equitable provide FSA with information on the distribution of assets of the with-profits fund as at end-June 2001. Equitable explain that, since then, they had sold around £1.4bn of equities, of which £1bn were 'overseas'.

'Equitable Life – Asset mix'

	£ billion	*%*
UK Gilts	*4.185*	*18.60*
Other Sterling fixed interest	*2.903*	*12.90*
Overseas fixed interest	*0.565*	*2.50*
Overseas index linked	*0.219*	*1.00*
UK equities – large capitalisation	*6.478*	*28.80*
– mid capitalisation	*0.974*	*4.30*
– small capitalisation	*0.232*	*1.00*
Investment Trusts	*0.523*	*2.30*
European Equities	*0.899*	*4.00*
US Equities	*0.613*	*2.70*
Japanese Equities	*0.286*	*1.30*
Other Far Eastern Equities	*0.205*	*0.90*
Direct Property	*1.840*	*8.20*
Property Funds	*0.329*	*1.50*
Property Partnerships	*0.758*	*3.40*
Alternative Investments (principally private equity partnerships & hedge funds)	*0.815*	*3.60*
Cash Deposits	*0.923*	*4.10*
	22.747	*101.10*

FSA's Head of Life Insurance forwards the information to Managing Director A saying '*I hope this is enough to meet* [the Bank of England's] *needs at present*'.

26/07/2001 [16:56] FSA's Chairman meets with the Economic Secretary to the Treasury to provide an update on events.

An FSA official relays a report from FSA's Chairman giving feedback from a meeting with the Economic Secretary to the Treasury. The feedback includes that:

- An HMT Director was convinced that making administration available was the best option but the Economic Secretary '*has not quite got there*' and was concerned that some policyholders might be disadvantaged by this.
- HMT '*recognise that it is quite possible that the Board will decide on Monday that it cannot make the interest payment and will choose to put the Society into provisional liquidation or, if available, administration*'.

[**19:33**] The Insolvency Practitioner replies with three observations on the subordinated loan, including: '*For a test of wrongful trading or a Companies Act solvency test it is irrelevant that* *the debt is subordinated to policyholders' claims (if that is the effect of subordination). A company must be able to foresee its ability to pay all its liabilities of whatever nature*'.

26/07/2001 [16:59] Equitable provide FSA with an update on their attitude to the interest payment on the subordinated loan. FSA record:

> *1. On the basis of the 2000 regulatory returns, submitted at the end of June 2001, and reflecting the valuation as at end 2000 (the "traditional" basis for assessing a life office's financial position for the purposes of such matters) the payment could properly be made, as the* [required minimum margin] *would remain intact after the interest payment. But* [the Chief Executive] *implicitly recognised that in the Equitable's current circumstances, this test lacked some credibility.*
>
> *2. Therefore the directors were giving thought to whether it would be appropriate for them to make the interest payment if the company was insolvent in Companies Act terms. They might decide to do so, on the basis that a £28m payment was justifiable if it could sustain the Society through the period until an orderly administration could be arranged. But* [Equitable's Chief Executive] *recognised that this would be a brave decision.*
>
> *3. They were clearer now (but still not crystal clear) that 1st August was the date by which irrevocable instructions had to be issued to make the payment due on 6 August.* [The Chief Executive] *thought that it might be helpful if by that date, FSA had not received firm advice on the likely quantum of misselling liability.*
>
> *We are considering what attitude to recommend the Treasury should take on possible consent to this payment even if the* [required minimum margin] *is breached. The issue will be on the agenda for tomorrow's meeting with Equitable.*

FSA's Head of Life Insurance relays this information to supervisors and also tells them that this issue might be overtaken by reports that a stockbroker had suspended a credit facility for Equitable on the grounds that they were insolvent.

The following morning [**at 09:46**], the Director of GCD comments that, in relation to paragraph 3 above, '*there can be no question of it being "helpful" for us not to have received advice on quantification by the key date*'.

26/07/2001 [c17:15] FSA meet Halifax following a rumour that had been circulated on the wire press that a stockbroker had stopped a foreign exchange line of credit to Clerical Medical on the grounds that Equitable was insolvent.

FSA contact the stockbroker to establish whether there was any truth in the rumour. The stockbroker says that the credit facility was due to end on 27 July 2001 and their credit committee had decided that they would require collateral of $5m as assurance in order for them to be able to renew the line of credit. Equitable had refused the terms and the line of credit had not been renewed.

FSA's Managing Director A sends FSA's Chairman, Managing Director B and the Director of Insurance his note of the meeting with Halifax's Chief Executive and also a note of a one-to-one conversation with him. The Managing Director says:

> *We discussed this briefly with* [the Chief Executive] *who has undoubtedly (as a result) gone away to think hard about how Halifax would respond to a problem with Equitable if one did emerge ...*
>
> *At* [the Chief Executive's] *request I also talked to him one-to-one.* [He] *stressed how much Halifax had riding on the Equitable and I decided to tell him something of what was in hand, given that they may have some useful influence with Equitable and, importantly*

> *from a supervisory perspective, it is important that they are not destabilised by for example not being able to explain properly what Halifax exposures are if a problem did emerge.*

I explained that the water had been made deeper and muddier by [Counsel's] *Opinion (the creation of which he is, of course, only too aware of) and by the difficulty of knowing what it might mean to Equitable's solvency. I said that further information was being gathered (but this would take time) and in the meantime we were vulnerable to a loss of confidence by the Equitable Board who might decide they could not go on. I said we were exploring every route to find a breathing space of the kind administration brings if the circumstances justified it.*

26/07/2001 [19:08] FSA's Line Manager E prepares a note on Equitable's subordinated loan. He explains that the only view he could reach is that Equitable should go ahead with the interest payment on the loan if the solvency cover was intact but not if their cover for the required minimum margin had been breached. The Line Manager says that: '*In the time scale, I cannot see that there would be an* [required minimum margin] *breach that would not be tied in with other things that would make allowing the payment to be made preferable to not consenting*'. The '*Detail*' section of Line Manager E's note states:

> *We need to decide whether or not supervisory consent should be given to the Society and* [Equitable Life Finance] *to proceed with the next interest payment on 6 August 2001 in the event that the position on the potential mis-selling issue is clearer and the Society declares that it is no longer able to cover its* [required minimum margin].
>
> *In simple terms, the downside of not giving consent is that the terms of the bond backing the loan are public and indeed, as the debenture is* [London Stock Exchange] *listed, it seems likely that a formal statement would need to be made acknowledging the Society's [potential] financial difficulties. That would have serious consequences for confidence among policyholders, and could also be damaging to markets that would expect the Society to be forced to begin making urgent disposals of its equity holdings (approx £8 billion including indirect holdings). This would be anticipated either as part of a switching strategy to move to gilts and other fixed interest, or as part of a formal insolvency procedure.*
>
> *On the other hand, the loan arrangements were consented to and have been acceptable for solvency purposes on the basis that the loan debt was subordinated to the other liabilities of the Society, and in particular the insurance liabilities. If at a time when the Society is unable, or likely to be unable, to meet its obligations to its policyholders in full, it seems somewhat implausible that the regulator should wish to undermine the protections that have been put in place for relevant policyholders. It is though important to recognise that the interest due (at £28 million) is fairly small scale compared with the overall reserves (£25 billion for the with-profits liability).*
>
> *It would seem, therefore, that the decision to consent or not is finely balanced and depends ultimately on the position at the time the payment is due. Neither outcome is entirely desirable. However, provided there is a realistic prospect that the difficulties may be avoided, the negative consequences of a default would probably be sufficiently material that we would wish the Society to proceed to pay the interest as it falls due, particularly following the recent speculation. However, in such circumstances, the* [required minimum margin] *would probably not have been breached and the issue of consent would not arise.*
>
> *Conversely, if the* [required minimum margin] *has been breached on 6 August 2001, it is almost certain that that breach will be accompanied by a solvency breach for company law purposes. In those circumstances, it seems unconceivable that the directors would not have concluded that they needed to initiate formal procedures and that a market statement of the position would have to have been made by* [Equitable Life Finance]. *In*

	such circumstances, it would seem entirely appropriate for the interest payment not to be made at that point. It would be open to the Society, after a satisfactory compromise of its liabilities, to resume payments at any point in the future. [**22:20**] The Director of Insurance forwards the note to the Director of GCD and Managing Director B, saying that he suspected that, at the meeting with Equitable the following day, FSA would not be able to say more than the decision as to whether to provide regulatory consent to the payment was one reserved to HMT. The Director of Insurance says that he thought that '*much may depend on what confidence we may have in the alternative approach to valuing potential misselling claims which seems to me to be quite crucial to an assessment of the Society's financial position*'.
26/07/2001 [entry 9]	HMT inform FSA that the Chancellor of the Exchequer holds a policy with a company linked to Equitable (University Life) and so might be conflicted from taking decisions on the company.
27/07/2001 [08:40]	Halifax telephone FSA further to the discussions the previous day. Halifax say that Equitable's Board had informed them that they had received an oral briefing from Counsel on their opinion and the thrust of Equitable's message was that there was a realistic chance of a claim by non-GAR policyholders, but the potential liability could not yet be quantified. FSA reiterate that the key issue is to quantify the potential liabilities and say: '*If these could be shown to be small then life would clearly be much easier*'. Halifax say that they had seen legal advice which stated that any liability was negligible and other advice stating otherwise. Halifax ask about the possibility of administration and the process of liquidation.
27/07/2001 [09:34]	FSA's Director of GCD asks that the Head of Actuarial Support and the Insolvency Practitioner attend the meeting with Equitable that day so that FSA could be clear on what was said by Equitable about their financial position. [**09:37**] The Director agrees with the views in Line Manager E's note of the previous day on the interest payment on the subordinated loan.
27/07/2001 [10:06]	The Director of GCD writes to FSA's Chairman (copied to supervisors, legal and Counsel) setting out some views on the points that were relevant to FSA's decision making on Equitable's financial position. The Director of GCD says: '*The key point is that we should not in my view allow it to get into a position where "the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities."*'.
27/07/2001 [10:16]	FSA send HMT their response to three further questions which had been asked the previous night about administration orders.
27/07/2001 [lunchtime]	FSA's Chairman reports to the Managing Director of HMT's Financial Regulation and Industry directorate on a meeting that had just been held with Equitable. FSA's file note records that: [FSA's Chairman noted] *that the situation remained uncertain (and further legal and actuarial advice was being sought) but the following points had emerged:* • *EL's Board would be presented on Monday with a range of possibilities for the costs of the misselling liabilities arising from* [the Society's Counsel's] *opinion. Some of these possibilities would make EL insolvent. EL had indicated that this would lead them either to stop paying non-contractual bonuses or to seek liquidation.* • *EL had received advice from* [their lawyers] *that, in liquidation, the liquidator might suspend payments of pensions.*

- [FSA's Chairman] *had, as agreed with* [HMT's Managing Director] *the previous night, said that there was a chance that HMT might be able to make administration available although no decision to do this had yet been taken. EL had been attracted by this possibility and had agreed to work up a document saying why this would be a better option for policyholders. One possible technical difficulty was identified in that it was possible that the Equitable would not be able to prove to a Court that it was insolvent and would have to risk having the application thrown out. Work would be done to assess the extent of this risk.*

FSA's file note continues:

> [FSA's Chairman] *said to* [HMT's Managing Director] *that this situation meant that there was a strong possibility that administration was the best option and our strong advice was that they should make it available as soon as was possible.* [The Managing Director] *said that he accepted that the arguments were very strong but that ministers were not yet convinced. He asked that* [the Chairman] *set out this recommendation in a letter addressed to* [HMT's Managing Director]*, which should highlight the point that pensions might not be paid in liquidation.* [FSA's Chairman] *undertook to provide a letter this afternoon.*
>
> [HMT's Managing Director] *asked whether it might be possible that administration would be required before the tentatively agreed date of 1 August.* [FSA's Chairman] *noted that the market situation was fragile and a number of rumours had been circulating. It would therefore be possible that Equitable could be pushed into taking action before that date and conceivably as early as Monday.* [The Managing Director] *said that it would be practically difficult to make administration available on that timetable but he would see what could be done.*

FSA's note also records that the Chairman had updated the Governor of the Bank of England on the situation, and that: '*The Governor said that the Bank would stay attuned to whether this was causing any wider impact in the market and would let us know if they heard anything*'.

27/07/2001 [15:09]	Equitable send FSA the weekly customer servicing reports.
27/07/2001 [15:13]	FSA's Managing Director A circulates a note to record FSA's contingency planning, the meetings planned for the coming weekend, and the actions and responsibilities of officers.
27/07/2001 [15:44]	PIA seek advice as they were receiving requests from independent financial advisers for further guidance as to how they should be advising Equitable policyholders and asking about FSA's attitude to previous advice given. PIA send a copy of their note to FSA. PIA note that it had been suggested in the press that their stance (note: as set out in their '*Regulatory Update 82*', issued in December 2000) was no longer sustainable. PIA suggest elaborating on the previous guidance and provide a draft question and answer briefing setting out what they had in mind for use by their contact centre. [**16:47**] FSA say that they should not deviate from their current line and should refer to the statement issued on 16 July 2001.
27/07/2001 [16:00]	FSA's Chairman telephones HMT to say that complications had emerged related to their work on the benefits of administration. HMT say that they wanted FSA's views before Equitable's Board meeting on 29/07/2001. It is agreed that FSA should stress to Equitable that they should plan on the basis that administration was unlikely to be available.
27/07/2001 [17:00]	FSA supervisors meet to discuss Equitable. The note of the meeting records:

[Managing Director B] *reported that he had spoken to* [Equitable's Chief Executive] *who had realised himself that administration might not be as good an option as it had appeared in the meeting that morning.* [He] *had reinforced that view.* [He] *had also spoken to* [Equitable's Chairman] *to say that we thought that they should not rely on administration.* [The Chairman] *had taken the point but said that his major concern remained whether the Board would be able to sanction the interest payment on the subordinated debt. It was reported that* [Equitable] *had contacted* [a firm of insolvency consultants] *and it was likely that they would be providing advice to the meeting on Sunday.*

The action points arising from the meeting were:

- *A clear and agreed view was needed by the 4pm meeting on Saturday as to what we saw the pros and cons of administration and provisional liquidation to be in order that we could advise HMT. In particular, this would need to highlight what we might realistically expect to happen to annuities payments under each option so we, and ministers, are aware of the likely impact when considering the issue. We should also consider the relative flexibility available to a provisional liquidator versus an administrator – and to ascertain if possible what an administrator's approach might be in practice.*
- *We need to consider what the contingency plan would be if* [Equitable] *goes to court to apply for administration/provisional liquidation and the Court finds that Article 4 of its constitution prevents it from doing so.*
- [Equitable's Appointed Actuary] *would be advising the Equitable Board of a ballpark figure for the misselling liabilities on Monday. It was agreed that* [the Head of Actuarial Support] *would stay close to this work in order to be able to advise us on it.*
- *A Press Office presence would be arranged for Sunday afternoon. External advisors were on call to test external lines when needed.* [The Head of Press Office] *would seek to ensure maximum co-ordination of all parties for any announcement.*
- *Contingency planning would take place over the weekend to prepare press material and consumer help material in case of a possible announcement.*
- *Consideration needs to be given by the Sunday meeting to whether there are any actions that can be taken to influence the* [Policyholder Protection Board].
- *The question was raised as to whether any party might be able to provide a letter of comfort to guarantee the interest payment. It was agreed that further thought should be given to how this might work but we should not approach external parties about this until the overall situation could be considered at the Sunday meeting.*

27/07/2001 [18:06] The Financial Services Compensation Scheme send FSA comments, following a meeting the previous day, on compensation.

27/07/2001 [entry 12] FSA give Notice to Equitable under sections 44(2B) of ICA 1982 that they require the Society to commission a report from its Appointed Actuary's company into the financial position of the Company as at 30 June 2001.

27/07/2001 [entry 13] FSA send Equitable an extract from their Counsel's opinion on the calculation of the quantum of liability for possible mis-selling as, although the opinion was provisional, they believed that it might be significant to Equitable's consideration of the issue. On this, an official has written:

Damages only by reference to loss caused by misinformation, not fund performance ⇨ £1.2bn

27/07/2001 [22:31]	The Association of British Insurers call FSA. Amongst other things, they explain that, earlier that day, HMT had raised the possibility that the Association of British Insurers provide financial assistance to the compromise scheme, and had suggested that the industry should give serious thought to it '*since this was "another misselling case" in which the industry was involved*'. The Association said that they had responded that their members would '*respond "with outrage" to such pressure*'.
27/07/2001 [23:26]	Equitable and their auditors telephone FSA to let them know the advice that they were being given and to check FSA's understanding of the position.
28/07/2001 [12:34]	FSA's Insolvency Practitioner suggests to the Head of Actuarial Support that he should discuss with Equitable whether mis-selling liabilities could be discounted for the probability as to whether they might arise. The Insolvency Practitioner explains: *Looking at* [Counsel for FSA's] *further opinion, he says that a claimant would be entitled to claim compensation for a consequential loss <u>if</u> he can demonstrate that he would have followed an alternative course but for the misrepresentation ... It seems to me that policyholders each have their own tolerance for risk. Equitable was regarded (perhaps wrongly) as a highly performing fund but there is a genuine risk <u>and</u> reward assessment that a policyholder could make. Therefore there will be within the mix of all non-GARs some policyholders who have a high enough appetite for risk that they would still have bought Equitable policies. This means that if misselling claims were presented to the society piecemeal and adjudged each on their merits then not all would succeed. There is therefore a basis on which the "realistic cost" of misselling liabilities might be evaluated at less than the "full legal rights" cost.* *There is unfortunately, and unlike the GAR take-up rate, no empirical evidence as to the range of risk profiles amongst Equitable policyholders.*
28/07/2001 [16:00]	FSA meet with a firm of consultants '*who Equitable were likely to appoint as Administrator or Liquidator if either of those routes were followed*'. The key points identified include: that the differences between provisional liquidation and administration were very small; that the risk of rushing an administration order was considered material; that, under provisional liquidation, it was probably possible to make payments to policyholders, but that this might be harder under administration; that Article 4 of Equitable's Articles of Association could prevent the Policyholder Protection Act 1975 from having effect; that FSA/HMT could put in place measures to mitigate risk by making changes to the Policyholder Protection Act 1975 and could issue a section 45 Order to prevent Equitable from reducing policy values further; and that FSA's Director of Insurance had spoken to Equitable, who had reported a more optimistic position with regard to mis-selling liabilities, and that the required minimum margin would remain intact. The action points resulting from the meeting are: that a meeting with HMT would be arranged for 29/07/2001; that FSA's Director of GCD would speak to HMT to bring them up to speed; '[The Director of GCD] *to draft outline of argument for*' (Note: this sentence was incomplete); and that the Director of Insurance would speak to Equitable to request a copy of their legal advice.
28/07/2001 [after 16:00]	FSA's Chairman informs a HMT Director of the outcome of the discussions with the firm of consultants. He says that they had agreed that '*the top priority was to find a way to allow the Society to continue ... making annuity payments and as a contingency ensuring that policyholders would have access to* [Policyholder Protection Board] *in the event of either an administration or provisional liquidation, therefore guaranteeing that policyholders would receive a minimum of 90%*'.

The Chairman says that '*there appeared to be increasing tension between the Equitable Board* – [the Society's Chairman] *in particular appeared to be keen to* [throw] *in the towel*'.

The HMT Director notes that the Association of British Insurers had been clear that it was not the responsibility of their members to contribute to '*a sweetener of a* [compromise] *scheme – the issue was to do with regulatory failure*'. He also notes that Treasury Ministers were becoming increasingly nervous and the Association's comments had not helped.

28/07/2001 [18:30] FSA speak to Equitable to try to obtain a copy of the legal advice that Equitable had received from their solicitors on the mechanisms for winding up the Society.

28/07/2001 [19:51] Counsel for FSA send FSA the latest version of their opinion on mis-selling.

28/07/2001 [20:44] FSA's Chairman writes to HMT, following their telephone conversation, to update them in writing on FSA's discussions about the Society's options that had taken place with Equitable and with their advisers. The Chairman first emphasises that FSA's top priority was to find a way to allow Equitable to continue to meet their commitments while remaining solvent. Having set out the situation with regard to administration and provisional liquidation, the Chairman turns to Article 4 of Equitable's Articles of Association:

> *In brief, if the article has the effect which the Equitable canvass, the amount of its liabilities would reduce with its assets, so it could never become insolvent, and there would be no liabilities to policyholders on which the* [Policyholder Protection Board] *could pay compensation. We believe that this would be the wrong interpretation of the article. We also believe that this would be a perverse outcome, which would seriously undermine the Policyholders Protection Scheme as a source of confidence for policyholders.*
>
> *Fortunately, we think that there is action which the government could take to avoid this result. This is because the* [Policyholders Protection Board] *must take policy values at the amount set by the Insurance (winding up) rules, and there is a community obligation, in the Insurance Winding Up Directive, which would in our view require those rules to operate on the basis that policyholders are entitled to preference over other creditors, rather than on the Society's interpretation of article 4. There is also action which we need to consider under s45 of the Insurance Companies Act 1982. This might be used, for example, to prevent the Society* [exercising] *powers under article 4 to reduce policy values below policyholders contractual entitlements.*

28/07/2001 [20:52] FSA's Director of Insurance prepares a '*rough draft*' of a paper on a proposed section 45 Order to prevent Equitable using powers under Article 4 to reduce guaranteed amounts payable under their contracts.

FSA's Head of Prudential Policy amends the paper.

The following day, the Director thanks the official for his '*much better*' paper.

29/07/2001 [11:00] FSA meet with HMT to discuss Equitable. FSA's note of the meeting records that the key points of the discussion were:

- that HMT would brief ministers on 30 July 2001;
- that there was little difference between provisional liquidation and administration;
- that Equitable's latest assessment of mis-selling liabilities was £250-500m;
- that, if Equitable proposed cuts in guaranteed values, then FSA would consider intervention under section 45;

- that it was not possible to bring the European Insurance Winding-up Directive into force at present;
- that it would be preferable if publication of the Society's Counsel's opinion were deferred.

The actions resulting for FSA are:

- [Head of Actuarial Support] *to seek further information about the Society's estimate of the cost of misselling and the basis on which it had been calculated.*
- [Head of Actuarial Support] *to provide HMT with some background figures on Equitable annuitants.*
- [The Director of GCD] *(through* [Counsel]*) to ascertain if* [Counsel for Equitable] *supported* [his] *revised line on how misselling liabilities should be calculated.*
- [FSA's Chairman] *to inform* [Equitable's Chairman] *before the Equitable Board meeting at 3pm that:*
  - *The differences between provisional liquidations and administration did not appear to us to be significant, unless the Halifax point proved significant.*
  - *That we would have significant concerns about any course of action that reduced liabilities to policyholders in a way that would affect the compensation they would receive from the* [Policyholders Protection Board].
  - *That we feel it would be unwise to publish the* [Society's Counsel's] *opinion without greater clarity about the Society's financial position (including the results of the* [Appointed Actuary's company's] *work).*
  - [FSA's Chairman] *to send a letter to HMT outlining our view of the situation following the meeting with representatives of the Equitable at 5pm this afternoon.*
  - [Managing Director A] *to send HMT some material on the potential wider market impact arising from provisional liquidation or administration.*

The actions resulting for HMT are:

- *To advise whether FSA presence was needed (either at the meeting or on call), for the meeting with ministers tomorrow morning.*
- *To give further consideration to the interaction between Section 4 and the* [Policyholders Protection Act 1975] *and what action could be taken to ensure a satisfactory outcome, if necessary.*

29/07/2001 [11:05] FSA's Head of Press Office asks the Director of GCD and Legal Adviser E if there was any reason why the section 45 Order did not simply require Equitable to take steps with a view to removing Article 4. He says that that would put the issue to Equitable members, who would be likely to vote against it '*since the alternative is that* [their] *rights get written down without their active input through a 425 scheme (if* [Equitable's solicitors/Counsel] *are right)*'.

29/07/2001 [14:00] FSA and Counsel meet to '*take stock*' on Equitable. Counsel says that he had revised his opinion and that he was now saying that mis-selling liabilities should not exceed the impact on policy values caused by the existence of GARs. It is agreed that, if this calculation were used, then mis-selling liabilities should not exceed Equitable's free assets at that moment in time. It is noted that, should the market value adjuster be increased to over 10%, policyholders who took benefits at a non-contractual time could be worse off than if a liquidation took place. FSA state: '*In the event of the Society proposing an increase in the MVA, we would need to give serious consideration to whether this was cause for us to intervene*'.

	[**15:00**] FSA's Chairman speaks to Equitable's Chairman to, among other things, highlight FSA's concerns over any reductions in policy values to below the amounts that would be available from the Policyholders' Protection Board. FSA's Chairman reports that Equitable had accepted FSA's points.
29/07/2001 [15:51]	FSA provide HMT with some information on the numbers of Equitable policyholders, the '*balance sheet liability*' and the amount of annuity income in payment.
29/07/2001 [16:51]	FSA's Managing Director A sends FSA's Chairman and Managing Director B a copy of a letter to HMT about the wider equity market impact of Equitable going into administration or provisional liquidation. (Note: this letter appears to have been sent by the Chairman to HMT later that day).
29/07/2001 [18:00]	FSA meet Equitable, their auditors, solicitors and Counsel to hear the results of an Equitable Board meeting to consider the way forward for the Society. FSA's note of the meeting records the discussion. Equitable's Chairman summarises the Board's conclusions: *The Society appeared to be solvent on every basis for calculating solvency.* *The Board had been informed of various difficulties which would arise in any of the possible mechanisms for dealing with a potential insolvency. Both provisional liquidation and administration (if that were to be available) would lead to greater loss to creditors than if the Board continued with its current plans.* *The Board had concluded that there was no difficulty in paying the interest on the subordinated debt which falls due on 6th August, and would therefore pay it.* *The second opinion of* [the Society's Counsel] *and the two opinions of* [Counsel for FSA], *do not entirely agree on the potential for liabilities for mis-selling.* [The Counsel who was advising Equitable on the compromise scheme] *had offered some useful ideas. The Board was content for all the Counsel involved ... together with supporting solicitors, to get together to seek a consensus view on this question. They recognised that it could take until August 20th before* [the Society's Counsels] *were in a position to sign an opinion.* *Equitable Life would need to do more work to get a better idea of the quantification of mis-selling liabilities. They had received a spectrum of views from* [the Society's Appointed Actuary and its auditors]. *The Board had taken a rational, worst case basis for assessing mis-selling liabilities in reaching their decision on the way forward. (*[Equitable's] *had indicated to the FSA privately in advance of this meeting that in the Board's view, this figure was £900m). The Board hoped that further work would show that a better position could be sustained.* *The Equitable would press ahead with a Section 425 compromise scheme. The Board wanted to stop "inwards litigation" from policyholder action groups and others. Such litigation could be expected in the period between publication of* [Equitable's Counsel's second opinion] *and a compromise arrangement.* [The Counsel who was advising Equitable on the compromise scheme] *had advised that there were procedures for dealing with these litigation risks, and that they should ask the Court for them to be stayed pending the 425 scheme.* *There would be more regular meetings of the Board, and meetings with their advisers. On occasion, Board representatives might wish to meet with the FSA.*

FSA's Chairman asks several questions, including: if Equitable would prefer administration or provisional liquidation, should things go wrong; whether there was a risk of further policy value cuts; what Equitable would be saying publicly; the effect of surrender levels on cash flow; and about the sensitivity of Equitable's financial position to stock market movements.

29/07/2001 [18:38] FSA's Managing Director A informs his Chairman that, after the meeting, he had talked to one of Equitable's non-executive directors with whom he had used to work at the Bank of England. The Managing Director records:

> *He is particularly concerned about the following:*
>
> > *a) the terms of Equitable policies* [are] *so flexible that some two-thirds of the money currently flowing out is not paying the MVA (or financial adjustment as it is now called).*
> >
> > *b) this* [plus] *the impact of equity price falls worries him – he thinks a 5% fall in equity prices would put real strain on their solvency position.*
> >
> > *c) he will go on pressing for a significant further reduction of equity holdings. He personally puts the likely outflow in the next 12 months as high as £7bn. So while their short-term cash position is fine, this is going to require continuing positive action in selling equities.*

29/07/2001 [entry 8] FSA report to HMT on the meeting with Equitable.

29/07/2001 [18:57] HMT prepare initial drafts of possible Government statements on the situation.

29/07/2001 [22:02] An HMT Director writes to the head of the Chancellor's private office (copied to other Ministers' private offices and senior officials). The HMT Director says:

> *In advance of our meeting with* [the Chancellor] *tomorrow, I attach* [FSA's Chairman's] *letter to me of this evening and the various notes we prepared today. The notes are unpolished and the exact situation for which they were intended will not now occur. But they serve as useful background for a discussion of the issues. They cover:*
>
> - *the meeting at the FSA today;*
> - *the article 4 problem and its effect on policy holder protection;*
> - *the effects on policy holders of the various options the* [Equitable] *Board were considering;*
> - *the pros and cons of introducing an administration scheme;*
> - *a draft statement and possible options for the government's stance;*
> - *draft Q and As; a note of systemic risk and possible government support;*
> - *a letter* [from] *the FSA on systemic risk.*

HMT's Director suggests that, at the meeting, the Chancellor considers:

- *the current situation.* [FSA's Chairman's] *letter;*
- *policy holder protection, article 4 and options;*
- *administration and options;*
- *the review (*[an official's] *submission of* [27 July 2001]*);*
- *the case for government support;*

- *the "package" which should accompany the* [Counsel for Equitable's] *opinion's publication on 20 August;*
- *in the light of the above, the government's "stance" and priorities on Equitable.*

30/07/2001 [10:32]	FSA's Director of Insurance informs his Chairman that, as agreed, he had spoken to the Association of British Insurers last night to postpone the meeting that had been arranged.
30/07/2001 [12:32]	FSA's Chairman sends Managing Director B a provisional checklist of things to be done by 20 August 2001.
30/07/2001 [entry 3]	The Policyholder Protection Board's solicitors write to FSA to record and expand on the advice given in a telephone conversation on 23 July 2001, in response to FSA's letter of 19/07/2001.
30/07/2001 [entry 4]	FSA's Insolvency Practitioner provides FSA officials with a note about the extension of administrators' powers in relation to insurers.
30/07/2001 [17:31]	FSA agree with Equitable that they would have weekly meetings with their Chief Executive and Finance Director. FSA also inform Equitable that Managing Director B or Managing Director A would want to keep in regular contact with the Society's Chairman.
30/07/2001 [18:03]	Equitable send FSA a copy of the proformas for use in the half year accounts and which were to be used in the compromise scheme documentation. Equitable ask that FSA should confirm whether the information was acceptable. [**18:23**] Line Manager E seeks comments on whether it is acceptable. The Line Manager says that, following a conversation with Equitable that afternoon, Equitable had been working on mis-selling and had devised a scheme that they would be looking at with their solicitors, and possibly with Counsel, the following day. He says that Equitable planned to put their outline proposals on mis-selling to FSA on 2 August 2001 and to meet on 3 August 2001 to talk them through those proposals.
30/07/2001 [18:20]	Counsel send FSA a revised version of their opinion.
30/07/2001 [18:30]	FSA's Chief Counsel B informs supervisors and legal advisers of a conversation with Counsel who had said that he had had a discussion with Counsel for Equitable. The Chief Counsel says that there appeared to be little scope for bringing the two opinions together.
30/07/2001 [entry 9]	Equitable respond to FSA's With-Profits Review paper.
31/07/2001 [08:25]	FSA's Managing Director A responds to Chief Counsel B's note of the conversation with Counsel. The Managing Director says that: '*this is clearly bad news and together with all the noises coming out of the Action Groups strengthens my own feeling that (a) this is all going to have to get tested in Court and (b) there will have to be some process (probably administration) to allow time for that*'. Managing Director A also says that: '*there is 1 bit in your write-up which seems to me to be surreal and that is where there has been "aggressive selling" or a "positive recommendation to buy a policy." What on earth is this supposed to mean? Are we now heading for a world in which salesmen for a single company have to hand over a policy saying "I really can't recommend this policy but if you must have it here it is"?*'. [**14:47**] Chief Counsel B advises: '*The problem is that the courts have identified two measures of recoverable loss, one where the advice actually caused the claimant to enter into the*

transaction, the second (more restricted) where the claimant merely got some information. What [Counsel for Equitable] *appear to be saying is that because Equitable employed salesmen and because most of their sales were as a result of advice it may well be possible for claimants to argue that* [Equitable] *is responsible for all of the "loss" which is consequential upon the advice to acquire a policy i.e including the loss attributable to lower investment performance. There is no suggestion that salesmen cannot advise or recommend*'.

31/07/2001 [09:42] FSA's Head of Actuarial Support says that he did not understand a part of FSA's Chairman's letter to HMT of 29/07/2001. The Head of Actuarial Support says:

> [Equitable] *have made, I understand, and agreed with their advisers and auditors, a best estimate of the liability, taking account of the range of possibilities. It would not in my view be correct to suggest that they would remain solvent in the worst case scenario and I believe that a number of their advisers are aware of this. Indeed,* [the Society's Chairman] *did explain to us after their board meeting that the mis-selling provision was being assessed taking account of the basis of quantifying redress as argued in* [Counsel for FSA's second opinion]*, and not on the basis originally promulgated by* [Counsel for Equitable].

[**10:08**] The Head of Life Insurance points out that the phrase used by Equitable's Chairman had been '*rational worst case basis*' and that he had not said on which of the opinions those assumptions had been based.

[**10:15**] The Head of Actuarial Support asserts that Equitable's Chairman had said that the Society's provision (which was less than £900m) had been assessed on the assumption that Counsel for FSA's second opinion was the appropriate way forward. He agrees that the independent review of mis-selling liabilities would have to produce figures on the two alternative opinions.

[**16:27**] FSA's Chairman says that the sentence had been considered carefully but that, if the Head of Actuarial Support had any doubts, FSA must proceed urgently to resolve them.

31/07/2001 [11:05] Further to Chief Counsel B's note of 30/07/2001 [**18:30**], Managing Director B says:

> *What I infer from this is that the "rational worst case basis" referred to by* [Equitable's Chairman] *on Sunday afternoon (which enabled the Board to feel comfortable about meeting the various solvency requirements) may not be the correct position – i.e being restricted to* [the FSA's Counsel's second] *basis. As we discussed yesterday we must move as quickly as possible to form our own assessment of the potential range of liability on the* [Counsel for Equitable] *basis as well as the* [Counsel for FSA] *basis so we see an "absolute worst case basis".*

31/07/2001 [12:14] FSA's Insolvency Practitioner circulates a revised draft Notice to Equitable to instruct the Appointed Actuary's company to assess the quantum of mis-selling liabilities. The Insolvency Practitioner says that the aim was to agree the bases of the assessment internally that day and to discuss them with Equitable and the company the following day.

The Insolvency Practitioner also circulates a draft Notice to Equitable to report certain information monthly and weekly, with the intention of discussing these with Equitable the following day.

[**13:08**] The Head of Life Insurance identifies two questions which might arise for FSA to consider before the meeting with Equitable.

[**14:06**] The Head of Actuarial Support provides some suggested changes to the draft letter.

[**14:57**] The Head of Actuarial Support also says: '*If we are to monitor their financial condition to the level of comfort being sought at our recent internal meetings here, then I believe that we need the detailed analysis of information on a Companies Act basis as suggested in* [the Insolvency Practitioner's] *draft letter. However, given the lesser significance now being attached to the statutory position, then a less detailed summary of the results on the statutory basis could be added to the above requirement*'.

31/07/2001 [12:33] FSA's Head of Insurance Policy writes to the Director of GCD about Article 4.

[**16:34**] The Head of Insurance Policy later writes to Legal Adviser E about Article 4 and the permitted links regime.

31/07/2001 [entry 6] The Tripartite Standing Committee (Deputies), hold an extraordinary meeting to discuss the latest news and prospects concerning Equitable. HMT record the discussion under the following headings.

<u>Mis-selling liabilities</u>
FSA tell the Committee that:

> *... the Equitable Board had convinced both themselves and the FSA that they could go on making payments and were not insolvent and the FSA had no basis for challenging that.*

FSA also report that Counsel for Equitable and Counsel for FSA could not yet reach agreement on the '*"quantum for redress" ie the basis on which Equitable's liabilities for misselling should be calculated*'.

FSA explain that work was '*progressing*' on quantifying Equitable's mis-selling liabilities and that they had required Equitable to commission '*an independent reporting accountant ... to carry out a full analysis of the liabilities on various legal bases*'.

HMT's note records:

> [An HMT Director] *questioned the statement in* [FSA's Chairman's] *letter of 29 July to him that the FSA had not worked through the quantification of the liabilities with the Equitable. While the regulator was not responsible for Companies Act solvency, in Equitable's case it was surely worth looking closely at the basis on which the Board had reached its view.*

To which FSA reply:

> *... that it was impossible for the FSA on Sunday to have done anything further to clarify the extent of the liabilities – they could not reach a firm view on this themselves. However, all Equitable's advisers were satisfied that it was reasonable for the company to continue in business.*

FSA also confirmed that '*the reporting* [accountants] *... would report on the figures to the FSA as work on clarifying the liabilities on both the* [Counsel for Equitable] *and* [Counsel for FSA] *bases progressed*'.

FSA add that '*the Equitable Life Board had looked at the liabilities on both bases on Sunday. The cost on a* [Counsel for Equitable] *market average comparator basis, was apparently not as great as originally feared. The £3.0-5.0 billion first estimate had been very much a cockshy*'.

<u>Fall in equity markets</u>
On the risks to Equitable's solvency position of further stock market falls, FSA:

> *... reported that, as of 6 July the Equitable had a Companies Act surplus of just under £2 billion, not taking account of non-GAR misselling liabilities. Some aspects of this valuation might reflect an unduly prudent view but others could reflect an optimistic view.* [FSA's

> Managing Director A] *thought that a further 5% (or 250 point) fall in the FTSE 100 index from current levels could well cause difficulties for the company. If the prices of a major chunk of its assets went down by this amount, the company would be paying out in benefits more than they could afford to do so. They would then have to increase the level of the MVA or take some other steps to rectify the position – which could risk bringing the company down. (It should be noted that because of the flexibility of the terms of Equitable's policies, MVAs could not be applied in many cases.) The Equitable might also face liquidity problems if the number of policyholders withdrawing their funds was so large that the company had to sell big amounts of securities in difficult market conditions.*

The effect of market conditions on the positions of other companies is discussed.

<u>Handling of the publication of the Society's Counsel's opinion</u>
Publication of the Society's and FSA's Counsels' opinions is discussed, along with possible FSA guidance on the industry issues.

<u>Options for the way forward</u>
HMT's note records:

> [FSA's Director of Insurance] *said that Equitable believed that, if their proposals for the s.425 scheme of arrangement could be published with the* [Counsel for Equitable's] *Opinion, they could secure a stay on litigation until the s.425 scheme had been voted on. There was the possibility under this scenario that policyholders might see the misselling issue as a problem particular to the Equitable rather than a general one. On this basis it could be worth considering what the authorities could do to make it more likely that Equitable could proceed with its scheme of arrangement.*

FSA continue:

> *This broke down into two aspects: ensuring that the company did not become insolvent before the scheme could be voted on; and helping to make the scheme sufficiently attractive to policyholders that they would vote for it. On the former, he wondered whether the government could underpin the company with some guarantee to keep it going – there was a precedent for the government's doing so in the Pool Re (terrorism insurance) case.*

HMT respond that they '*thought the provision of government funding was a remote prospect. It might in theory be possible for the government to guarantee the Equitable's liabilities* [but] *this would raise major moral hazard and other risks and would be very difficult to justify*'.

The Bank of England '*agreed that the question was why Equitable should be underwritten by the government*' and '*noted that the company itself could hedge itself against further market falls through the use of FTSE put options*'.

HMT inform the Committee of their present thinking on the next steps, which was as follows:

- *Treasury officials would continue to explore the option of introducing an administration scheme for insurance companies with the Insolvency Service and possibly the* [Association of British Insurers] *but the Order should be limited to life companies and no public consultation should be undertaken.*
- *If the Equitable, the Halifax and the FSA were all in favour of administration, the Treasury would probably be inclined to proceed. It would be important however that the FSA should give a clearer view on this ...*
- *The position on Article 4 of Equitable's Articles of Association remained of concern. We were currently considering what Ministers might say if Equitable did get into the situation where it was proposing to make payments to policyholders*

lower than they would receive under the [Policyholder Protection Act 1975] *scheme arrangements. We needed to establish more clearly what the legal position was and what levers we had at our disposal to ensure the safety net would apply. Discussions with the Lord Chancellor's Department and the Insolvency Service were ongoing but there looked to be no prospect of changing the Insolvency Rules before 20 August. Indeed, primary legislation might be required, although use of an Order under section 45 of the Insurance Companies Act was being considered.*

On this last point, FSA say '*the risk was that an administrator or provisional liquidator would either not make payments or only do so on a payment on account basis (ie that he reserved the right to recover the payments)*'. FSA undertake to provide a note on the issue and '*any thoughts ... on remedies*'.

HMT's note concludes by recording that:

> *... it was agreed it would be helpful if publication of the* [Counsel for Equitable's] *Opinion could be delayed until more work could be carried out. The FSA could have a power to prevent Equitable from publishing the Opinion, although they would need to consult Ministers on its use.* [Director of Insurance] *observed that, post N2, the Financial Services Compensation Scheme could take the view that a s.425 scheme offered better prospects for Equitable policyholders than statutory compensation and could make arrangements for such a scheme. If Equitable could be kept going until N2 it could be possible to bring off a s.425 scheme. In conclusion* [an HMT Director] *said that nothing was being ruled out at this stage.*

31/07/2001 [13:09] FSA's Managing Director A informs the Chairman, Managing Director B and [**14:42**] Director of GCD of the discussion at, and the key action points arising from, the standing committee meeting.

31/07/2001 [14:08] In response to Line Manager E's request for comments as to whether the proformas for use in the half-year accounts were acceptable (see 30/07/2001 [**18:23**]), FSA's Insolvency Practitioner says that he was not sure that Equitable's proformas for use in the half-year accounts and compromise scheme documentation told policyholders what they needed to know about Equitable's financial position. The Insolvency Practitioner explains:

> *The essence of the compromise scheme is that there is a pot of free assets out of which the cost of meeting GAR liabilities must be paid and the cost of misselling compensation must be paid. Whatever is left in the pot must then remain big enough for the society to have some stability. The "deal" is then how these costs should be borne as between GARs and non-GARs and those missold* [and] *those not. The costs paid out of the pot reduce expectations of terminal bonuses.*
>
> *I feel very strongly, that policyholders should know not only the size of this pot (which is the "fund for future appropriations" in the statutory format attached) <u>but also</u>:*
>
> - *how much of the pot they already expect to get in terminal bonuses (ie the aggregate of the published policy values each policyholder receives);*
> - *how much of the pot GARs and non-GARs (and pre-93/post-93) policyholders could expect to receive before the deal;*
> - *how much is not presently allocated – ie the buffer to provide financial stability.*
>
> *I think this calls for another pro-forma balance sheet which necessarily will not be in a Companies Act format, and it should show the position before and after the proposed deal. It is likely that after deducting non-guaranteed expectations the society will look insolvent, but this is not necessarily a bad presentation.*

The Insolvency Practitioner provides an example of what he had in mind.

31/07/2001 [16:53]	FSA's Line Manager E sends Equitable FSA's '*collection of odd points*' about the compromise scheme, on which FSA would like further information. [**16:58**] Line Manager E informs other officials that he had done so, saying that most of the points had arisen from FSA's internal meeting held about a week earlier. [**17:30**] The Insolvency Practitioner asks if FSA could agree what information they expected from Equitable and circulates two suggested proformas. He describes the first as being the '*big picture*' explanation, showing how asset shares were being redistributed under the compromise scheme. The second is a statement for each individual policyholder. On the fairness of a scheme that also compromises mis-selling claims, he says '*the overall equation should work much more easily since we are back to merely a redistribution of PRE between GAR and non-GAR; however, pre-93 non-GARs close to retirement will still be losers*'.
31/07/2001 [entry 10]	The Policyholder Protection Board's solicitors write to FSA setting out their views on the scope of the Board's powers and duties in the event of '*a pre N2 "default"*'. FSA's Director of GCD asks Chief Counsel B to take this forward with the Policyholder Protection Board's solicitors and HMT. The Director of GCD notes that the Board's solicitors had not given a final view on Article 4 of Equitable's Articles of Association '*but note that its effect is that the Board "may not be empowered or required to exercise its powers ..."*'.
31/07/2001 [entry 11]	FSA write to Guernsey Financial Services Commission about whether the policy value cuts by Equitable had been known to FSA before the decision was announced; ring fencing international policyholders; and, other issues not relevant to Equitable.

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01/08/2001 [entry 1] FSA's Director of Insurance sends the Head of Life Insurance a paper that had been drafted on 28/07/2001 [**20:52**], which sets out the action that might be necessary to prevent Equitable reducing guaranteed amounts payable under their policies. Attached is a Notice under section 45 of ICA 1982. The Director notes that the paper and accompanying section 45 Order had been '*in the event not used. But you may need for your files*'.

01/08/2001 [10:36] Line Manager E writes to FSA officials about outstanding issues. The Line Manager informs officials that Scrutinising Actuary F had written to Equitable on 19/07/2001, and the Society had replied on 20/07/2001 [**17:46**]. He attaches Equitable's reply, split into three documents, named '*solvency statements*', '*future profits*' and '*general*'. The Line Manager says:

> *Also in the package is the application for the renewal of the section 68 order for future profits, which Equitable are asking to be increased to £1.1 billion for 31 December 2001. We received that application at the time the last returns were submitted, but had not previously received the actuarial certificate of 28 June that is now included in the package. I have to say I am not entirely persuaded that it is reasonable to rely on the historic profits that arose in a trading company as opposed to the likely future profits that will arise in the company in its current state. Perhaps* [Scrutinising Actuary F] *could* [advise] *on his return about the likely technical acceptability of the continued use of the implicit item in 2001, taking into account what we consider the position might look like by the year end.*

Line Manager E goes on:

> *We have also received in the package the outstanding monthly solvency reports, covering April, May and June, showing a surplus over the* [required minimum margin] *of £850m, £650m and £660m respectively. However, the covering letter mentions that when the markets fell to 5320 on 19 July, they thought that the surplus had just about been eliminated. Since then of course the FTSE 100 fell slightly further, hitting a low around 25 July of 5220.*

[**10:54**] The Head of Actuarial Support says that Scrutinising Actuary F would look at this in more detail on his return. The Head of Actuarial Support also comments: '*As you say, there are no obvious showstoppers, but the cover for the margin of solvency looks very thin at present, (after making a resilience provision but before allowing for potential mis-selling costs)*'.

[**18:29**] Line Manager E thanks the Head of Actuarial Support and says that he had not been trying to chase a reply as he '*thought there were some things in the response that needed to be aired, though I did try to circulate the letters in a way that suggested the routine regulatory team already had things in hand. The lack of interest suggests I was probably successful!*'.

At some point, the Director of Insurance replies to Line Manager E saying:

> *Between* [19 and 25 July] *the Society was selling equities – including, I think £1bn of overseas equities. We will need to see whether this kept them the right side of the line. I think it must have done since the* [Appointed Actuary] *was able to advise the Board, and the Chairman to advise us on 29/7 that its margin was intact, even taking into account potential misselling claims.*

01/08/2001 [15:00] FSA meet Equitable. (Note: FSA's files do not contain any note which they had themselves prepared of this meeting. Also, it is unclear which documents were handed to Equitable at the meeting and which were the subject of the discussion.) According to Equitable's note of the meeting (which was sent to FSA on 7 August 2001 and subsequently confirmed, on 14 August 2001, to be an accurate record), at the meeting:

- FSA handed over a draft of a letter requiring Equitable to commission their Appointed Actuary's company to investigate the amount of mis-selling liabilities. Equitable record that: '*the objective is to deal with the problem that the FSA is unable to obtain independent actuarial support. FSA will obtain the information they need by having access to the work* [the Appointed Actuary's company] *are to do for ELAS*'. FSA note that they were seeking the data so that they could undertake their own analysis.
- FSA provided a draft of the monthly financial reporting that they would like to receive from Equitable. Equitable note that no insurance company carried out a full data analysis more than once or twice a year and so the quality of more regular data would be limited. FSA say that they were seeking the information that Equitable used to inform their decisions to '*continue the business*'.
- Equitable record:

> [FSA's Insolvency Practitioner] *said they would like to have an end of June position confirmed by* [the Appointed Actuary's company] *together with a monthly "roll forward". He wants to see Balance Sheets on Companies Act and Insurance Act basis showing the level of free assets. He provided some draft schedules to help explain his proposal.*
>
> [Equitable's Chief Executive] *noted that the proposed Question 9 was very sensitive information which could be very damaging to members' interests if it leaked. There was general agreement that an indication ("thin" or "very thin" etc) could be given orally instead.*
>
> [FSA's Line Manager E] *said that the FSA are open to suggestions as to what data is provided formally and informally.*

When confirming the notes of the meeting as accurate, the one point that FSA raised about Equitable's notes of the meeting was that FSA thought '*the words in brackets* [*"thin" or "very thin" etc*] *are too specific and restrictive as a description of the sort of oral indications which we will expect to receive*'. FSA suggest that the words should be deleted.

- It was agreed that the draft proformas of the information that FSA wanted represented proposals and that FSA and Equitable should aim to agree the reporting requirements by 3 August 2001.
- FSA asked whether mis-selling claims would fit into the compromise scheme. Equitable say that they would either be part of the scheme or run parallel to it. Equitable say that they would report further on this in the following week.

02/08/2001 [entry 1]	Equitable give notice to FSA of the appointment of a new manager at the company.
02/08/2001 [entry 2]	HMT thank FSA's Chairman for his letter of 29/07/2001 and provide an update on their work on administration and the possible impact of Article 4 of Equitable's Articles of Association on policyholder protection.
02/08/2001 [09:40]	FSA's Director of Insurance sends the Director of GCD a draft of a letter, on the implications for the continuity of payments to annuitants in the event of provisional liquidation or administration, that he proposes to send to HMT.
02/08/2001 [10:42]	FSA's Insolvency Practitioner prepares a paper regarding who should meet the costs of mis-selling compensation and whether those costs should be borne by GAR and non-GAR policyholders in proportion to their asset share, or whether no one should have to pay for their own mis-selling costs. The Insolvency Practitioner suggests that FSA needed clarification on this issue, probably from Counsel, so that they were able to properly assess the fairness of the scheme compromising both GAR rights and mis-selling claims.

02/08/2001 [before 11:00]	HMT inform FSA that a firm of actuarial consultants had issued a report to public sector pension schemes that recommended people to stop paying into Equitable policies and that trustees should ask for bulk withdrawal terms. HMT say that they were concerned that this might cause reputational or cash flow damage to Equitable. FSA say that the withdrawals of funds that had taken place '*shouldn't leave those left behind worse off - indeed probably the reverse*'.
02/08/2001 [14:48]	Further to the Insolvency Practitioner's note of 28/07/2001 [**12:34**] on mis-selling quantification, Chief Counsel A asks the Director of GCD if anyone had considered the negative effect of bringing forward the liabilities: '*eg including them in a GAR/non-GAR scheme or otherwise crystallising them now by some other legal mechanism*'. [**16:36**] The Insolvency Practitioner explains that FSA had brought in a tax expert who would consider the issue. [**18:09**] Chief Counsel A questions whether it should be assumed that the tax expert would be considering the issue. The Chief Counsel says that she would raise the issue up with Chief Counsel B. (Note: Chief Counsel A later (on 6 August 2001 [**at 20:43**]) suggests to Chief Counsel B that they should leave the issue, as it would '*come out in the wash*'.)
02/08/2001 [14:54]	FSA's Chief Counsel B writes to the Head of Actuarial Support about a calculation that he had provided regarding Equitable's mis-selling provision in a '*Rational Worst Case Scenario*'. FSA's Head of Actuarial Support's calculation concludes: *There is of course still considerable uncertainty about a number of these assumptions and the value that can be placed on the different elements of the calculation. It does though seem that a "rational worst case" scenario could result in a provision of around £1.5-2.5 billion, though we could not rule out the possibility of the Courts taking an even worse interpretation (eg on assumption (4) above which could add another £500m-£1Bn, or on assumption (10) which could add a further £1 billion).* *The implication would be that even if they could find just enough free reserves to cover this, they would have to make substantial cuts in the bonuses for* [GARs] *which could conceivably result in counterclaims from this block of policyholders which would be even more difficult to meet.* Chief Counsel B says that there was much that needed to be explained about the calculation and asks for a meeting to discuss the matter. [**15:05**] Chief Counsel A says: '*I suggest I attend any meeting. Looks like* [the Head of Actuarial Support] *and I might helpfully agree a short note which could iron out some of these issues*'. [**15:35**] The Head of Actuarial Support replies: *Let me hasten to reassure you all that these very tentative figures (on a note headed "Draft") were based on an initial analysis of what the worst case on* [the Society's Counsel's initial basis] *might imply, ie the higher basis of quantification that he proposed in his draft opinion, and not the lower basis which* [the FSA's Counsel] *has now suggested may apply. This has necessarily included a long list of assumptions that would need to be refined.* [**17:39**] Chief Counsel A writes: [Head of Actuarial Support], *We had a quick chat. It may be helpful to copy recipients to know the following:* *1. As you say below, you were doing no more than beginning to think about the figures at one end of the continuum (best case to worst case scenario for Companies Act reserving). A lot more work is needed (with input from others) before ELAS (or FSA) can come to a view.*

2. You were assuming that compensation would be based on an industry comparator (not the cost of GARs).

3. Many of your worst case scenario assumptions are highly debatable.

4. In any event, Companies Act reserving is not required to be on a worst case scenario basis.

5. Finally, even if the worst case scenario was eventually accepted to be as you have outlined (in draft!) and ELAS were to reserve on that basis, there are options available to ELAS to maintain solvency (eg, further reducing bonus or shifting into gilts).

[**18:04**] FSA's Head of Actuarial Support concedes that he agreed but notes that FSA '*would of course need in that hypothetical worst case eventuality to talk through the possibilities in paragraph 5 in more detail, and see to what extent their solvency position could be improved and policyholder expectations fulfilled. (There is insufficient information at this stage to make a proper assessment on this, given the wide range of uncertainties)*'.

02/08/2001 [18:26] FSA's Line Manager E informs colleagues that a meeting with Equitable to discuss the Compromise Scheme and how they would use it to deal with mis-selling planned for the following day - had been postponed until the following week. The Line Manager explains that Equitable were not yet in a position to discuss mis-selling, and that therefore the meeting had had to be postponed.

[**18:52**] The Director of Insurance writes to the Head of Life Insurance in reply, expressing his concern that Equitable were '*slipping again*' on the Compromise Scheme. The Director of Insurance suggests that they should meet, along with other officials, at the end of each day to discuss progress and priorities and to agree action for the following day.

The Director says that he would also like to discuss with the Director of GCD how FSA should progress the Article 4 issues in his absence.

02/08/2001 [entry 9] HMT's Head of Financial Stability and Markets sends the Chancellor of the Exchequer the minutes of the Tripartite Standing Committee (Deputies) meeting held on 31/07/2001.

02/08/2001 [entry 10] In response to the query of 31/07/2001 [16:34], Legal Adviser E provides a note on Article 4 of Equitable's Articles of Association and its interaction with the permitted links regime in ICR 1994. The advice given, in summary, was that:

a) it is not clear that [Article] *4 is caught by* [Regulation] *43;*

b) if [Article] *4 is caught, however, the conclusion must be that, since it determines policyholder benefits, it is a core term of the relevant contracts;*

c) illegality in respect of a core term of the contract renders the contract as a whole illegal and unenforceable by either party;

d) in relation to a core term tainted by illegality, the scope for severance of the illegal term and the enforcement of the balance of the contract without it is limited;

e) the better conclusion, in my view, is that Article 4 is not amenable to challenge as a prohibited link, is not a core term and remains amenable to possible challenge on other grounds, for example as an unfair contract term.

02/08/2001 [entry 11] FSA's Chief Counsel B draws attention to the Policyholders Protection Board's solicitor's letter of 30/07/2001 and that:

... what [they] *say in relation to the question we asked them concerning the valuation of policy benefits in a liquidation and in particular the valuation of a policyholder's expectation of a future benefit.*

The simple point made by [the solicitors]*, and I think this has some force, is that where the valuation rules are being applied in a liquidation of an insolvent company the policyholder's future expectations should probably fall to be treated as having a nil value at least to the extent that any future benefit is dependent upon distributions from profits. The position would be different however were the Equitable to be wound up on a solvent basis and where there were assets attributable to the payment of future bonuses. This would suggest, that if the Equitable were wound up on an insolvent basis then the* [Policyholders Protection Board] *would be looking to pay 90% of the guaranteed contractual benefits but probably no more.*

03/08/2001 [entry 1] FSA's Legal Adviser A provides advice on Equitable's reserving requirements in relation to their assumptions on annuity guarantee take-up rates. The advice given was as follows:

1. In 1998 [Chief Counsel A] *gave some preliminary comments on the application of Part IX of the Insurance Companies Regulations. In particular on the proposition that the regulations require Equitable to reserve as though 100% of its policy holders will choose to take the guaranteed annuity offered under the relevant policies. Much water having passed under many bridges,* [Chief Counsel A] *has asked me to look again at the matter.*

2. In suggesting that Equitable should reserve on the basis of a 100% take up rate, reliance was placed on regulation 64 of the 1994 Regulations. Regulation 64 sets out a general principle. The amount of the liabilities shall be made on actuarial principles and shall include appropriate margin for adverse deviation of the relevant factors. The liabilities must be determined in compliance with each of regulations 65 to 75.

3. It is not clear that any of the other regulations are relevant. In particular, regulation 72 provides that provision shall be made on prudent assumptions to cover any <u>increase</u> in liabilities caused by the exercise of options. In this case, the exercise of the option will not serve to increase the liabilities.

4. As I understand the present position, take-up rates are in the region of 60% by value but c. 90% by number. The present reserving is on the basis of just under 100% take up with the reduction below 100% taking into account certain mortality assumptions.

5. We recently took the advice of [Counsel] *as to whether it was necessary to reserve on the basis that policyholders took benefits at age 50. Although in the end this was determined by the construction of regulation 72(3),* [Counsel's] *advice was effectively that reserving on a worse case scenario was not required.*

6. In these circumstances, it is not clear to me that there is anything in the regulations that <u>require</u> the present level of reserving and that a lower level of reserving is permissible if that is prudent. I shall be happy to reconsider in the light of any comments.

03/08/2001 [entry 2] FSA write to HMT on Article 4 and '*the steps which might be taken to ensure that it does not cause any uncertainty as to the availability of compensation, or other financial support, to the Equitable or its policyholders*'. FSA set out their understanding of the position, which included that, like HMT, FSA '*continue to believe that Article 4 should not be construed as meaning that the Equitable cannot become insolvent, or that, if it did, financial assistance could not be provided and its policyholders could not be paid compensation*'.

03/08/2001 [entry 3] An HMT Director writes to an HMT official (copied to the Chancellor of the Exchequer's Private Secretary and others) about advice which had been given by the Civil Service pension scheme advisers that group schemes should consider stopping paying new money into Equitable and should ask for bulk surrender values. The Director says that the Civil Service pension scheme wanted to send their members a copy of the report, along with the latest guidance from the National Association of Pension Funds. The HMT Director writes:

My clear view was that (i) we could not give public service pension schemes any information which was not generally available; (ii) the managers of public service pension schemes had to take whatever action they believed appropriate in the light of their statutory and contractual duties.

... However, this news clearly has implications for Equitable. I have discussed these with [Managing Director A] *at the FSA. His view is that there should not be an immediate problem. Asking for a bulk surrender value will take* [some time]*, and, within their rights, Equitable would be likely to make such a transfer pretty unattractive. It was not therefore "today's problem". The publicity which might follow wider circulation of the* [adviser's] *report would not be good but there were many reports of this sort floating around. He did not know the value of the* [Principal Civil Service Pension Scheme] *stake but thought it would be pretty large. FSA were any way keeping an eye on withdrawals.*

03/08/2001 [10:59] FSA's Director of GCD asks Chief Counsel A, following a query from his Chairman some time ago, to advise on whether there was any material in the Baird Report that might influence policyholder decisions on the compromise scheme. [**15:20**] Chief Counsel A says that she was happy to do so but needed a copy of the report.

03/08/2001 [12:31] FSA's Director of GCD provides Chief Counsel B with comments on his draft guidance about Counsel's opinions on mis-selling liabilities.

[**13:03**] In response to a point raised about the existence of separate funds or sub-funds, the Head of Life Insurance asks the Head of Actuarial Support to produce a definitive note on the actuarial complexities of the management of a long term fund.

[**14:33**] The Head of Actuarial Support points out that he was not an expert in insolvency law for insurers but offers his understanding that '*Section 55 of ICA 82, in conjunction with the 1985 Winding-Up rules, disapplies the normal rules for the operation of a long-term fund in the event of a winding-up*'. He goes on to explain the issue in more detail.

03/08/2001 [16:33] The Treasury Solicitor's Department send FSA a note on the scope for using powers under section 45 of ICA 1982 to require Equitable to act on HMT's/FSA's interpretation of Article 4 of Equitable's Articles of Association. HMT attach an amended draft Notice that could be used. The advice provided included the following:

In my view, section 45 could be used to require [Equitable] *not to rely on the wider interpretation of Article 4 – or strictly, of any provision made in accordance with that Article in a policy granted under those Articles – but only on the basis of section 45(1)(b) and on the ground in section 37(2)(aa), coupled with paragraphs 5 and 7 of Schedule 2A to the Act. I do not consider that section 45(1)(a) and the ground in section 37(2)(a) could be relied on, as suggested in last weekend's draft. My reasons for this view are as follows.*

Sections 45(1)(b) and 37(2)(aa) allow a requirement to be imposed on a UK company "for the purpose of ensuring that the criteria of sound and prudent management are fulfilled with respect to the company" on the ground that any of those criteria "is not or has not been or may not be or may not have been fulfilled". Those criteria are defined in section 5(4) as the criteria set out in schedule 2A; paragraph 5 of Schedule 2A specifies one of the criteria – somewhat tautologically – as that the company "conducts its business in a sound [and] *prudent manner", and paragraph 7 then states that a company is not to be regarded as fulfilling this criterion "if it fails to conduct its business with due regard to the interests of policy holders".*

It seems to me that HMT/FSA could properly take that view that it would not be in the interests of policy holders for [Equitable] *to cease to meet in full the contractual* *entitlements of its policy holders, or to act on an interpretation of Article 4 and provisions made under it according to which* [Equitable's] *liabilities to those policy holders were regarded as reducing in line with its net assets.*

It follows that if [Equitable] *were to act on such an interpretation or to cease to meet those entitlements in full, under paragraph 7 of Schedule 2A HMT/FSA could properly consider that the criterion in paragraph 5 of that Schedule "is not fulfilled" with respect to* [Equitable]. *That would mean that the ground in section 37(2)(aa) was established. Equally, if it appeared to HMT/FSA that* [Equitable] *may be going to act on such an interpretation or to cease paying out in full, the ground in section 37(2)(aa) would be established on the basis that the criterion in paragraph 5 "may not be ... fulfilled" with respect to* [Equitable]. *In either of those circumstances, imposing a requirement on* [Equitable] *not to act on interpretation, or to continue to meet its contractual obligations so far as possible, would clearly be "for the purpose of ensuring that the [criterion in paragraph 5 of the Schedule is] fulfilled with respect to the company" within section 45(1)(b).*

Sections 45(1)(a) and 37(2)(a) are about protecting policy holders against the risk of a company being "unable" to fulfil their reasonable expectations. That might include, for example, obliging a company to invest differently (or not to change certain investments) if its current investment policy (or such a change) would be likely to leave it with too small a fund to meet those expectations. Those sections do not seem to me to enable a requirement to be imposed which does not affect an insurer's <u>*ability*</u> *to meet policy holders' reasonable expectations, but merely obliges the insurer* <u>*actually*</u> *to meet those expectations.*

The requirements being proposed here fall in my view into the latter category. A requirement to meet contractual entitlements in full or to act on an interpretation of Article 4 under which more is paid out will do nothing to improve [Equitable's] <u>*ability*</u> *to meet policy holders' expectations: it will not lead to any increase in the fund available for that purpose. Indeed, if anything such a requirement might reduce* [Equitable's] *ability to meet those expectations, since it will lead to* [Equitable] *having less money than it would otherwise and might even precipitate an insolvency. This is why I do not consider that requirements of this sort can be imposed under sections 45(1)(a) and 37(2)(a).*

03/08/2001 [17:50]	FSA's Director of GCD responds to the Insolvency Practitioner's note of 02/08/2001 [**10:42**], saying that his understanding was that both GAR and mis-selling costs were liabilities of the company. Therefore, they '*come off the top*' and the Insolvency Practitioner's first approach was the relevant one.
06/08/2001 [entry 1]	FSA write to HMT, following the Tripartite Standing Committee meeting on 31/07/2001, to confirm FSA's understanding of what would happen if Equitable went into administration or liquidation.
06/08/2001 [entry 2]	An HMT official provides the Economic Secretary to the Treasury with an update on possible legal solutions to the Article 4 problem.
06/08/2001 [10:19]	FSA's Director of GCD thanks Chief Counsel B for providing him with a copy of PIA's draft mis-selling report and gives his thoughts on PIA's handling and the report itself. On handling, the Director of GCD writes:

... my main concern is whether there is any need for the report to be maxwellised. Given that it reaches conclusions that the company had engaged in misselling, and that it is to be published, it seems to me that there is a serious issue about maxwellisation. If you agree, it would be sensible to put this in hand as soon as possible, so that it can be complete before the report is needed for publication.

The second handling point relates to the possibility of disciplinary proceedings. I myself [am] *particularly concerned about a statement which was made in a letter to all members at a late stage of the court proceedings indicating that the maximum exposure of the society was only £50 million. From memory, the papers I have seen call into question whether this was a sustainable statement at the time it was made. We need to consider it not only from a viewpoint of disciplinary action by the PIA, but also in the context of section 47 of the Financial Services Act.* [The Director of Insurance] *will be sending a paper to Enforcement on these aspects, so that we are in a position to say what we have in mind to do when this document is published.*

On the report, the points of detail made by the Director of GCD include:

- that it might be helpful to '*deal not only with customers who bought non-GAR policies from the relevant date, but also those who topped them up from that date*';
- that the report should mention that the transitional arrangements for the implementation of the new regulatory regime permited FSA to initiate new disciplinary proceedings against a company on the basis of past contravention;
- that a part of the report is: '*a key paragraph in indicating that we agree with the conclusion reached by counsel that the Equitable failed, in a generic way, to comply with the disclosure requirements to which it was subject. I think we need to be clear about the status of this finding, given that it is not made in the course of disciplinary proceedings. We need to find a way of expressing this so that it does not appear to prejudge the outcome of any disciplinary proceedings which we may subsequently take, and also so that it does not appear to be reaching a disciplinary decision without proper due process. For example, perhaps we need to make it clear that the conclusion can only be reached without due process in a way that does not prejudice the outcome on any eventual proceedings. But I am not only convinced that this would be adequate and would be glad if you could give it some further thought*'; and
- that, as the report concludes that there had been mis-selling up to the date of publication of the House of Lords' decision, it raised the question of whether there had been mis-selling after that date. The Director of GCD explains: '*Presumably, this would be the case, because although policyholders would be aware of the decision, they might still not be aware of its potential financial consequences for them. Indeed, as my note indicated earlier, the company may have given them greater reassurance on this point than was properly justifiable*'.

06/08/2001 [10:32]	FSA's Director of GCD asks Chief Counsel B to lead on work on the Financial Services Compensation Scheme, in his absence. The Director asks that the Scheme rules should be able to deal with the legal issues that FSA expected could arise in relation to Equitable.
06/08/2001 [10:44]	FSA's Director of GCD informs FSA's Chairman and Managing Director A of the results of his review of the Baird Report's comments on mis-selling to non-GAR policyholders.
06/08/2001 [11:15]	The Director of GCD provides Chief Counsel A with a report on events of the weekend of 28 and 29/07/2001.
06/08/2001 [13:18]	Equitable send FSA two documents from their compromise scheme launch pack. [**14:41**] FSA's Head of Actuarial Support says that there were a number of features of these documents that '*leave me feeling uncomfortable*'. He explains:

1) The effect on the balance sheet is likely to be fairly small, given that the value of the new guarantees being offered (to GAR's and non-GAR's) appear to be fairly close in value to the provision for GAR's and the small provision being made for mis-selling costs (though they would of course avoid the potentially larger figure for mis-selling costs could arise in a worst case scenario). Consequently, the supposed advantages (if indeed they exist anyway) of a less restricted bonus and investment policy may not be readily available.

2) It is unclear whether Equitable will be able to pay any guaranteed bonus this year as a result of the low investment returns. They should not be raising expectations of what the scheme can achieve too far.

3) An investment return increased by 1% per annum as a result of the scheme may be rather optimistic, though of course policyholders will not have any clear benchmark to see whether or not this has been achieved (as they will not know what investment policy would have been followed if the scheme were not approved).

4) I do not see how their proposals "ensure" that policyholders electing for 25% cash could buy an annuity that would replace at least 75% of their maximum GAR rights. This must depend inter alia on the current annuity rates at the time of retirement.

5) On a point of detail, the maximum cash for the policyholder in their example would be three times the annuity purchased by the "rest of fund".

6) The commentary on the other options looks very sparse.

7) In the accompanying letter, are we content for them to write that the Scheme "will be approved by FSA"? Surely, this should say "will need to be approved".

Finally, all the numbers will of course need to be checked against the latest version of the schema in due course.

06/08/2001 [15:25] FSA's Legal Adviser E asks Line Manager E what work Equitable were doing to quantify their mis-selling liabilities, who was doing it and what work they were doing to quantify their future liabilities '*if there is no 425 scheme*'.

[**16:44**] Line Manager E replies that the '*actuarial team (which in practice means the appointed actuary, who is a consulting actuary ... and the Equitable's old actuarial department, now part of* [Halifax Equitable Clerical Medical]*) will be advising the Society on this. They will also be supported by* [the Appointed Actuary's company] *who will provide comparative information for other providers and validate the work being done by the Appointed Actuary*'. Line Manager E says that he did not believe that the conclusions reached on the liability that existed would be any different if there were no compromise scheme, as Equitable '*need to work out the liability, and then work out the basis on which it might be compromised and at what price*'.

Line Manager E also explains that FSA would see this information as: '*What Equitable will be doing for its own purposes is to be the subject of a formal requirement imposed under s.44(2B) ICA for an expert review*'.

06/08/2001 [15:37] FSA's Director of GCD writes to Managing Director A, further to the information supplied by HMT about public sector pension schemes. The Director of GCD says that Equitable's freedom to '*toughen*' terms for withdrawals was subject to the Unfair Terms in Consumer Contracts Regulations 1999 and that their position would be stronger if they were to publish the criteria on which they exercised their discretion to set the market value adjuster. He also says: '*As enforcement authority, this would also improve our position, as well as helping policyholders know where they stand*'.

06/08/2001 [16:00]	FSA hold an Equitable Life Lawyers Group meeting. The Group discuss: significant developments over last fortnight; progress on outstanding points; new items; and matters arising from the Insolvency Practitioner's counterfactuals paper.
06/08/2001 [16:41]	FSA seek advice from Counsel in relation to assessing Equitable's exposure to mis-selling claims. [**17:56**] In response, Line Manager E says that he and Chief Counsel A thought that it would be useful for him to be aware, and to mention to Counsel, that Equitable's market value adjuster was not always applied to policy surrenders. The Line Manager explains that this was because of the flexible nature of some of the Society's policies. Line Manager E says that, because of this, the market value adjuster had only applied to about one third of the £2bn of withdrawals made since December 2000. The following day [**at 14:05**], Chief Counsel B says that he would draw this to Counsel's attention. The Chief Counsel also says: '*The point about flexibility is that it might materially reduce the costs to Equitable of compensation paid to those who take their benefits early rather than surrender, transfer and suffer an mva*'.
07/08/2001 [09:21]	Having discussed the issue the previous night, FSA's Head of Actuarial Support sends Managing Director A a note outlining his concerns about Equitable's latest compromise scheme documentation. [**12:07**] The Managing Director says that he too had '*a good deal of discomfort*' with the policyholder communication. Focusing on the first point, the Managing Director also concludes: *... that the promised uplifts account for much/all of the Halifax* [£250m] *+ the no longer needed provisions for GARs (say* [£1.3bn]*) and for misselling. The Society therefore potentially continues after a compromise with less uncertainty about the future but with very little initial room for manoeuvre. (For example a 10% fall in share prices just after the compromise would spark another round of policy value reductions - and such risks need to be spelled out.)* [**13:36**] The Head of Actuarial Support agrees with the Managing Director's analysis and expands that there: *... are two separate sets of calculations to look at. First, the Companies Act balance sheet and secondly the effect on bonuses.* *For the Companies Act balance sheet, we understand that they had around £1.6 billion free reserves at end-June before making any provision for mis-selling. After the scheme is agreed, the GAR provision of £1.3 billion should be removed, the mis-selling provision should also be removed, and a Halifax contribution of £250 million should be received but instead, there are likely to be additional guarantees given to GAR's of around £1 billion along with any guarantee that may be offered to non-GAR's (no details of this have been given to us so far).* *Accordingly, I would conclude that the free reserves are still likely to be of a similar magnitude of around £1.5 - £2 billion. As you say, they would still therefore be vulnerable to a fall in equity values if they aim to maintain a significant level of equity investments.*

On the second set of calculations, the policy values for GAR's are likely to be increased by around £1.3 billion, and the policy values of non-GAR's by around £700 million (assuming a 4-5% uplift) as a result of the scheme. This will be funded by the removal of the £1.3 billion provision for GAR's and the Halifax contribution of £250 million, leaving a potential shortfall of up to around £500 million. It is not clear to me whether they have sufficient margins available to fund this without making a further small cut in bonuses for everyone.

In any event, I am not sure how acceptable the scheme will be if Equitable reserve the right to remove the uplifts (on a proportionate basis of course for everyone) at any time in the future.

07/08/2001 [09:30] HMT send FSA a copy of the report regarding the Civil Service pension scheme.

[**11:57**] FSA's Managing Director A gives his immediate reaction to the report, saying that:

a) it is somewhat less alarmist than HMT originally implied but pretty gloomy for all that;

b) we are clearly likely to get drawn into a row about transparency over the terms of bulk surrenders. Personally I have every sympathy with those who think that there should be transparency in the process by which surrender values are calculated. perhaps we could put this on the agenda for the next evening "wrap-up" meeting.

07/08/2001 [09:53] Equitable send FSA the weekly customer servicing reports.

07/08/2001 [entry 4] FSA issue Equitable with a Notice pursuant to section 44 of ICA 1982 requiring the Society to instruct the Appointed Actuary's company to assess possible mis-selling liabilities. FSA explain that they:

... had intended to instruct another firm to carry out work in relation to such possible misselling. The Society will, naturally, be carrying out its own estimation of such potential liabilities and will, I assume, be supported in this by the Appointed Actuary and staff from his firm ... The FSA will also need to have sufficiently detailed information to form its own assessment of the possible liabilities.

In order that there is no duplication of effort and undue disruption to the Society's work towards a compromise scheme, I am writing to require the Society to further instruct [the Appointed Actuary's company] *to address the estimation of possible misselling liabilities on, at least, the assumptions which the FSA will need to evaluate. You may wish to evaluate other bases yourself or with* [the company's] *help.*

FSA continue:

We are not asking that [the Appointed Actuary's company] *form a view as to whether misselling has occurred or, if it has, what the basis of compensation should be. Rather, we are providing a range of assumptions to be made, and are asking only that* [the company] *carry out the computations necessary to quantify possible liabilities on these assumptions. We then need* [the Appointed Actuary's company] *to provide the FSA with details of these computations in sufficient detail that we can review them, understand how they are derived and overlay our own analysis as legal opinions develop.*

07/08/2001 [entry 5] Equitable's Appointed Actuary writes to FSA's Head of Actuarial Support about the reinsurance treaty and, in particular, the issue of the renegotiation clause if claims reached £100m, the issue having been raised by the Society's new auditors. The Appointed Actuary says:

> *From the Society's point of view I believe that the attached extracts show that the matter was discussed with you, changes made, the final Treaty sent to you, and the Treaty used for 1998, 1999 and 2000 Returns.*
>
> *The purpose of this letter is therefore to ask you to confirm for the benefit of myself as new Appointed Actuary and ... the Auditors, that the attached describes the position from your point of view and that you have nothing to add.*

The Appointed Actuary encloses a note, dated 2 August 2001, from a former Appointed Actuary to which he attaches four documents, with the following description:

> *A – The relevant extract from the draft treaty submitted to FSA/GAD in advance of a meeting held on 28.1.99 plus the relevant notes from that meeting. Those notes show the people present and at 8 record the views which FSA/GAD expressed on the clause in question.*
>
> *B – Copy of our note of 1.2.99 to* [IRECO] *requesting the various changes indicated by FSA/GAD (point 3 deals with the clause in question) together with our suggested rewording of the clause.*
>
> *C – Relevant extract from the updated treaty submitted to FSA/GAD in advance of a further meeting on 19.2.99. This is unchanged from what we had suggested to* [IRECO] *in B above and was not discussed further at the 19.2.99 meeting.*
>
> *D – Letter dated 22.2.99 from* [Head of Actuarial Support] *recording the points they had asked us to negotiate on further at the 19.2.99 meeting. You will note that the £100m renegotiation point clause is not mentioned as a matter needing further attention and the statement on page 2 confirming that, subject to the specific points mentioned, the treaty would have the intended reserving effect.*

In the note, the former Appointed Actuary says that he thought:

> *... it is also pertinent to remember that no query was raised in connection with the credit taken for the treaty in either the 1998 or 1999 returns and I assume the same is also true for the 2000 returns*.

07/08/2001 [entry 6] FSA host a conference call with Equitable. According to FSA's note of the call, the following issues were discussed.

Equitable's Chairman said that he was spending a significant proportion of his time dealing with the press, whose focus was on what would happen if the compromise scheme failed. FSA record that he:

> *... continued to emphasise that the Board had not considered this, but were focussing solely on getting the compromise scheme to work. He was however concerned that the compromise scheme could be defeated by GAR policyholders, in value rather than number. He was clear that if this scenario materialised the Society would be in a severe state of instability and the govt would come under renewed pressure to intervene.*

It is noted that press attention had not '*majored*' on the review of Equitable's financial position.

On Equitable's solvency position:

> [FSA's Managing Director A] *noted that the FSA continued to adopt a cautious line on the Society's solvency position and pointed to the fundamental uncertainties referred to in*

the annual report. [Equitable's Chairman's] *line was that he was happy the Society was, and will continue to be solvent. He noted that he refers to the fact that ELAS remains in close contact with the FSA and this appears to provide some reassurance.* [FSA's Director of Insurance] *noted that the FSA could not adopt a more positive stance as we had not yet seen the figures on which ELAS were basing their statements.* [The Chairman] *said that the FSA should do whatever they can to reassure themselves – if information was required to verify the Society's stated position, the FSA should not hesitate to request it.*

The timing of the publication of Counsels' opinion and the compromise scheme are discussed, along with progress on that scheme.

Equitable's Chairman acknowledges that relations between the company and Halifax '*could be closer and better*'.

FSA note that they were aware that the Appointed Actuary's company were advising public sector schemes to '*get out wherever possible*' and that this was likely to hit the press within the next few days. FSA suggest that Equitable should be ready to publish figures on outflows from the with-profits fund if, for example, the adviser's report caused concerns. Equitable's Chief Executive acknowledges FSA's view, '*although the outflow figure was higher than he would like to have to announce*'.

07/08/2001 [entry 7] FSA write to the solicitors for the Policyholders Protection Board about the opinion on Article 4 from Equitable's Counsel in relation to the operation of the Policyholders Protection Act 1975.

07/08/2001 [entry 8] FSA talk to Equitable about the proposals for dealing with Counsel's opinions and claims for mis-selling within the compromise scheme. Line Manager E circulates a note of the discussion the following day. The Line Manager records that Equitable's initial thinking had been to:

... follow their approach to buying out the GAR, namely follow a two stage process that first identified the overall loss (ie the aggregate cost to the Society of meeting claims) and then devise a mechanism for sharing that amount among qualifying policyholders.

In terms of the aggregate cost, they were coming to the view that the loss was the effective reduction in policy values from the suspension of bonus for 7 months in 2000 to pay for the House of Lords, which in effect reduced policy values by 4.7%. There was also a cut in reversionary bonus as they estimate, had it not been for the [House of Lords'] *judgment, they would have applied a reversionary bonus 4% higher for 2000. In fact this amount has to be adjusted for some policies because policies between 1988 and 1996 have a 3.5% income guarantee and have already received the bulk of their 4%, and so would be compensated at a lower level.*

In terms of the amount allocated as compensation to individuals, they thought there were two possible ways forward. One was to have a points system so that they could assess the different basis of claims against the society and weight the claims depending on the chances of success and the likely form of damages. They could then allocate points to each policyholder to reflect the claims that they would have and allocate the compensation according to individual scores. The alternative was a less scientific approach that would work on the basis that either a person had the basis for a claim or they did not, and make no distinction between the basis of the claim (or its value or probability of success). I got the impression that they are inclined to favour the latter since it is easier to understand and arguably no less fair that the more sophisticated approach which could have the effect of compensating a person for the same loss several times over because of the number of bases on which they could bring a claim.

They are of the view that the compensation cost is additional, and therefore a charge on the with-profits fund as a whole (and ranks ahead of any "liability" to pay discretionary *benefits.) As it is a charge against the fund as a whole, this means it has effectively to be met by all policyholders, and therefore is paid for substantially by the non-GARs.*

Line Manager E goes on to comment that this:

> *... raises an issue that is largely presentation, but quite critical in terms of handling. Namely, should the cost be covered by making a transparent cut in policy values to free up sufficient assets to cover the compensation costs to non-GARs (and if so should that be done before or as part of the scheme); or should the amount of uplift of GARs and non-GARs be scaled back to put them in the position they would have ended up in had they been put through each stage of the adjustment. In other words, should they be offered (say) a 20% and 4% up lift for GAR and non-GAR policyholders respectively, with policy values simultaneously being cut back by 3%, or should the uplift simply be reduced to say 15% and 1% (with an explanation as to why those are the right numbers).*

The Line Manager adds that FSA:

> *... also need to think about this point from a technical viewpoint because it may be that there are situations where the iterative approach to calculating revised policy values would produce a different outcome to the application of a simple uplift factor. For example, it may vary depending on the extent to which a policy value includes enough terminal bonus to cover the "loss" in value.*

07/08/2001 [17:36]	FSA's Legal Adviser E provides a note on whether group scheme policyholders should receive the same benefits under the Policyholders Protection Act 1975 as any other policyholder. The Legal Adviser concludes that such group scheme policyholders should do so. [**18:58**] Legal Adviser C agrees and confirms that it was the same under the Financial Services Compensation Scheme rules.
07/08/2001 [18:50]	Line Manager E distributes some notes setting out his thinking on the compromise scheme, ahead of a meeting later that week to discuss what view FSA should take as to whether to intervene to stop the scheme proposed being put to the Society's members.
08/08/2001 [13:21]	In response to Line Manager E's note of the meeting held the previous day with Equitable, FSA's Managing Director A comments that, on handling, Equitable would be '*crazy to go for the first of the 2 options you describe (the transparent one)*'. The Managing Director notes, however, that '*whatever they do the furore will surely be about the assumption that this is a charge off the top and that therefore the non-GARs end up paying for most of it, despite the fact that the source of the loss comes from GARs getting a bigger slice of the pie, largely at the non-GARs expense in the original* [House of Lords] *judgment*'. The Managing Director asks officials to think hard about the rationale for this and whether FSA '*buy it*'. [**13:26**] Chief Counsel B advises that FSA's shared legal view was that any mis-selling compensation was a charge to be borne by all with-profits policyholders '*with the result that Non Gars as a class bear a substantial part of the misselling costs*'. [**13:31**] The Head of Insurance Policy queries whether '*it is only under the* [Counsel for FSA's basis] *that non-GAR's in effect pay for most of their own compensation. Under* [the Society's Counsel's basis] *the compensation is to top up the Equitable policy values so that they equal the industry average. If payment of the compensation itself reduces the policy values this in turn means that the amount of compensation must increase. The total amount that non-GAR policyholders receive remains constant (equal to the industry average). It is merely the split between policy value and compensation which changes*'. [**13:36**] The Head of Actuarial Support suggests that there was an issue that needs to be discussed. He explains that:

The effect of their proposal is that non-GAR's will be offered a net uplift of only around 1-1.5% of their policy value and will therefore still be around 3-4% worse off than if the GAR problem had not arisen (largely as a result of the non-GAR's representing around 75-80% of all the policies by value and therefore having to meet the bulk of all the costs).

An alternative would be to offer the non-GAR's a 4-5% net uplift but this would result in the GAR's having to take a cut of around 15% in their policy values which is unlikely to be palatable. There may of course be other intermediate offers that could be made between these two positions.

[**15:28**] Chief Counsel B explains that he thinks that '*the approach is the same for* [the FSA's Counsel's opinion] *and* [the Society's Counsel's opinion] *– to the extent that both support claims for damages based upon a tort (inadequate disclosure (s62); misrepresentation; negligent misrepresentation). The position would be different if the claims were contractual in nature and Equitable acted to give effect to what would be enhanced policy rights and values*'.

[**15:56**] The Head of Actuarial Support says that he was:

... a little puzzled by this. Does this mean that the possible basis of redress mentioned by [Chief Counsel A] *whereby Equitable is asked to guarantee to provide benefits in future at the average industry level for a comparable policy, is no longer required?*

Incidentally, I believe that as part of the pensions mis-selling review, we did allow some insurers to provide redress by way of a guarantee that they would be no worse off than if they had remained a member of their previous occupational pension scheme. Perhaps, though, there was deemed to be some form of contractual warranty involved?

[**21:18**] The Head of Prudential Policy asks Chief Counsel B to confirm that '*under* [the Counsel for Equitable's opinion] *non-GAR policyholders would <u>not</u> effectively be placed in the same position they would have been in had they effected a policy with another insurer (industry average) instead of Equitable?*'

08/08/2001 [16:03] PIA write to FSA in response to discussion earlier that day about advice provided by independent financial advisers. PIA send them the question and answer briefing prepared on 27/07/2001 [**15:44**] and ask FSA to consider if they had now decided to elaborate on the guidance previously given. PIA say that they agreed with FSA that independent financial advisers were looking for more information but note that '*feedback from the consumer helpline indicated that many* [Independent Financial Advisers] *were reluctant to give advice*'.

[**16:37**] FSA clarify that:

1) I'm <u>not</u> suggesting that we necessarily put anything new out to [Independent Financial Advisers] *and if you are not getting that many calls that seems to argue against putting anything new out.*

2) The text you've got below looks OK to me but there is a quite separate worry that [Independent Financial Advisers] *have been expressing and I'd like us to agree a line on that too. The worry is that where an* [Independent Financial Adviser] *doesn't want to give advice that we will somehow insist or discipline them for not giving advice. I presume our answer to this is "Where an* [Independent Financial Adviser] *feels that they lack sufficient information on the Equitable to be comfortable giving advice they should make that clear to their client" ...*

08/08/2001 [entry 3]	FSA meet Equitable for a weekly round-up. FSA's note of the meeting includes the following. <u>Reporting requirements</u> It is noted that the independent review by reporting accountants of Equitable's financial position was under way but that the review by actuaries to assess the potential mis-selling liabilities would now proceed on a different basis, as neither FSA or Equitable had been successful in appointing someone to do the work. On the regular financial reporting requested by FSA, Equitable '*expressed some concerns ... because he thought the Society did not have all the information that we were asking for*'. The issue is discussed further and it was established that the reporting could largely be provided in the format requested. FSA record that they: '*did not propose to make that subject to a formal notice of requirements. This would give us greater flexibility to update the form and content of the information to reflect concerns at any particular time*'. <u>Compromise scheme</u> Equitable provide an update on the compromise scheme following a meeting of their steering group the previous day. Equitable's Chief Executive also mentions that they would be seeking FSA's consent to buy back up to 10% of the subordinated loan and says that he thought that '*following the interest payment and the recent announcement, the earlier difficulties had largely gone away*'.
08/08/2001 [entry 4]	FSA's Chief Counsel B sends the Director of GCD, the Director of Insurance and Chief Counsel A a copy of a note to two PIA Enforcement Heads of Departments which was intended to bring them up to date on the current position on mis-selling of non-GAR policies by Equitable.
08/08/2001 [entry 5]	FSA's actuarial scrutiny file includes pages from Equitable's website regarding the timing of and reasons for the changes to policy values.
09/08/2001 [10:20]	Equitable send FSA a copy of their '*Ready Reckoner*', which had been sent to their policyholders on 6 August 2001.
09/08/2001 [10:38]	Chief Counsel B answers the FSA's Head of Prudential Policy's question of the previous day, confirming that: *1. No, the particular distinction between* [Counsel for Equitable] *and* [Counsel for FSA] *(there are others of course) is that they part company on the extent of the recoverable loss.* [The Society's Counsel] *says all the consequential loss is recoverable including loss attributable to poorer investment performance.* [Counsel for FSA] *is prepared to apply a more restricted approach (although he concedes that on the facts an investor who was positively <u>advised</u> to take out an endowment policy may be entitled to damages on the potentially more generous basis – actually I suspect most Equitable policyholders purchased on advice given by a sales representative – this is something I consider I need to mention to counsel, we did not accept an argument from the Equitable and others in the context of the pensions review that policies had merely been sold in response to the provision of "information".* *2. To the extent that the <u>Society</u> has incurred a civil liability to compensate for tort, this is a liability of the Society generally and is to be met out of the Society's assets.*
09/08/2001 [14:51]	An FSA legal adviser circulates the draft minutes of the Equitable Life Lawyers Group meeting on 06/08/2001, along with the legal issues paper of 25/06/2001, which he suggests is in need of updating.

09/08/2001 [15:39]	HMT send FSA a note on Article 4. HMT say that the note '*represents the collective views of Treasury lawyers but it has no official status*' and that: '*If the note seems a bit inconclusive it is because there are tactical and political questions which will need to be (and are being) considered first*'. HMT's position on Article 4 is that they '*strongly share the FSA's view (and that of* [Counsel]*) of article 4*'. HMT comment on the various suggested solutions.
09/08/2001 [16:16]	FSA send Counsel two substantive comments on the latest version of their opinion (draft 2).
09/08/2001 [entry 6]	FSA's Head of Actuarial Support replies to Equitable's Appointed Actuary's letter of 07/08/2001, saying that: *Our understanding of this paragraph is that the treaty would not be cancelled but that negotiations would take place with the aim of restructuring the treaty in a mutually agreeable manner. In particular, the "Adjustment Premium" would be redefined in respect of future years. However, our understanding from these meetings in early 1999 was that Equitable would not agree, and could not be forced to agree, to a restructuring that had a materially adverse effect on the value of the reinsurance offset that could be included in the FSA returns. You have no doubt come to a view yourself and if differs materially from ours, I would be grateful if you would let me know.*
09/08/2001 [entry 7]	PIA send FSA a procedural note on what the conduct of business regulators would be doing and when.
09/08/2001 [entry 8]	HMT's Director of Financial Regulation and Industry updates the Economic Secretary to the Treasury on Equitable in relation to: administration and Article 4; advice on response to the Treasury Select Committee; a possible Government statement; and dealing with related correspondence. The Director notes that the delay in publication of Counsel's opinion '*potentially provides a bit more time/expands the range of options for announcing an enquiry*'.
10/08/2001 [13:56]	An FSA legal adviser (Legal Adviser F) provides advice on the powers of an administrator to continue payments to annuitants and on the giving of such powers to a provisional liquidator.
10/08/2001 [entry 2]	FSA write to Equitable to request some additional information along with the underlying data for the quantification of potential mis-selling liabilities. FSA ask for this by 17 August 2001.
10/08/2001 [entry 3]	FSA send HMT a draft Order under section 45 of ICA 1982 that would require Equitable not to publish Counsel's opinion.
10/08/2001 [entry 4]	PIA write to FSA about guidance to the industry in the light of Counsel for Equitable's opinion on mis-selling.
13/08/2001 [09:15]	Equitable send FSA the weekly customer servicing reports.
13/08/2001 [entry 2]	FSA write to Equitable about the compromise scheme. FSA say that they were yet to reach a view on the scheme and ask Equitable for the outstanding information, along with the further information to be supplied. FSA formally set out their concerns about the proposed scheme.

13/08/2001 [16:54]	FSA's Chief Counsel B sends officials a note (dated 10/08/2001) on Article 4 of Equitable's Articles of Association and where FSA should go now. The suggested ways forward are: *a) Continue to ask HMT to make changes to relevant subordinate legislation pointing out in particular the scope which exists for the* [Policyholders Protection Board and the Financial Services Compensation Scheme] *to be seized of a matter even without a formal decision on whether the company is solvent* *b) Carry out preparation necessary for a possible judicial review application of* [the Policyholders Protection Board] *– particularly locus for FSA to bring an application and how we might otherwise sponsor an application by an affected policyholder.* *c) Proceed with proposed changes to* [the Financial Services Compensation Scheme] *Rules on the basis that this ought to mitigate the problem post N2 but acknowledging that the rule might fall away in the face of a contrary ruling by the court.* *d) Develop further the scenario planning for how the Article 4 point might best be resolved by the Court in the context of insolvency proceeding.*
13/08/2001 [entry 4]	FSA's files include an internal Equitable paper, dated 10 August 2001, entitled '*Mis-selling and the S425 Scheme*'. On this, an official has written that it had been received from Equitable on 13 August 2001. By way of introduction, the paper explained that: [Counsel] *has opined (although only in draft form at present) that at least some categories of non-GAR policies have a strong claim for mis-selling. This increases the uncertainty as to the future financial position of the Society and individual with-profits policyholders. GAR policyholders are uncertain as to the total cost they may have to bear in the future for mis-selling compensation claims to non-GARs, and the non-GARs are uncertain as to the likelihood of success of any individual claims they may bring and the timescale in which they might receive any compensation due.* *As the main driving force for undertaking a S425 scheme was to bring back a level of certainty to the Society's with-profits fund, it seems necessary to consider how the uncertainty brought about by* [Counsel's] *opinion can be factored into the current plans for a compromise scheme between GAR and non-GAR policyholders.* Equitable say that the main options to solve the problem were: • *Mis-selling claims are dealt with on an individual basis either through the Courts, by bilateral agreement or through an Ombudsman.* • *The FSA may instigate a review on an individual policy basis of a similar nature to that used for personal pensions mis-selling.* • *Undertake a second S425 compromise scheme for mis-selling of non-GAR policies.* • *Incorporate mis-selling of non-GAR policies in the current S425 scheme.* *In both of the last two options the non-GARs would be offered compensation for giving up their legal rights to pursue a mis-selling claim.* The paper then sets out the appraisal methodology used; an appraisal of the main options; conclusion of the main options; and the ways that mis-selling claims could be included in the existing compromise scheme proposals. In conclusion, the recommendation was that the best way forward would be to bring mis-selling claims within the GAR compromise scheme.
14/08/2001 [10:14]	FSA's Head of Life Insurance seeks advice on how to respond to an invitation from the Institute of Actuaries to give evidence to their Investigating Committee, who were looking into a complaint of alleged misconduct against a former Chief Executive of Equitable.

	[**10:28**] Managing Director A comments that FSA's Chairman most definitely wanted to leave open the possibility of FSA taking action against previous Equitable officers.
14/08/2001 [14:23]	In the light of Equitable's letter of 07/08/2001, Line Manager E tells Chief Counsel A and the Head of Actuarial Support that he had just looked at the correspondence about the reinsurance treaty. The Line Manager says that he was happy for the reply to be sent, if the head of Actuarial Support had not already done so. However: '*I did ... wonder for a moment about the wisdom of sending a letter in which we were happy to advance a view on the legal interpretation of a contract, but then refuse to express a view on the interpretation of comments made by us (in a corporate sense)*'.
14/08/2001 [15:44]	PIA write to FSA about consulting on proposed guidance to the industry in the light of Counsels' opinions on mis-selling. PIA set out three options (in light of Counsel's advice) which were: first, to make use of section 155(7) of FSMA 2000, which allowed PIA to publish rules without consultation if delay would prejudice the interests of consumers; secondly, to publish a formal FSA consultation paper; or thirdly, to send individual guidance to firms which undertook GAR and non-GAR business.
14/08/2001 [16:24]	Chief Counsel B circulates some further thoughts on the Article 4 issue, after having been shown a professional paper ('*Review of the Law Relating to Insolvent Life Insurance Companies and Proposals for Reform*', dated January 1984) presented to the Institute of Actuaries. [**21:56**] The Head of Insurance Policy says that he suspected that the paper was not accurate and sets out what he understood to be the correct historical context for Article 4.
14/08/2001 [16:26]	In response to Chief Counsel B's note of 10/08/2001, the Director of Insurance comments that FSA should increase pressure on HMT to do what they could to resolve the problem.
14/08/2001 [entry 6]	Following discussion the previous day, the Director of Insurance writes to FSA's Director of Regulatory Strategy and Risk setting out what he believed to be the potential enforcement issues arising from the Equitable case. On FSA's powers under ICA 1982, the Director of Insurance writes that the Act: *... is generally directed more at the maintenance of prudential standards and does not generally provide for action against individuals or companies except for the purpose of safeguarding policyholders or potential policyholders (in other words it does not generally provide an apt remedy in relation to <u>past</u> events except where this is appropriate to protect present and future policyholders). The most likely avenues would appear to be:* *a) "Fit and proper" action – but note this is only available against people who occupy, or who propose to take "notifiable" positions.* *b) The Insurance Companies Act makes a number of actions and failures criminal offences (and the directors may be held criminally liable for offences committed by an insurance company). The most relevant are likely to be in relation to the submission of regulatory returns between 1988 and 97 with inadequate disclosure of the contingent liability represented by the GAR policies. The relevant prosecution authority is HMT. I am not aware of any prosecution of this sort and I think this possibility should be regarded as theoretical.*

The Director says that it seemed to him that:

> ... [FSA's] *next steps on the Equitable should be determined by references to our statutory objectives and our aim should be to select the optimum mix of tools to address these. Our focus thus far has been very heavily towards the prudential issues and mitigating risk of loss to policyholders by close monitoring of the Society's financial position; by working to ensure that a failure, if one occurs, can be handled in such a way as to cause least disruption to payments and that appropriate compensation is available; and working with the Society to ensure that the scheme of arrangement which it intends to put to policyholders represents a better option for them than the alternative and is fair as between different groups of policyholders. Intervention Action, under Insurance Companies Act powers (which given the profile of the case would need to be approved by HMT Ministers) is planned, on a contingency basis, to require the Society to handle this process in an orderly way. Enforcement action, particularly in the form of disciplinary action against culpable individuals might, on further enquiry, prove to be appropriate, although (it seems to me at least) is likely to be a secondary issue as compared with our main prudential objectives. Nonetheless it must be right to consider the full range of tools, available to us.*

14/08/2001 [entry 7] FSA meet to discuss their views on Equitable's compromise scheme proposals. Line Manager E's note (dated 16 August 2001 and including comments by Chief Counsel A) includes the following record of the discussion. By way of introduction, the Line Manager explains that FSA's:

> *... discussion was on the basis of the information provided so far, and subject to further supporting material being provided in due course. It was also in the knowledge that a further layer of compromise has to be built on top of the GAR scheme. We did not seek to reach a view on that (other than that it was unthinkable that the GAR scheme could feasibly go ahead without it once* [the opinion of either or both of Counsel for the Society or the FSA] *had been published). The net effect the second part scheme will be to scale back the compensation under the GAR/non-GAR part, but this will happen proportionately and so does not affect the analysis of the GAR/non-GAR component. (Once the legal opinions are published, absent a scheme, effectively the value of policies would have to be scaled back which would reduce the value of the GAR rights by an amount that corresponds to the adjustment that would have to made to the uplift under the scheme.)*
>
> *Our consideration, consistent with the draft criteria letter, was on the two components of the GAR scheme – the method for determining the aggregate amount of money available to buy out the GAR rights and the methodology for distributing that pot among the GAR policyholders.*

On '*The size of the pot*', FSA say that Equitable's proposal (for a 'pot' based on the current best estimate of the cost of providing annuities at the guaranteed rates specified in the policy) was '*arguably a perfectly reasonable and justifiable approach to setting the pot since in a sense it reflects the current costs of the GARs to the non-GARs*'. FSA note that work was being undertaken by both FSA and Equitable on an alternative approach, which would look at the value that the annuity guarantees would have on the open market. The note goes on to record that:

> *One of our proposed criteria was that the value being paid was a fair value for the rights being given up. It is not proposed by Equitable Life or the FSA that the transaction should result in one side making a profit at the expense of the other. It seems to us that an amount higher than that derived by either of these methodologies would advantage GAR policyholders to the detriment of non-GARS; and a lower value would unfairly advantage the non-GARs. This view was subject though to fairness being achieved in the division of the pot ...*

FSA note that their second criterion of '*Dividing the pot*', '*addressed the fair distribution of the pot to policyholders so that individual groups would not suffer a material detriment (or increase) compared with the rest*'. FSA record:

> *There has always been a presumption, that we have never challenged, that the GARs would be bought out in exchange for an uplift in policy value. The idea of some other mechanism, such as the offer of a windfall single cash payment, has never been seriously considered. The proposition is that the uplift would operate on both the guaranteed and non-guaranteed amounts. This would appear a logical position to reach since if all the uplift were added to the guaranteed amount, it would not achieve the wider objective of the scheme of releasing statutory reserves and stabilising the fund. It is my understanding that we all accept that approach.*
>
> *The key factors that have been identified in placing a value on the rights of individual GAR policyholders are:*
>
> *a) policy value;*
>
> *b) the type of policy;*
>
> *c) age;*
>
> *d) time to retirement;*
>
> *e) sex;*
>
> *f) marital status;*
>
> *g) whether they will take tax free cash; and*
>
> *h) whether or not they are paying (or can pay) future premiums.*
>
> *I do not believe that we have identified further factors that need to be considered, nor subject to the issue on future premiums, do we object to the approach they have taken.*

FSA then examine the detail of each of the key factors. In conclusion, they say that they: '*will wish to undertake further verification of the information on which this assessment is based. We also wish to resolve the subsidiary issue of future premiums. Any conclusions on the acceptability of the GAR scheme will also depend on progress on the mis-selling scheme and the review of financial data. However, in principle, I believe those of us present at the meeting have concluded that we do not object to the proposals put to us*'.

14/08/2001 [entry 8] FSA write to PIA's Chairman in response to a letter of 10 August 2001. FSA say that they had not been discouraging independent financial advisers from advising clients on Equitable.

14/08/2001 [18:48] The Economic Secretary to the Treasury holds a meeting about Equitable. The action points from the meeting include issues in relation to the establishment of the Penrose Inquiry and '[administration] *v* [provisional liquidation] *v winding up etc*'. On the latter, the action points are:

> *a)* [The Economic Secretary to the Treasury] *would like categorical advice from the FSA on the admin v provisional liquidation issue in the form of a submission with a firm recommendation (not an exchange of letters) ...*
>
> *b)* [The Economic Secretary to the Treasury] *understands that it is now hoped that* [Equitable] *will remain solvent but would like to see a grid that compares the various other scenarios for the future of* [Equitable] *including*
>
> *administration*
> *provisional liquidation*
> *full liquidation*

voluntary winding up
compulsory winding up

and draws out the implications for policy holders under each scenario including:–

i) likely impact on policy values, any distributional effects, and any Article 4 issues

ii) likelihood of continued pension/annuity payments to policyholders in [solvent run-off]*, interim and long term*

iii) the likelihood of a successful Halifax deal

[iv)] *the* [Policyholders Protection Board's/Investors Compensation Scheme's] *commitments to pay compensation (90% of what?)*

v) likely calls for Govt compensation

vi) likely calls for any other Government action (eg tax angles)

c) HMT to seek the views of Halifax and the [Equitable] *itself on which of the above options they would favour. Also to ask* [Equitable's] *own interpretation of Article 4.* [The Economic Secretary to the Treasury] *to see FSA's latest advice on article 4.*

d) [The Economic Secretary to the Treasury] *would be grateful for further advice on whether there are any downside risks to putting a generalised consultation document on the administration order out soon ahead of* [the publication of the opinions of Counsel for Equitable and Counsel for FSA] *(as part of a package of other* [FSMA 2000] *orders).*

14/08/2001 [19:54] HMT's Director of Financial Regulation and Industry asks two HMT officials what the Policyholders Protection Board would pay in the event of insolvency. The Director explains his reason for asking:

... is that in my simple minded way I said to myself:

- *the question of insolvency revolves around whether the society has assets to cover 100% of its liabilities, plus the regulatory margin. Liabilities would need to rise further by over 10% therefore, or assets fall further by over 10% (ie c £2.5bn plus the size of the margin), compared to the changes needed to trigger insolvency, for the 90% threshold to be passed. ie insolvency (were it to occur) would be unlikely to be so bad as to trigger* [Policyholders Protection Board]*, or* [if an insolvency occurred after the new regulatory regime had come into force, Financial Services Compensation Scheme]*, payments.*

15/08/2001 [09:26] HMT forward their query on what the Policyholders Protection Board would pay to FSA.

[**09:58**] FSA set out their understanding of the position, which was as follows:

The 90 per cent is (and I paraphrase given that the precise wording in the [Policyholders Protection Act] *1975 may be different in any event from the future* [the Financial Services Compensation Scheme] *rules) the percentage of the benefits that would be paid based on the value of the contract at the time of the winding up, determined in accordance with the insurance company winding up rules (which will have to be remade by the Treasury with the DTI's consent under* [FSMA 2000]*).*

The interpretation of the relevant provisions has not been fully tested. We believe in the case of eg an endowment it would be based on the current guaranteed value of the policy. In the case of a pension fund, it would probably be the same (ie on the basis of the guaranteed fund) except that in the case of a pension plan that provided a GAR, the liability that would have to be met would be the annuity at a guaranteed rate at the *future point on the basis of a guaranteed fund, which would therefore translate into an obligation to provide (or fund) an annuity which provide 90% of the benefits that would have been payable on the basis of the GAR that could be purchased with the guaranteed fund. We would expect an annuitant in payment to get 90% of their income.*

There are however (or so I believe) references in the regulations to [expectations] *of policyholders. That may not mean that policyholders are automatically entitled to receive their full share of terminal bonus, but it may be that they can claim for more than the guaranteed amounts referred to above. So the position is not entirely clear.*

Compensation for mis-selling payable pursuant to section 62 of the FS Act 1986 is not a contractual right under the policy and would not therefore be compensated by the [Policyholders Protection Board]. *It would instead fall to either the PIA indemnity scheme or the* [Investors Compensation Scheme] *(but I am not entirely sure which of the two). The normal payout rules would apply (90 per cent up to the relevant caps).*

Solvency can be defined in a number of ways. For the insolvency act purposes, terminal bonus which is not guaranteed is not taken into account, so the trigger is at a lower level then aggregate policy values. The solvency margin is relevant to our supervisory arrangements and its breach provides a trigger for intervention powers. However, it is not relevant for determining whether a company is solvent in a company law sense. [ie an insolvent insurer would already have gone through the solvency margin. NB. The companies act and ICA valuations are done on different bases anyway, so you cannot compare insolvency and regulatory concepts directly.] In addition, although slipping below the 100 per cent may in theory mean there will be plenty of money left and could well cover more than 90 per cent of the policy values, in practice that will probably not happen because i) lots of money gets taken up by the insolvency practitioners, ii) non-cash assets could have to be disposed of at distressed prices and therefore below book value and iii) certain [liabilities] *(eg the GAR rights) will increase in value since they would be valued on the basis of 100 per cent take up rather than the current 60 per cent.*

15/08/2001 [entry 2] Equitable write to FSA in response to various letters. First, in response to FSA's letter of 10/08/2001, Equitable confirm that they expected to be able to give the Appointed Actuary's company all of the information requested to enable them to meet FSA's deadline for the reviews.

In response to FSA's letter of 31/07/2001, Equitable provide a report of the Society's financial position under a Companies Act basis, as at 30 June 2001. Equitable also enclose the proposed format for the monthly reporting of its financial position and weekly reporting on the processing of claims.

In response to FSA's letter of 13/08/2001, Equitable say that the Society's Chief Executive would reply more completely to this.

Equitable also repeat their concerns about the compromise scheme that '*the sign-off process for the FSA is very unclear to us and that there seem to be many parties involved who appear to revisit issues which on occasion we thought had been closed*'. Equitable also complain that there were multiple points of contact with FSA and ask them to nominate a project co-ordinator.

15/08/2001 [entry 3] Equitable send FSA a copy of a letter sent that day to the Guernsey Financial Services Commission about international policyholders.

15/08/2001 [entry 4] FSA write to Equitable about the possibility of them undertaking a visit to see what progress was being made regarding complaints and enquiry handling arrangements. FSA say that they envisaged the visit being over three days and suggest 5 to 7 September 2001 as preferable dates.

15/08/2001 [10:33]	FSA's Head of Life Insurance prepares a list of what he saw as the potential '*show-stoppers*' to the compromise scheme, which he sets out in the form of a draft letter to Equitable. Having received comments, the letter is revised and handed over to Equitable at the meeting later that day. The Head of Life Insurance's letter reads:

1. ... the FSA is not yet in a position to take a view on the proposed Section 425. However, we agreed that it would be useful if I could set out for you, on the basis of our present understanding, what we at working level see as outstanding issues, and the weight we attach to them (without prejudice to FSA's final view).

2. I start from the proposition that before the Equitable announce any proposals for a scheme, it needs some reassurance from FSA that we see no "show stoppers" (that is to say, any aspects which are so significant that our inability to support them (or at least indicate no objection) would be fatal to the success of the scheme).

3. At present, there are a number of aspects on which we do not have enough information to give that kind of assurance. These are:

3.1. The treatment of mis-selling liability. This covers:

(a) The legal basis for assessing liability (in the light of [the opinions of Counsel for Equitable and for FSA]*);*

(b) The method of quantification (in the light of the work being done by [Equitable's Appointed Actuary and his company]*).*

3.2. The financial position of the Equitable, where we should want to see the results of the work commissioned from [the Appointed Actuary's company].

4. As regard the GAR/non-GAR element of the scheme, we have asked for extra information, which we shall need before we can take a considered view; but this relates to aspects which we do not anticipate will give us significant difficulty provided that the information which we have asked for does not contradict or undermine the approach which Equitable has set out in its Business Case. We have already asked for some work on financial option theory to test the justification for the cost based approach to assessing the aggregate amount to be made available to buy out the GAR rights; and we have asked for some additional figures to show the effects of the scheme on holders of flexible GAR policies (equivalent to the information supplied in respect of retirement annuity holders at a meeting with [Equitable's] *team on 13th August).*

5. A further point to flag up at this stage is that the latest version of the Business Case appears not to deal with the distinction between premium and non-premium paying policyholders. This issue is I think linked to the question of whether or not you cease to apply the GAR to top-ups (after due notice). We need to understand what approach you are taking, and why. More specifically, we note that a substantial number of policyholders can no longer make top-ups (for example under the tax rules which prevent top-ups if self-employment has ceased). It is not clear why this group should receive compensation for giving up the ability to make top-ups.

15/08/2001 [14:00]	FSA meet Equitable for a weekly review. FSA's note of the meeting records discussion of the following issues:

<u>Compromise scheme</u>

Equitable's Chief Executive says that he had become increasingly concerned about Equitable's lack of project management and that many of the delays experienced were due to Halifax Equitable Clerical Medical. FSA's Director of Insurance notes '*we were on the same side in* *that we both wanted to find a solution to the Society's current difficulties*' and that FSA had formalised their requests in response to the concerns expressed by them (see 15/08/2001 **[10:33]**).

Mis-selling
Equitable report that they had raised with Counsel a question about their original instructions (namely, that those instructions had suggested that Counsel should take certain unproven facts as given when providing his advice. This had had the effect that any mis-selling, if it had happened, had done so from 1988) and that he had requested further information. The Director of Insurance notes that, while the proposed compromise scheme was effectively an out of court settlement:

> *... the mis-selling elements were also of direct relevance to the FSA's role since they related to a possible breach of Lautro (and so PIA) rules. The fact that the FSA had powers to require a process for giving redress meant that we also needed to be satisfied that the offer being made was a fair one.*

Possible legal action against former Equitable directors and auditors and the regulators
Equitable say that their solicitors were still considering the position.

Premium paying/paid up policyholders
FSA ask why the compromise proposals included compensation to policyholders for giving up rights to pay further premiums, an option which in some cases they did not have. Equitable say that they would look into the issue.

Subordinated debt
FSA say that they had been unable to take a view on the proposal that Equitable should buy back some of the subordinated loan until more progress had been made on the independent reviews on the Society's financial position and on mis-selling. Equitable express regret at this, as they believed it would be in policyholders' interests to buy back the debt while the market price was favourable.

15/08/2001 [14:48] HMT's Director of Financial Regulation and Industry speaks to Halifax '*primarily to say lines are open which he welcomed*'. Halifax say that they would prefer administration to provisional liquidation and raise a concern that Equitable's public relations efforts were poor and that they needed to get '*more "pace and grit" into the timetable and confront policyholders with a "stark choice" over the future. Hmm*'.

[**17:27**] The Director also speaks to Equitable's Chief Executive. He records, among other things, that '*On insolvency he was confident; only litigation could make* [Equitable] *insolvent in companies act terms; he was also pretty confident they could meet the regulatory margin requirements although a fall in markets would pose risks*'.

15/08/2001 [entry 8] FSA hold a regular 'wash up' meeting on Equitable.

15/08/2001 [entry 9] HMT talk to FSA and receive an update on the position.

15/08/2001 [entry 10] PIA's Pension Review Monitoring Department provide FSA with a note on Equitable's provisioning for the Pensions Review1

16/08/2001 [entry 1] FSA receive a telephone call from Clerical Medical's Chief Executive who wanted to have '*an "informal" talk about relations with Equitable*'. Clerical Medical say that they had been given no notice of Equitable's decision to cut policy values and, therefore, had not been able to prepare for the increased communications that had resulted. FSA note the difficult position in which Clerical Medical had been placed.

16/08/2001 [13:31]	Equitable send FSA three documents for the compromise scheme launch pack, being: '*Consultation Document*'; '*Background to the Compromise Agreement*'; and a letter to policyholders. [**14:00**] Line Manager E circulates the papers and suggests discussing them at their end of day meeting. [**17:00**] An official says that the letter to policyholders needed amendments as it was too long and '*does not even begin to address the policy holders needs as in "what's in it for me"*'. The official also says that more emphasis on the effect on policyholders, as opposed to the benefits to Equitable, would be desirable. [**18:36**] The Head of Actuarial Support comments on some points of detail.
16/08/2001 [15:47]	Line Manager E sends round the notes of the meeting on 14/08/2001 and asks the Director of Insurance and Managing Director A for their views on the conclusions and on how to take the matter forward. [**22:17**] Chief Counsel A says that she was happy with the broad structure and the '*bottom line*' but suggests that they should meet the following day to discuss.

17/08/2001 [entry 1] FSA's Managing Director A provides FSA's Chairman and Managing Director B with a state of play report on Equitable before going on leave. Managing Director A begins by saying:

> *Other than the Equitable, there isn't much to report, you'll be pleased to know that can't await your coming in/other contacts.* [FSA's Director of Regulatory Strategy and Risk] *is struggling manfully with* [an insurance company]*; Argentina continues to hover on the edge; markets are weak but not yet (at time of writing I hasten to add as things are volatile!) at new lows.*

The Managing Director sets out the overall picture and progress on Counsel for Equitable's opinion and on the compromise scheme. The progress report says that FSA:

> *... have had some quite hot debates with Equitable over presentation. However you cut it, there is no new money (other than the Halifax £250 mn). Equitable's likely offer has touches of Alice-in-Wonderland (everyone gets "prizes" in the form of some sort of uplift). And this will be seen through very quickly. We have therefore urged Equitable not to oversell the results of a vote in favour. In particular, the Scheme will <u>not</u> produce sizeable free reserves and will not immediately restore full freedom of investment (though it will, of course, remove the constraint imposed by the current uncapped GAR liabilities). Rather, it seems to me, successful completion of the Scheme is bound to be followed by a period of relatively cautious investment policy (*[on account of] *lack of free reserves) and the desire to build up reserves through a careful bonus policy. Originally, the Society were describing the benefits of a vote in favour in glowing terms but more recently have become more circumspect.*

On Equitable's solvency position, the Managing Director reports that there had been no signs yet of problems but he suggests that FSA's Chairman and Managing Director B would '*want to press hard on at least 2 issues, even if there appears to be a relatively clean bill of health*'. These were:

> *Any positive value ascribed to <u>implicit future profits</u>. (Even on the most positive scenario, the business will contract rapidly and we know that, to the extent people get out without paying an MVA they are not paying an up-front sum that could be regarded as making good the loss of future profits on this business.)*

> *Our old friend* <u>*reinsurance*</u>*. There appears to be something in the current arrangements that require a mutually acceptable renegotiation of the reinsurance contract if payments under it get to £100mn. Any reliance* [the Appointed Actuary's company] *place on this reinsurance has got to be fully realistic.*

Managing Director A says that the work on estimating potential mis-selling liabilities had gone more slowly than desired and he explains the current position on possible FSA guidance on mis-selling.

Under '*Enforcement*', the Managing Director says:

> *We believe (but Equitable won't confirm) that* [solicitors] *have advised Equitable that they can go after at least some past Officers and Directors. Equitable intend to cover that with the other material they put out.*
>
> *For our part,* [the Director of Regulatory Strategy and Risk] *has been talking to Enforcement about what we might do – things are made more difficult here by the fact that* [three Enforcement Heads of Departments] *all have substantial exposure to Equitable and will wish to rule themselves out. A note from* [the Director of Insurance] *is attached at Annex 5 but,* [Chairman]*, you will need to give direction to this on return.*

The Managing Director reports on FSA's discussions with HMT regarding '*gagging*' Equitable from publishing their Counsel's opinion on mis-selling claims; the merits of administration and provisional liquidation; and the correct interpretation of Article 4 of Equitable's Articles of Association. He says:

> *HMT are clearly expecting options in this whole area to be put to the* [Economic Secretary to the Treasury] *for resolution... However much this jars, given their powers to help or hinder and the risks if it all goes wrong, then the fact that they want to take the decisions may have a silver lining.*

17/08/2001 [entry 2] FSA provide HMT with their thoughts about Article 4 of Equitable's Articles of Association.

17/08/2001 [10:40] Chief Counsel B writes to an official with a suggestion for a proposed rule amendment to the Financial Services Compensation Scheme to deal with Equitable's Article 4 issue.

17/08/2001 [16:41] FSA's Director of Regulatory Strategy and Risk informs FSA's Company Secretary that '[her] *3 most experienced* [heads of department] *in Enforcement are all seriously conflicted and I did not know this until something landed on their desk ... They* [sensibly] *immediately told me and handed the material to me*'.

On 20 August 2001 [**09:23**], the Company Secretary asks the Director of GCD how they should handle this, as FSA had not explored conflict of interest issues beyond Board members and front line insurance staff.

On 22 August 2001 [**09:36**], the Company Secretary responds to the Director:

> *I guess* [potential conflicts] *must arise with relative frequency and the individuals concerned appear to have acted quite properly in accordance with the Code ... requires staff to declare a conflict to the line manager whenever it arises in the course of their work.*
>
> *The Code does not itself require specific disclosure of insurance products, so I have no information on those. Within Insurance division they do have such a requirement which is superimposed on the Code. There is no such an add-on in Enforcement, so far as I know; they rely on the general provisions relating to conflict handling.*

If you think this is not secure enough, then there are a number of options to consider:

1. *You could superimpose a requirement for Enforcement folk to disclose insurance products they hold; but that would still leave you with the problem of how to handle the conflicts;*

2. *You could ask those whose conflicts have been disclosed (assuming you wanted to keep them on the* [Equitable] *case) to undertake not to deal in their* [Equitable] *policies for the time being (which is what the* [Chairman] *asked the Board to undertake) or you could move them to other work;*

3. *I could send out a general reminder to staff to be vigilant about the need to disclose conflicts whenever they arise.*

[**18:36**] The Director says that the Chairman's committee should state the position that should be taken.

17/08/2001 [17:10]	FSA's Chief Counsel B circulates a revised version of PIA's mis-selling report.
17/08/2001 [18:02]	FSA's Chief Counsel B also circulates revised guidance to the industry on reviewing guaranteed annuity business and with-profit disclosure.
17/08/2001 [19:18]	FSA's Chief Counsel B writes to PIA (copied to the Director of Insurance and the Director of GCD) about the possible publication of their mis-selling report into Equitable and/or guidance on mis-selling.
17/08/2001 [entry 8]	FSA's Chief Counsel B provides the Director of GCD with handover notes before going on leave, giving details of the status of work in hand.
17/08/2001 [entry 9]	An HMT official sends the Economic Secretary to the Treasury a note on the tax implications to policyholders of the insolvency of a life insurance company.
20/08/2001 [09:09]	Equitable send FSA the weekly customer servicing reports.
20/08/2001 [12:16]	FSA's Head of Life Insurance provides supervisors with an outline timetable for the compromise scheme, based on the latest information from Equitable and FSA's own internal planning.
20/08/2001 [15:40]	Legal Adviser E informs FSA's Equitable Life Lawyers Group that meetings of the Group had been suspended until further notice. This was because FSA now held round-up meetings at 17:00 each day, along with the 'steady stream' of ad hoc meetings about Equitable.
20/08/2001 [15:54]	FSA's Legal Adviser C checks if any officials had comments on Chief Counsel B's note of 17/08/2001 [**10:40**].
20/08/2001 [afternoon]	FSA hold a 'wash up' meeting. The Director of Insurance circulates the action points arising from the meeting regarding the: financial position; compromise scheme; Counsel's opinions; Article 4 and provisional liquidation v administration; communications; enforcement; external reviews; compensation rules; timetable and process; and origins of LAUTRO disclosure rules and related issues.
20/08/2001 [17:01]	FSA telephone HMT for an update on the work on making administration available for insurance companies and are informed that the Economic Secretary to the Treasury wished to go ahead with a consultation process along normal lines.

	The following day, FSA's Director of Insurance comments that he hoped that this would not complicate an emergency introduction of administration for insurers, should that prove necessary.
20/08/2001 [entry 7]	FSA's Head of Life Insurance writes to the Director of Insurance to record the outcome of a '*first cut review*' of the latest launch material, with the objective of identifying any material inadequacies or omissions in the documentation. The main points identified include: that there was insufficient justification for the numbers used in the scheme; and that Equitable needed to have a plan to deal with policyholders who had left before the scheme was effective, but who retained potential mis-selling claims.
20/08/2001 [entry 8]	Equitable ask the Economic Secretary to the Treasury for a meeting to explain the consultation exercise that they were undertaking '*to achieve the best possible outcome for existing policyholders and to ensure the future stability of the fund*'.
21/08/2001 [morning]	FSA's Chairman meets the Association of British Insurers to discuss issues arising or likely to arise from the Equitable situation.
21/08/2001 [09:30]	Equitable's Chief Executive faxes FSA a letter (dated 17 August 2001) which puts in writing a number of concerns he had about FSA's handling of the compromise scheme. The Chief Executive asks that a clear FSA project should be put in place, as without such a project '*there will remain a serious risk that FSA issues may delay the timetable*'. The Chief Executive expresses surprise at the points FSA had raised in relation to the pricing of options, the 'best estimate' compensation figures and the treatment of policyholders close to retirement. The Chief Executive asks that FSA should concentrate on the principles of the scheme proposals as, if those could be agreed '*then the methodology and calculations should follow automatically from them and avoid needless questioning on legal or actuarial issues which is most unlikely to be productive*'. He concludes by quoting his dictionary definition of 'compromise' (being '*the settlement of a dispute by mutual concession*'), saying '*I do feel that that needs to be remembered by those who are attempting to put up further hurdles*'. FSA's Director of Insurance circulates the letter, commenting: *1. This strikes me as a letter which is neither helpful nor sensible. I think however that we should respond to* [the request for a clear FSA project to be put in place] [unclear] *meeting – though in practice we have had regular meetings with the project team. I assume you have the right liaison point for this. In terms of project planning we are,* [unclear], *largely responsive to the Equitable.* *2.* [The concerns on the three issues raised] *simply retort genuine concerns without any reasoned argument. But the guts of the letter* [suggesting that FSA concentrate on principles] *which, in practice, is what we are doing.* *3. Let us discuss what, if anything, I should say in reply.*
21/08/2001 [10:49]	FSA's Insolvency Practitioner provides comments to Legal Adviser C on Article 4 and the Financial Services Compensation Scheme, including that the approach suggested 'strikes me as remedying a very specific ambiguity in the wording of Equitable's articles which might not fit with the wordings in other mutuals' articles of association'. He suggests an alternative approach which would '*include PRE in the* [Financial Services Compensation Scheme] *quantification of claim rules and then to state that any restriction in the company's liability to its members or policyholders designed to prevent a company becoming insolvent should not be taken into account when calculating the PRE value*'. [**13:48**] Legal Adviser E says that he and Chief Counsel A had some difficulty with that approach and suggests a meeting to discuss the issue.

21/08/2001 [12:28]	Equitable send FSA weekly reporting on claims advised and processed up to and including 17 August 2001.
21/08/2001 [14:03]	Equitable send FSA some draft consultation documents for the compromise scheme. [**14:58**] FSA's Head of Life Insurance circulates the documents.
21/08/2001 [14:07]	FSA's Line Manager E circulates a revised draft letter to Equitable on FSA's assessment criteria for the compromise scheme. He notes that the original draft had been handed over to Equitable for comments but had never formally been sent. Line Manager E says that he has had a further thought, which was that: *... the role of the FSA is set out very narrowly in* [ICA 1982] *terms. However, it seems to me that with the recent proposal to extend the scheme to deal with potential mis-selling, on the basis of a breach of PIA rules, and in relation to which we might require rectification, we need to widen this considerably. I am not sure to what extent there are powers of the Secretary of State that are directly delegated to the FSA that might be relevant, but I find it hard to imagine that there are none. Also am fairly sure that there must be a corresponding role for the PIA which it derives from the rule book. I would welcome advice on that. It is important I think that we set out all the legal basis on which we would have powers to intervene or in relation to which we would wish to make representations to the court.* [**14:44**] The Head of Life Insurance says that this should be updated and issued.
21/08/2001 [15:07]	FSA's Actuarial Risk Review Team send the Head of Actuarial Support three papers: '*Annuity Options*' dated 16 August 2001; '*Swaptions Versus Annuity Options*' dated 15 August 2001; and '*Valuation of Annuities: Technical Note*', which appears to have been produced on 14 August 2001. [**18:32**] The Head of Actuarial Support queries one of the assumptions used.
21/08/2001 [entry 8]	FSA meet Equitable. According to FSA's note of the meeting, Equitable had decided not to publish their Counsel's second opinion ahead of their proposals for the compromise scheme. The Appointed Actuary's company were due to present findings on the financial position of Equitable to FSA on 24 August 2001; Equitable would be present. FSA hope that the meeting would also cover the results of their work on mis-selling liabilities. It was noted that FSA had received the six-monthly and weekly financial reporting and that the monthly figures were to follow the next day. Equitable's Chief Executive undertook to respond to the Head of Actuarial Support's letter of 10/08/2001. A number of aspects of the compromise scheme are discussed, including: the plans for dealing with the mis-selling liabilities of non-GAR policyholders who had left the fund; whether Equitable had received legal advice that non-GARs had to pay for 75% of their own compensation; GARs on top-ups; the new version of the launch document; and any problems that could delay the process.
21/08/2001 [entry 9]	FSA write to Equitable about their 2000 returns. FSA say that Equitable's letter of 20/07/2001 had given rise to a number of further questions. In response to question 1, FSA say that they were awaiting outstanding figures on the reserves held against smoothed asset shares and FSA:

a) ask how Equitable reserved for accumulating with-profits business in the resilience scenario and whether the reserves held were sufficient to meet policyholders' reasonable expectation surrender values.

b) ask Equitable to explain why they believed the reserves held in the resilience scenario were consistent with policyholders' reasonable expectations in that scenario. FSA also ask for comment on whether there was any implied cross-subsidy in the resilience reserves of different product groups.

c) ask what level of market value adjuster was implied by the reserves in the resilience scenario and to advise how the current adjuster of 7.5% was spread across the three components of the market value adjuster articulated in their letter of 29/11/2000.

In response to question 2, FSA ask:

a) how expense reserves were consistent with Regulation 66.

b) why different approaches were being used in the base and resilience scenarios to reserve for expenses on accumulating with-profits business.

The answers to question 3 and 4 are noted.

In response to question 5, FSA ask for more information so that they could properly consider the application for a section 68 Order.

The answers to questions 6 and 7 are noted.

21/08/2001 [entry 10] An HMT official writes to the Economic Secretary to the Treasury regarding whether to proceed with a consultation on making administration available for insurers.

22/08/2001 [09:27] FSA's Director of GCD gives his immediate thoughts on FSA's revised assessment criteria letter circulated the previous day, saying that:

> ... *the criteria should reflect the* [House of Lords'] *decision that everyone should get their legal rights before anyone gets a bonus. This is relevant to the concern that people can take misselling rights with them – a concern only if the compromise doesn't give these rights their full value. Of course it could be said that the scheme must be capable of compromising these claims. But that misses the point. Legal claims for misselling can be compromised – but we need to recognize that people can only be expected to compromise them in a way that reflects their value. In the case of misselling rights the value includes the fact that as legal claims they have priority over bonus expectations.*

[**09:46**] The Director of Insurance says that he:

> ... [thought] *that the present version of the scheme should achieve this. The reduction in the misselling claim reflects the fact that the total pot is diminished by the value of the total misselling claim and that the portion available to fund non gar benefits is reduced proportionately, to the extent that reduction is possible consistent with guaranteed values. But perhaps we should meet to discuss: I'm nervous about too much speculative e-mail traffic, (of which this immediate response to* [the Director of GCD] *is an egregious example).*
>
> *But I should like also to talk about the "window of opportunity issue".* [The Director of GCD] *has commissioned some work from* [Legal Adviser F]*, but it is not clear that this will necessarily resolve matters and I understand that it was not clear at yesterday's meeting that the Society has any very clear way forward either. This is a potentially big issue on which I think we, as FSA, need a clear line before anything in the scheme is settled. And self-evidently, it isn't a detail that can be fixed following consultation.*

	[**09:53**] The Director of GCD agrees with a suggestion that they should discuss the issue at their daily meeting later that day.
22/08/2001 [entry 2]	The Appointed Actuary's company write to FSA about the reports to be prepared under section 44(2)(B) of ICA 1982 on Equitable's solvency and to estimate the amount of contingent liabilities to which the company was exposed as at 30 June 2001. The company enclose a copy of their engagement letter, sent to Equitable the same day.
22/08/2001 [entry 3]	FSA's Head of Life Insurance circulates Equitable's letter of 15/08/2001. He asks the Head of Actuarial Support to consider whether the material provided was acceptable.
22/08/2001 [19:45]	FSA's Legal Adviser F tells the Director of GCD that Halifax have asked to see FSA's Counsel's opinion. [**21:43**] Chief Counsel A relays the views of Counsel in relation to this.
22/08/2001 [16:45]	FSA's Director of Insurance circulates a 'Dear Managing Director' letter for possible issue at the time that Counsels' opinions on mis-selling were published. [**18:29**] The Head of Actuarial Support provides comments.
23/08/2001 [11:37]	FSA's Director of GCD, [**11:58**] the Head of Actuarial Support and [**12:45**] the Director of Insurance discuss further the drafting of the 'Dear Managing Director' letter. [**15:30**] The Director of Insurance prepares a revised version.
23/08/2001 [morning]	FSA attend a meeting of the Society's Compromise Scheme Steering Group. Line Manager E reports that the key issue arising was that Equitable's Board had signed up to sending out the launch packs to policyholders by 19 September 2001. He suggests that this would require FSA '*to have settled our position*' by 7 September 2001.
23/08/2001 [16:05]	Equitable provide FSA with balance sheets and profit and loss statements for 30 June and 31 July 2001.

Balance sheet as at 30 June 2001:

	Insurance Act Basis	
	£m	*£m*
Assets		
Investments		
Property	*2,091.0*	
Equities	*10,744.8*	
Fixed Interest Securities	*11,750.5*	
Unquoted Investments	*2,180.2*	
		26,766.5
Reinsurers share of technical provisions		
GAR liabilities	*664.0*	
Unit linked liabilities	*3,688.3*	
Other liabilities	*345.8*	
		4,698.1
Current assets		*715.6*
Tangible assets		*0.0*
Implicit items		
Future profits	*901.0*	
Other s68 concession	*0.0*	
Total assets		*33,081.2*
Liabilities		
Guaranteed fund on accumulating with profits policies	*16,978.8*	
Less discount applied to liabilities (see notes)	*(438.0)*	
		16,540.8
Other with-profits liabilities	*2,951.4*	
GAR provision	*2,170.0*	
GAR rectification	*200*	
Non-profit liabilities	*4,204.9*	
Misselling liabilities (estimate) ([for potential non-GAR mis-selling claims]*)*	*0.0*	
Other misselling liabilities (eg Pension Review)	*124.0*	
Linked liabilities (reinsured to Halifax)	*3,688.3*	
Outstanding Claims	*0.0*	
Resilience reserve	*759.0*	
Subordinated loans	*0.0*	
Provision for other risks and charges	*18.0*	
Other current liabilities	*586.6*	
Total liabilities		*31,243.0*
Required Minimum Margin		*1,081.0*
Excess over [required minimum margin]		*757.2*

Balance sheet as at 31 July 2001:

	Insurance Act Basis £m	£m
Assets		
Investments		
Property	*2,080.0*	
Equities	*8,957.1*	
Fixed Interest Securities	*12,326.6*	
Unquoted Investments	*3,330.2*	
		26,693.9
Reinsurers share of technical provisions		
GAR liabilities	*674.0*	
Unit linked liabilities	*3,577.0*	
Other liabilities	*348.9*	
		4,599.9
Current assets		*584.3*
Tangible assets		*0.0*
Implicit items		
Future profits	*882.0*	
Other s68 concession	*0.0*	
Total assets		*32,760.1*
Liabilities		
Guaranteed fund on accumulating with profits policies	*16,627.7*	
Less discount applied to liabilities (see notes)	*(430.0)*	
		16,197.7
Other with-profits liabilities	*2,934.8*	
GAR provision	*2,201.0*	
GAR rectification	*200*	
Non-profit liabilities	*4,364.7*	
Misselling liabilities (estimate) ([for potential non-GAR mis-selling claims]*)*	*0.0*	
Other misselling liabilities (eg Pension Review)	*124.0*	
Linked liabilities (reinsured to Halifax)	*3,577.0*	
Outstanding Claims	*250.0*	
Resilience reserve	*72.1*	
Subordinated loans	*0.0*	
Provision for other risks and charges	*18.0*	
Other current liabilities	*711.0*	
Total liabilities		*30,650.3*
Required Minimum Margin		*1,059.0*
Excess over [required minimum margin]		*1,050.8*

23/08/2001 [entry 4] Equitable ask FSA for help in relation to directors and officers insurance cover. They explain that half of their £10m cover was due for renewal on 30 September 2001 and that the insurers had decided that they were not prepared to renew the policy. Equitable enclose a letter from one of their directors which expressed concern over both the amount and possible lack of cover.

23/08/2001 [entry 5] An HMT solicitor sends the Director of Financial Regulation and Industry a note on what the Policyholders Protection Board would pay if Equitable were to be wound up.

23/08/2001 [entry 6] HMT's Director of Financial Regulation and Industry briefs the Economic Secretary to the Treasury ahead of a meeting that is to take place with Equitable's Chief Executive.

The Director attaches a note of a conversation with the Chief Executive that had taken place on 15/08/2001 [**17:27**].

23/08/2001 [entry 7] FSA's Chairman provides the FSA Board with a written explanation as to why it had been decided not to prevent Equitable from '*seeking*' new business after the House of Lords' ruling. The statement reads:

> *As the review shows, staff met Equitable Life management before the House of Lords judgement was issued, to discuss the company's options in the event that the judgement was highly unfavourable to the society.*
>
> *The society's management told us at that time that they would take immediate steps to provide for the new liability to guaranteed annuity policyholders, mainly by removing bonuses for the first 7 months of the year. And they would put the society up for sale immediately. They would also have to adopt a more defensive investment posture, with a lower proportion of equities in their portfolio to protect their solvency. This seemed to us to be an appropriate course of action in the circumstances.*
>
> *They, and we, expected that the value of Equitable Life as a brand, together with the value of its sales force and administration systems, would be sufficient to attract a buyer. Over 15 companies quickly expressed an initial interest. The society believed that the sums available from a sale should be sufficient to allow the company to adopt a "normal" investment strategy going forward, by providing stronger backing to the fund, or perhaps even large enough to fill in the "hole" created by the House of Lords judgement and to allow the foregone bonuses to be reinstated.*
>
> *In the circumstances, therefore, allowing the company to continue to write new business did not seem to be particularly risky for new policyholders. Their interests did not depend on a sale achieving the higher estimate, since the foregone bonuses applied only to policyholders with the company before the House of Lords judgement. The state of the society was well known, and particularly the fact that it was up for sale.*
>
> *By contrast, to close the society to new business would have significantly reduced its value. We would have been exposed to criticism that we had damaged the prospect of a successful sale, and therefore the prospect of "putting right" the existing policyholders. Furthermore, the grounds on which the company might have been closed to new business are highly doubtful. It continued to meet its solvency requirements, and we did not think that the company's management could be considered unfit and improper, or that they were not meeting the basic criteria of sound and prudent management.*
>
> *There is, of course, a separate question as to whether the extent of disclosure of the company's financial position to prospective new policyholders was, in the event, adequate to ensure compliant sales.*

24/08/2001 [entry 1] Equitable write to FSA confirming their answers to issues raised by FSA on the compromise scheme.

24/08/2001 [10:10] FSA's Legal Adviser E asks Legal Adviser F to undertake 'the critical legal task' identified at a meeting the previous day to assess the basis on which Equitable proposed that mis-selling liabilities should be quantified. He notes that meeting Equitable's timetable would require 'FSA signoff' of the compromise scheme documents by 7 September 2001.

[**11:58**] Legal Adviser F replies:

> *I don't think that a "signoff" from the FSA side depends on* [the Society's Counsel's opinion] *being finalised or the principles he comes up with as much as identifying the principles which Equitable actually* <u>*use*</u> *in their calculations/estimates. One of the questions we may need to ask ourselves is whether they are following* [the Counsel for Equitable's] *approach (or* [FSA's Counsel's]*), but what* [the Society's Counsel] *says is not the prime question we have to address.*
>
> *I think we also need to make up our mind on this aspect whether we are assessing whether Equitable's approach is reasonable (having regard to the advice available to us and any calculations done on quantification) or whether we are suggesting a different number. I believe the approach contemplated in your report of yesterday's meeting is the former, but if* [Counsel for FSA] *and we are being asked to give a view, it is only fair and reasonable for those seeking it to indicate what they want a view on.*
>
> *Currently the scheme documentation is thin on how they reach their number – notably the justifications for their "calculation". That raises the question of when sufficient information will become available – it is unrealistic to expect a view if relevant information is not available until a day or two before the deadline. It is also unreasonable to ask for a view on something which will change.*
>
> *Is there yet any additional information about how/why the scheme documentation reaches the approach it does?*

On 29 August 2001 [**09:31**], the Director of GCD says that he agrees.

24/08/2001 [11:24] PIA provide FSA's Chairman with a paper on guidance in the light of their Counsel's opinion, updating the advice given on 17 August 2001. The paper considers what FSA might publish by way of interpretation and guidance at the time that they published their Counsel's opinion.

24/08/2001 [13:22] Equitable send FSA a copy of Counsel's opinion on the reasonableness of the proposed compromise scheme.

24/08/2001 [16:11] FSA's Line Manager E sends FSA's Chairman a note on a meeting that had taken place earlier that day with the Appointed Actuary's company about Equitable's financial position. The note reads:

> [The company] *gave us a presentation of their findings this morning. At this stage, the conclusions are in draft, and do not take account of potential liabilities for mis-selling on which work is continuing. A copy of their slides is attached.*
>
> *We asked Equitable Life to appoint* [the company] *to report upon its financial position on three different statutory bases - the Insurance Companies Act basis, the Companies Act basis and the Insolvency Act basis. Each of these three bases, at least in theory, includes an element of prudence. The Insurance Companies Act basis is the most prudent (though it does allow an implicit item for future profits and disregards the subordinated loan liability) and the Insolvency Act basis is the closest to realistic best estimate. On all three*

bases, [the Appointed Actuary's company] *report a surplus of assets over liabilities. At one extreme, on the Insurance Companies Act basis,* [the Appointed Actuary's company] *report that Equitable covered its required minimum margin by £758 million at the end of June 2001 (£1,025m at the end of July). At the other extreme, on the Insolvency Act basis, they report that Equitable had a surplus of £2,200m. These figures do not take into account any explicit liability for future discretionary bonuses or for compensation to non-GARs. In effect, on all three bases,* [the company] *have quantified the surplus assets that are available to pay the mis-selling and, after that has been paid, to fund future (non-contractual) bonuses. In advance of the finalisation of the work quantifying the mis-selling claims it is not possible to reach a definitive conclusion on Equitable Life's ability to fund those claims. However, based on the preliminary work that has been done the level of surplus assets reported by* [the Appointed Actuary's company] *as being available to meet those claims does not give us any cause for concern.*

The reason for the improvement on the statutory basis between June and July is that the Society sold significant volumes of equities, switching to cash and fixed interest, which has a marked impact on the resilience reserves that are required.

The difference between the Companies Act and Insolvency Act basis is accounted for, in particular, because a degree of prudence is released from the former, by using more realistic interest rate assumptions. [The Appointed Actuary's company] *have suggested that there is likely to be scope to increase the free assets to around £3 billion on a realistic basis (although this would mean making no allowance for discretionary bonuses or the effect of large surrenders).*

The work on the quantification of the potential mis-selling analysis cannot be completed until the legal position has been settled, so certain assumptions are having to be made for the time being. They are continuing the comparisons with the rest of the industry. There are already some potentially helpful signs, although the information should be treated with caution at this stage. [The Appointed Actuary's company] *have said that overall, investment returns achieved by Equitable Life (on the periods since 1988 and 1993 to the present) have been in line with the industry average, but costs are lower. This means that the position is more favourable than the average. In terms of amounts distributed, Equitable Life was around the industry average, though following the suspension in bonus allocation since the House of Lords and the recent policy value cuts, this pushes Equitable into the third quartile. The position if smoothing is taken into account apparently brings Equitable back towards the average.*

The Society has provided us with a copy of an opinion by [Counsel] *(which we are considering) on the reasonableness of the Society's approach to the compromise scheme. They have also undertaken to provide us, on Tuesday, with the comparisons* [the Appointed Actuary's company] *have undertaken of the relative position of Equitable's products (broken down by type and inception year) with the market.*

We are due to receive a full report on quantification next week, but the information so far would appear to support the Society's planning assumptions in relation to the cost (subject to the legal advice on the basis of calculation).

The Appointed Actuary's company report the financial position under ICA 1982 as at 30 June 2001 as follows:

Assets	*£m*	*£m*
Investments		
Property	*2,091.0*	
Equities	*10,744.8*	
Fixed interest securities	*11,750.5*	
Unquoted investments	*2,180.2*	
		26,766.5
Reinsurers' share of technical provisions		
GAR	*664.0*	
[Halifax Equitable Clerical Medical] *reinsurance*	*4,034.1*	
		4,698.1
Current assets		*715.6*
Implicit items		*901.0*
Total assets		*33,081.2*
Liabilities	*£m*	*£m*
Guaranteed fund on accumulating with-profits	*16,978.8*	
Less discount applied	*-438.0*	
		16,540.8
Other with-profits liabilities		*2,951.4*
GAR provision		*2,170.0*
GAR rectification		*200.0*
Non-profit liabilities		*4,204.9*
Mis-selling (eg GAR)		*0.0*
Other mis-selling (eg Pensions Review)		*124.0*
Linked liabilities (reinsured to [Halifax Equitable Clerical Medical]*)*		*3,688.3*
Resilience reserve		*759.0*
Provision for other risks		*18.0*
Other current liabilities		*586.6*
Total liabilities		*31,243.0*
Required minimum margin		*1,081.0*
Excess over [required minimum margin]		*758.0*

24/08/2001 [17:55] FSA's Actuarial Risk Review Department provide the Head of Actuarial Support with some preliminary observations on a discussion document entitled '*Realistic GAR Costs – Allowing for Optionality*' (dated 23 August 2001) that he had received that morning from the Appointed Actuary's company. The introduction to the document explains that:

> [The Society] *has prepared some calculations on the expected realistic cost of GAR options on in-force policies. This is a vital input to the GAR/Non-GAR compromise vote. Those calculations were prepared using deterministic assumptions. In this note we explore how one might allow for possible variations in interest rates, and we produce some example calculations to illustrate the potential effect.*

The Risk Review Department's key observations are:

- that the results of the Appointed Actuary's company confirmed FSA's earlier point (see 21/08/2001 [**15:07**]) that '*optionality (i.e. time value) can be a material component of the total value of a GAR option, particularly when the GAR option has a long time to maturity and is not very far in-the-money ...*'; and
- that the Appointed Actuary's company's approach to valuation was very similar to that used by FSA.

24/08/2001 [19:14] FSA's Director of Insurance sends the Head of Life Insurance a note of a conversation he had had with Equitable about Counsel's opinion on mis-selling liabilities. The note records:

> [Equitable's Finance Director] *said that he had now seen a further draft of the Opinion from* [their Counsel]. *It had been drafted by* [his] *junior and was significantly different from what they had understood* [Counsel for Equitable's] *current view to be from a conversation they had had with him yesterday. It was not clear whether it would be where he would finally end up, but they were not confident that it would change.* [Counsel, who were advising the Society on the Compromise Scheme,] *(and they understood* [Counsel for FSA]*) thought it was seriously flawed. But if he stuck by it, and it therefore entered the public domain, it would be a material factor in their efforts to secure agreement to a reasonable and fair scheme.*
>
> *In short* [the Society's Counsel's opinion] *was "becoming more aggressive on misselling". He was tending to the view that all cases should be treated as advice cases; and that the full cost had to be borne by the GAR policyholders rather than the non-GARs, the effect of which was to require that misselling costs should be grossed up to take account of damage to future bonus prospects.*
>
> *Given the strength of* [Counsel advising the Society on the Compromise Scheme's] *contrary opinion he said that the directors were likely to treat this position as "one of a number of disparate legal views". They would not be inclined to try to give full effect to it in the scheme. It appeared that* [Counsel for Equitable's] *intention was simply to reverse the effect of the House of Lords' judgement and achieve ring fencing by a different route. They were not convinced that* [he] *had fully understood the implications or, indeed, the way that the fund operated. They would try to get him to understand but were not optimistic.* [FSA's Chief Counsel A] *confirmed that* [Counsel for FSA] *would be prepared to talk to* [the Society's Counsel] *if the latter approached him.*
>
> [Equitable's Finance Director] *asked whether we envisaged publishing the* [Counsel for FSA's] *Opinion – he had understood that we did not. We said that we did intend to do so, together with some more general indication to the industry that they should consider the implications.* [He] *said that this would be helpful, especially if they needed to distance themselves from* [the Society's Counsel]. *He said that they were rethinking their strategy on publication of the scheme. They were now absolutely clear that they would not publish* [their Counsel's opinion] *ahead of the scheme. They were toying with the idea that they might publish the scheme with an opinion from* [Counsel for Equitable] *endorsing it as fair, taking account of a range of legal opinions including* [Counsel's own opinion] *(and if possible* [the opinion of Counsel for FSA]*).* [The Society's Counsel] *might then be published a day or so later. However this was far from certain.*
>
> *We asked about the implications for solvency.* [The Finance Director] *said that since they had no Opinion from* [their Counsel] *at this stage it was difficult to know what weight to give it.* [Counsel advising the Society on the Compromise Scheme's] *advice was clear and the directors would not be justified in taking any precipitate action at this point: they had in any case a reasonable prospect of resolving matters effectively through the*

scheme. He accepted however that the Insurance Companies Act position might prove more problematic, and could present us with some difficult decisions.

27/08/2001 [15:44] FSA's Chief Counsel A writes to the Director of GCD further to Line Manager E's note of 24/08/2001 [**16:11**] and the Appointed Actuary's company's presentation on Equitable's solvency position. She says that this '*interim*' report was broadly '*good news*' but that she needed to draw his attention to three issues: Article 4; the market value adjuster; and the Society's retirement age assumptions. On the first issue, Chief Counsel A writes:

> ... [the Appointed Actuary's company] *say they understand the Equitable Board has been advised that they cannot become insolvent because of* [Article] *4 (and therefore wrongful trading cannot arise). If this is so (I have not checked), this is a change of position and it is not obvious to me how we can in the face of it justify continuing to assert that the* [Policyholders Protection Act 1975] *will apply without (at a minimum) making clear there is a contrary view. I think this is probably so even if the* [Policyholders Protection Board's] *position is the same as ours (so far as I am aware their Counsel has still not opined). In addition, we do not know and have not considered what the implications are for the presentation of the GAR/non-GAR scheme. I think the first thing to do is ask* [Line Manager E] *to ascertain the position from the Equitable. Then we can take it from there.*

On the market value adjuster, Chief Counsel A says:

> ... [the Appointed Actuary's company] *say GAD (presumably our Actuarial Support team) accept that the MVA can be* [used] *to prevent prejudice to remaining policyholders in the event of mass surrender. This suggests the ability to use the MVA actually to discourage (or penalise) surrenders where this is appropriate to protect remaining policyholders, rather than merely to ensure that policyholders do not take away more than asset share. Our actuaries may have that view (I have not checked) and that is my preliminary view, but I am not aware that legal advice has been requested or given on this issue. Perhaps* [Legal Adviser C] *can comment.*

On the final issue, Chief Counsel A notes that '[the Appointed Actuary's company] *says that assuming GARs retire at the earliest date is generally prudent, but they have not checked that it is prudent in all cases.* [Legal Adviser A] *has I think instructed Counsel on the regulatory requirements in this area and I ask him to remind us what that advice is. As* [the company] *says, this is a second order issue*'.

28/08/2001 [entry 1] FSA's Director of Insurance responds to a note from the Director of GCD of 24 August 2001, following a policyholder complaint about Equitable's income drawdown policies. He says that, as FSA had already required Equitable to review mis-selling issues for this type of policy, and as provision had been made for the cost of redress, there appeared to be nothing new for FSA to do.

28/08/2001 [10:42] FSA's Head of Life Insurance asks that any comments on the compromise scheme consultation documents, circulated on 21/08/2001 [**14:03**], should be passed to Line Manager E by the end of that day.

[**14:38**] The Insolvency Practitioner provides detailed comments on the letter to policyholders, which include:

- *The emphasis remains on the society investing more freely for growth and adopting a more generous bonus policy if the compromise is agreed. Are we satisfied that this is not a misleading statement? The society has not said how their investment policy would change, and it is unlikely that it would change. Equally, there is no indication as to what bonus policy the society would follow after the scheme*;

- *In the "what next" section there is no mention of the pre-hearing to determine classes. Neither is there mention in the "how do I know it is fair" section that each group of policyholders will be represented at that hearing*; and:
- *... they say that the scheme document will be sent with exact details of how it will affect each policy, but we want the society to send each policyholder an actuarial estimate of the value of the GAR rights being given up, not just the uplift offered in return. It would be helpful to extract this commitment from the society now.*

On the consultation document, his comments include:

- *... I think that the statement "Policies will be much safer and are likely to grow faster after a compromise" is misleading and at the least requires the society to state how its investment policy will change if the scheme is approved. Same comment re the penultimate sentence on page 5: "The restrictive investment policy and cautions bonus policy is likely to lead to significantly lower growth on all policies."*;
- *... I wonder whether it is true that* [the Society's auditors] *"have verified" that the calculations are "correct"? I would be surprised if they expressed anything in this form and wonder whether their work will be directed at the figures in the explanatory statement rather than any of the calculations in the launch papers*;
- *... The GAR cost is estimated at £1.2bn but the non-GAR misselling claims are estimated at £1.0bn – why the difference? The first sentence on page 11 suggests that* [the Society's Counsel] *has put a £1.0bn value on claims and I doubt he has mentioned any figures*; and:
- *... I agree that "after a compromise" ... "bonuses will have to be prudent to ensure strength is maintained" and this should be the consistent tone throughout.*

[**15:23**] An official from FSA's Press Office comments that Equitable: '*need to explain clearly to people where the money is coming from. There has already been press coverage suggesting that people had 16% knocked off their policy values and are now having some of it given back, so where is the money to come from? Equitable need to come up with an understandable answer to this fundamental question or face constant policyholder and press suspicion over the whole deal*'.

[**15:37**] Chief Counsel A agrees with the Insolvency Practitioner that Equitable should say something about the convening hearing.

28/08/2001 [13:00] Chief Counsel A informs FSA's Director of GCD that the Appointed Actuary's company's slides were wrong in saying that Equitable's Board had been advised that Article 4 prevented them from becoming insolvent.

28/08/2001 [13:58] FSA's Director of Regulatory Strategy and Risk writes to the Director of GCD to express her concerns about the publication of PIA's mis-selling report and the implications that this might have for any enforcement action taken by FSA.

28/08/2001 [14:33] FSA's Chief Counsel A responds to the Director of GCD's request of 03/08/2001 [**10:59**] that she should examine whether the Baird Report might impact on the compromise scheme. From a very quick review of the report, the Chief Counsel notes two issues:

> *1. There are some very occasional factual errors which might cause the press and policyholders to misunderstand the position or raise doubts about what they are being told by the Equitable. For example ... it is said that in 1998 GARs were approx. 30% higher than CARs. This may be true on average (I do not know), but the range of GARs is considerable and the 30% figure may therefore tend to mislead (and raise expectations).*

2. [The report] *recommends ... that GARs be valued stochastically and consistently with traded option prices in the market. We are doing that for our own purposes internally (to establish the value of GAR rights given up, against which the fairness of the uplift should be judged), but I am not aware that Equitable are doing it. So the publication of the Review Report might tend to support arguments that the uplift has not been shown to be fair.*

But both these matters do not seem to me to be significant. I do think though that someone ought to go through the Report line by line in due course with the GAR/non-GAR scheme in mind. I am sorry but I am not able to perform that task due to pressure of other work.

As an aside presumably the very publication of the Review Report will give Equitable policyholders an opportunity to get angry all over again, so there is reason to delay publication if possible by a couple of weeks after publication of the GAR/non-GAR launch document and the misselling opinions.

28/08/2001 [14:41] Equitable send FSA their weekly customer servicing reports.

28/08/2001 [14:46] FSA's Legal Adviser F provides Chief Counsel A and the Director of GCD with his concerns about the mis-selling aspects of the compromise scheme documentation. The Legal Adviser explains:

The description of the scheme suggests that it deals with the whole of the company's assets, and that the whole of its assets are currently attributable to its current policyholders. It then goes on to describe the way in which the cake has to be cut differently to how it is at present, taking account of the various kinds of liabilities which exist. Thus it goes on to describe that the misselling liabilities have to be borne as to 73% by the non-GARs.

If this is truly what is going on – ie showing how the entire cake is to be divided up among the existing policyholders – then I am concerned that the company is not allowing properly for its other actual and contingent liabilities. I suspected that this was not the case, but the various balance sheets put together by [the Appointed Actuary's company] *reinforces that.*

Thus I think what is going on is that the company is telling the relevant policyholders that ultimately the net assets belong to them as opposed to everyone else. Thus it is appropriate to tell them how their asset share (much of which will be a contingent share not a current one) will change as a result of the scheme. This leaves out the middle step of saying that the actual payment for misselling claims is from the current free assets (ie which have not been allocated to bonuses) and (presumably) the same for the GAR buyout sums there is presumably also some provisioning for other creditors, actual and contingent against the same free assets. Leaving out this middle step exposes the company (and FSA) to later allegations that policyholders are having their policy values reduced as a result of payments made to former members to compensate for misselling etc. I would not discount the possibility that someone might seek to attack the scheme on those grounds.

I do think that this middle step is vital to the misselling (and probably other) aspects of the scheme, and that leaving it out potentially prevents a proper understanding by a lay member of what is truly going on (assuming I understand it correctly), and thus could preclude its meeting a "fair, clear and not misleading" test.

[**15:39**] Chief Counsel A asks Legal Adviser F if she could have '*a quick word about this*'.

28/08/2001 [19:29]	FSA send Equitable their comments on the compromise scheme documentation.
28/08/2001 [20:03]	FSA hold a 'wrap-up' meeting. The Director of Insurance circulates the key points of the meeting later that day which include, under '*Financial Position*': *No points of clarification or doubt on the* [Appointed Actuary's company's] *presentation. Not clear when we would receive final report - presumably not before misselling work by* [the Appointed Actuary's company] *was complete. We needed to consider whether, and if so what and when, we should make public about the fact that we had required this work and what the results were. NB the work was expressly confidential to the Society. We had no gateway to allow publication. (*<u>[Chief Counsel A]</u>*: to confirm?). But presumably we could disclose that we had required an independent review of the financial position which did not give rise to any doubts about the Society's statements. NB too that the half yearly results will be published with a statement from the auditors (the auditors will want to talk to us first to ensure both that we understand the uncertainties and to make sure that we do not know anything they do not!).* <u>*Action:* [Head of Life Insurance]</u>*. We should discuss further with* [the Society's Chief Executive] *tomorrow to find out when they will publish their half year figures and what, if anything, they will say at the time of the launch.*
28/08/2001 [21:02]	Equitable send FSA an updated version of the actuarial report for the compromise scheme, which now included mis-selling.
28/08/2001 [entry 11]	FSA write to Equitable in response to their letter of 15/08/2001. FSA confirm that the proposed format for Equitable's monthly reporting on their financial position was acceptable to FSA, subject to two minor refinements.
29/08/2001 [09:46]	FSA's Director of Insurance writes to Chief Counsel A, after a discussion the previous night, about what FSA should do in the light of Counsels' opinions on mis-selling by Equitable and whether they should require Equitable and/or the industry to undertake a review and, if necessary, implement a rectification scheme. The Director of Insurance seeks the advice on the legal implications of what he had in mind, which was: *a) The FSA has made no final determination as to whether misselling took place or loss was suffered in respect of the non disclosure of GAR exposure. However in the light of legal advice provided to the Society and to the FSA it seems clear that policyholders are likely to be able to bring successful claims for compensation.* *b) The FSA is aware that the Society is seeking to resolve these claims by offering* [compensation] *as an essential part of the proposed compromise scheme under s425. The FSA considers that this is an appropriate way to proceed, and does not intend to take further action until the results of the vote on the scheme is known and the issue has been considered at the court.* *c) However, in considering whether or not to vote for the* [scheme]*, policyholders are entitled to know what the FSA would be likely to do if the scheme is not endorsed by policyholders and by the court. In these* [circumstances] *the FSA, consistent with the advice provided to it by leading counsel, would be minded to require Equitable to review policies sold by it to non GAR policyholders and, where appropriate, to offer redress. Where it was reasonably clear that policyholders, had they known of the GAR exposure, would not have bought a policy from the Equitable then the redress payable would be the difference between the value of the policy they actually bought and the value of an average performing* [comparable] *product bought from another provider. Such redress would however be subject to two important limitations:*

(1) The total cost of redress falling on the Society should be limited, as a maximum, to the cost which it may reasonably be estimated to have to in meeting its GAR liabilities;

(2) Since the cost of meeting misselling costs falls on the with profits fund, of which non GAR policyholders are 75% owners, the redress payable to such policyholders should be reduced by that proportion.

[**16:51**] Following a meeting with the Director of Insurance and Chief Counsel A, Legal Adviser F writes to the Director of GCD to provide guidance. He explains that they:

Broadly ... agreed that FSA ought to prepare itself to take appropriate lines about reviews and rectifications, and that the sort of matters which [the Director of Insurance's] *email identifies are broadly the right ones. However we all agreed that the drafting would need some attention in tone and wording – given that it is important for* [Conduct of Business] *Standards to be content (with appropriate input from Enforcement and Consumer Relations) and its obvious links to the misselling lines more generally we wondered if the drafting might be led from* [Conduct of Business] *Standards assisted by* [the General Counsel's Division]*. This is something which may be discussed at the wrap up meeting.*

We did however identify that there may be a number of other aspects which might need to be covered – such as the difficulties in proving a case and assessing damages (the fraught legal issues), the ongoing right to seek redress by individual policyholders pending any FSA imposed review etc, the potential involvement of PIA's areas (given that the s425 consultation documents may trigger the need to have lines, and we expect their publication ahead of [FSMA 2000 coming into force]*).*

29/08/2001 [10:15] FSA's Line Manager E reports that he had co-ordinated and passed on to Equitable (on 28/08/2001 [**19:29**]) FSA's comments on the latest draft of the compromise scheme consultation document. The Line Manager says that a revised draft was due later that day and asks that any further structural or presentational issues should be raised as soon as possible.

29/08/2001 [morning] FSA's Chairman is informed by the Economic Secretary to the Treasury that HMT have decided to commission an inquiry into Equitable (the Penrose Inquiry) and that HMT intended to make the announcement of this on 31 August 2001. FSA's file note records:

> [HMT's] *primary handling concern was to minimise the possibility that the compromise scheme would be disrupted and, to this end, they were extremely concerned not to give the impression that government support would be forthcoming as a result of the review. Therefore, they planned to emphasise the extremely high hurdles that would need to be met before the possibility of any government* [support] *in the statement and background briefing that would accompany the announcement. The* [Economic Secretary to the Treasury] *asked if we would be able to support this in public.* [FSA's Chairman] *noted that it would be difficult for us to do so as it is not for us to say whether there might be a government liability. He noted that it would look odd for us to comment on the principle when, under* [FSMA 2000]*, any awards assessed against the FSA by the Complaints Commissioner would be payable from industry fees.*
>
> [The Chairman] *asked at what point in time the remit of the inquiry would stop. The* [Economic Secretary to the Treasury] *said that it might well need to go beyond the close of the Equitable to new business and it was hard to see a definitive stop point after that.* [The Chairman] *expressed concern that this could lead to the inquiry reviewing work as it was happening, which would hinder the compromise scheme. It was agreed that HMT would look for a form of words to say that the initial work of the inquiry would be to look at the origins of the problem and that the inquiry will not be influencing the compromise scheme, although it may cover issues relating to it in its final report.*

> *The* [Economic Secretary to the Treasury] *saw it as an advantage that HMT were announcing this ahead of having received* [the Baird Report]. *The briefing would emphasise that HMT had full confidence in the Baird review but the public interest was so strong that the narrow remit of* [the Baird Report] *could no longer be sufficient.* [FSA's Chairman] *asked whether this would effect the publication of the Baird review. The* [Economic Secretary to the Treasury] *said this would need to be discussed with Penrose when HMT received it.* [The Chairman] *emphasised that any delay would put the FSA in a very difficult position, both in terms of our position in front of the* [Treasury Select Committee] *on 16 October and not being able to take forward the recommendations for the future, which would require public consultation. The* [Economic Secretary to the Treasury] *said that HMT were still committed to its publication but would need to consider the timing.*

FSA also speak to HMT to clarify a number of points and it is agreed that a meeting would take place on 29 August 2001, after HMT had sent FSA the draft terms of reference and associated material.

29/08/2001 [11:28] FSA's Legal Adviser C tells Chief Counsel A, in response to her note of 27/08/2001 [**15:44**], that neither he nor another legal adviser had been asked to advise on '*using the MVA as a sword rather than a shield*'. However, the legal advisers were in the process of seeking advice from Counsel on the market value adjuster and this point could be included, if that was thought appropriate.

[**21:26**] Chief Counsel A agrees that it would be right to ask for Counsel's views, but says that '*any instructions would require careful actuarial input, and I do not think that can be provided to your timescale*'.

29/08/2001 [14:51] FSA meet Equitable to discuss the various ongoing issues, including: the legal opinions; the solvency implications of the Society's Counsel's opinion; the data on mis-selling; timetable for GAR compromise scheme; directors' and officers' liability insurance; and repurchasing some of the subordinated loan.

29/08/2001 [15:51] Equitable send FSA final draft documents for the compromise scheme.

[**17:05**] Line Manager E circulates the documents within FSA, saying that he would attend an all-day review meeting about these on 31 August 2001.

29/08/2001 [15:56] FSA's Director of Insurance circulates a '*Skeleton Submission on Equitable*' about the compromise scheme for discussion at a meeting that evening. The submission sets out the '*Issues for Decision*' by FSA as follows:

> *a) Should FSA intervene in relation to consultation on the proposed S425 scheme*
>
> - *To require the Society not to proceed;*
> - *To require any modification to the proposals themselves;*
> - *To require any modification to the presentation of the proposals, the background, or the reasons for/alternative to them.*
>
> *b) What should the FSA say*
>
> - *About the proposals;*
> - *About FSA's role in relation to them - (including the criteria by which we will evaluate them?);*

- *About mis-selling, and possible regulatory action in relation to mis-selling;*
- *About the financial position of the Society and/or the independent review of this.*

c) What should FSA say about wider implications for the insurance industry?

The recommendations put forward in the submission were:

S425 scheme
a) Subject to resolving continuing uncertainties over mis-selling liabilities, the Society's proposals are not such that we should seek to prevent their presentation to policyholders as a basis for consultation.

b) There are no major unresolved issues (mis-selling quantification apart) which should lead us to require more modification to the proposals.

c) Presentation remains an issue. We should work with the Society to improve the drafting. The only issues where we may need to require change are:

- *Reference to the position of the FSA and its legal advisers*
- *Exaggerated reference to the uncertainty of litigation in relation to mis-selling claims.*

FSA Position
- *In relation to the proposals, we should note these as an important step towards a compromise scheme, which FSA believes is likely to be the most appropriate way to resolve the Society's difficulties. We await the results of the consultation exercise.*
- *On the role of the FSA, we should give a factual account of our responsibilities; say that we will continue to monitor the financial position of the Society very closely; will work closely with the Society as they develop their proposals in the light of policyholders comments; will wish to satisfy ourselves that their final proposals meet our criteria, will ensure that they are fairly and clearly presented, and will set out an analysis of the evidence to the Court.*
- *On mis-selling we should say that we have not reached any formal view on mis-selling, but note the legal advice given by* [Counsel for Equitable] *and* [Counsel for FSA]*; that we note the intention to include mis-selling claims in the compromise scheme and accept that there is an appropriate way to proceed; explain what we would do by way of review/redress in the event that the scheme is not endorsed by policyholders or the court.*

The Skeleton Submission also discusses timing issues, regarding which it is stated that FSA should aim to communicate their decision to Equitable by 6 September 2001, while noting that they could intervene to prevent the launch later than this if necessary.

29/08/2001 [entry 8] Legal Adviser F provides the Director of GCD (copied to others) with advice on the potential liability of former members of an unlimited company. The summary of his advice is that:

Two potential sources of liability occur to me (looking only at their position as former members of a body corporate rather than in any other capacity):

a) the potential for being required to contribute to the company's assets so that it can meet its liabilities; and

b) the possibility that they may have received distributions from the company which were unlawful (akin to dividends paid when there are no accumulated profits to distribute).

Having looked into these I do not think that either are of practical benefit in the current situation: the former because of the timing, and the latter because of the speculative nature of the claims.

30/08/2001 [09:26] FSA's Director of GCD responds to Legal Adviser F's request for guidance of the previous day (see 29/08/2001 [**16:50**]). The Director of GCD writes that he:

> ... [thinks the Director of Insurance] *is looking for advice on the substance of the proposal that we would limit the amount we would mandate to what-effectively-people would get under the 425 scheme. Can you focus on this? Would probably need to be done by own initiative variation, as an executive procedure decision, subject to review by the tribunal, would arguably mean giving less than court or ombudsman would award, and less than on any other misselling. Would be criticized as subordinating interests of misselling victims to desire to see 425 scheme agreed. Legally sustainable? May depend on reasons, which* [the Director's] *note doesn't articulate but related to desire to avoid regulator mandated redress offering an apparently better deal for leavers to that available under the 425 for stayers. Also – need to get view from* [Counsel for FSA] *when issues identified.*

[**09:45**] Legal Adviser F says that he agreed: '*but our comments immediately re-raise a major concern I have about the 425 scheme (hopefully a presentational one). If the scheme is massively out of kilter (lower) with what the court/ombudsman would award (on our best guess/advice etc) then how can FSA possibly stand by and be seen to endorse it as fair? If it is fair under the 425 scheme, then why would FSA be under attack for the matters you mention?*'.

[**09:52**] The Director of Insurance replies to the Director of GCD (having not seen Legal Adviser F's comments) saying:

> *As to policy reasons underlying the approach to discounting it is partly as* [the Director of GCD] *suggests. But as we discussed I think it is as, if not more, important that we recognise that "grossing up" (to put it the other way) could produce a level of claims by individuals which, if granted to all, would damage the fund, perhaps ultimately to the point of insolvency. We could not allow payments to be made to early birds at levels which would damage others later in the queue. We would, depending on what amount we required by way of reserves have either to petition for winding up (if the Society did not do so), apply to the court for a reduction in policy values (if preferable to a winding up) or, at the very least, require to the company to reduce/suspend non contractual payments. The net effect on the "missold" policyholders would be likely to be at least as bad, if not worse, than the approach I have suggested which, in effect, mirrors the approach which* [Counsel for FSA] *advises is appropriate in the context of the scheme – and for much the same reasons.*
>
> *Even though it seems to me defensible on grounds of common sense and fairness, I recognise that it may be legally difficult although I was encouraged that at our discussion yesterday there appeared no obvious problem. But as we agreed it will be very important that we have explored all the angles and that* [the FSA's Counsel] *provides supportive advice.*

30/08/2001 [10:34] The Economic Secretary to the Treasury asks that the timing of the consultation on administration for insurers should be agreed with her.

30/08/2001 [10:38] Further to the discussion on Equitable's draft compromise scheme documentation on 28/08/2001 [**10:42**], FSA's Insolvency Practitioner says that he agreed with the official and says that he thought that: '*some basic explanation of how a with profit fund works and in particular how policy value (and guaranteed value) relate to asset share is vital. The essence* *of the "deal" is how to carve up the remaining free assets of the Society: there is no new money. If the Society does not explain it in these terms then we should. However, I don't think we can provide such supplementary information until the final scheme is published (ie October)*'.

[**11:47**] The official agrees with the Insolvency Practitioner and notes the Director of Consumer Relations' view that FSA should not be forced into doing Equitable's job for them and that Equitable should properly explain this point, and others, to their policyholders.

30/08/2001 [11:46] FSA's Insolvency Practitioner comments on the issue of Equitable repurchasing the subordinated loan, following the meeting with Equitable held the previous day. He says that: '*Such a repurchase would not amount to a preference since the society is solvent at the time of the transaction*'.

[**13:02**] In reply, the Director of Insurance adds:

> *Solvent, but subject to fundamental uncertainty as to the quantum of misselling claims from policyholders. And the debt is <u>subordinated</u>. I don't think we should risk giving our consent in these circumstances. We should indicate that we need to see the uncertainty reduced before we could allow money to be paid out to those whose interests are subordinated to those of policyholders.*

30/08/2001 [12:41] PIA provide FSA with a draft statement of what FSA might say on 19 September 2008 at the time of the launch of the compromise scheme consultation, about a review of redress for mis-selling by Equitable required by the regulators. PIA's note takes account of the discussions which had taken place about this on 29/08/2001 [**09:46**] and earlier that day (see [**09:26**]). PIA explain:

> *The underlying concerns expressed in* [the exchanges that morning] *were reflected in my comments yesterday evening on your draft submission. That is, what is our desired outcome/result of the compromise agreement. If, for example, we believe that it is in everyone's interest for the package to be accepted (including on the grounds of the greater good) then, in the circumstances of the time, it can only be regarded as fair and reasonable.*
>
> *If, on the other hand we take the view that such fairness and reasonableness is dependent upon maximising the opportunities for non-GAR policyholders to get the maximum compensation, then manifestly we can only advise that they should leave their options open. To head this one off we would have to get the* [Financial Ombudsman Service] *to sign up to our position (which I would have thought they could do without compromising their freedom to look at each case individually). That would leave the courts as the only alternative avenue still open.*
>
> *The attached could be laced with more explicit warnings that the society can/could stand only so much financial strain before insolvency beckoned, including as a result of any "better deal" from the* [Financial Ombudsman Service]. *The problem here is that attention could turn to an industry (or even Government) bail out.*
>
> *We can only decide what to say and how far to go once we have* [crystallised] *the outcome we want from the compromise agreement and whether or not we have a chance of getting the* [Financial Ombudsman Service] *to buy-in to our position as set out in the attached.*

[**16:41**] The Director of Insurance thanks PIA and returns the statement with some suggested amendments. In reply to what FSA's policy objectives were, the Director says that he saw them as twofold:

a) I think that policyholders do need to know the probable consequences of not approving the scheme, whether good or bad. This is the approach we have insisted the Society take in presenting the scheme – hence the detail on winding up etc in the documentation. It is also consistent with the criteria we are applying to our attitude to the scheme that in its component parts and across the piece that it should represent a fair exchange between what policyholders are gaining and what they are giving up, and that this should be clearly explained. In giving up misselling rights policyholders are giving up whatever review/redress scheme might give them, and they need to understand what this might involve and what it might mean for them.

b) I believe that to ensure that policyholders understand the alternatives, and in particular what might be involved in a review/redress scheme, it is not enough that we should make the Society cover this in their literature. The Society cannot know how we would approach this. It is reasonable that policyholders should look to us for this. If we are to provide information on this, we need to be clear how we would handle such a scheme in the particular circumstances of the Equitable and what the practical constraints might be. An essential part of this is to determine, in principle, whether a redress programme would follow a "grossing up" approach (in which case we would probably need to intervene to avert some of the undesirable consequences) or whether it would not.

An incidental benefit of this is that what, on the legal advice we have received, we would regard as unrealistic expectations by non GAR policyholders as to the potential value of misselling claims does not distort the vote. But I don't think our objective is to give the scheme the best chance of success. It would be inconsistent with our overall approach to do other than to ensure that policyholders have the clearest and most reliable information that can be provided (in a very uncertain world) on the issues which are relevant to the decisions they have to make.

30/08/2001 [12:46]	FSA's Head of Life Insurance sends Managing Director B a draft letter to be sent to Equitable, setting out the criteria on which FSA would assess the compromise scheme.
30/08/2001 [15:24]	FSA's Head of Actuarial Support circulates a draft note of his conclusions on the actuarial report which accompanies the compromise scheme documentation.
30/08/2001 [20:32]	FSA's Director of Insurance sends the Director of GCD a draft letter about FSA's considered views on the relative advantages and disadvantages of administration against provisional liquidation, which he proposed to send to HMT.
31/08/2001 [entry 1]	Equitable reply to FSA's letter of 15/08/2001, saying that they believed that Equitable had provided FSA with all of the information previously requested. Equitable ask FSA to confirm that they had no further information requests outstanding.
31/08/2001 [entry 2]	Legal Adviser E writes to an FSA legal adviser about the impact on the industry of guaranteed annuity options and the need for FSA to quantify the issue and about the possible need to issue guidance.
31/08/2001 [17:04]	FSA's Director of Insurance provides his Chairman with a draft submission on the compromise scheme, dated 30 August 2001, which had been prepared by Line Manager E. The Director of Insurance explains that the submission represented work in progress and he highlights some '*significant uncertainties*' which remained. These include: mis-selling and the finalisation of Counsel for Equitable's opinion; calculation of the GAR and non-GAR uplifts which '*depends crucially on the misselling quantification*'; and what information FSA should publish alongside the scheme and Counsels' opinions.

31/08/2001 [17:07]	Legal Adviser F sends the Director of GCD, Chief Counsel A and Legal Adviser E a copy of the possible statement by FSA on the review and redress (see 30/08/2001 [**16:41**]). The Legal Adviser says that he was '*not happy with it in this form, but am content that it is heading in vaguely the right direction*', although he had one major reservation as to whether some of the content was appropriate for the general public. [**21:31**] Chief Counsel A agrees with Legal Adviser F that the drafting needed work and that the underlying policy had not yet been sufficiently well thought through.
31/08/2001 [21:00]	Equitable's solicitors send FSA an actuarial summary document to be included in the compromise scheme documentation.

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02/09/2001 [20:19]	Equitable's solicitors send FSA revised drafts of the launch documents, comprising a letter to policyholders, letter to trustees, consultation document and background document.
03/09/2001 [09:41]	Equitable send FSA the weekly customer servicing reports.
03/09/2001 [10:24]	FSA's Line Manager E circulates the latest version of the launch documents for the compromise scheme.
03/09/2001 [10:29]	FSA's Line Manager E circulates the actuarial summary document received on 31/08/2001 [**21:00**]. The Line Manager explains that this was intended to be included as an annex to the background document and contained the technical information on how the compromise scheme had been put together and the assumptions used. The Line Manager notes that, because of this, it was aimed at commentators and advisers rather than ordinary policyholders. [**10:57**] The Head of Actuarial Support says that he still had reservations about: *(1) The description of the comparison of fund performance and payouts for non-GAR policies in paragraphs 2 and 3 where I have not been able to reconcile their figures with those from other sources ... and where I also believe that they should be looking at single premium* [policies] *and not just those with monthly premiums.* *(2) There is no explanation of where the comparison figure of £250 million in paragraph 5 has come from.* *(3) The proposed uplift for pre-75 policies looks rather too high, though the cost of this and hence the effect on other policyholders should not be significant.*
03/09/2001 [entry 4]	Equitable write to FSA setting out their continuing concerns in relation to the planning process for the compromise scheme and fundamental concerns in relation to Counsel's opinion on mis-selling liabilities. Equitable's Chief Executive says that he was: *... deeply concerned by your suggested approach to the forthcoming legal opinions. We do not intend to admit liability for several very fundamental reasons:–* *1. There is no legal certainty arising from the views of* [Counsel for FSA and Counsels advising the Society on mis-selling claims and on the compromise scheme] *2.* [Counsel] *is our QC for the scheme and, if he is content that what we are proposing is fair, we will go ahead with it.* *3. There is continuing uncertainty over quantum.* *4. The position of ex-policyholders should not be high on the priority list.* [Equitable's Finance Director] *thought he had your agreement that this point could be considered later, if appropriate.* *Our purpose is to deal with the uncertainties by the compromise proposal and we would have to be strongly opposed to any FSA action which put this at risk.* *The potential mis-selling claims are a consequence of the House of Lords decision. I remain disturbed that the FSA, when asked the direct question, refused to say that it found the House of Lords judgement perverse.* FSA's Director of Insurance forwards the letter to the Head of Life Insurance, commenting: *I think this letter reflects grave lack of understanding ... as I have reiterated to* [the Chief Executive], *our position is that we have <u>not</u> yet determined that there has been misselling. But we are concerned about what we and the Society should do <u>if</u> it is found.*

We would expect to give some indication of this on the 18th. The Society should be prepared for the consequences retrospectively as well as prospectively. I will try to distribute a response this pm.

03/09/2001 [11:47]	FSA's Head of Life Insurance circulates a revised version of FSA's information sheet '*Questions and answers about Equitable Life*', last revised on 16 August 2001. The answer to the question '*Is Equitable Life solvent?*' has been amended and the answer '*Yes*' removed. The paragraph continues: '*Equitable Life made clear in its annual accounts and in its regulatory return (a report that it must make to us), that it continues to face some fundamental uncertainties – for example, in relation to the cost of its liabilities to the Guaranteed Annuity Rate (GAR) policyholders*'. The word '*regulatory*' is also inserted into the following sentence: '*However, the latest figures we have received from Equitable Life show that it continues to meet its regulatory solvency margin requirements*'. The word '*projected*' is added before '*policy values*', where it is mentioned.
03/09/2001 [12:19]	FSA's Insolvency Practitioner provides Line Manager E with some brief comments on the drafting of the insolvency aspects of the latest launch documents.
03/09/2001 [12:30]	FSA send Counsel a copy of the actuarial summary document received on 31/08/2001 [**21:00**].
03/09/2001 [16:26]	FSA write to Equitable to confirm the points that had been discussed over the past several weeks about how FSA saw their role in relation to the compromise scheme. FSA set out their powers of intervention under sections 38 to 45 of ICA 1982 and state: *The FSA will need to consider from time to time throughout the process leading up to the final hearing of the section 425 scheme whether it would be appropriate to exercise any intervention powers. It will wish to consider whether it should convey its views on the scheme to policyholders. It will also wish to consider whether it would be appropriate to appear in Court either to make representations relative to its own role to protect the interests of policyholders, or to assist the Court where it can in assessing the effect of the scheme (and the alternatives to a scheme) on policyholders and by explaining the FSA's own approach in assessing the scheme.* FSA explain their criteria for assessing the compromise scheme: *In considering the scheme, we envisage a two part analysis. The first part would look at, for each relevant group of policyholders, the proposal put to them and whether it represents a "fair exchange" for the rights they are being asked to give up. In this part of the analysis, we would also look to make a comparison between the benefits and disbenefits of the scheme to each group of policyholders taking into account the benefits and disbenefits that could arise if the scheme did not go ahead, and the uncertainties surrounding the alternatives to a scheme.* *In the second part of the analysis, which would only become relevant if the first test were passed, we would look to make an assessment of whether the scheme gives disproportionately greater benefits to some policyholders compared with others and whether the disbenefits fall disproportionately on some.* *In order to make the assessments referred to above, we will need to consider the proposals for valuing and buying out GAR rights and rights that might arise in relation to mis-selling claims and in doing so, take into account any likely outcomes in the event the scheme did not proceed.* *In relation to the buyout of the GAR rights, we will be considering:*

- *<u>For those with GAR policies:</u> whether the proposed uplift, taken with other prospective benefits, is a fair exchange for surrendering the GAR.*
- *<u>For those with non-GAR policies:</u> whether the cost of funding the GAR uplift is a fair exchange for the benefit associated with avoiding the continuing (but variable) exposure to GARs.*

We will also need to undertake an equivalent analysis in relation to the mis-selling claims (having regard to the responsibilities and powers of the FSA and PIA under the Financial Services Act 1986, and, in due course, the similar provisions under the Financial Services and Markets Act 2000) to take a view as to

- *<u>For those with non-GAR policies:</u> whether the redress offered under the scheme is a fair exchange for giving up possible mis-selling claims, taking into account the amount of redress that might be obtained by other methods, including through the Courts, the ombudsman or compensation required by the regulator to be paid by Equitable Life, and the likelihood of success of such claims.*
- *<u>For those with GAR policies:</u> whether the cost of funding the buyout is a fair exchange for avoiding the continued (and uncertain) exposure to potential mis-selling claims.*

We do not believe that it would be practicable or appropriate to consider those points in relation to each individual policy or policyholder. However, we will wish to assess, in relation to each question, whether there is any group of policies or policyholders within the relevant categories for which the answer would be significantly different than for the generality of that category, and if so whether such a group would be unfairly advantaged or disadvantaged.

Lastly, FSA set out their views on the information to be provided to policyholders:

We attach considerable importance to the timely provision of relevant information to policyholders in a form that will enable them properly to understand and assess the proposals they are being asked to support. We see the information being on two levels: an assessment of the overall consequences of the proposed scheme and alternatives to it (including continuing the run-off or liquidation), and the information policyholders will receive illustrating the range of consequences for them under the scheme compared to the alternatives.

03/09/2001 [21:19] Equitable send FSA the weekly reports on customer servicing.

04/09/2001 [04:09] Equitable's solicitors send FSA the latest versions of the compromise scheme launch documentation.

[**10:45**] Line Manager E circulates the latest versions of the launch documents received that morning. He later [**18:14**] says that the information had been revised where Equitable had realised that they had made a mistake in relation to the treatment of pre-1975 GAR policies.

04/09/2001 [10:03] FSA's Head of Life Insurance provides some comments on a draft letter to Equitable about the compromise scheme. The Head of Life Insurance tells Chief Counsel A that her detailed drafting comments on mis-selling and the legal position had not been included.

[**11:32**] Chief Counsel A notes that the wording she had provided had been cleared by Counsel.

[**12:35**] Having reviewed the letter on behalf of Chief Counsel A, Legal Adviser F says that he would be: '*uncomfortable in not putting the sort of wording which* [Chief Counsel A] *put forward in this letter, given that we have had counsel's advice as strong as this (particularly* *since it reinforces the internal concerns). As it stands the letter could be read as indicating a lowish level of discomfort on the issue, whereas the truth is rather stronger. Surely ELAS would be extremely annoyed with us if the letter glossed over something we see as one of our main outstanding concerns?*'.

04/09/2001 [entry 3] FSA reply to Equitable's letter of 03/09/2001. FSA confirm that they had received the information from Equitable's Appointed Actuary to enable them to review the assumptions and calculations underlying the Society's quantification of potential mis-selling claims. This assessment had been based on a comparison with an industry average of comparable products. FSA say that they had set out some areas of concern and were to meet with the Appointed Actuary on 5 September 2001 to go through those concerns.

FSA say that their legal team had '*some serious reservations about the way the legal analysis on which the quantification of potential mis-selling claims is explained in the launch documents* [for the compromise scheme]'. Those concerns related to the explanation of whether all non-GAR policyholders had suffered loss which '*has so far not been demonstrated*'. FSA understand that Counsel had now discussed this, as had been agreed previously.

FSA set out their views, following Equitable's letter of 03/09/2001:

> *I should confirm that I had not suggested that you should admit liability to mis-selling or that any claims in respect of mis-selling should be treated, for the purposes of the proposed compromise scheme, as other than "potential". However I was, and remain, concerned that, at least in the latest version of the documentation that I have seen, much is made of the uncertainties of litigation as justifying the discount which you propose should be applied to the quantification of potential claims. As you know, my view is that since litigation is not the only basis on which policyholders might expect to see such claims pursued, such discount factor as is applied should reflect the full range of possibilities. This should include claims resolution via the ombudsman and the possibility that, if mis-selling were to be found, the FSA might require the Society to review and offer redress for affected policies. I should emphasise that this latter is not a foregone conclusion: we have, in fact, reached no view on this one way or the other. But equally, it does not seem to me to be something which can simply be ignored. Indeed, this possibility makes it all the more important that the FSA should be able to come to the view that the scheme which you are putting forward is fair in respect of potential mis-selling claims. If we are able so to satisfy ourselves, then we may be able to indicate, at least in response to any questions put to us, that policyholders should not expect that any review/redress process, which we might mandate, would produce a better outcome for them than they would achieve under the scheme.*

On reserving for potential mis-selling liabilities, FSA say:

> *You will recognise too that, as we have pointed out in earlier discussions, the Society will need to be able to meet any costs that might arise from mis-selling claims by non-GAR policyholders who have surrendered their policies, or whose policies have matured, before the scheme is promoted and whose potential claims will accordingly not be compromised under it. For that reason some quantification of this potential liability is also necessary. Such quantification should also factor in the possibility of FSA mandated review/redress.*

On the House of Lords' ruling, FSA say:

> *I do not believe it would be possible for the FSA to characterise a ruling by the House of Lords as "perverse". On the issue of guidance, the FSA gave very careful thought to whether it could offer guidance on the implications of the House of Lords judgement for*

> *life offices generally, but it concluded that the implications were so closely related to the facts of the particular case that generic guidance to the industry was at best unlikely to be helpful, and at worst could be misleading.*

FSA take the opportunity to reply to Equitable's letters of 17/08/2001 and 24/08/2001 about the compromise scheme, noting that a number of discussions on this issue had taken place since then and that they had set out FSA's criteria for assessing the fairness of the scheme in their letter of 03/09/2001. FSA say: '*At a more detailed level, we are now more comfortable on most points where we had raised questions or concerns, subject to the points I have made above, and the fact that the scheme itself is not yet finally settled*'.

04/09/2001 [11:06] FSA write to Equitable before the meeting that afternoon to say that the agenda had been largely set by their letter of 03/09/2001. FSA list the specific topics that FSA would like to discuss as: legal analysis of mis-selling claims; treatment of mis-selling claims for people who had left, or might leave, the fund before the compromise scheme was in place; and uniform uplift for non-GAR policies.

[**11:33**] Equitable telephone FSA before the meeting to relay a request from their Chief Executive that FSA should confirm that the mis-selling issues were the only outstanding issues they had. Line Manager E informs the Head of Life Insurance that he: '*explained that we are not in a position to do that since there are others in the organisation who will need to express a view (eg the Chairman) and that we have not been able to consult him properly when we* [are] *still dealing with some of the fundamentals (and waiting for information that we had asked for weeks ago)*'.

[**11:40**] FSA's Head of Actuarial Support comments that there was still '*the relatively minor issue of pre-75 policies*', that he had alerted Equitable's Appointed Actuary to it, and '*would be prepared to let this go if necessary (on the basis that they are being well treated and the cost to others should not be material)*'.

[**11:56**] Chief Counsel A says that she did not think that FSA could give up the issue of the pre-1975 policies but suggests that it was a point that could be resolved during the consultation.

[**14:39**] Line Manager E informs Chief Counsel A, Head of Actuarial Support and the Head of Life Insurance that Equitable's Appointed Actuary had just telephoned, having realised that they had made a mistake in relation to the uplift for pre-1975 GAR policies. Line Manager E reports that the proposed uplifts were now in the range of 3% to 7%, which '*seem much closer to the kind of range that I think* [the Head of Actuarial Support] *had expected, and should put us firmly back into "best estimate cost" territory*'.

04/09/2001 [14:30] FSA write to Equitable, in response to a letter of 13 August 2001, '*requesting FSA consent for the Society to buy back part of its subordinated debt on a basis that would not require disclosure to the market*'. FSA say:

> *We do not believe that we could justify giving consent for such a buy-back at the present time. As the Society has made clear in its published accounts, there is a fundamental uncertainty surrounding the financial position at the moment. We shall wish to see this uncertainty significantly reduced before giving consent for money to be paid out to those whose interests are subordinated to those of policyholders.*

04/09/2001 [14:54] Counsel inform FSA of a discussion with Counsel for Equitable about an objection that had been raised by a policyholder action group.

[**20:03**] FSA's Director of Insurance later suggests to the Director of GCD that they should delay questioning Equitable about the issue until the following week as he did not want to distract them from the other very high priority issues that had already been raised with them.

04/09/2001 [15:00] FSA meet Equitable.

According to FSA's note of the meeting, the agenda was largely driven by the Director of Insurance's letter of the same day on the issues remaining to be resolved on the compromise scheme before the FSA could decide not to intervene. The points discussed include:

- that Equitable needed to review the presentation of the quantification of mis-selling liabilities to make clear what the legal assessment was and to explain the basis for the calculation that was being used;
- that FSA questioned Equitable's approach to discounting the potential liability. However, it was noted that this question might be overtaken when FSA received further information from the independent assessment that was being carried out;
- that FSA seek confirmation that the solicitors acting for the non-GARs would not be recommending that the group should be separated into more than one class because of their different legal rights; and
- that: '*There was a continued concern about the potential difficulties of policyholders seeking to leave the society and bring claims in parallel to the scheme, in a way that would mean that they could avoid meeting part of the cost themselves, although the Society indicated it thought that the risks were unlikely to be sufficiently great (given quantum and uncertainty) to justify the PR difficulties of trying to address the problem by cutting policy values (either by increasing the financial adjuster or reducing terminal bonus further)*'.

FSA hope to be able to give a clearer indication of their position by 6 September 2001.

04/09/2001 [16:46] Equitable send FSA revised figures on pre-1975 policies for the compromise scheme documentation.

04/09/2001 [18:49] FSA send Counsel a brief analysis of why FSA thought that grossing up was not relevant to mis-selling claims.

04/09/2001 [entry 10] FSA's main supervisory file includes a note from the Appointed Actuary's company to Equitable about a question raised by FSA in relation to a draft paper that they had prepared, entitled '*Assessing Potential Cost if Non-GAR Policyholders Are Deemed to Have Been Mis-sold*' (dated 29 August 2001).

(Note: the paper dated 29 August 2001 was not held on any of FSA's files.)

The note explains that the draft paper:

> *... included a table on page 5 comparing asset shares and policy values. This estimated that accumulated Policy Values as at end 2000 were about 95% of Asset Shares looking back across policies sold in the period 1988-2001.*
>
> [FSA's Head of Actuarial Support] *subsequently asked for more information, comparing policy values and asset shares year by year.* [Equitable] *responded on 3 September with the information shown in Appendix A. The ratio of Policy Values to Asset Shares from* [Equitable's] *work averages about 88%, compared to the 95% above.* [The Head of Actuarial Support] *has queried the consistency of these figures.*

The Explanation

- [Equitable's] *figures were for single premiums, not regular premiums, and covered only pensions business, whereas the figures in* [the Appointed Actuary's company's] *note included* [with-profits] *annuities and Life business (ie all* [with-profits] *Non-GARs, as requested). To eliminate these differences, we have carried out an analysis which looks specifically at regular premium pensions business, and the results are shown overleaf. By inspection, the average ratio is about 89%, which is very close to the figures provided by* [Equitable].

	(A) Estimate of asset share after GAR costs	(B) Guaranteed Fund	(C) Final Bonus	(D) (B) + (C) Policy Value	(E) (C)/(D) Final Bonus %	(F) (D)/(A) PV as % of AS
Annual Premium commenced on - (Assumes this year's premiums are exposed for whole [year to date].)						
01/01/2000	1,485	1,649	-193	1,455	-13%	98%
01/01/1999	2,555	2,758	-326	2,431	-13%	95%
01/01/1998	3,762	3,923	-418	3,505	-12%	93%
01/01/1997	5,171	5,166	-447	4,719	-9%	91%
01/01/1996	6,724	6,503	-450	6,053	-7%	90%
01/01/1995	8,526	7,942	-421	7,522	-6%	88%
01/01/1994	10,243	9,492	-355	9,137	-4%	89%
01/01/1993	12,447	11,160	-198	10,962	-2%	88%
01/01/1992	15,045	12,972	34	13,006	0%	86%
01/01/1991	18,004	14,970	284	15,254	2%	85%
01/01/1990	20,641	17,193	579	17,772	3%	86%
01/01/1989	23,950	19,666	1,128	20,794	5%	87%
01/01/1988	27,742	22,418	1,797	24,215	7%	87%
01/01/1987	31,853	25,479	2,788	28,268	10%	89%
01/01/1986	36,790	28,917	4,639	33,556	14%	91%
01/01/1985	42,388	32,805	7,161	39,966	18%	94%
01/01/1984	48,961	37,201	10,554	47,755	22%	98%
01/01/1983	56,953	42,172	15,608	57,779	27%	101%
01/01/1982	67,519	47,792	22,031	69,823	32%	103%
01/01/1981	79,173	54,147	28,478	82,625	34%	104%
01/01/1980	93,403	61,334	38,978	100,312	39%	107%

- *We have also established that the class of* [with-profits] *annuity business exhibits different characteristics from the other life and pensions business. For* [with-profits] *Annuities, the policy value calculations in* [the Appointed Actuary's company's] *note make no cuts in policy values as at 16 July 2001 (compared to cuts of 16% and 14% for pensions and life). We understand this is consistent with what has happened in practice. Because of this, the* [with-profits] *annuity policy values are actually higher than asset shares. Hence, the aggregate ratio of policy values to asset share increases significantly when this class is included – as evidenced by* [the company's] *comparison. (We understand from the Society that it is intended to limit future additions to* [with-profits] *Annuity policy values in order to achieve a similar effect to the cuts already implemented for the other classes of business.)*

- *There are other smaller differences in the approach taken between the two sets of figures, but the explanations above are the most significant, and we believe they provide a suitable reconciliation.*
- *Please note that whichever set of figures is used has little bearing on the rest of* [the company's] *paper. That paper concentrated primarily on comparisons of ELAS against its peers. In particular, the comparisons of payouts used an entirely different data source. The paper did not make any market comparisons for* [with-profits] *annuities, as we have not seen any reliable data to do so.*

04/09/2001 [entry 11]	Legal Adviser F advises the Director of Insurance and the Director of GCD as to whether there were alternative sources of directors' and officers' cover for Equitable's Board (see 23/08/2001 [**entry 4**]). The Director of Insurance comments to the Head of Life Insurance '*Not much help here!*'.
04/09/2001 [entry 12]	An HMT official sends the Economic Secretary to the Treasury a note on the policyholder groups that she should meet and attaches draft letters inviting them to send representatives to a meeting.
04/09/2001 [22:09]	FSA's Chief Counsel A provides Line Manager E and the Head of Actuarial Support with comments on the latest launch documentation and actuarial report. The Chief Counsel's comments include that, where Equitable had said '*a reserve "would have to" be set aside to meet potential claims for misselling*', '*Presumably this should read "must" be set aside*'.
04/09/2001 [entry 14]	Equitable provide FSA with the timetable for the initial external review of the creditors' pack documents.
05/09/2001 [09:36]	Equitable's solicitors send FSA the latest versions of the documents and guidance for pension fund trustees.
05/09/2001 [entry 2]	FSA write to HMT, further to their letter of 17/08/2001, setting out their views on the relative advantages and disadvantages of administration and provisional liquidation of Equitable should the company consider that they could no longer continue without seeking the protection of the court. FSA say that their view, supported by Halifax and Equitable, was that there was significant advantage in administration and that the arrangements should be put in place, at least on a contingency basis. FSA explain that insurance companies could not currently be placed into administration and, as a result, the practice of provisional liquidation had developed instead. FSA say that there were significant presentational and substantive disadvantages in provisional liquidation, with the presentational factor being the most compelling. On the presentational advantages of administration, FSA say: *In the situation faced by the Equitable a compromise scheme under S425 of the Companies Act seems clearly to offer the best outcome for policyholders. While this could be promoted by either an Administrator or a Provisional Liquidator, there can be little doubt that promotion of such a scheme by an Administrator, whose very purpose is to achieve the continuation of the business, would be perceived very differently by policyholders than the appointment of a provisional liquidator, notwithstanding that he could also promote such a scheme.* On the substantive advantages of administration, under the heading '*Continuity of annuity payments*', FSA say:

There are some 139,000 Equitable life annuities in payment at present. Continuity of these payments, which for many pensioners will represent a significant proportion if not all, of their income, is therefore a significant issue. While, absent resolution of the Article 4 issue, there must be significant doubt as to whether either an Administrator or a Provisional Liquidator would be able to continue such payments without the explicit leave of the Court the position of an Administrator is likely to be somewhat more flexible in this respect since the current draft Order under FSMA 2000 s.360 specifically empowers the Administrator to make payments falling due as distributions on account of the policyholder's anticipated distribution in any eventual insolvency.

FSA argue that there are procedural and cost advantages in using administration. The third substantive advantage given is that administration was reversible. FSA state:

The solvency of a company carrying on long-term assurance business is a matter of judgement about future events rather than an empirical fact.

The Equitable is subject to the uncertain costs of providing GAR benefits and of compensating non-GAR policyholders, who might have been entitled to better warning of the GAR risks. If excessively cautious views are taken of these costs now, and if a s425 scheme cannot be put in place liquidation might be unavoidable, with very significant damage, disruption and cost. However, in the longer term these costs might prove less than feared. If so, the company could be restored to solvency. In practice, it is very difficult to see winding up proceedings, once commenced, being reversed. Administration, by contrast, is designed to provide temporary protection and is intentionally reversible.

FSA outline what they saw as the presentational and substantive disadvantages of administration, both of which were linked to not undertaking a period of public consultation on the legislation before it was made. FSA say that these disadvantages did not outweigh the advantages.

05/09/2001 [entry 3] FSA speak to Equitable and put the question to them: '*Have you been advised that you can legally calculate uplift not merely on contractual entitlement but also on the non contractual element of policy values, even if this could mean that uplift is not based evenly on legal entitlements? eg two people with the same legal entitlement get different uplifts because policy values have different non contractual elements?*'.

The question emanated from an objection to the compromise proposals from one of the policyholder action groups.

05/09/2001 [13:13] PIA inform FSA that the Association of Independent Financial Advisers had commented that FSA's factsheet about Equitable, issued the previous month, had been very useful but that it had not addressed the question raised by Managing Director A on 08/08/2001 [**16:44**].

05/09/2001 [entry 5] Line Manager E provides FSA's Chairman and Managing Director B with a paper on the compromise scheme. The paper states that FSA needed to consider:

a) whether to exercise formal powers to intervene

i) to stop the Society going ahead;

ii) to require it to modify its proposals

iii) requiring it to modify the presentation of its proposals,

b) the FSA's public position about the scheme and the issues arising,

c) what the FSA should publish at the time of the launch on possible mis-selling by Equitable and on the wider implications for the industry.

The paper continues under the following headings.

<u>Objectives</u>
It is noted that FSA had said publicly that they saw a compromise scheme as being '*a positive way for the Society to resolve its difficulties*' and, therefore, that they were keen to see a '*decent*' scheme adopted. Line Manager E says that FSA needed to ensure that their approach '*best meets the interests of policyholders, the Society and the wider industry in a way consistent with the FSA's statutory objectives*'.

<u>Timing</u>
It is noted that FSA needed to indicate their position to Equitable before the Board meeting planned for 7 September 2001, while noting that '*In deciding what to do now, we need to bear in mind the stance we may take later*'.

<u>Recommendations</u>
Line Manager E writes:

> *If we considered that the scheme being proposed was unfair or unreasonable, we would need to consider intervening to stop the consultation. However, subject to the satisfactory resolution of the outstanding issues relating to mis-selling liabilities, which are fundamental to the whole package, we do not consider that there are any substantially unreasonable elements of the proposed scheme to which we ought to object. We should not therefore use our powers to prevent the Society going ahead with the consultation, or at this stage to require it to modify the proposals on which it will consult. (N.B. we do not need to determine that there <u>has</u> been mis-selling. The mere fact that leading Counsel will have opined that there is a substantial risk of successful claims is enough to make it reasonable for the Society to compromise these.)*

The paper continues:

> *The only circumstances in which we believe that it would be appropriate to compel changes to the documents would be:*
>
> > *a) if they were misrepresenting the position of the FSA or its legal advisers; or*
> >
> > *b) if they gave a misleading picture about the scheme or the position of the society (for example by overstating the legal uncertainties on mis-selling or giving a misleading impression about the financial position before or after the scheme, or simply by omission).*

FSA state that they did not consider the information to be misleading or that it misrepresented their position. They set out the public line that should be taken:

> *It is not the FSA's role to design the scheme, but rather to consider whether the scheme devised by the Society is acceptable to the FSA and whether it is appropriate to exercise any of the powers available to us, including seeking to make representations before the court.*

<u>Basis of FSA's powers</u>
The paper sets out the powers under which FSA could intervene in the compromise scheme deriving from ICA 1982, FS Act 1986 and the PIA rulebook. FSA state that the basis on which they would be likely to intervene would be that: (a) the launch of the consultation, whether because of the substance or the presentation, would of itself be damaging (or potentially damaging) to the interests of policyholders; or (b) the scheme had little prospect of success and that the launch of such a scheme could itself be damaging.

Our position
The paper reiterates FSA's stated view that such a scheme was the best way for the Society to overcome its difficulties, noting:

> *The FSA's support for a scheme on this basis would provide a degree of confidence that may well encourage policyholders to vote in favour. However, that could be undermined if we were seen to have been too ready to accept the Society's approach or if we were to change our position in the future, which we might in the light of the consultation. Such a course of action could also cause wider damage to confidence in the FSA and the system generally.*

The scheme proposals
The paper explains the proposals for the scheme that had been put forward under the sections 'The GAR Scheme', 'The non-GAR scheme' and 'The combined scheme'.

Other views
The paper notes that Halifax and the independent actuary for the scheme had had similar concerns to those expressed by FSA, particularly on presentational issues.

05/09/2001 [18:55] FSA's Chief Counsel A asks the Head of Life Insurance if he would be passing on to Equitable comments on the drafting of the compromise scheme documents that had been made at the meeting with FSA's Chairman. Chief Counsel A suggests two points to raise.

05/09/2001 [19:13] FSA's Chief Counsel A informs the Head of Actuarial Support that Counsel was happy to meet with the Independent Actuary for the compromise scheme to answer any questions about his and Counsel for Equitable's opinions. The Chief Counsel asks him to let the actuary know.

The following morning [at **08:58**], the Head of Actuarial Support says that he would be interested in attending such a meeting '*so that we can begin to make some sort of sensible quantification of the balance sheet provision*'. [**12:17**] Chief Counsel A says that he saw no reason why the Head of Actuarial Support should not attend a meeting.

06/09/2001 [09:52] FSA write to Equitable stating, as had been discussed the previous evening, that '*it is essential (and could be a cause for us to exercise formal intervention powers if not dealt with) that you remove the reference ... to endorsement by the FSA's legal advisers of the Society proposal ... to determine the loss potentially attributable to misselling*'. FSA raise two further drafting points that they wanted to see amended.

06/09/2001 [10:18] FSA write to Equitable's advisers about the timing of publication of Counsels' opinions on mis-selling. FSA say that they expected to publish their Counsel's opinion at the same time as the launch documents for the compromise scheme were published '*to ensure a coherent and comprehensive FSA public position in response to the launch*'. FSA also state that they were satisfied that consultation had taken place in a way which had maintained the independence of Counsel.

06/09/2001 [14:35] HMT offer some comments on FSA's question and answer briefing.

06/09/2001 [15:37] The actuaries conducting the mis-selling review send FSA's Head of Actuarial Support an updated paper.

(Note: the paper that was sent was not held on any of FSA's files.)

06/09/2001 [15:55] FSA's Chief Counsel B circulates a draft statement, '*Equitable Review and Redress: Comparing the Compromise Scheme and Individual Redress*', further to the one prepared on 30/08/2001 [**16:41**]. Chief Counsel B says that he thought that such a statement: '*needs to be quite explicit about what is involved and needs to acknowledge the point that in any individual claim* *brought by way of litigation or, perhaps through the Ombudsman, there would be no discount to reflect the uncertainties of litigation. This is something which I think goes to the reasonableness of the compromise*'. The Chief Counsel suggests that the statement could be discussed at the daily round-up meeting.

The statement reads:

> *The FSA is aware that policyholders assessing the merits of the Society's compromise proposals may wish to gauge what their position might be if, instead, the FSA were to take action with a view to ensuring that ... the Society paid compensation to all those to whom it may be due in consequence of the mis-selling of non-gar policies. One option available to the FSA would be to require the Society proactively to review the sale of all policies to non-gar policyholders. This would involve examining in each case the probability of there having been a failure to provide the policyholder with information or advice sufficient to meet the regulatory standards in force at the time and whether the investor would have been likely to have acted differently had adequate information and advice been provided. It would also be necessary for the Society to examine in each case whether the policyholder has as a result suffered financial loss. Such a proactive review would not necessarily result in compensation or significant compensation being paid to all non-gar policyholders.*
>
> *In the FSA's view, based upon the legal advice which it has received, the amount of compensation which is likely to be due in the majority of cases would be based upon a comparison between the current value of the Society's policy and the value of a comparable policy from another provider. This comparison could conveniently and appropriately be made by reference to a suitable industry average return. The FSA's advice is that in most cases it would be likely to be necessary to restrict compensation to an amount which is no greater than that attributable to the impact of the Society meeting the full cost of the GAR policies in accordance with the decision of the House of Lords'.*
>
> *It appears that the Society has broadly followed these principles in its compromise scheme proposals. However the scheme also proceeds on the footing that, rather than cash compensation, policyholders should accept an adjustment to their policy value in return for giving up mis-selling claims relating to the cost of meeting the gar policies. The value of the proposed adjustment is discounted to take account of an estimate of the chances of mis-selling claims succeeding and also the probability that the economic impact of compensation would in any event fall to be borne (to the extent of 73%) by non-gar policyholders collectively. On the basis of the present proposals this leads to the Society placing an overall value on the potential mis-selling claims of [£846m] which after applying the discounting factors is reduced to [£400m]. This sum would then be applied to produce an uplift of 2.5% across all non-gar policy values.*
>
> *If instead the Society were to examine individual cases and pay compensation where it is due, on the same principles, the compensation amount would not be substantially different but would obviously not fall to be adjusted by reference to the chances of the claim being successful and nor would there be a deduction to reflect the economic impact that non-gar policyholders as a class will have to bear (being a significant proportion of the costs incurred by the Society in meeting such claims). There would however be some commensurate economic effects on non-gar policyholders. For example, the institution of a systematic review of policies would be very likely to lead to a reduction in current policy values and the amounts which in the future would be available to the Society to distribute by way of discretionary bonus. Both would be reduced by the amounts paid out by way of compensation and by the provisions which the Society would be obliged to make.*

Policyholders would therefore be wrong to conclude that the compromise proposals would necessarily involve them being treated in a significantly less advantageous way than if their cases were individually considered as part of a proactive review of individual cases. In particular policyholders should not view the proposed discount to reflect the fact that non-gar policyholders could pay 73% of the claims as being inconsistent with the overall result if they were successful in pursuing an individual claim. As is explained elsewhere, the FSA acknowledges that in any compromise of this kind there will inevitably be trade off between the potential and uncertain value of claims which might otherwise be successfully pursued and the amount available by way of compromise. In the opinion of the FSA the proposal in the scheme to discount the value of the policy uplift by a further factor to reflect the uncertainties of litigation is a factor which falls within what is a reasonable range of possibilities and is a figure on which it is appropriate for the Society to consult.

06/09/2001 [17:04] Equitable's advisers for the compromise scheme send FSA the latest versions of the compromise scheme documentation.

[**18:30**] Following FSA's daily round-up meeting [at **17:00**], FSA's Head of Life Insurance says that it had been agreed that there remained an issue regarding claims from policyholders who had left, or who might leave, before the compromise scheme came into effect. The Head of Life Insurance notes that it had also been agreed that they would review the relevant parts of Counsel for Equitable's opinion over the weekend and would meet on Monday to discuss, before putting the issue to Equitable at the meeting planned for 11/09/2001.

[**22:09**] In reply, Chief Counsel A writes:

Unfortunately (and sorry if I am stepping on your toes [Chief Counsel B]*) it rather looks as though we will need to be ready (at a minimum) to say that we disagree with the basic principles for compensation outlined at pages 13 and 20 of the Background* [document]*, while acknowledging that it is possible that nevertheless, on the* [Counsel for FSA's] *theory, we could end up at the same point or near it (or could we – see paras 5.2.1 and 5.3?). Or does anyone think we should recommend to* [FSA's Chairman] *that we should intervene? My first instinct is to say not, because the issue will be clear to many once the Opinions are published (and accordingly transparent for the purposes of the consultation). Should we go back to* [the Chairman] *in any event?*

06/09/2001 [18:42] FSA's Head of Actuarial Support writes to Counsel, having given some further thought, following their discussion that afternoon, to the issue of redress for non-GAR policyholders. The Head of Actuarial Support sets out his understanding of the position to be:

1) If a Court were to award damages to the non-GARs, then this would most likely take the form of a cash payment equivalent to the loss in "policy value" sustained by the non-GAR policies. This would have a potential aggregate value of around £850 million if it were based on the "loss" of final bonus last year, or around £200 million if it only took account of the "loss" of the 4% declared bonus that might have been awarded in the absence of the [House of Lords'] *judgment.*

2) This cash payment would reduce the amount of assets available to fund the potential final bonuses to non-GAR policyholders. This means that in principle, all policy values might be cut by around 4% (though I acknowledge that there is a separate issue lurking around about whether it is justifiable to base these reductions on the total policy value and thereby for example have "policy values" for more recent policies that are below the guaranteed funds). Accordingly, the non-GAR policies would gain an immediate cash payment but lose some potential final bonus.

3) Another consequence would be that the "free reserves" on the balance sheet would be reduced as well by the £850 million cash payment. Therefore, there would be an increased risk of insolvency which would of course have an adverse effect on all continuing policyholders.

4) Under the proposed compromise scheme, the non-GAR policyholders will instead receive a combination of a 4% guaranteed bonus addition to their basic benefits (or 0.5% for those who have already received a 3.5% "guaranteed investment return"), together with a 1.5% increase in policy values (plus a further 1% in respect of the Halifax money). The effect on the balance sheet for in-force policies (ie before considering the more difficult issue of those who have left or may leave before the compromise scheme is agreed) is expected to be a reduction in free reserves of around £200 million in respect of mis-selling costs (ie the value of the above guaranteed bonus).

5) It is very difficult then to make a direct comparison of these two alternatives (namely the cash payment or the compromise scheme) as they have a slightly different effect on (a) the guaranteed benefits, (b) the potential final bonus (and hence payouts) and (c) the balance sheet (and hence the risk of insolvency).

6) This does all though highlight the problem that a significant number of policyholders may elect to leave before the scheme is approved, either on a contractual date (if available) or by taking early surrender (when they would be subject to the financial adjuster). These policyholders would then have the possibility of obtaining a cash payment by way of damages without suffering a loss in their benefits (unless the society now reduces either the final bonus or the financial adjuster and the policyholder cannot then claim for additional damages as a result of this change).

06/09/2001 [22:20]	Equitable inform FSA that they have had no further meetings or discussions with the Appointed Actuary's company following their presentation on 24/08/2001. Equitable say that they had treated the presentation as final and believed that FSA should be entitled to do the same.
07/09/2001 [entry 1]	Equitable write to FSA regarding changes to the Board of University Life.
07/09/2001 [09:22]	Further to Chief Counsel A's comments of 06/09/2001 [**22:09**], FSA's Head of Life Insurance says that he thought Equitable were '*quite clear and transparent about the legal advice, and how they had reached their basis for compensation; and that on this basis we would not be justified in intervening*'. He arranges a meeting with Managing Director B at 11:30 to discuss this.

[**11:32**] Chief Counsel B provides a summary of the outcome of a discussion between legal advisers, which was subsequently agreed by Counsel. The Chief Counsel says:

We doubt very much whether there is a fundamental problem which should cause us to object to the publication of the document. But it is [a] *great pity that the Equitable has expressed itself in this way.*

The problem is that the drafting leaves room for the gars to conclude that the non-gars have not suffered any financial loss. On this basis the gars might well question the basis for offering any compromise to the [non] *gars.*

It would be preferable if, notwithstanding the qualifications the Society were to say in plainer terms that ... on the basis of Option 3 it is satisfied that the non gars have suffered a degree of loss which is at least as great as the transfer of value. This is we understand (but could [FSA's Head of Actuarial Support] *please confirm) where the* [Appointed Actuary's company's] *analysis leads and is in any event supportable by comparing the option 1 finding with option 3 (the with profit fund has in general terms performed as well as competitors but pay outs for non gars are materially less than for comparables (subject to the qualifications)).*

07/09/2001 [09:25] FSA's Head of Life Insurance informs other officials that Equitable had confirmed the previous evening that no further work had been done on the independent report into their financial position, commenting that: '*This is Equitable's response to my request for a final version of the "draft" notes left with us by* [the Appointed Actuary's company] *on Equitable's financial position. We can take those notes as now final*'.

[**11:58**] The Insolvency Practitioner suggests: '*I think we should ask for a copy of the report without "draft" stamped all over it but should accept that it might come with a covering letter from* [the Appointed Actuary's company] *saying that the work we asked for on sensitivities has not been done (and any other caveats* [that the Appointed Actuary's company] *think appropriate). In other words, we will not put the Society to the expense of more work on sensitivities since although that would be useful it is not essential; but we do need something which can be held up to scrutiny as the basis for the FSA saying that it relied on it as comfort that the Society was solvent*'.

07/09/2001 [19:26] FSA's Insolvency Practitioner provides the following comments on the updated paper on mis-selling quantification (see 06/09/2001 [**15:37**]):

> *(1) I would still like to capture enough information to work out how much non-GAR misselling claims might be limited by the £48,000 cap under the PIA indemnity scheme. Can we follow this up once the launch document is out and things are less frantic. Better to have information available should the stock market falls leave the Society exposed to solvency issues.*
>
> *(2) It's still difficult to get a grip on the quantum of misselling liabilities without knowing how much is paid in premiums year by year: ie what weighting do you give the % shortfalls for investments made at different times? However, this seems a second-order consideration.*
>
> *(3) I think they might have double discounted the presumed over-declaration of bonuses in the industry: ie ... they illustrate a reduction in the Society's policy values of 10% (presumably the 16% reduction on 16 July less a presumed 6% reduction yet to filter through in the industry). This produces % differences for monthly premiums of -4%, -8% and -11% for 5, 10 and 13 year terms. The table at the bottom of page 11 then produces a weighted average of these % differences combined with single premium % differences. The result is -6%, -11% and -12%. However, they then go on to discount the effect again on page 12 producing weighted averages of -2%, -6% and -7%.*
>
> *Thus, I think the true position is that the misselling liabilities are significantly above the GAR cost (of 5%).*
>
> *(4) We then need to consider what value to give the "unique flexibility" of the Society's policies. The way I see this, the flexibility is the ability to retire between a wide range of dates. For some policyholders, retirement flexibility will be irrelevant to their circumstances and therefore they would attach no value to this option. For others, particularly the self employed I would suggest, this would be a crucial feature – so much so that they would be likely to remain with the Society even if they knew of the GAR risks if there truly is no comparable product on the market. In which case they would be hard-pushed to demonstrate a loss because they would not have followed a different course of action. I think policyholders will fall into one extreme or the other – at which the "flexibility" of the product has little value. Thus, I do not think that there should be much discounting of the misselling liabilities because of this product feature. ie the misselling liabilities will remain above the GAR cost and the "*[Counsel for FSA] *cap".*

My conclusion is therefore that the [Appointed Actuary's company's] *work supports the approach taken by* [Chief Counsel B] *in his excellent note of 6 September: a draft statement which the FSA could make following the launch document to the effect that policyholders should not expect more or less than is offered under the scheme were they to seek individual redress, (predicated on the assumption that compensation would be capped by reference to the GAR cost).*

07/09/2001 [21:01] FSA write to Equitable following discussion that morning to express their concern about one aspect of the drafting of the latest compromise scheme documentation.

07/09/2001 [entry 6] FSA provide Equitable with a '*comfort*' letter for them to show to Halifax. The letter confirms that FSA do not object to Equitable proceeding with the proposed consultation on the compromise scheme, subject to the points raised in their earlier letter of that day being satisfactorily addressed.

10/09/2001 [entry 1] FSA meet the Financial Ombudsman Service to '*bring them up to speed on the issues surrounding Equitable Life*'. FSA's note records:

[The Financial Ombudsman Service] *said that they had just over 400 complaints about misselling by Equitable (these were "converted" cases, which had been accepted as complaints for* [the Financial Ombudsman Service] *to deal with). Most complaints related to a period during and after the litigation, and were from non-GAR policy holders who complained that their potential exposure had not been disclosed.* [The Financial Ombudsman Service] *had "parked" these complaints, on the basis that it was not sensible to deal with them while other enquiries (such as the FSA's independent enquiry) were proceeding. They were keen to continue to put on hold applications in the pipeline, and to dissuade new claimants coming forward, until there was a clearer basis on which to decide on how to proceed.*

FSA also record that:

[The Financial Ombudsman Service] *suggested that the normal basis for compensation should be repayment of premiums plus interest. We commented that this may be a possible appropriate remedy for those who had taken out policies very recently; but it was not appropriate for longer term policies, and therefore would not be suitable as a basis for an across the board settlement.*

10/09/2001 [09:54] FSA's Head of Life Insurance asks Chief Counsel B if he could send Equitable the latest part of Counsel's opinion on grossing up. The Head of Life Insurance explains that Equitable were worried by what their Counsel had said on this point and that they were hoping to get a different opinion from other Counsel.

The Head of Life Insurance says that a change to the compromise scheme launch documentation requested by Equitable had been accurate, but asks whether it went far enough to meet FSA's concerns. He says that the point in question was to the effect of: '*The starting point for fair value compensation for non-GAR policyholders as a group, is a comparison to industry payouts. There are practical difficulties with this approach, and these are discussed in section [5] (of the background document)*'.

[**16:14**] Chief Counsel B replies that he believed FSA could '*live with*' Equitable's description of the principles for compensation.

[**19:41**] FSA inform Equitable that they did not regard the statement as ideal but note that it was factually accurate. FSA also confirm that they had no issue with two other amendments to the documentation.

10/09/2001 [10:07]	Equitable send FSA the weekly reports on customer servicing.
10/09/2001 [10:59]	FSA's Chief Counsel B writes to the Head of Life Insurance about a request from the Guernsey regulators on 7 September 2001 to have sight of Counsel for FSA's opinion on mis-selling. [**11:03**] Line Manager E tells Chief Counsel B that he had been '*thinking about what we needed to do about alerting other regulatory bodies. To a degree,* [Counsel for Equitable/Counsel for FSA] *may not be very relevant to them – since they relate to issues that do not directly affect Guernsey, Germany or Ireland*'. The Line Manager notes, however, that there were wider issues relating to the compromise scheme and suggests that the best approach might be for Equitable to provide advance copies of the advice to their regulatory supervisor in those countries. Line Manager E also suggests that FSA could provide the other regulatory bodies with a copy of their question and answer briefing note.
10/09/2001 [16:56]	An FSA official circulates the latest version of FSA's information sheet '*Questions and answers about Equitable Life*'. The official explains that amendments had been made to paragraphs 7 ('*What has the FSA done to regulate Equitable Life and to protect policyholders?*') and 11 ('*Is the Government going to step in if Equitable Life becomes insolvent?*'), and that paragraph 9 ('*What about the Independent Inquiry?*') had been added. The official asks for comments. The Head of Life Insurance suggests some amendments the following day.
10/09/2001 [19:30]	FSA's Director of Insurance writes to the Head of Life Insurance about guidance from FSA to accompany the publication of Counsels' opinions. The Director of Insurance says that the guidance produced by Chief Counsel B on 17/08/2001 [**18:02**] could be published subject to a few minor amendments.
10/09/2001 [23:24]	FSA's Press Office seek comments on a draft question and answer briefing note on the compromise scheme.
11/09/2001 [10:34]	FSA send Equitable a suggested agenda for their meeting later that day. The items are: grossing up; policyholders who leave with their claim for mis-selling uncompromised; premiums plus interest as a method of compensation; and advice versus information as a basis for compensation claims.
11/09/2001 [13:52]	FSA's Chief Counsel B circulates '*what is probably*' the penultimate draft of Counsel's opinion.
11/09/2001 [14:00]	FSA and Equitable get together for their weekly meeting to discuss latest developments. FSA's record of the meeting includes the following. Quantification of mis-selling liabilities is discussed and it was '*noted that much turned on whether Equitable's salesforce had given advice*' and it is '*accepted that the "advice" given by the tied sales force ... was probably not "advice" in the sense used by our respective Counsel, although the intention was that advice claims (if any) would be bound within the terms of the scheme*'. FSA question whether Equitable's approach was reasonable when there was no clear statement of the value that was being given up in exchange for the right to pursue mis-selling claims. Equitable say that they, and their Counsel, were '*comfortable that the offer was a commercial judgement within what they had calculated to be a reasonable range for compensation if it went to litigation*'. Equitable recognise that they would have to deal with the potential liabilities in their Companies Act half-year accounts and in their regulatory returns. FSA record that Equitable had '*discussed with the audit partner and they were minded to include a figure based on the*

	amount taken as the starting point for the scheme (ie £850 million), with appropriate notes to explain the uncertainty'. FSA raise the question of whether return of premiums plus interest could be used as a basis for compensation for more recent sales. Equitable express doubts about the validity of such an approach, but agree that the issue should be considered by their Counsel. FSA ask '*if the Society had any further thoughts about the possibility of seeking to prevent policyholders leaving the with-profits fund and taking their mis-selling claims intact*'. Equitable's Chief Executive '*noted the difficulties, and said that they had not seen a way to solve the problem. He had been advised that it was not possible to ask policyholders to waive all their rights if they surrendered because of the Unfair Contract Terms regulations. He agreed that an increase in the MVA was a possibility, but that was unfair in that it attacked those surrendering early while those with maturing policies got away without penalty. They agreed to consider this further, but they thought the risk of taking action were likely to be too great compared with sitting tight. (They noted that with markets falling below 5,000, the cover currently provided by the 7.5% adjustment was thin)*'. FSA say that they would expect Equitable to speak to the Guernsey, German and Republic of Ireland regulators. FSA ask if Equitable could '*arrange for the presentation from* [the Appointed Actuary's company] *to be finalised*', to which they agree. Equitable mention that Standard & Poor's had announced an intention to issue a temporary downgrade of their rating for the company when the compromise scheme documentation was published. FSA '*made it clear that we were not in a position to influence* [Standard & Poor's] *but agreed that the announcement would not be helpful*'.
11/09/2001 [14:28]	PIA provide FSA's Press Office with some comments on the draft question and answer briefing note about the compromise scheme.
11/09/2001 [entry 5]	FSA meet the Association of British Insurers to brief them about Equitable's progress on the compromise scheme and about the legal analysis of Counsel for FSA's opinion on mis-selling by Equitable. The Association express alarm at '*very wide and severe*' consequences of the legal analysis for the industry.
11/09/2001 [17:21]	FSA's Chief Counsel B responds to the Director of Insurance's note of the previous day about the publication of FSA guidance on mis-selling. The Chief Counsel puts forward suggestions as to how this could be done. PIA also offer some comments.
11/09/2001 [18:50]	FSA hold a round-up meeting and agree the work that needed to be carried out on the compromise scheme. The work planned includes publishing: a press notice giving FSA comment and preparing a related Q&A; guidance to the industry on mis-selling in the light of Counsels' opinions; a letter to Chief Executives; and Counsel for FSA's opinion.
12/09/2001 [12:10]	FSA's Head of Life Insurance circulates various documents about the compromise scheme ahead of a meeting of FSA planned for the following day.
12/09/2001 [12:17]	While prioritising his work, Line Manager E uncovers a message about Equitable's request for a future profits implicit item for possible use in their 2001 returns. The Line Manager asks Scrutinising Actuary F whether either of them had asked Equitable some of the questions and whether the '*ball is currently in their court*'.

[**17:22**] Scrutinising Actuary F explains that he had asked the question on 19/07/2001 and had received a reply on 20/07/2001 and, as the reply had not been sufficient to give FSA the comfort they required, he had written again on 21/08/2001. He suggests that one of them should chase Equitable for a reply.

[**17:31**] Line Manager E says that he thought that the Scrutinising Actuary was on the case, and that:

> *As for chasing, I am not inclined to do much – there will not be much enthusiasm on 7th floor for approving the recommendation to the Treasury (or for FSA to sign off on a waiver post* [FSMA 2000 coming into force]*) just at the moment, and lets face it, if the Society does not provide the information, we cannot process the application. I am not around after this week, until 3rd October, so perhaps we can take it up then if you have not heard in the meantime.*

12/09/2001 [14:59]	An FSA actuary sends the Head of Actuarial Support his thoughts on the industry guidance that was to be issued with the publication of the opinions of Counsel both for the Society and for FSA.
12/09/2001 [15:27]	FSA's Head of Actuarial Support informs officials of a telephone call from Equitable, saying: *I have just spoken with* [Equitable's Appointed Actuary] *who tells me that Equitable are about to increase their financial adjuster from 7.5% to 10% in view of recent market moves ...* *Regarding their overall solvency,* [he] *believes that their margin of solvency will remain covered (albeit with a fairly low mis-selling provision) as long as the FTSE 100 remains above 4500. (I understand that Companies Act solvency would similarly be maintained down to around an index level of 4000).* [**15:39**] In response to Line Manager E, the Head of Actuarial Support understands that '*about to*' meant mid-afternoon that day. [**16:18**] Line Manager E reports that the announcement had been made at 16:00. The Line Manager says that he had checked FSA's fact sheet, which did not mention the market value adjuster, and he suggests that FSA's website might be in need of updating.
12/09/2001 [15:46]	In response to the notes of the meeting with the Financial Ombudsman Service on 10/09/2001, Chief Counsel A says: '*Just to note for the record that we discussed later (at an Equitable Wrap-up meeting) that the remedy of premiums plus interest might not be appropriate even for relatively new policyholders*'.
12/09/2001 [16:58]	FSA's Chief Counsel B writes to Counsel seeking to clarify some parts of his opinion.
12/09/2001 [17:07]	FSA's Chief Counsel B tells the Head of Life Insurance that FSA needed to ask Equitable formally for their consent to publish Counsel's opinion. He provides the possible wording to use.
12/09/2001 [17:40]	The Economic Secretary to the Treasury seeks an update on a number of issues, including the timing of the publication of the compromise deal and the impact of the FTSE 100 Index fall on Equitable's solvency position. On the latter, the advice sought is on '*how far the FTSE has to fall before the* [Equitable's] *solvency looks questionable – and on the sensitivity to further changes*'.

13/09/2001 [entry 1]	FSA's Head of Insurance Policy circulates a report by a tax expert on major tax issues related to Equitable going into administration, liquidation or being wound up. The conclusions reached by the report are: *The likely options for* [Equitable] *can be broadly divided between those which fall short of a "stop order" on a winding up, and following such an order. Up to that cut off point, the tax impact is low key. Following a stop order there would be a significant tax impact on both* [Equitable] *and most policyholders (who would be creditors at that point).* *The Revenue do not appear willing to offer any concessions with the policyholders' tax position on a winding up, which seems unduly harsh.* *Winding up a mutual life office is untested in tax terms, and certainty cannot be achieved. However, the conclusions are likely some 95% certain post a stop order, and somewhat less at some 75% certain prior to that point.*
13/09/2001 [10:01]	FSA write to Equitable to finalise the formalisation of the monthly reporting requirements. FSA query whether they had received an answer to one suggested change. [**21:54**] Equitable confirm that they would make the change going forward and promise to get back to FSA on whether they would be able to provide certain separate information on GAR and non-GAR policies.
13/09/2001 [13:33]	FSA's Head of Actuarial Support forwards the actuary's comments of 12/09/2001 [**14:59**] about guidance to the Director of Insurance, Line Manager E and the Head of Life Insurance.
13/09/2001 [17:01]	FSA speak to Equitable, who provide them with a copy of Counsel's opinion, dated 21 August 2001, on: *... a point relating to damages for alleged mis-selling.* *The following assumptions are not apparently in dispute:* • *A is a non-GAR who has a claim for 100.* • *The Society ... is liable to A for 100.* • [Equitable] *can recover 100 from members as a whole, including GARs and non-GARs.* • *Such recovery can take the form of withholding bonuses and in the case of mis-selling litigation is likely to do so.* • *A very large number of policyholders, being all the non-GARs, have similar claims to A.* *The question in dispute is whether each of the non-GAR members from whom bonus is withheld can claim the amount of such withheld bonus as further damages from* [Equitable]. The opinion given is that '[A non-GAR policyholder] *cannot claim as part of his damages the loss suffered by him as a result of mis-selling to the other non-GARs*' (subject to some possible exceptions). FSA note that Equitable had also just received Counsel's opinion on the proposed compromise scheme and that Equitable promised to send FSA a copy, which Equitable subsequently do.

The opinion, marked '*draft 13 Sept 2001*', includes Counsel's view on whether the classes of creditor to be summoned to vote in meetings on the proposed scheme had been correctly constituted. In relation to GAR policyholders, the opinion states:

> *Each GAR policyholder has different rights under his policy. But there are groups of GAR policyholders with similar GAR rights. These groups are those with GAR rights calculated on a similar interest rate basis and those with the ability to choose a flexible form of GAR annuity. The value of GAR rights will vary depending on which group the policyholder falls in and it is proposed to vary the uplift for each group accordingly. The value of the GAR rights will further vary with the age of the policyholder and the uplift within certain of the groups will also vary accordingly. The result is that GAR policyholders will receive* [an] *uplift in an amount which equals an actuarially justifiable estimate of his GAR rights.*
>
> *On* [that] *basis we are of the opinion that there is a reasonable prospect that the Court will be satisfied that GAR policyholders form a single class.*

In relation to non-GAR policyholders, the opinion states:

> *We have previously expressed the view that, in relation to non-GAR policyholders, the issue of class determination is more difficult ...*
>
> *In particular, as appears from* [the Society's Counsel's opinion]*, non-GAR policyholders have several different potential mis-selling claims with a very wide range of merits. We anticipate that a credible challenge to the constitution of the non-GAR class could be made by a dissenting non-GAR policyholder who presented evidence to the Court that he had a claim against the Society with a very high likelihood of success. The policyholder would argue that he is not in the same class as, for example, a non-GAR policyholder whose policy was purchased before 1980 and whose claim had virtually no prospect of success.*
>
> *On this basis we initially expressed the view that it would be preferable to offer a percentage uplift to all non-GAR policyholders which varied with certain important aspects of their claims. This would be similar to the variable uplift proposed for GAR policyholders. We were subsequently informed that a scheme which sought to offer differential percentage uplifts to non-GAR policyholders is not likely to be supported by the requisite majority of creditors. In view of the fact, and considering a number of other matters relating to the reasonableness or otherwise of a flat percentage uplift to non-GAR policyholders* [*As set out in paragraph 7 of the Joint Note*]*, we expressed the view and continue to be of the view that the court is likely to be satisfied that the classes have been correctly constituted.*

13/09/2001 [17:36] FSA's Chief Counsel B provides FSA's Press Office with some comments on the draft question and answer briefing on the compromise scheme.

13/09/2001 [17:51] FSA's Press Office circulate the latest drafts of a press statement to be made by FSA on the proposed compromise scheme and the question and answer briefing.

[**21:33**] Chief Counsel A suggests some amendments.

14/09/2001 [11:57] FSA's Insolvency Practitioner suggests to Line Manager E, the Head of Life Insurance and the Head of Actuarial Support that FSA should '*emphasise, and enforce*' their need for information on policy values and terminal bonus to be properly provided by Equitable in the monthly financial reporting. The Insolvency Practitioner notes that Equitable had not provided the required information in June and July and were thus in breach of the section 45 Notice issued.

The Insolvency Practitioner estimates that policy values were currently 10% too high.

14/09/2001 [12:57] FSA's Director of Insurance circulates a proposed FSA statement '*Reviewing Guaranteed Annuity Business and With-Profit Disclosure*'.

[**13:41**] Chief Counsel A provides drafting comments.

14/09/2001 [16:35] Line Manager E sends FSA's Chairman copies of FSA's proposed statements, press lines, guidance and question and answer briefing on the compromise scheme.

[**20:09**] Chief Counsel A provides a revision to the suggested answer to the question: '*How could you have allowed mis-selling to go on for so long without doing anything about it?*'. The suggested answer reads:

> *It has only been possible now (following the clarification of the Equitable's legal position by the House of Lords) to form a provisional view about whether policies sold to non-GAR policyholders have been missold. Some 6000 out of [26,000?] policies were sold following the* [House of Lords'] *judgement. Those non-GAR policyholders are included in the compromise scheme. The regulators judged at the time that the closure of the Equitable to new business immediately following the* [House of Lords'] *judgement would have prejudiced its chances of finding a buyer – where a sale would, of course, have injected money into the fund.*

14/09/2001 [19:31] Equitable confirm that they would make the amendments requested to the monthly reporting requirements.

14/09/2001 [entry 5] Equitable's Appointed Actuary sends a letter to FSA's Head of Actuarial Support (copied to their auditors), informing them of the existence of a side letter to the reinsurance treaty. The Appointed Actuary explains that Equitable had:

> *... sought legal* [advice] *on implications of this side letter, and they are unclear, although we are advised that the side letter is arguably of no effect.*
>
> *So shortly after the terrible events in America, you will appreciate that the reinsurance parent company is fully stretched managing its exposure. We have received a written indication that the Irish European Reinsurance Co Ltd and its parent want to find out clarification that removes any doubt as to the implications of the side letter.*

14/09/2001 [entry 6] FSA's Head of Life Insurance sends Chief Counsel B a note about a telephone conversation that he had had with Equitable. The Society had told him that it could find no evidence that Equitable had modified their sales literature after the House of Lords' ruling. The Head of Life Insurance records:

> [Equitable's Finance Director] *was concerned about this; but he also remarked that he could find no evidence that the FSA had required any modification to the sales literature. He asked me what the FSA had done in this regard. I said that I did not believe that the FSA had put any specific requirements on Equitable Life with respect to its sales literature after the House of Lords' judgement ...*

The Head of Life Insurance tells Chief Counsel B that he had spoken to PIA about this who:

> *... confirmed my recollections. PIA had visited Equitable just before the House of Lords' judgement in June, and did not raise the question of the consequences of the House of Lords' judgement, as they understood that Equitable were working on that themselves. After the judgement, the view was that the Equitable was solvent, that they were likely to succeed in securing a buyer, and that therefore there was no reason why they should not go on selling. But it was the Equitable's responsibility to ensure compliance with the PIA rules at all times.*

The Head of Life Insurance says:

> *I do not know why* [the Finance Director] *asked about the FSA's position but I am inclined to be cautious in responding to him. My inclination is to go back to him in writing to say that insurance companies are responsible at all times for ensuring that they are compliant with PIA rules; this applied to the Equitable after the House of Lords' judgement just as much as any other time; and that companies should not expect the FSA to tell them when they need to modify their sales literature.*

The Head of Life Insurance later notes that he had replied to Equitable along the lines set out in the paragraph above at a meeting on 17 September 2001.

14/09/2001 [entry 7] An HMT official provides advice to the Economic Secretary to the Treasury on the advantages and disadvantages of proceeding with the consultation on administration for insurers, in the light of recent events. The advice includes that HMT:

> *... do not believe that recent events have altered the pros and cons of proceeding with the consultation. Although* [Equitable] *raised the financial adjustment penalty on with profits policies surrendered early from 7.5% to 10% on Wednesday, its financial position has not been weakened in a substantial way by the events of this week.*

16/09/2001 [17:38] FSA's Chief Counsel A sends Chief Counsel B some comments on Counsel for FSA's opinion.

16/09/2001 [21:00] Further to Chief Counsel A's comments the previous day, an official from FSA's Press Office makes some suggestions regarding FSA's question and answer briefing.

17/09/2001 [entry 1] An HMT official sends the Economic Secretary to the Treasury a briefing on FSA's views on the relative advantages and disadvantages for Equitable of administration as against provisional liquidation.

17/09/2001 [10:40] FSA send Guernsey Financial Services Commission's solicitors a copy of their draft Counsel's opinion.

17/09/2001 [15:09] Equitable send FSA the weekly reports on customer servicing.

17/09/2001 [16:03] FSA's Chief Counsel B circulates the latest version of Counsel's opinion.

17/09/2001 [16:16] Following a meeting that day with Equitable, at which FSA had said that they were awaiting a response to a request that Equitable should consent to the publication of legal advice within the Baird Report, Chief Counsel B alerts the Director of Insurance and the Head of Life Insurance to the fact that their Counsel's opinion also referred to legal advice received by the company.

17/09/2001 [entry 6] FSA's Director of GCD sends Line Manager E a copy of a letter from a policyholder that had appeared in a national newspaper on 14 September 2001. The Director of GCD says that FSA needed to be clear whether the legal analysis put forward by the policyholder (about the ability of Equitable to reduce bonuses at their discretion) was correct.

17/09/2001 [20:07] FSA's Chief Counsel A notes that the Head of Life Insurance had mentioned that, in their meeting earlier that day, Equitable had hinted that they might consider suing FSA for letting them '*missell*' post-House of Lords. The Chief Counsel informs FSA's Press Office that it had been agreed that FSA would send Equitable a copy of their question and answer briefing but without the question discussed on 14/09/2001 [**16:35**].

18/09/2001 [10:24]	FSA send Equitable a copy of their draft question and answer briefing paper and ask for their consent to provide it in advance to the Financial Ombudsman Service and to the Guernsey regulator. FSA also ask for consent to publish Counsel's opinion, for the reasons discussed at their meeting the previous day. FSA's Head of Life Insurance later [at **11:03** and **18:13**] circulates internally the draft briefing, noting that there remained particular sensitivity over questions about sales after the House of Lords' decision and on solvency. [**22:05**] FSA's Head of Press Office asks the Head of Life Insurance if FSA knew what the Independent Actuary would say on 20 September 2001.
18/09/2001 [10:46]	FSA's Chief Counsel B asks the Head of Life Insurance and the Press Office that it should be made clear in FSA's press statement that FSA were publishing Counsel's opinion pursuant to section 206 of the FS Act 1986. [**12:00**] The Head of Life Insurance asks, if FSA published under the powers of that Act, whether they still needed Equitable's consent to do so. [**17:09**] Chief Counsel A highlights several '*awkwardnesses*' with this. She explains that some of the information contained in the opinion had been acquired under ICA 1982 and some while HMT had still been the direct regulator. Chief Counsel A says that the gateway for disclosure was limited and it would be better if Equitable consented to the publication of the relevant material.
18/09/2001 [13:48]	FSA's Director of Insurance provides a report about Equitable (largely on the compromise scheme) to FSA's Board, ahead of a meeting on 20 September 2001.
18/09/2001 [14:00]	An official from FSA's Press Office outlines the timetable of announcements to be made by Equitable over the coming days and suggests what FSA needed to do in response. [**14:24**] In reply, FSA's Chairman offers some '*cautionary thoughts*', arguing for less media exposure for FSA. The Chairman says: *1) The Equitable may have made mistakes in the scheme of which we are unaware. They always have before.* *2) They may come out with statements/announcements which surprise us. They regularly do.* *3) The scheme may change before it goes final. We can't be seen strongly to back one, then strongly back another which has changed significantly.* *4) There may well be stories to the effect that ELAS want to sue us/our predecessors. We know* [Equitable's legal advisers] *are briefing policyholders and they won't tell us what they will say, though I can't believe they don't know. So it would look odd if we were too close to them.* *5) We will be asked questions about other firms, which we don't want to stimulate, and to which we have no good answers.* *6) We will be asked about our report, about which we can say nothing useful at this stage.* The following day Chief Counsel A comments: '*Sage advice*'.
18/09/2001 [15:27]	FSA send Counsel their views on whether the market value adjuster applied by Equitable could be said to constitute a penalty.

18/09/2001 [17:12]	Further to 05/09/2001 [**13:13**], PIA query with FSA whether there had been any developments on the guidance provided to independent financial advisers. PIA say: *There was an article in the press last week which reported that* [Independent Financial Advisers] *are refusing to give advice because they are unsure of the stance we are taking. They are effectively saying to consumers that the policyholder has to make up their own mind about what to do. This reaction is causing concern among some policyholders because we are directing them to* [Independent Financial Advisers] *for advice but they are then being told that they can't have that advice.* PIA say that they: *... think this is a tricky position for us to be in. Your comments would be appreciated. And you may remember that* [Managing Director A] *was keen to issue something.*
19/09/2001 [entry 1]	Equitable seek confirmation from FSA that they could write new business in relation to pension funds which had been split due to divorce.
19/09/2001 [08:45]	FSA's Chief Counsel B provides FSA's Consumer Relations Department with a copy of the latest version of Counsel's opinion and says that, if the Department thought it appropriate, the Department could send it to the Financial Ombudsman Service and the Financial Services Compensation Scheme subject to certain conditions.
19/09/2001 [09:15]	Further to their reminder the previous day (see 18/09/2001 [**17:12**]), PIA say that the unanswered correspondence to them from the Association of Independent Financial Advisers was now '*embarrassingly stale*'. PIA continue: '*Given that the compromise proposals land on policyholders' doormats tomorrow we really must, I think, have something coherent to say to* [the Association of Independent Financial Advisers and the Independent Financial Adviser] *community on the contact centre etc. – they will be calling!*'. [**10:21**] FSA ask for the question and answer material to be recirculated so that it could be agreed and used by both FSA and PIA in response to queries from advisers. [**19:22**] PIA recirculate the briefing with an added question in relation to the compromise scheme.
19/09/2001 [09:16]	FSA's Head of Life Insurance informs officials that Equitable were still working on whether they would give their consent to FSA for publication of their legal advice. [**09:24**] Chief Counsel B adds that he had been speaking with Equitable's solicitors, who had provided a form of words designed to allow Equitable to maintain their legal privilege.
19/09/2001 [10:41]	Further to a telephone conversation that had taken place, Equitable write to FSA seeking confirmation that they had no objection to the Society buying back 10% of the £350m subordinated loan at the current price of between 51p and 55p per £1 nominal. Equitable say that FSA: *... had asked that we defer until the* [Appointed Actuary's company's] *work was available. That has been completed and we continue to more than meet the* [required minimum margin]. *At a cost of say £20m it is not material and repurchase if announced might improve policyholder confidence.* [**14:10**] The Head of Life Insurance forwards this on to the Director of Insurance, saying that he had: *... told* [Equitable's Finance Director] *that we would look again at this when the compromise scheme was out.* [FSA's Insolvency Practitioner's] *initial view is that the key issue is whether*

Equitable is likely to become insolvent before the scheme is completed. If not, the buyback is likely to be in policyholder's interests. Only if insolvency intervenes might policyholders lose as they would no longer get preference over the bondholders for the portion of the debt bought back. Otherwise, the current price makes this a good deal for policyholders.

The Head of Life Insurance says that the issue would need to be considered by FSA's Insurance Supervisory Committee and he asks the Director of Insurance whether he was content for the case to be put to the Committee.

19/09/2001 [10:51] FSA's Head of Life Insurance tells the Head of Press Office that FSA did not know what the Independent Actuary would say at the time of the launch of the compromise scheme and that any statement might therefore have to be dropped.

[**11:59**] The Head of Press Office says that, if the Head of Life Insurance was saying that the Independent Actuary was not going to say anything then '*there is a problem*'. The Head of Press Office explains that he: '*thought as part of the compromise, the independent actuary was going to offer a "view" as to the overall fairness of the proposals put forward for consultation. Other than the financial press and rent-a-quote financial advisers, this view was about the only steer policyholders would get at this stage to help them determine how to respond to the consultation (we are saying: "sensible basis on which to consult", but we won't offer a formal view till the final proposals are put together for the vote)*'. He continues that: '*If there is no such "view" from the independent actuary at this point ... how do policyholders start to gauge fairness in order to feedback? Plus I think there is an expectation that the independent actuary will actually say something tomorrow*'.

19/09/2001 [13:29] Counsel provide FSA with the latest version of their draft opinion.

19/09/2001 [13:41] An official circulates '*what is hopefully*' the final version of FSA's press notice.

[**15:54**] Chief Counsel A says that she remained '*a bit uncomfortable with the first sentence of the press release which I know does not literally promise a stable fund following a successful compromise, but it does stray towards it*'.

[**16:44**] The Head of Life Insurance says that he believed the reference to '*stability ... is OK in this context, and can be interpreted as referring to the removal of the uncertainty created by the uncapped liabilities*'.

19/09/2001 [15:03] FSA's Chief Counsel B checks with the Head of Life Insurance, Chief Counsel A and the Head of Prudential Policy that they were happy with an extract from Counsel's opinion about non-GAR policyholders who surrender their policies, and the operation of the market value adjuster.

[**15:12**] Chief Counsel A and [**16:25**] the Head of Life Insurance say that they are happy with it.

19/09/2001 [15:23] FSA send the Independent Actuary a copy of Counsel's '*very near final*' opinion.

19/09/2001 [15:23] Chief Counsel B provides a two page summary of Counsel's opinion.

19/09/2001 [15:31] FSA's Insolvency Practitioner raises a point with the Head of Life Insurance, being that '*the Society's Q&As include the statement that they are publishing all the relevant Counsel's opinions. Yet* [Counsel's] *opinion (which I do not believe they intend to publish) contains some highly relevant views on the strength (or lack of strength) of potential misselling claims*'.

[**15:39**] The Head of Life Insurance understands that Equitable hoped to publish the opinion but that '*like so much else!*' it was not yet finalised.

19/09/2001 [15:45]	FSA's Head of Life Insurance sends to 13 FSA officials electronic copies of documents delivered that morning from Equitable. Those documents were: • Equitable's question and answer paper on the compromise scheme. • Equitable's media timetable. • A document entitled '[the Appointed Actuary's company's] *Papers – Realistic G…*'. • A document entitled '[the Appointed Actuary's company's] *Papers – Assessing P…*'. • The final report from the Appointed Actuary's company of their independent review of Equitable's financial position (requested by FSA on 11/09/2001 [**14:00**]). On the last document, the Head of Life Insurance explains '*the substance was given to us several weeks ago, but was marked "draft" – we asked them to give us a final version, even though there has been no additional work since then*'.
19/09/2001 [15:47]	Equitable send FSA their question and answer briefing for the compromise scheme proposals. [**16:13**] The Head of Life Insurance circulates the briefing and notes that the Independent Actuary would not be making any statement on the compromise but that he had told Equitable that he regarded the principles underlying the scheme to be appropriate and applied fairly.
19/09/2001 [15:48]	An FSA official seeks comments on an amended version of FSA's information sheet on Equitable and on the contents of their web page. [**20:57**] Chief Counsel A provides comments on the web page.
19/09/2001 [17:15]	Equitable send FSA a copy of their press notice to be released the following day. Under the heading '*The Society's financial position*', the press release states: '*Not only is the Society solvent but it satisfies the requirements of the insurance regulations, which are stricter than a simple solvency test*'.
19/09/2001 [19:27]	An official distributes within FSA the final version of FSA's press notice, to be issued the following day.
20/09/2001 [morning]	FSA issue a press notice on the proposed compromise scheme and publish their Counsel's opinion on mis-selling by Equitable.
20/09/2001 [11:22]	FSA's Head of Life Insurance informs the Head of Press Office that, if asked, the Independent Actuary for the compromise scheme would say '*he considers the principles underlying the compromise are appropriate and have been applied fairly in developing the proposals sent to policyholders; and that he believes the current proposals should be the subject of consultation with policyholders*'.
20/09/2001 [11:36]	Equitable's advisers inform FSA of the procedure for production of the Creditors' Pack. [**14:39**] FSA's Insolvency Practitioner suggests that FSA should now turn their minds to what they would say at the convening hearing. The Head of Life Insurance and, the following day, Chief Counsel A comment on the Insolvency Practitioner's suggestion. Chief Counsel A concludes that FSA would have little of substance to say at the convening hearing, as opposed to the substantive hearing. She makes some proposals as to how FSA should prepare to handle that process.
20/09/2001 [12:30]	FSA's Head of Life Insurance distributes FSA's final agreed question and answer briefing note.

20/09/2001 [13:20]	FSA send the German, Guernsey and Republic of Ireland regulators copies of the compromise scheme launch document and FSA's press notice of that morning. [**14:06**] FSA inform Equitable of this.
20/09/2001 [16:39]	FSA's Head of Life Insurance suggests that the question and answer briefing material for responses to independent financial advisers was '*getting over complicated*'. The Head of Life Insurance suggests: *... a couple of short sharp responses, focusing on the publication of the compromise proposals on the following lines:* *Question: Does the FSA expect* [Independent Financial Advisers] *to give advice to Equitable Policyholders, even though the* [Independent Financial Adviser] *does not want to?* [Answer]*: This is entirely for each* [Independent Financial Adviser] *to decide (subject to any obligations they may have to existing clients who are Equitable policyholders). The FSA neither requires nor prohibits* [Independent Financial Advisers] *from giving advice in particular cases.* *Question: How should an* [Independent Financial Adviser] *determine what advice to give an Equitable policyholder, as to whether or not to accept the compromise scheme?* [Answer]*:* [Independent Financial Advisers] *who advise Equitable policyholders on the Compromise Scheme should apply their professional judgement within the existing PIA rules. The Equitable has published a great deal of information about the Compromise Scheme itself; but it will be important that* [Independent Financial Advisers] *take fully into account the individual circumstances of the client.* [**16:43**] FSA's Press Office say that they are happy with the proposed line to take, while noting that '*If* [Independent Financial Advisers] *can't give advice, who can!*'. They also say that it is '[worth] *remembering, to counter any suggestion that we* [are] *warning* [Independent Financial Advisers] *off advising Equitable customers, that we and our website consistently advise people to take advice*'.
20/09/2001 [entry 6]	According to FSA's later account of events (see 11/10/2001 [**14:30**]), the Head of Actuarial Support returns to the office and reads Equitable's letter of 14/09/2001 about the side letter to the reinsurance treaty. It appears that, at this time, he sends copies of the letter to the Head of Life Insurance, Chief Counsel A and Scrutinising Actuary F, suggesting that FSA ought to ask for a copy of the side letter.
20/09/2001 [entry 7]	Baird provides his report to a meeting of FSA's Board.
20/09/2001 [entry 8]	FSA's Director of GCD provides a report to FSA's Board on legal issues relating to the Baird Report.
21/09/2001 [09:41]	FSA's Head of Life Insurance says that, now the compromise scheme had been launched, FSA needed to plan their input into the next phase. He suggests that a meeting should be held the following week.
21/09/2001 [14:00]	According to an electronic diary record (held on FSA's file about the compromise scheme), Chief Counsel A is informed by solicitors acting for FSA on the compromise scheme that they were also advising IRECO and its parent company on the reinsurance treaty with Equitable.

Chief Counsel A says that the Head of Actuarial Support had told her that he had been made aware of the existence of the side letter to the treaty but that he needed to make further enquiries as to the details. Chief Counsel A checks with Equitable that they had no problem with the solicitors acting both for FSA and IRECO.

21/09/2001 [19:57] Equitable send FSA a balance sheet and profit and loss statement for 31 August 2001. The figures are presented as follows:

	Insurance Act Basis	
	£m	*£m*
Assets		
Investments		
Property	*2,067.3*	
Equities	*8,231.8*	
Fixed Interest Securities	*12,428.5*	
Short Term Deposits	*2,428.1*	
Unquoted Investments	*1,030.9*	
		26,186.6
Reinsurers share of technical provisions		
GAR liabilities	*685.0*	
Unit linked liabilities	*3,516.1*	
Other liabilities	*352.7*	
		4,553.8
Current assets		*776.3*
Tangible assets		*0.0*
Implicit items		
Future profits	*877.0*	
Other s68 concession	*0.0*	
		877.0
Total assets		*32,393.7*
Liabilities		
Guaranteed fund on accumulating with profits policies – GAR	*4,303.7*	
Guaranteed fund on accumulating with profits policies – non-GAR	*11,695.4*	
Less discount applied to liabilities (see notes)	*(423.0)*	
		15,576.1
*Other with-profits liabilities**		*2,911.9*
GAR provision		*2,233.0*
GAR rectification		*200.0*
Non-profit liabilities		*4,425.0*
Misselling liabilities (estimate) ([for potential non-GAR mis-selling claims]*)*		*220.0*
Other misselling liabilities (eg Pension Review)		*118.5*
Linked liabilities (reinsured to Halifax)		*3,516.1*
Outstanding Claims		*575.0*
Resilience reserve		*21.0*
Subordinated loans		*0.0*
Provision for other risks and charges		*4.6*
Other current liabilities		*859.6*
Total liabilities		*30,660.8*
Required Minimum Margin		*1,052.7*
Excess over [required minimum margin]		*680.2*

22/09/2001	An FSA legal file on Equitable contains a copy of Equitable's letter of 14/09/2001 that had been forwarded to Chief Counsel A by the Head of Actuarial Support. The letter has been stamped with the date 22 September 2001.
24/09/2001 [09:00]	FSA officials meet to discuss Equitable's Creditors' Pack.
24/09/2001 [09:35]	Equitable send FSA an initial external review of the Creditors' Pack. [**10:31**] The Head of Life Insurance circulates the information.
24/09/2001 [11:17]	FSA's Head of Life Insurance sends the Insolvency Practitioner and the Head of Actuarial Support the financial information received from Equitable on 21/09/2001. The Head of Life Insurance asks whether the information complied with their requirements. [**11:48**] The Head of Actuarial Support replies: *My understanding is that they now consider they need to hold around £850 million for mis-selling, and that they are not including any provision for those non-GAR policyholders who have already left.* *In addition, we know that markets have fallen substantially since end-August though correspondingly they have increased the financial adjuster on surrenders (and may therefore be able to discount their guaranteed funds rather more).* *I think therefore that we should ask the actuary for an urgent update of their financial position taking account of all these factors.* [**12:47**] The Insolvency Practitioner comments: *There is, as yet, no s.45 requirement. However, what has been supplied does not comply with the draft requirements. The Policy Value information ... has, once again, not been completed.* *The Society has shown a provision of £220m for non-GAR misselling costs. This is the wrong figure to use as a matter of principle. They should use the gross "realistic estimate" cost of £850m. If they did this, then the Society would exceed its required solvency margin by a mere £50m. Given stock market falls since 30 August, the Society must surely be in breach of its* [required minimum margin] *now. If so, the statements that it is making about solvency in the course of consultation need to be tempered.*
24/09/2001 [17:34]	FSA's Chief Counsel B writes to the Head of Life Insurance about the meeting that morning about Equitable's Creditors' Pack. The Chief Counsel says that, had he attended the meeting, he would have agreed with the view that FSA needed to have a reliable means of knowing what policyholders were saying in response to the consultation. Chief Counsel B also says that he understood that the Head of Actuarial Support was undertaking an analysis of which classes of policyholder were likely to be better off with compensation by return of premiums plus interest, rather than by reference to the impact of the GARs. He says that, when that analysis was complete, FSA could consider instructing Counsel. The Head of Actuarial Support replies: *At the present time, I would estimate that all policies written since around 1997 would be in the position that a refund of premiums plus interest at 5% (Is this the judgment rate?) would be greater than the underlying policy value. This should include all policies written since 1995 if we allow for the policy values being around 8-10% too high at the present time (ie they are not supported by the underlying value of assets).* *For regular premium policies, the cutover date would be around 1995 or 1993 respectively.*

This indicates that we are talking about around 100,000 individuals, plus perhaps 200,000 members of group schemes, who could be better off with a recission of their contract if this option were available to them (though I am not sure what form of contract exists for members of group schemes). I would expect this to cover all types of policy, including retirement annuities, with-profit immediate annuities, endowments, single premium bonds etc.

If we were to allow for the effect of the application of a financial adjuster on surrender, then even more policies would need to be included.

24/09/2001 [17:47] Equitable send FSA the weekly reports of the amounts of claims advised and processed. The information provided included that, for the week ending 21 September, there had been £50m of claims at maturity and £58.9m of claims for surrenders. The information also showed that the backlog of unprocessed claims had increased from around £100m at the end of July 2001 to around £500m at the end of August 2001, the backlog then remaining at between £400m and £500m.

FSA's Head of Life Insurance distributes the information the following day (at **10:28**).

24/09/2001 [18:41] Equitable send FSA a copy of the side letter to the reinsurance treaty, dated 1 April 1999. They explain: '*We are seeking clarification of the side letter and we have had legal advice that it is unclear as to what it means. However* [IRECO] *is extremely preoccupied with the World Trade Centre disaster*'.

(Note: the fax is dated 14 September 2001; however, the fax transmission records that it had been sent from Equitable on 24 September 2001 at 18:41.)

25/09/2001 [entry 1] FSA's Head of Life Insurance comments to the Head of Actuarial Support (copied to others) about the side letter, that: '*I think we will need to consider with GCD what this means. It is not a legally binding document: and it fails to achieve its stated aim of "clarifying" the position. But paragraph 2 appears to cast some doubt on the effectiveness of the treaty in certain circumstances*'.

On another version of Equitable's fax of 24/09/2001, the Head of Actuarial Support writes to the Head of Life Insurance (copied to Chief Counsel A and Scrutinising Actuary F) expressing his concerns that: the side letter had not been disclosed to FSA or GAD; the second paragraph was completely at variance with what they had been told by the then Appointed Actuary at the meeting in February 1999; and the third paragraph could very well invalidate the reinsurance offset shown in the returns.

(Note: the Head of Actuarial Support's note is undated; however, it was written on a version of Equitable's fax of 24/09/2001 that had been date-stamped 25 September 2001.)

25/09/2001 [10:32] FSA's Head of Actuarial Support responds to the Insolvency Practitioner's note on the financial information received from Equitable (see 21/09/2001 [**19:53**] and 24/09/2001 [**11:17**]). The Head of Actuarial Support says that he agreed with his assessment and adds that the policy value information would be likely to show policy values 8-10% higher than underlying assets.

[**14:32**] The Head of Actuarial Support comments further, having now received a copy of the side letter to the reinsurance treaty, saying:

We have a further problem that has emerged. Apparently, [Equitable's Appointed Actuary] *signed a side-letter on behalf of Equitable which was not disclosed to us, but calls into serious question the validity of the reinsurance offset of £700 million for which they are taking credit. This would of course mean that they are now well below their required margin of solvency.*

The Head of Life Insurance adds: '*This would not have been known either to Baird et al but should be an interesting topic for Penrose to pursue!*'.

25/09/2001 [entry 3] FSA write to Equitable, saying that FSA were extremely concerned at the possible implications of the side letter. FSA say that the existence of the side letter appeared to raise questions about the value of the reinsurance offset shown in the Society's annual returns and that FSA would like to discuss the implications of this with Equitable '*at the earliest opportunity*'. FSA say that they would be in touch to arrange a meeting later that week, at which they could review the issue along with financial reporting arrangements and the process for scrutiny of the compromise scheme.

26/09/2001 [11:26] FSA's Director of Insurance informs Managing Director B of the disclosure by Equitable of the side letter. He notes that, although the letter had been explicitly expressed as not being legally binding, it '*would appear to cast doubt on the reinsurance treaty on which the Equitable relied to cover the reserves which we insisted the Equitable set up to cover their GAR liabilities*'. The Director refers to his letter to the Society of the previous day. He says that, in addition, he had also spoken to Equitable's Chief Executive and had stressed that the Society must take immediate steps to put the issue beyond doubt, '*if need be by negotiating a further amendment to the Treaty or by securing a formal and binding acceptance by Ireco that they would not seek to rely on the side letter*'.

The Director goes on: '*Our immediate concern must be to assess the implications of the letter and to ensure that the Equitable does whatever is necessary to put its financial position (at least in this respect) beyond doubt*'. He says that FSA would need to consider whether to investigate the matter, inform the Serious Fraud Office, and review which other life companies had any exposure to IRECO. The Director of Insurance also states that:

> *Ireco is an Irish reinsurance company (a subsidiary of* [Prospective Bidder F]*). As such it is not supervised by the Irish Insurance authorities. However if, as may be the case, Ireco has specialised in assisting companies to disguise their true financial position by entering into "bogus" (or at least doubtful) reinsurance treaties then this may fall foul of other requirements of Irish law. Subject to comments from enforcement I should like to discuss this urgently with the Irish supervisory authority (who do maintain a somewhat distant watching brief over the reinsurance sector). It may also be appropriate for there to be contact with Irish company and/or criminal investigation authorities.*

[**11:57**] FSA's Head of Actuarial Support comments:

> *There is clearly a serious issue here over the conduct of* [the individual] *who was the appointed actuary and finance director when he wrote this letter in April 1999. This letter was never disclosed to us. Moreover, its contents are at variance with what we were led to believe in discussions with him in January and February 1999. Thirdly, if the side-letter is legally binding, then I believe it would also seriously call into question the value of the reinsurance offset for which he* [has] *claimed credit in his valuation of the liabilities in both the 1998 and 1999 financial returns.*
>
> *These points alone would in my view be sufficient to warrant a formal complaint about his conduct to the actuarial profession.*
>
> *There are also of course a series of possible issues relating to the financial management of the Equitable, including whether policyholders were misled as to their expectations, on which a complaint to the profession against* [the former Appointed Actuary] *and others at Equitable Life could be mounted. We had held off on these broader issues while the various other enquiries were continuing.*

26/09/2001 [12:08]	FSA's Director of Insurance informs Managing Director B of the position in relation to Equitable's directors' and officers' cover.
26/09/2001 [16:36]	FSA's Chief Counsel A prepares instructions for Counsel to advise on the status of the side letter and asks for comments on them from the Head of Insurance Policy. [**17:34** and **17:59**] The Head of Insurance Policy provides some comments, including: *You also correctly point out that even if the side-letter is not legally binding it raises serious questions as to the legitimacy of its use to support provisioning. You will recall that* [Regulation] *64(3) of the 1994* [Regulations] *makes this depend upon actuarial principles. I have remembered that we have given guidance (which in fact I wrote) on how these principles are to be applied. See Guidance 1998/1 (para 5.5.(6) of Guidance Note 9.1 in the* [Interim Prudential Sourcebook]*). This makes reliance upon such reinsurance dependent upon both the legal form and economic substance. I have not copied this paragraph of guidance out as I assume you have easy access to it.* [**17:53**] Chief Counsel A sends the instructions to Counsel. [**19:33**] Chief Counsel A sends the Director of GCD a copy of the instructions to Counsel. The following day, he suggests a further point to ask Counsel.
26/09/2001 [20:11]	Chief Counsel A passes the Director of Insurance's note on the side letter to Chief Counsel B and Legal Adviser F, informing them that she had sent instructions to Counsel on the issue. She goes on to say: '*We also have concerns about Equitable's reserving for misselling (as disclosed in the August monthly returns) and* [the Head of Life Insurance] *and* [Head of Actuarial Support] *will I hope be speaking to* [Counsel] *about that on Thursday*'.
27/09/2001 [09:05]	FSA's Director of Insurance asks the Head of Actuarial Support to consider what could be done to enable FSA to monitor and model Equitable's financial position. [**14:09**] The Head of Actuarial Support replies: *I would certainly agree that we need to have the up-to-date financial position from* [Equitable's Appointed Actuary]*, along with their current thinking on bonus rates and the financial adjuster on the surrenders. I propose to modify the generic* [Chief Executive Officer] *letter slightly for them, and tailor this to their specific circumstances. In particular, we shall wish to discuss in more detail how they intend to provide for potential mis-selling costs.* *They have also in the past provided us with a matrix showing how this would alter in the event of changes in equity values or in fixed interest yields. I would certainly like to request this again, as we do not have the data ourselves to construct reliably such a model.*
27/09/2001 [11:28]	In response to the instructions sent to Counsel on the side letter (see 26/09/2001 [**16:36**]), the Head of Actuarial Support says: *I would be doubtful about allowing even a value of £100 million in view of the intent expressed that they would never wish to make any "cash" claim on the reinsurer!* *Another aspect, but I think for later, might be the role of* [the Appointed Actuary's company] *(were they aware of the August correspondence?) and the auditors ... who are required by regulation to report events of "material significance".*

27/09/2001 [15:55]	Equitable ask FSA for an idea of their '*success criteria*' for Equitable's consideration of policyholders' comments and feedback on the compromise scheme proposals. [**16:23**] FSA's Head of Life Insurance replies: '*I think the Society needs to demonstrate that it has taken account of all representations and comments, and that any changes to the scheme (or decisions not to change it as the case may be) are fully explained and supported by reasoned argument*'.
27/09/2001 [entry 4]	FSA write to Equitable about the reinsurance treaty, further to their letter of 25/09/2001. FSA note that a meeting has been arranged for the following day. FSA request: a copy of addendum 1 to the treaty which they do not have on their files; any relevant information about the status of the side letter; and the fullest possible update on the legal advice Equitable had received about the status of the side letter. FSA also say that they would want to discuss at the planned meeting Equitable's current financial position '*taking account of the implications of the side letter, and also other recent and current developments (notably recent stockmarket falls, the provisioning which you need to hold for mis-selling, and provisioning for non-GAR policyholders who have already left or may leave the fund with their mis-selling claims intact)*'.
27/09/2001 [17:24]	Equitable send FSA a copy of addendum 1 to the reinsurance treaty.
27/09/2001 [entry 6]	HMT reply to FSA's letters of 06/03/2001, 10/08/2001 and 17/08/2001. HMT agree that it would be desirable to achieve some certainty on the meaning of Article 4 of Equitable's Articles of Association, without the need for it to be determined by the courts. HMT say: '*In particular this would help avoid the possibility that the continuity of payments could be disrupted if Equitable Life were to be placed in administration or provisional liquidation. The difficulty we continue to have is that, in our view, both solutions proposed in* [the Director of Insurance's] *letter would not solve the problem*'. FSA's Director of Insurance comments on the letter: '*I see little point in going back on this*'.
28/09/2001 [13:17]	FSA have a discussion with Counsel about the side letter and their instructions of 26/09/2001. According to Chief Counsel A's summary, which recorded Counsel's preliminary comments (prepared to assist with FSA's meeting with Equitable later that day and not cleared by Counsel), the legal questions were: • *Must Equitable cancel the reinsurance when the £100m limit is reached?* • *If not, can it nevertheless use the reinsurance agreement to offset its provisioning? Or to offset it in the amount of £700m?* • *Can Equitable only draw cash if the conditions in the side* [letter] *are met?* • *If so, does this matter only for reserving?* Chief Counsel A records that good legal arguments existed to the effect that the side letter should have no legal effect or could be withdrawn by Equitable. However: '*in the interim unless Equitable has very confident and credible legal advice, the FSA will need to consider urgently whether, in view of the legal uncertainty, it would be prudent for the Equitable to claim the full £700m (ICR 1994)*'. Chief Counsel A also records the following under '*Other questions*': • *Did present management of the Equitable (breach of criteria of sound and prudent management?), its audits (breach of* [Regulation] *3 of the Auditors (Insurance Companies Act 1982) Regulations 1994?) or its appointed actuary (breach of professional guidance?) know about the side letter in August when* [Equitable's

Appointed Actuary] *wrote to* [FSA's Head of Actuarial Support] *on 7 August? Before publication of the Launch Document?*

- *Did* [Equitable's then Chief Executive] *know about the side letter (almost certainly yes) (breach of professional guidance?).*

28/09/2001 [15:28] FSA's Head of Actuarial Support informs Chief Counsel A that Equitable '*wrote to us about the side-letter on 14 September, so they must have known about this before the launch document came out the following week? Is this relevant though to the launch of their consultation?*'.

28/09/2001 [15:30] FSA meet Equitable and their auditors.

According to FSA's note of the meeting, on the side letter:

> [Equitable's Finance Director] *said that on 7 August, after* [Equitable's Appointed Actuary] *had sent his letter of that date to* [FSA's Head of Actuarial Support], [the former Appointed Actuary] *(who had been consulted on the terms of that letter, and had agreed with them) had reverted to* [the Appointed Actuary] *with a copy of the side letter saying that he ought to be aware of it. Equitable Life then made further enquiries. They had found no reference to the side letter in the minutes of board meetings. They held discussions with the reinsurers, with their lawyers and with* [the former Appointed Actuary].
>
> *The reinsurer (IRECO), had described the side letter as providing clarification of what would happen if the £100 million trigger level was reached; but these discussions left Equitable Life unclear on how the side letter related to the treaty. In late August, IRECO told* [Equitable's Finance Director] *that the letter represented "best endeavours" to achieve a satisfactory resolution in these circumstances. However, on 27 September IRECO gave Equitable their view that the side letter gave IRECO the option to terminate the Treaty. Equitable Life have told IRECO that they do not accept that interpretation. But they have disclosed the position to their* [directors and officers] *insurer, and* [the Finance Director] *is meeting the general counsel of* [IRECO] *this week.*
>
> *The advice of* [the Society's solicitors] *to date is that the side letter is not necessary to interpret the Treaty; that the Treaty allows for arbitration, and that although a court might not take account of the side letter, an arbitrator might. Arbitration would be under the jurisdiction of the country of the counterparty, namely Irish jurisdiction.*

On Equitable's financial position:

> [Equitable's Appointed Actuary] *said that the Equitable continued to meet its required margin of solvency. The assumptions which he made in reaching this view were that the Equitable would be granted a Section 68 order to take credit for the changes to the valuation rate of interest being brought in* [when FSMA 2000 comes into force]*; that the resilience test would not impose any additional liability; that the provision for non-GAR mis-selling was £220 million; that only £100 million credit could be taken for the Reinsurance Treaty; that the GAR takeup rate was assumed to be 85% rather than 90% as at present; and no provision had been made for those leaving the funds. On this basis, there would be an excess of about £400 million over the* [required minimum margin].
>
> *A discussion followed on the basis for calculating the liability for mis-selling. The FSA argued that the liability must be higher than £220 million, since this was the figure assumed under the scheme, where a discount was allowed for the fact that non-GAR policyholders would be paying for about 75% of their own compensation. However, a reserve needed to be sufficient to cover the possibility that the scheme did not go through, and in that circumstance the FSA believed that it would not be appropriate to allow a discount for policyholders having to meet most of their own compensation.*

In response to this, the argument was put forward that even if the scheme did not go ahead, and policyholders went to the Ombudsman, the Ombudsman would have to consider the effect of any compensation award paid to an individual policyholder, on all other policyholders, and that since there was likely to be a very large number of claims, this would result in compensation awards being adjusted to take account of the total size of the mutual fund: so that the effect would be the same as the discount under the scheme.

The FSA were not entirely convinced by this argument, and Equitable Life agreed to write to the FSA addressing this point in a more considered way.

Equitable's auditor '*wished to draw the FSA's attention to the importance of the topics under discussion, for the purposes of the notification requirements placed on the auditor*'.

28/09/2001 [17:51] FSA's Head of Actuarial Support writes to Chief Counsel A after the meeting, saying:

> *The* [Appointed Actuary's company's] *letter of engagement understandably includes the usual set of disclaimers and caveats. However, it does place certain requirements on the directors, including*
>
> > *"The Directors will provide to us appropriate confirmation that all the information, explanations and documentation provided to us are true, accurate, complete and not misleading and that we are entitled to rely on them".*
>
> *In the slides for the presentation to FSA,* [the Appointed Actuary's company] *included the sentence*
>
> > *"Renegotiation or withdrawal of the GAR reinsurance treaty could have a significant impact on solvency. We note that in most circumstances, change is subject to* [Equitable's] *agreement, but this is a dependency (a successful Compromise Scheme vote would eliminate the risk)"*
>
> *Nevertheless, the balance sheet that they included in their presentation allowed for a value of £674 Million to be ascribed to this reinsurance agreement.*
>
> *No mention was made of the existence of this side-letter by either* [the Appointed Actuary's company] *or Equitable at the presentation itself.*

[**20:00**] Chief Counsel A replies that FSA would need to bring this to the attention of '*the investigator*' in due course.

Behind this note on the regulators' files is a briefing note by a legal firm on company law reform and a review carried out by the Company Law Review Steering Group. The following paragraph has been highlighted:

> *The Final Report also recommends an extension to the duties of directors and employees to assist auditors in the execution of their statutory duties. It is already a criminal act for a director or officer of a company knowingly or recklessly to provide misleading, false or deceptive information.*

28/09/2001 [entry 5] An HMT official provides the Economic Secretary to the Treasury with a note on the Corley Report which had been published that day.

October 2001

01/10/2001 [10:14]	FSA's Director of Insurance writes to the Head of Life Insurance to record '*a number of conversations*' which had taken place about the difficulties Equitable were experiencing in obtaining adequate directors and officers cover.
01/10/2001 [10:16]	Equitable send FSA an update on the Creditors' Pack drafting and review process.
01/10/2001 [10:53]	Chief Counsel A responds to the Head of Actuarial Support's query of 28/09/2001 [**15:28**], saying: '*I think we were unclear until Friday whether the stated date of 14 Sept (on the fax to us with the side letter) was correct and just when* [Equitable's Appointed Actuary] *and others had actually received it. It is relevant yes because arguably there is a material misleading relevant to the consultation. Luckily for them, the Launch is for consultation and is not the formal scheme or the matter would be more serious*'.
01/10/2001 [18:03]	FSA's Chief Counsel A comments on a draft paper for FSA's Board. The Chief Counsel queries whether FSA: '*should ... mention too the debate we are having with Equitable about the misselling provision? It is almost certainly not big enough*'.
01/10/2001 [19:37]	FSA's Director of Insurance writes further on the issue of Equitable's directors' and officers' cover saying that Equitable had informed him that adequate cover had been put in place. The Director of Insurance says: '*The cover excludes liability relating to any solvency problems flowing from the side letter to the reinsurance treaty, but is apparently acceptable to the Society. As we know the Society are confident that the side letter does not undermine their solvency position and that, even if – which they do not believe to be the case – it were to be interpreted as allowing the reinsurer to cancel at £100m of claim, their solvency margin remains intact*'.
01/10/2001 [entry 6]	FSA's Director of GCD asks Chief Counsel A whether he was correct to assume that no legal advice had been sought or given on a particular clause in the reinsurance treaty. Chief Counsel A replies that only preliminary advice had been given, as was summarised in her note of 28/09/2001 recording her discussion with Counsel, which she attached. The Chief Counsel says that: '*We await a copy of Equitable's final advice. Not much hangs on it in the sense that they will have to persuade us that the reinsurance will count for more than £100m*'.
02/10/2001 [entry 1]	FSA arrange to meet Equitable later that week. FSA say that they believed that a meeting was necessary to review Equitable's financial position in the light of: *(1) the responses that your colleagues promised to points raised at last Friday's meeting, namely:–* • *the update on the status of the Reinsurance Treaty; and* • *a more considered analysis of the liability for potential mis-selling (taking account of the liability to those who leave before a scheme is in place, and the fact that in the absence of a scheme it is difficult to see how the same discount can be allowed as under the scheme, where non-GAR policyholders would be paying for about 75% of their own compensation); and* *(2) in the light of your responses to the questions in my letter of 26 September about the impact of stockmarket falls.*

02/10/2001 [entry 2]	FSA seek advice from Counsel on the possibility of compensation by means of return of premium plus interest to non-GAR policyholders.

02/10/2001 [10:00] FSA's Chairman thanks the Director of Insurance for his note of 01/10/2001 [**19:37**] but says that he assumed that FSA were still pursuing with Equitable the solvency implications of the existence of the side letter to the reinsurance treaty.

[**10:13**] The Director of Insurance confirms that this was the case. The Director explains that FSA were awaiting a detailed justification from Equitable of their own assessment. The Director says that he understood that the Society's assessment '*indicates that they continue to meet their* [required minimum margin] *even on "worst case" assumptions about the impact of the side letter*'. The Director of Insurance continues by saying that Equitable's ability to continue to meet their required margin of solvency:

> *... depends, among other things, on the reserve to be set up to cover misselling costs absent a compromise, on which* [the Head of Actuarial Support] *has been working with* [Legal Adviser F]. *On the Society's figures there is some room for increasing the reserve from what they believe appropriate, but it is quite tight.*

The Director of Insurance also raises an issue of separate concern that payouts on maturity might still be greater than asset share. He notes that Equitable '*naturally, are not keen to announce a further reduction in policy values at this point since they judge that this would damage, probably fatally, their chance of gaining agreement to the compromise*'.

[**12:03**] In reply (but not to the Chairman), the Head of Actuarial Support circulates his estimate of mis-selling liabilities, which is dated 1 October 2001. The Head of Actuarial Support says it was:

> *... likely that the Society is still solvent, and it may still just be covering its margin of solvency, but there remains fundamental uncertainty relating to the amount of these mis-selling claims, the proportion of the claim that would be guaranteed, the number of potential leavers (for whom all the claim would have to be paid in cash), and the possibility of sizeable claims arising instead under the heading of recission of contracts.*

On current payouts, the Head of Actuarial Support says:

> *... I would estimate that the claim values paid on contractual events are around 5-7% too high at present. The free reserves in the balance sheet seem to be falling by around £200 million every month, mainly as a result I believe of the payment of final bonuses on claims for which there is no provision on the balance sheet.*

The Head of Actuarial Support's note of an estimate of Equitable's mis-selling provision at 30 September 2001 states that the required provision should be:

Policies written since January 1996	*£180m*
Policies written between 1988 and 1995	*£200m-£400m*
Leavers between June 2000 and 16 July 2001	*£20m-£60m*
Leavers since 16 July 2001	*£40m plus a further £50m-£100m*
Claims for recission of contract	*£100m*

The Head of Actuarial Support's note concludes:

> *The overall accounting provision for the above headings, after taking account of the probability of success could then be around £300-550 million, with a best estimate likely to be in the range of £400-£500 million. For the FSA returns, we would expect to see a greater margin for prudence, and probably a contingent liability for potential recission claims, which might indicate a provision of between £600 and £700 million.*

02/10/2001 [10:38]	FSA write to Equitable following their meeting on 28/09/2001, at which Equitable had said that they were assuming credit for a concession under section 68 of ICA 1982 in relation to the valuation regulations. FSA say that they had not yet received any application for such a concession and that Equitable should submit one as soon as possible, should they need the concession.
02/10/2001 [12:18]	FSA's Director of Insurance sends Managing Director B and the Head of Life Insurance the notes of a speech by a trade union official about Equitable, made at the Labour Party Conference, saying that it was: '*Relevant to the* [Treasury Select Committee] *briefing*'.
02/10/2001 [14:51]	Equitable send FSA the latest draft versions of the Combined Scheme Document, Indicative Statement of Value and Proxy Forms, ahead of a Creditors' Pack drafting meeting on 5 October 2001. [**16:19**] The Head of Life Insurance circulates the documents and asks for comments by 4 October 2001. [**18:46**] FSA's Insolvency Practitioner says that there were three key pieces of information which had been missing from the Combined Scheme Document, those being: aggregate policy values; background to the policy value reductions; and value of GAR rights being given up. He also says that it was to be welcomed that: '*The Article 4 issues are explicitly addressed and it is made clear that there is no certainty that the* [Policyholders Protection Board] *would respond if the Society were wound up*'. [**19:28**] An official from FSA's Consumer Relations Department endorses the points made by the Insolvency Practitioner. [**20:11**] The Director of Insurance says that he was not sure that the information on Article 4, and there being no certainty of compensation from the Policyholder Protection Board, was to be welcomed. The Director says that he would be concerned if the uncertainty were to be overstated.
03/10/2001 [09:09]	Further to 02/10/2001 [**20:11**], FSA's Head of Life Insurance explains that the Article 4 point had been included to meet FSA's earlier comment that the implications of the alternatives should be clearly spelt out, although: '*I'm not sure that Article 4 was what we had in mind!*'. [**13:15**] A Press Office official says that she had mixed feelings about the Article 4 information: *On the one hand, some openness about the possible non-applicability of the* [Policyholder Protection Board] *is, in principle, to be welcomed.* *On the other hand, it will make us,* [Policyholder Protection Board], [the Financial Services Compensation Scheme] *et al appear disingenuous for not previously drawing attention to it.* *Our defence has to be that HMT intends to correct this. Provided this is true, then it might be best not to flag it. – Not least because, in the current environment, it might just cause panic in the meantime re other insurers if people fear that they would also not be covered by* [Policyholder Protection Board]/[the Financial Services Compensation Scheme] *if other insurers should collapse if the equity market were to shoot down further.* *So there might be a market confidence argument for not drawing attention to it.* *But if* [Policyholder Protection Board]/[the Financial Services Compensation Scheme] *could say something helpful about how most companies <u>would</u> be covered by their schemes (even* [though] *they don't customarily comment at all on general cases, but treat applications for compensation on a case-by-case basis), that might help square the circle.*

> *It would mean that Equitable could disclose the Art 4 issue; we could say that we were aware but that HMT intended to resolve the issue; HMT would endorse this; and if anyone asked about the general applicability of* [the Financial Services Compensation Scheme] *etc, they would reassure people re their general coverage of* <u>*other*</u> *insurers in the meantime.*
>
> *If we could arrange this, I think I would tend to favour disclosure in the interests of transparency. If any of those pieces of the jigsaw don't fall into place, I would be inclined, on market confidence grounds, to discourage Equitable from disclosing the issue until HMT does something about it.*

	[**14:24**] The Head of Actuarial Support provides various comments on the Creditors Pack documentation, including that: '*there are numerous inconsistencies in the drafts about the value to be attributed to the Halifax payment for GAR's and non-GAR's. I still do not understand why proportionately more of this (as a percentage) is being given to the GAR's than to the non-GAR's!*'. [**19:46**] Chief Counsel A replies to the Press Office official, saying that: '[Article] *4 is difficult. In terms of principle it is hard to argue against letting the* [Equitable] *say something about it. But the public reaction to just about anything they say will be astronomically out of proportion. Unfortunately I do not think we can say that HMT intends to correct the problem ... I recall HMT think the issue would need to be resolved by the Courts and have said they would not do anything in advance of that. I do not think however there is a market confidence issue (if things are handled properly) because it seems almost certain that the* [Equitable] *is the only one affected by the* [Article] *4 problem*'. [**21:40**] The Director of Insurance reports that he had spoken to the Chairman of the Policyholder Protection Board who had told him that the Board would not wish to argue that Article 4 was an impediment to compensation, but that they would probably want to invoke the excessive benefit provision of the Act.
03/10/2001 [15:14]	FSA's Chief Counsel B sends the Head of Life Insurance, Line Manager E and an official from their Consumer Relations Department some documents about waivers from PIA rules for Equitable complaints.
03/10/2001 [15:32]	Equitable's Finance Director replies to FSA's note of 02/10/2001 [**10:38**]: '*I have not spoken to* [the Appointed Actuary] *since your email, but the comment was in the context of what would our position be if the reinsurance treaty is not available. Our lawyers still assert that we can probably rely on the treaty. We are seeking clarification urgently and will apply for a s 68 concession if necessary*'. [**19:18**] The Head of Life Insurance forwards the response to the Director of Insurance (copied to others) with the comment: '*So there!*'.
04/10/2001 [10:25]	Further to Equitable's reply of 03/10/2001 [**15:32**], the Head of Actuarial Support comments that: *In view of the letter apparently received from IRECO saying that they would intend the treaty to be cancelled if the claim ever exceeded £100 million, I think it would be very difficult for Equitable to take credit for more than this amount in a "prudent" statutory valuation, where the actuary has to take account of both the credit and legal risk under this reinsurance agreement.* [**10:29**] Chief Counsel A agrees with the Head of Actuarial Support, subject to seeing the advice from Equitable's solicitors.

04/10/2001 [17:08] FSA send Equitable's advisers their high level comments from a preliminary scrutiny of the latest drafts of the compromise scheme documents. FSA say that there were three important pieces of information which policyholders should have but which did not appear to have been included, those being:

> 1. *Aggregate Policy Values*
>
> *The launch document stated that "since the policy value reductions in July 2001 ... aggregate policy values and the value of the investments underlying policies are now broadly in line. Information in respect of this and other financial matters will be available in the interim financial statements for the six months to 30th June 2001". Will this include aggregate policy value information? The financial position of the society, and material movements since 30th June, will need to be adequately disclosed. In assessing the value of their uplifts to policy values, policyholders need to know what the Society's position is on further possible cuts to policy values.*
>
> 2. *Background to the 16th July Policy Value Reductions*
>
> *The launch document said that the Society intends to issue a booklet containing the background to the policy value reductions when revised policy value statements are sent out in October. Will this be sent out separately from the Creditor Pack? We should like to see a draft of this booklet please.*
>
> 3. *Value of GAR rights being given up*
>
> *We think that policyholders need to understand the difference between GAR rates and CAR rates, in order to be able to assess the value to them to the proposed policy value uplift. (In doing this, they will of course need to take into account the value to them of greater stability, greater flexibility in the terms of annuities available, etc – but they need to be able to start from the value of the GAR rights being given up).*

FSA also say that they were looking forward to seeing the draft of the Appointed Actuary's report and the financial information described in the documents. FSA say that they were still thinking about the material on Article 4.

05/10/2001 [11:08] An FSA official writes to the Head of Actuarial Support, the Director of Insurance, the Head of Life Insurance and Line Manager E about a proposal from Equitable to write new business (see 19/09/2001 [**entry 1**]) where a policy had been split due to divorce. [**11:30**] The Head of Actuarial Support, [**12:08**] Line Manager E and [**13:16**] the Head of Life Insurance agree that the proposal seems reasonable.

On 07/10/2001 [**16:28**], Chief Counsel A says that she does not intend to provide advice on this issue unless she had to, adding: '*I doubt it is necessary, assuming you are content as a matter of policy that Equitable be "permitted" to do what it suggests ...*'.

05/10/2001 [14:06] PIA say that they agree with Chief Counsel B's analysis of 03/10/2001 [**15:14**].

05/10/2001 [15:19] Equitable write to FSA saying that they would need FSA to provide a formal statement on the compromise scheme to the convening hearing planned for 1 and 2 November 2001. Equitable ask FSA to confirm that the provision of such a statement appeared feasible.

[**19:50**] The Head of Life Insurance says to Chief Counsel A that he presumed that this was not a requirement of the scheme but believed that FSA would in principle be willing to express a view to the court at that stage.

05/10/2001 [18:08] FSA's Line Manager E sends the Head of Life Insurance, the Director of Insurance and the Head of Actuarial Support a list of points to raise with Equitable at the meeting on 08/10/2001, including:

- to ask for a reply to FSA's letter of 21/08/2001 about Equitable's 2000 returns and also on their request for a future profits implicit item;
- the 'synthetic bond' as FSA '*had to return to the question of whether going forward we would look for consistency with 2000 or the rest of the industry*';
- in relation to the FSA's Consultation Paper 84 and the proposals in the Interim Prudential Sourcebook to update requirements on the methods and assumptions to be used in actuarial valuation of long term insurance business, FSA should be '*mindful that it could impact on the value of the implicit item for future profits, we should ask whether they intend to ask for a section 68 order for this or not*'; and
- in relation to 'Policy statements', Line Manager E says that he: '*spoke briefly to* [an Equitable actuary] *who said that they were still expecting to be able to issue policy value statements "this month". Back in June/July they said that the systems would be interrupted for 6 weeks, though 10 have already passed and we are now getting a lot of complaints. The media have also picked up on this. We need to urge them to get on with this, and also find out what the position is with online and telephone valuation requests – ie are they now available, and if not when will they be back on stream*'.

05/10/2001 [19:01] Equitable provide FSA with an update on Equitable's solvency position on three different bases, in response to their letter of 27/09/2001. The information is provided at the request of Equitable's Appointed Actuary. The information is based on the estimated position at the end of 24 September 2001. Equitable explain:

The three bases of presentation are:

1. Our normal presentation assuming a full resilience test based on "test 2" of the GAD letter dated 14 May 2000 and taking no account of any measures that that might improve the free assets in the short term. This takes into account the full effect of the reinsurance treaty for GAR liabilities.

2. A presentation which assumes no resilience falls in the value of equities or property and also makes some estimate for the improvement for the N2 yields on equities. Again the full effect of the reinsurance treaty for GAR liabilities is taken. Please note that in such a circumstance the future profits implicit item would reduce to close to zero.

3. The same as 2. above but showing the effect were the reinsurance to only be valid up to £100m.

	1	*2*	*3*
	£m	*£m*	*£m*
Value of non-linked assets	*24,850*	*24,850*	*24,850*
Future profits implicit item	*635*	*0*	*0*
	25,485	*24,850*	*24,850*
Mathematical reserves (including resilience)	*24,330*	*23,505*	*23,890*
	1,150	*1,345*	*960*
Required Minimum Margin	*1,000*	*945*	*960*
Excess Assets	*150*	*400*	*0*

Equitable state that the figures include a provision for mis-selling of non-GAR policies of £220m. Equitable explain their rationale for this level of provision is as follows:

> *The Society has received legal advice from* [Counsel] *that non-GAR policyholders may have claims against the Society because they were not warned of the extra potential costs of GARs when they bought their policies. The total amount of all potential claims has been estimated on an aggregate basis to be £850m (following the bonus changes at 16 July 2001).*
>
> *However, not all these claims are likely to be successful. The range of probability of success of those potential claims, when taken as a whole, has been estimated by the Society's legal advisers to vary widely from perhaps 20% to 70%.*
>
> *Around 75% by value of the Society's with-profits funds is owned by non-GAR policyholders. Successful claims would mainly have to be met out of the with-profits fund. Consequently around 75% of non-GAR policyholders' claims could end up being paid for by non-GAR policyholders themselves. There are differing legal views on whether, if claims were able to be framed in a certain way, this would still be the case. The extent of the claims that would in effect be paid for by non-GAR policyholders themselves would be up to 75% depending on which legal opinions were followed.*
>
> *The provision for potential claims has been determined assuming that in the absence of a successful compromise scheme under s425 of the Companies Act (as proposed by the Society) that the claims will be resolved through a review instigated by the Pensions Ombudsman or the FSA under PIA rules. It is assumed that such a review would have a defined basis of assessing the damages for any individual case which would take into account all relevant factors including the extent to which non-GAR policyholders would pay for the claims themselves.*
>
> *The total estimated value of potential claims on an aggregate basis of £850 million has been discounted to reflect the probability of success (between 20% and 70%) and because non-GAR policyholders would bear part of the cost of the claims themselves (between 0% and 75% but estimate to be between 25% and 65%). The Board has taken the view that the likely value for potential claims lies in the range of £100 million to £300 million. A provision for the cost of potential claims from non-GARs has been set at £220m.*

07/10/2001 [15:16] FSA's Chief Counsel A suggests to the Head of Life Insurance that FSA needed to be cautious in responding to Equitable's request for a statement to be provided to the compromise scheme convening hearing. The Chief Counsel suggests that, until FSA better understood what Equitable hoped to achieve at that hearing, what they were expecting from FSA, and had some idea of the consultation responses, FSA should be as non-committal as they reasonably could be. Chief Counsel A asks if FSA knew what the Independent Actuary would be saying at the hearing.

08/10/2001 [09:08] FSA's Director of Insurance says that he agreed with Chief Counsel A's comments of the previous day, saying that he imagined:

> *... the Equitable may want us to express support for the "two classes only" approach, with which we may have some difficulty. I doubt whether at this stage we can commit to much more than the view that the promotion of "a" compromise scheme is an appropriate way forward. I guess the court may also be interested in establishing a view on solvency where I guess we are still in the "fundamental uncertainty" position.*

[**18:51**] The Head of Life Insurance later responds that, on reflection, he had got '*cold feet*' over the weekend and that FSA covered this issue on very non-committal lines at their meeting with Equitable that morning (see below).

08/10/2001 [morning]	FSA meet Equitable for a weekly review meeting. According to FSA's note of the meeting, discussion largely focused on Equitable's letter of 05/10/2001 and the issues arising from it. Equitable give an update on the position with regard to the reinsurance treaty: IRECO had indicated that they would provide a revised agreement by 11 October 2001; and Equitable had made it clear that the issues needed to be resolved by 18 October 2001, in time for the compromise scheme. Equitable agree to provide FSA with a copy of their legal advice on the effect of the side letter. FSA note that, under scenario 3 of the solvency information supplied by Equitable, there were no free assets over the required minimum margin and that no resilience reserve had been provided for, having assumed that a section 68 Order for a '*CP84 concession*' had been granted (although an application had not yet been made). FSA ask for justification for the provision of £220m for mis-selling and for further information on the quantification, provisioning and extent to which such claims could be recovered from policyholders. On the financial condition of the Society, Equitable say that they were working with their auditors on a half-yearly financial statement for use with the compromise scheme. Equitable take FSA through the solvency presentations set out in their letter of 05/10/2001. FSA say that, if Equitable wanted a section 68 Order, they should submit an application as a matter of urgency. Equitable say that policy values were not significantly out of line, reporting to FSA that: '*At the stock market lows, aggregate values stood at about 105% of the value of the with-profits fund, but they were now back to around 102% following the modest improvements*'. Equitable's Appointed Actuary '*said he was clear of the need to act if policy values became excessive once again, though he was alive to the sensitivity of this and also the need not to give any public indication of the kinds of level at which he thought action would be needed as this would enable policyholders to select against the fund*'. On Article 4 of Equitable's Articles of Association, FSA invite the Society to provide a copy of the advice received from Counsel so that the arguments could be properly tested. FSA also suggest that Equitable should discuss with the Policyholder Protection Board and/or the Financial Services Compensation Scheme '*as their approach to compensation could be very relevant*'. Equitable inform FSA that the court convening hearing for the compromise scheme had been set for 1 and 2 November 2001. They undertake to provide further details on a query about the weighting arrangements for the policyholder classes which had been raised by solicitors acting on behalf of non-GAR policyholders.
08/10/2001 [entry 3]	FSA's Head of Life Insurance writes to Managing Director B, following the meeting with Equitable that morning, about the public line that FSA should be taking as the '*ability of Equitable Life to meet its required minimum margin of solvency is now seriously in doubt*'. The Head of Life Insurance sets out their latest understanding of Equitable's financial position, following their letter of 05/10/2001 and the meeting earlier that day. He says that FSA proposed to seek Counsel's opinion on what a reasonable range for mis-selling provision would be. The Head of Life Insurance says that: *In these circumstances, we need to consider carefully what the FSA's public position should be. At present in answer to the question "is the Equitable solvent?" press office have been giving the answer (and the same answer is contained on the FSA website):–*

> *"We have been monitoring Equitable Life's financial position closely, and on the basis of the information available to us, we are satisfied that it continues to meet its regulatory solvency margin requirements. Nevertheless, Equitable Life made clear in its annual accounts and in its regulatory return (a report that* [they] *must make to us), that it continues to face some fundamental uncertainties – for example, in relation to the cost of its liabilities to the Guaranteed Annuity Rate (GAR) policyholders. The proposed compromise scheme is designed to address those uncertainties."*

The Equitable's solvency is not in question. But there is now a serious question over whether it continues to meet its required minimum margin of solvency.

FSA's Head of Life Insurance says that there was a case for leaving the line unchanged until the position on the reinsurance treaty and quantification of mis-selling liabilities had been clarified. He notes that any change was '*bound to attract attention, and could undermine confidence in the Society at a delicate stage in its attempt to secure a compromise scheme which we believe will be in the best interests of all policyholders*'; however: '*It is not clear that the required minimum margin has been* [breached]'. The Head of Life Insurance continues: '*On the other hand, there is sufficient doubt about the position to make the present line difficult to sustain. What is new is that we now have (confidential) information which throws doubt on the credit for £700 million claimed under the Reinsurance Treaty. We are not yet in a position to reach a view on this*'.

The Head of Life Insurance suggests that FSA should think seriously about removing the relevant page from their website as an interim measure until the position had been clarified (noting that '*This can be explained as being for updating*'). He also suggests reviewing the line taken in response to press queries.

08/10/2001 [17:19] Line Manager E asks the Head of Life Insurance, the Head of Actuarial Support and Chief Counsel A for comments on a draft letter to be sent to Equitable requiring them to submit a plan for the restoration of a sound financial position. The Line Manager says:

Since our discussion earlier, I am becoming more dubious about whether or not we have the powers to require the production of a plan. I also think that by asking for a plan, we will as [Chief Counsel A] *pointed out cause some irritation that might be counterproductive, and lead to the resending of the draft s.425 scheme documents.*

So instead I have tried an approach that says that there may well have been a breach; that we are aware that the plan is under development, but we need to keep [an] *eye on the position until the plan is adopted, or in case it is not adopted at all. And that approach is to confirm the information that we have requested and they agreed to provide.*

[**22:07**] Chief Counsel A comments:

Just to be clear, I think we do have the power now to require a plan. ELAS are almost certainly underprovisioning for both misselling and resilience.

The following day [**at 09:55**], FSA's Head of Actuarial Support adds:

I would concur with this view based on the information as set out in the letter of 5 October from [Equitable] *with which* [Equitable's Appointed Actuary] *appeared to concur at his meeting with us yesterday (though in relation to scenario 1, there was a resilience provision but no allowance for the legal risk on the reinsurance agreement).*

	[**12:38**] Line Manager E says that the: '*position on 24 September seems clearer than the position today, given that my back of the envelope calculation suggest that the value of their equities is currently £1 billion higher. Is it right though that the test is whether there has (at any time) been a breach of the* [required minimum margin] *rather than whether the breach is continuing?*'. [**12:56**] Chief Counsel A suggests that: '*the power applies to past or current failures, but discretion must then be exercised by FSA as to whether a plan ought to be requested. It would eg arguably be disproportionate if there had been only a "technical" breach which was quickly rectified*'.
08/10/2001 [19:18]	Equitable send FSA copies of the latest progress report on the production of Equitable's Creditors' Pack. Line Manager E circulates the report the following day [at **09:42**].
08/10/2001 [15:38]	An FSA official circulates documentation in relation to the compromise scheme. Over the following two days, FSA officials discuss some of the terminology used in the documentation (including the term 'policy value') which they regard as potentially ambiguous.

FSA's exercise of powers pursuant to ICA 1982

09/10/2001 [entry 1] **FSA exercise the power, delegated to them under the Contracting Out (Functions in Relation to Insurance) Order 1998, to require Equitable pursuant to section 32(4) of ICA 1982 to produce a plan for the restoration of a sound financial position, as FSA were not satisfied that the Society had maintained the prescribed margin of solvency**. FSA say:

> [Your] *letter makes clear that the Society faces considerable uncertainty as to its ability to cover its required margin of solvency. Indeed, it appears that on 24 September 2001, which is the date used for the presentation of the figures quoted in the letter, on the basis of the scenario in which credit for reinsurance would be restricted to £100 million and mis-selling liabilities of £220 million are assumed, the Society would only just be able to cover its solvency margin, but with no free assets. However, in this scenario, credit is assumed for a concession under section 68 of the Insurance Companies Act 1982 ("the 1982 Act") for a modification of regulation 69(5), for which an application has been made only today. At the same time no provision is made for a resilience reserve. On the basis of that scenario, and in the light of our present dialogue on reserving for mis-selling, the FSA believes that the Society must have been in breach of its solvency margin requirement on that day. While markets have improved slightly in the last week, the FSA can have no confidence that this unsatisfactory position does not continue.*
>
> *Section 32(4) of the 1982 Act gives the FSA power to require the production of a plan for the restoration of a sound financial position in the event that a company has failed to maintain the prescribed margin of solvency. In present circumstances the FSA must now formally ask for the submission of such a plan within 2 weeks of the date of this letter.*

FSA recognise that Equitable intended to resolve some of the uncertainties they faced through the compromise scheme but state that Equitable must recognise their obligations to fulfil their regulatory requirements, whether or not the scheme were accepted. FSA say that the plan submitted should address the uncertainties concerning the reinsurance treaty. FSA say that they would process Equitable's application for a section 68 Order as a matter of urgency and ask the Society to stand ready to respond quickly to any requests FSA might have for clarification, or further explanations in relation to the application.

FSA say that they remain to be persuaded that £220m was adequate provision for mis-selling liabilities but note that Equitable had agreed to provide further information on this. FSA point out that they would attach importance to full disclosure by Equitable to their members of any unresolved issues, particularly those which might bear on the Society's financial position, in any communication to policyholders about the scheme.

FSA's Head of Life Insurance seeks comment on the draft, as amended by the Director of Insurance and Managing Director B, from Chief Counsel A, Line Manager E and the Head of Actuarial Support prior to issue.

09/10/2001 [11:25] Equitable send FSA the weekly financial reporting information on claims processed. [**19:21**] FSA's Head of Life Insurance circulates the information.

09/10/2001 [12:58] Equitable inform FSA that the convening hearing for the compromise scheme had been set for 1 and 2 November 2001.

09/10/2001 [entry 4] Equitable submit an application for a section 68 Order to allow the maximum yield on equity shares and collective investment schemes to be calculated in accordance with Regulation 69 as described in Consultation Paper 84 issued by FSA (see discussion about this at the meeting on 08/10/2001).

[**16:37**] FSA's new line supervisor with regulatory responsibility for Equitable (Line Supervisor D) circulates the application to officials.

[**16:42**] The Head of Actuarial Support says that FSA would not be able to proceed further with the application until Equitable provided further information on the level of future profits that they reasonably expected after taking account of the new concession.

09/10/2001 [17:24] FSA's Head of Life Insurance provides Managing Director B and FSA's Chairman with a note about the compromise scheme and the timetable for decisions that FSA would need to take. The Head of Life Insurance says that FSA needed to decide their position on:

1) '*What we say to Equitable about their scheme documentation*'.
2) '*Publication of FSA Views on the Scheme*'.
3) '*Contingency Planning*'.

10/10/2001 [12:37] FSA's Public Affairs and Accountability Department requests further information in preparation for the FSA's appearance before the Treasury Select Committee on 16 October.

10/10/2001 [15:45] FSA's Chief Counsel B circulates a note following discussion with Counsel, who had provided an informal and preliminary response to the instruction of 02/10/2001.

10/10/2001 [16:31] FSA comment on Equitable's application for a section 68 Order of 09/10/2001, including:

> [Equitable's Appointed Actuary] *states that "A provisional estimate of the effect of the change to the equity yield calculation is an improvement in the Society's free assets of broadly £200m." We are not sure quite how this relates to the figures in* [Equitable's] *letter of 05 October. We suggest that you ask the Society to confirm whether he is in fact referring to the figures on Basis 2 of* [Equitable's] *letter, and if so, whether no resilience reserve is included, and what assumption is being made about the implicit item for future profits (*[Equitable] *say this item would reduce to close to zero).*

10/10/2001 [16:52] Scrutinising Actuary F asks Line Manager E whether he had asked Equitable, during the meeting held on 08/10/2001, about the outstanding reply to his letter of 21/08/2001. The Scrutinising Actuary also says that the questions he had asked about the future profits implicit item were now out of date, as Equitable had applied for a concession under Consultation Paper 84 but '*in any event we need to be content that whatever implicit item they are applying for as at 31.12.01 is supported prospectively*'.

[**17:19**] Line Manager E confirms that he had asked about the reply and had made the point about the implicit item.

10/10/2001 [entry 5] Equitable reply to FSA's letter of 21/08/2001 on their 2000 returns. The responses follow the numbering in that entry.

In response to question 1, Equitable say that they have attached a table of smoothed asset shares. (Note: this was not attached and was sent later – see 12/10/2001.)

a) Equitable argue that:

> *It has always been made clear to policyholders that no particular surrender basis is guaranteed and that financial adjustments will be applied to protect the interests of continuing policyholders. This does not give rise to "unlimited discretion" but has been the driver behind surrender bases and* [statements] *to policyholders.*

Equitable go on to explain:

The practical implementation of that driving principle has been to consider that the accumulated policy values (smoothed asset shares) may be reduced on early surrender for three main reasons to protect ongoing policyholders:

1. There may be a reduction due to the current level of markets. As the policy value reflects smoothed returns it may be above the level justified by the earnings on the underlying assets.

2. There may be an adjustment to reflect initial expense which may not be recouped due to the policy's early surrender.

3. There may be a further adjustment to protect the future solvency and investment freedom of the fund.

Equitable say that this had been explained to GAD in their letter of 29/11/2000 and note of 19/12/2000. Equitable then set out in detail the three types of adjustment used.

b) Equitable explain why they considered the reduced reserves in the resilience scenario to be consistent with policyholders' reasonable expectations of surrender values.

c) Equitable state:

I have covered fully how the financial adjustment in resilience conditions is made up of the three types of reduction ... above. In summary, type 1 is dependent on the market levels implied by the test, type 2 recoups lost future loadings and would be related to the ½% p.a. fund charge and type 3 is based on the discounted guaranteed amounts.

The 7½% financial adjustment current when you wrote in August was made up of 5% for type 1 and 2 and 2½% for type 3. This was not set in mass discontinuance conditions. The current 10% financial adjustment is set at 7½% for type 1 and 2 and 2½% for type 3. As markets move the level for type 1 and type 3 will balance out unless the financial adjuster is reset (as it was on 12 September 2001).

In response to questions 2 a) and b), Equitable say that, as from the June 2001 figures, they had included an explicit reserve for exceptional expenses and had brought the different approaches used for expense reserving into line.

On question 5, Equitable say that they were currently working through the issues and would respond fully when the work was complete.

10/10/2001 [entry 6] FSA confirm to Equitable that they have no objection to the writing of new business where a pension had been split in the event of divorce (see 19/09/2001 [**entry 1**] and 05/10/2001 [**11:08**]).

An FSA official seeks comments from Line Manager E on the draft before it is issued.

10/10/2001 [entry 7] FSA meet with representatives of several action groups. The discussion covers: FSA review and past regulation; transfers; financial condition and administration; with-profits annuitants; and compromise.

11/10/2001 [entry 1] FSA ask Equitable to confirm an aspect of the calculation used for their application for a section 68 Order on the calculation of the valuation interest rate (see 09/10/2001 [**entry 4**]).

11/10/2001 [14:30] The Head of Life Insurance provides FSA's Chairman with a chronology of events relating to the disclosure by Equitable of the existence of the side letter to the reinsurance treaty. The Head of Life Insurance says that it had been mainly the work of the Head of Actuarial Support.

This chronology records that Equitable's letter, dated 14/09/2001, informing FSA of the side letter, had been marked '*private and confidential*' and that it had been opened by the Head of Actuarial Support on his return to the office on 20 September 2001.

11/10/2001 [16:25] Equitable's public relations advisers send FSA a copy of '*A Plain English Guide to With-Profits*'.

[16:54] Line Manager E forwards it to other officials at FSA.

On this, Chief Counsel A has written:

> *Not very good.*
>
> - *how will* [terminal] *bonus be applied? Is there a lower bonus where GIRs apply?*
> - *doesn't answer all questions* [policyholders] *have raised*

11/10/2001 [entry 4] FSA's scrutiny file includes pages from Equitable's website on the timing and changes to policy values. It also includes other pages on financial adjustments for early surrenders and reduction in final bonus.

12/10/2001 [14:12] Equitable send FSA the missing appendix to their letter of 10/10/2001 on comparison of reserves to smoothed asset shares for accumulating with-profits policies as at 31 December 2000. The information in the appendix was as follows:

	Mathematical reserves, normal conditions	*Smoothed asset share*	*Mathematical reserves in changed conditions*
	£m	*£m*	*£m*
UK Life and General Annuity	*2,198*	*2,664*	*2,031*
UK Pensions 0% guarantee	*2,660*	*3,071*	*2,415*
UK Pensions 3.5% guarantee non-GAR	*8,271*	*9,920*	*7,420*
UK Pensions 3.5% with GAR option (including GAR reserve)	*6,611*	*8,356*	*6,059*
Overseas	*567*	*649*	*531*
Total	*20,307*	*24,660*	*18,456*

12/10/2001 [16:42] FSA's Line Manager E circulates a note, following a meeting with Equitable about the compromise scheme documentation, of the urgent points arising in relation to: classes; voting rights; reference to FSA role; and application of PIA rules. He seeks the views of Chief Counsel A, Chief Counsel B and the Director of Insurance on the points to be resolved.

12/10/2001 [entry 3] FSA issue an information sheet entitled '*Questions and answers about Equitable Life*'.

15/10/2001 [10:53] FSA's Chief Counsel A provides advice to the Chairman's office, in response to a request from a pension scheme trustee that FSA should intervene to secure a change to the voting procedure for the compromise scheme. The trustee argues that non-profit annuitants should be allowed a vote in the scheme and says that he believes that, if permitted to do so, such policyholders would vote for the compromise proposals. The Chief Counsel advises that this class of policyholders could not vote in the compromise scheme as they were not being asked to compromise any of their rights. However, Chief Counsel A goes on to note that this '*doesn't mean of course that more couldn't be said by FSA or Equitable (or the annuitants)*

	about the positive impact on these policyholders of a fair scheme being approved, and I think it is something we too might reasonably take into account at the margins in considering fairness'.
15/10/2001 [11:47]	FSA's Director of GCD asks Chief Counsel A whether Counsel's provisional note about the status of the side letter was all the advice that they needed. [**12:44**] Chief Counsel A replies, saying that the note was all they needed for now '*since the important bit of it was to confirm that we should not let ELAS use more than £100m from the reinsurance until the legal uncertainty is resolved*'. Chief Counsel A says that she understood that Equitable were not contesting the position that FSA had taken and that Equitable were negotiating with IRECO to '*make the uncertainty go away*'.
15/10/2001 [12:20]	Line Manager E distributes the latest versions of the compromise scheme documents.
15/10/2001 [14:20]	Line Manager E informs FSA's Director of Insurance, Chief Counsel A, the Head of Actuarial Support and Chief Counsel B that the Guernsey Financial Services Commission had told him that some international policyholders had instructed solicitors to challenge the classes for the compromise scheme. [**22:02**] Chief Counsel A sends Line Manager E's note on to Counsel and asks for his thoughts.
15/10/2001 [17:51]	Line Manager E provides FSA's Chairman with advice, ahead of a Treasury Select Committee hearing, on two letters from policyholders that had been sent to FSA by a Member of Parliament.
16/10/2001 [10:21]	Line Manager E circulates the notes of the meeting with Equitable on 08/10/2001. [**14:46**] In response to this, FSA's Insolvency Practitioner comments: '[Equitable's Appointed Actuary] *also made some comments about the future operation of the fund: that he would not expect to pay further terminal bonuses until the fund had built up somewhat and the guaranteed amounts for non-3½% guaranteed policies had been built up to an equivalent extent. I think this policy should be disclosed before the vote as well, although we did not express a view on this at the meeting*'. [**15:31**] The Head of Actuarial Support says that he did not understand the comment and that he understood '*their intention is not to declare any further guaranteed bonuses for the time being, and in the meantime to add a final bonus to reflect any positive difference between the policy value and the guaranteed fund*'.
16/10/2001 [15:26]	Equitable's solicitors inform FSA that Equitable had decided, subject to it being feasible from an IT perspective, to have three policyholder classes for the compromise scheme: GARs; non-GARs voting on their policy values; and non-GARs voting on their mis-selling claims.
16/10/2001 [16:37]	FSA write to Equitable about their 2000 returns because FSA: '*are still not comfortable with your basis of reserving for the accumulating with profits business. Since this is potentially very material, we raise some further questions below*'. FSA recognise that Equitable had explained the three elements of the market value adjustment to them on several occasions but believed that they had only informed policyholders of the 'type 1' adjustment, which reflected market movements. FSA give examples taken from Equitable's communications which supported their view. FSA ask Equitable to: • *... confirm where you have told policyholders explicitly that should the Society's experience deteriorate further, then surrender/transfer values may decline by more than any falls in the market, in order to protect the future solvency of the fund, and that they should therefore adapt their expectations accordingly. In other words, where has the type 3 component of the financial adjuster been explained to policyholders?*

- *... confirm at what point the Society would expect to have to make such a change and base future surrender values on the discounted value of guaranteed benefits. We would have thought that the Society were in a "mass discontinuance" situation already.*
- *... explain how you would reconcile this alternative prospective approach to determining surrender values with the above representations to policyholders.*
- *We presume that if surrender/transfer values were to be determined prospectively, based on the discounted value of guaranteed benefits, instead of retrospectively, based on adjusting policy values, then in some cases the surrender/transfer values may increase, whereas in other cases they may fall. For example, they may rise where the term to retirement is short, but fall for longer terms to retirement. Please could you comment on whether this view is correct, and indicate the effect, both across the portfolio as a whole, and for major blocks of business, of allowing for the present retrospective approach in assessing the PRE surrender values for reserving purposes.*

FSA present the following further questions:

Paragraph 3.8.6 of GN8 says that "when considering reasonable expectations with regard to discontinuance values, the Appointed Actuary must take account of representations made by the company to policyholders ... and also the practice of the company in determining discontinuance values, with particular regard to (a) the relationship between the discontinuance values and the value of the underlying assets, and (b) any circumstances of which the policyholder can reasonably be expected to be aware in which discontinuance values might be reduced due to losses not directly related to the investment return earned by the company on those assets." It seems to us that unless policyholders' expectations already recognise the potential impact of the type 3 adjustment, it is inappropriate to anticipate this in the valuation. As a consequence, the PRE surrender values reserved for in the valuation would be no lower than current surrender values.

- *Please can you explain how your valuation approach is consistent with paragraph 3.8.6 (b) of GN8.*

We are also uncomfortable with what you say in your letter (on page 2) about the Type 2 component of the financial adjuster. You say that this is designed to recoup future charges on business surrendered, in order that remaining policyholders are not left bearing an unfair level of fixed overheads. This appears to be a fairly general statement, of potentially wider application than the more restrictive statement made on page 1 of your letter (and in [Equitable's] *29 November letter), which limits the adjustment to recovering any, as yet unrecovered, new business costs on that business.*

- *Please could you also comment on this.*

We asked in ... our 21 August letter for you to comment on whether there was any implied cross-subsidy in the resilience reserves of different product groups, but you do not appear to have addressed this point. We were referring to the different valuation rates of interest used in the resilience scenario for different blocks of business. For example, we referred to page 257 of the Returns, where the valuation interest rate used in the resilience scenario is 6.26%. You explained that this is effectively 2.7%. However, the valuation interest rate used in the resilience scenario for the business reported on page 256 is 4.25%. On page 258 a rate of 4.80% is used. These varying rates appear to be a consequence of using different mixes of assets to back different lines of business. The question we were asking was essentially as follows, on which we invite your comments.

- *It seems that, on mass discontinuance, the discounted values of guaranteed benefits, which are based on different valuation rates of interest for different blocks of business, as described above, will represent a different proportion of "smoothed asset shares" for these different blocks of business. If our hypothesis is correct, how would you explain to policyholders (even with policies of similar outstanding term) that different financial adjusters were effectively being applied to different groups of contracts on non-contractual terminations in these circumstances?*

> *We asked in ... our previous letter what level of MVA is implied by the reserves in the resilience scenario. You say you have covered this fully, but it seems to us that you have only answered this part of our question in general terms. To get to the heart of what we were asking, we will ask the following:*

- *Please explain the implied level of each of the three components of the financial adjuster in the reserves you are holding, for each major product type, in each of the base and resilience scenarios. Please reconcile this with the breakdowns shown on Forms 52 and Forms 57.*
- *Please also compare the above adjustments with the current level of adjustments and, unless you have already done so, explain why the assumptions used in setting reserves should differ from those currently used.*

	On question 2 of the previous correspondence, FSA acknowledge that Equitable had changed their approach to reserving for expenses '*so that this is not a problem, so we will not pursue this further at this time*'. FSA are content to defer further dialogue about question 5, on the future profits implicit item, '*until the Society's requirements are clearer*'. FSA's Scrutinising Actuary F clears the letter with the Head of Actuarial Support, and discusses it with Line Manager E, before it is sent. [**16:37**] Scrutinising Actuary F circulates his letter within FSA, saying: '*The main issue is the level of reserves* [Equitable] *are setting for their accumulating with profits business ... At this stage we cannot quantify the extent of any under-reserving*'. [**16:53**] The Head of Actuarial Support replies: *I believe we should add "potential" before "under-reserving". They appear to have adopted a different method of reserving, under the resilience scenario, to that which we would expect to see under the new 2000 regulations. However, it is not clear how these reserves would compare to those that might have been calculated if they had followed the approach that we would have expected to see.*
16/10/2001 [19:58]	FSA's Director of Insurance asks the Head of Actuarial Support and another official whether he was right in thinking that it had not yet been possible to reach an agreed position within FSA on the evaluation of Equitable's 'best estimate' approach of valuing GAR policies.
16/10/2001 [entry 5]	Equitable send FSA a copy of their Policyholder Comment Analysis report.
17/10/2001 [10:45]	Further to 16/10/2001 [**16:53**], FSA's Scrutinising Actuary F says that he had intended that '*"potential" was implicit in the phrase "any under-reserving"*' and clarifies his concerns: *Also, I am not only concerned about the resilience scenario. It seems that the Society are limiting surrender values to the discount value of guaranteed benefits in the main valuation as well.*

[**11:16**] The Head of Actuarial Support adds:

At end-2000, the reserves held were broadly equal to the guaranteed fund without any discounting. Therefore, the surrender value test was not relevant in the base scenario at that stage. However, I would agree that in view of the fall in equity markets since then, and the discounting of the guaranteed benefits that is now being applied, we do need to be satisfied that these reserves take account of the underlying current PRE surrender value.

17/10/2001 [15:21] Equitable reply to FSA's letter of 11/10/2001 about their application for a section 68 Order. Equitable detail the changes that they wished to make when applying Regulation 69.

Equitable also provide their solvency position, on two bases, as at 24 September 2001 when the FTSE 100 Index stood at 4614:

	Basis 1	*Basis 2*
	£m	*£m*
Value of non-linked assets	*24,850*	*24,850*
Future profits implicit item	*635*	*635*
	25,485	*25,485*
Mathematical reserves (including resilience)	*24,330*	*24,130*
	1,150	*1,350*
Required Minimum Margin	*1,000*	*1,000*
Excess Assets	*150*	*350*

Equitable explain that:

Basis 1 is consistent with basis 1 detailed in [Equitable's] *letter dated 5 October 2001. This* [includes] *a full resilience test based on "test 2" of the GAD letter dated 14 May 2001 and excludes any measures that might improve the free assets in the short term.*

Basis 2 is a broad estimate of the effect of calculating equity yields in accordance with the changes to regulation 69 detailed above. All other aspects of the position remain the same.

17/10/2001 [16:43] In response to 16/10/2001 [**19:58**], Chief Counsel A says that she was concerned that FSA should have some sort of objective support for their own evaluation of the value of GAR rights and that it would be '*pretty drastic*' to ask Equitable to backtrack unless FSA's evaluation showed that there was some unfairness in the scheme.

18/10/2001 [10:06] FSA's Director of Insurance informs Managing Director B of a conversation he had had with Equitable about the latest position on the side letter. The Director reports that they had discussed the solvency implications if Equitable were unable to do a deal with IRECO. Equitable had said that they were moving further out of equities to protect their solvency position against the possibility that the reinsurance issue would not be resolved or could be resolved only partially.

18/10/2001 [13:01] FSA's Scrutinising Actuary F writes to Line Manager E about Equitable's letter of 17/10/2001, which stated that the effect of the change to the calculation was an increase in free assets of £200m. The Scrutinising Actuary says:

We are puzzled by the figures in his letter which show, on both "Basis 1" & "Basis 2", a future profits implicit item of £635m. In [Equitable's] *letter of 05 October to* [the Head of Life Insurance], *she said that if allowance were made for the improvement in assumed* *equity yields post* [FSMA 2000 coming into force], *the implicit item would reduce to close to zero. We are not satisfied that the implicit item of £635m would still be supported once the concession were granted, and this would need to be pursued with* [Equitable's Appointed Actuary] *before granting the Society any implicit item at 31.12.2001.*

18/10/2001 [18:11] FSA send Equitable a note on the outstanding information about the compromise scheme that they were expecting to receive.

[**18:54**] FSA also send Equitable drafting comments on the compromise scheme documents. The comments include:

- *... do you really want to say that the value of policies is "seriously at risk". This will be taken to mean something much more worrying than I think you intend it to mean. As it is a statement that could well be misleading, this could be taken as being in breach of section 47 of the FS Act 1986 and contrary to PIA rules. If it is not misleading, it means that the Society may have withheld important information about its financial condition!*
- *I am a bit concerned that* [a certain paragraph] *says that the Society will have to establish a provision to cover mis-selling claims if a compromise is not accepted. The reality is that* [as a matter of law] *the provision is needed now, although it would be released if a scheme were adopted. It may seem a technical point, but people may think that the current financial position* [we] *are all assuming takes no account of mis-selling, which is clearly not the case.*

[**19:05**] Line Manager E circulates internally within FSA his correspondence with Equitable.

19/10/2001 [entry 1] FSA's Line Manager E submits a paper to Managing Director B on Equitable's application for a '*CP84 concession*'. The Line Manager explains that the issue was:

Whether to recommend to the Treasury that they should issue to Equitable Life an order under section 68 of the Insurance Companies Act 1982 permitting the firm to accelerate the introduction of Rule 5.11(5) of the Interim Prudential Sourcebook: Insurers. This concession is commonly referred to as a CP84 concession, and has already been given to many other life offices.

The Line Manager recommends that FSA should recommend to HMT that the Order should be granted. On timing, Line Manager E states that it was: '*Urgent. Equitable Life's ability to cover its solvency margin may depend on the concession being in place*'. Line Manager E sets out the background to such concessions and under '*Why concession are sought now*' explains:

The effect of the change described ... above is generally to reduce the liabilities of life funds which hold equities. For companies whose solvency is tight, the relief could be material to their maintaining statutory solvency in a falling equities market. In current market conditions it is desirable to allow companies in this position to take the benefit of the relaxation now, in order to reduce pressure on them to sell equities for technical reasons (ie to maintain statutory solvency on the current valuation basis), as such technical selling would further depress equity values, and thus compound the problem across the industry. This can be done on a case by case basis by means of a section 68 Order.

Line Manager E says that Equitable estimated that the effect of this would be an improvement in their '*free assets*' of about £200m.

19/10/2001 [13:20] Equitable send FSA an explanation of the '*split Non-GAR Class issue*'. The document explains the reasons why Equitable had been advised that a third class of creditor consisting of non-

GAR policyholders having GAR-related claims was required; and why, within the class of GAR policyholders and the new class referred to above, voting values should be weighted according to the strength of the claims.

[**14:14**] Line Manager E circulates the note but says that it did not go far enough for FSA's needs.

22/10/2001 [morning] FSA meet Equitable, their auditors and their solicitors (who are acting for Equitable in relation to the reinsurance treaty) for a weekly review meeting. According to FSA's note of the meeting, the issues discussed included:

Plan for the restoration of a sound financial position
Equitable say that their key response would be that they were seeking to clarify the reinsurance treaty and were pressing ahead with the compromise scheme. They ask if FSA could be flexible on the deadline for submission of a plan as it was unlikely that negotiations on the treaty would be completed by the deadline set. FSA say that they wanted a formal response by the original deadline, but a holding reply would be acceptable.

Reinsurance
Equitable say that, until the issue was resolved, they were working on the assumption that the reinsurance was worth no more than £100m. They provide an update on the discussions with IRECO's parent company. Equitable say that, if the position could not be resolved quickly, it could delay the start of the compromise scheme. Equitable suggest that FSA have a discussion with IRECO's parent company so that they '*understand that we regard this a serious regulatory issue*'.

Mis-selling provision
Equitable had decided that there was an inconsistency with their approach to the provision for GAR mis-selling in the Companies Act accounts and proposed to establish a further provision of £50m to cover litigation and costs. Equitable say that they were expecting to make a provision for this in the region of £270–£300m in the returns. FSA question whether this was sufficiently prudent. Equitable's auditors say that they were content with this approach.

Equitable say, in the light of Counsel's opinion, that they believed it would be acceptable to use the market value adjuster to recover each policyholder's share of the costs of compensation on surrender and to make arrangements to settle individual claims with them when they withdrew their funds. The note continues:

> [FSA's Director of Insurance] *noted that there could be potential issues on the Unfair Contract Terms legislation and suggested that the Society might need to think this through further.* [Equitable] *suggested that there might be a need in future to review policy values.* [Chief Counsel A] *noted that using the MVA seemed the wrong way round. Provision should be made, then the MVA used accordingly or policy values reviewed.*

FSA repeat that Equitable must write to them with their analysis supporting their proposed provision for mis-selling.

Policy values
Equitable report that, as at 12 September 2001, aggregate policy values were 105% of available assets, but had since moved to around 102%.

22/10/2001 [11:03] FSA's Director of GCD writes to Line Manager E having seen his comments, made on 18/10/2001, about the compromise scheme. He says that the comments seemed to him to risk the real issues about the fairness of the scheme being lost among drafting points. He continues: '*I was however particularly concerned to see you urging that the Equitable should not suggest that, without the scheme, the value of policies would be seriously at risk. Isn't this the reality? It surely would be if they became insolvent*'.

[**11:29**] Line Manager E says that his comments had been detailed drafting points which FSA had been asked to provide in advance of a drafting meeting. On the Director of GCD's particular concern, the Line Manager says that the point of his comment had been to ask Equitable to be more precise, as the relevant wording had been ambiguous.

22/10/2001 [11:34]	FSA's Director of Insurance tells Chief Counsel A that, following the meeting with Equitable that morning, he had spoken to IRECO's parent company's solicitors to ask for a meeting later that day. The Director of Insurance says that he had briefed them on the issues that they would want to cover, which included: *... that, quite apart from the implications for Equitable I had some misgivings about the propriety of the side letter. And while Ireco was not subject to our supervision, it was part of a wider group, substantial parts were within our supervisory responsibilities.* [**14:30**] The Director of Insurance later reports that IRECO's parent company's solicitors would not be in a position to talk meaningfully about this for a few days, as they were still making enquiries. [**15:16**] Chief Counsel A passes the note to a manager in PIA's Enforcement Law and Policy Department and to Legal Adviser A.
22/10/2001 [14:00]	FSA's Chief Counsel A updates Legal Adviser F on what Equitable had said at the meeting that morning about provision for mis-selling. She reports that Equitable proposed to increase the provision in the returns to £300m-£325m, which she had said was not obviously prudent to her. Chief Counsel A asks the Head of Actuarial Support whether FSA needed to keep in mind the alleged mis-selling of transfers from GAR to non-GAR policies. [**14:14**] The Head of Actuarial Support admits that he had '*rather lost track of all the potential categories of policyholder that might be able to make a claim for the different types of mis-selling*'.
22/10/2001 [17:19]	GAD ask FSA's Scrutinising Actuary F for information on the key issues on which GAD had given advice in relation to Equitable in the period from January to April 2001. GAD explain that they had to produce a briefing for the Economic Secretary to the Treasury ahead of her appearance before the Treasury Select Committee.
22/10/2001 [17:37]	Line Manager E writes to all officials involved with Equitable following the meeting with the Society. He explains that Equitable would not now be able to meet their timetable for the compromise scheme and that the convening hearing is being put back from 1 and 2 November 2001 to later in that month.
22/10/2001 [entry 7]	FSA's Chief Counsel A provides Line Manager E with some comments on Equitable's draft letter to policyholders about the compromise scheme.
23/10/2001 [09:35]	FSA's Director of GCD writes to Chief Counsel A and the Director of Insurance, setting out the main legal issues remaining related to whether FSA could approve the compromise scheme. [**10:24**] The Director of Insurance says that this reinforced an earlier suggestion from the Director of GCD that FSA should prepare a draft witness statement for them to put to the court. [**12:09**] Chief Counsel A agrees with the points made.
23/10/2001 [13:34]	FSA's Line Manager E circulates a note following several telephone calls with an Equitable policyholder about Equitable's unit-linked business.

24/10/2001 [10:29] Equitable send FSA a copy of a letter dated 19 October 2001, entitled '*Policyholders' response to the proposed compromise*'.

Line Manager E circulates the letter to all officials involved with Equitable the following day.

24/10/2001 [10:38] Equitable send FSA a report on feedback from policyholders on the consultation exercise about the compromise scheme.

[**11:28**] Line Manager E circulates the report.

[**13:45**] FSA's Head of Actuarial Support provides some comments and suggests that FSA should discuss whether the scheme needed to be amended. His comments include:

> *... my feeling would be that policyholders joining over the last few years are being treated harshly, as they are having to bear the cost of the overallocation of bonus to pre-1990 policies, which Equitable has been reluctant to address (as this could be seen as challenging the "rights" of GAR policyholders).*

The Director of Insurance agrees that it would be useful to discuss these points.

24/10/2001 [13:21] FSA's Line Manager E prepares a draft briefing for FSA's appearance before the Treasury Select Committee.

[**13:58**] FSA's Head of Press Office says that the Committee might ask if FSA or Equitable had asked Halifax whether they would be willing to be flexible on the deadline for a compromise of GAR rights, with reference to the final payment arising from the sale. He asks if there were anything that FSA could say about this.

[**14:04**] Line Manager E says that this was all quite sensitive and ought not to be raised.

[**14:44**] The Head of Press Office argues that: '*No comment*', was not an option for FSA if they were questioned about this.

24/10/2001 [22:01] Equitable send FSA a copy of a draft letter (dated 23/10/2001), in response to FSA's requirement that they should submit a plan for the restoration of a sound financial position (see 09/10/2001 [**entry 1**]). Equitable's Chief Executive formally responds to FSA's requirement on 26/10/2001 [**09:57**]. (Note: the Chief Executive's letter has been reproduced in full within that entry.) Equitable's draft plan, which was substantially the same as that set out in the formal response, consists of:

> 1) renegotiating the reinsurance treaty with a view to being able to take credit in the returns of £750m.
>
> 2) as protection against a situation in which Equitable could not take credit for the reinsurance treaty of more than £100m, undertaking a '*special programme*' of switching their assets from equities into UK Gilts. Equitable say that £790m of assets had been switched during October to date, which should reduce liabilities by £400m.
>
> 3) achieving the policyholder compromise which, if sanctioned, would provide an improvement in free assets of about £1.3bn, comprising:
>
> - *the release of the difference between the non-GAR mis-selling reserve of £300m and the additions to guarantees of around £230m;*
> - *the release of the difference between the net GAR reserve of £1454*[m] *and the additions to guarantees of around £680*[m]*;*
> - *the related resilience reserves;* [and]
> - *the £250m Halifax monies (net of any tax payable).*

25/10/2001 [09:47] FSA's Line Manager E remarks that Equitable's plan to restore a sound financial position was more detailed than he had expected, noting, however, that it had been put forward as a draft plan. He says: '*I think it is not unhelpful that the letter questions whether the breach has in fact occurred, since it provokes a discussion of the Society's financial position which I found useful. That said ...* [Equitable do] *not challenge our authority to request a plan*'. Line Manager E says that it was unlikely that FSA could take any immediate follow-up action, due to individuals from both sides being unavailable for the remainder of the week. He asks the Head of Actuarial Support to consider the response.

[**14:13**] The Head of Actuarial Support says that he believes that, on the basis of Equitable's letter, there remained a number of fundamental uncertainties about Equitable's present financial position. Those were:

> *1) I am not convinced on the basis of the information presented that it would be prudent to assume that credit can be taken for more than £100 million of reinsurance cover. Professional guidance requires the actuary to have regard to the possibility that a reinsurance contract may prove unenforceable in certain circumstance, and I believe that such an eventuality must be a significant risk in this present case.*
>
> *2) I am surprised to see that they believe that liabilities can be reduced by around £400 million as a result of switching from equities to gilts. They have also told us that the effect of the* [FSMA 2000] *concession for assumed interest rates on equities is only worth around £200 million, and these figures do not really seem to be consistent.*
>
> *3) The figures ... suggest that a resilience reserve of around £200 million is held at present although this provision did not appear to be included in the scenarios.*
>
> *4) They mention that they could reduce policy values on some older policies where they still exceed asset shares. However, I would think they should be looking at this anyway in order to ensure a reasonable level of fairness between classes of policyholders, albeit that this could be difficult to present publicly.*
>
> *5) We are already in separate correspondence with* [Equitable's Appointed Actuary] *about our doubts over the suggested extension of the financial adjuster to include discounting of guaranteed amounts.*
>
> *6) The suggested resilience reserve based on a 10% equity fall is lower than the standard set out in our present guidance which suggests testing for a fall of around 20% in current market conditions.*
>
> *7) I hope that GCD will be able to advise on the reasonableness of the legal advice ... about the potential claims for mis-selling, and we can then look further at some of the figures that they quote for the likely cost of these claims. (I believe that* [Counsel] *was sceptical at one stage about their assumption that the redress payable to a leaver could be netted down for the overall "cost" of redress in respect of all non-GAR policyholders.)*

25/10/2001 [14:00] Equitable send FSA a balance sheet and profit and loss statement for 30 September 2001. The information is presented as follows:

	Insurance Act Basis	
	£m	*£m*
Assets		
Investments		
Property	*2,107.6*	
Equities	*6,884.1*	
Fixed Interest Securities	*12,265.0*	
Short Term Deposits	*2,467.1*	
Unquoted Investments	*984.8*	
		24,708.6
Reinsurers share of technical provisions		
GAR liabilities	*645.0*	
Unit linked liabilities	*3,232.1*	
Other liabilities	*356.9*	
		4,243.0
Current assets		*726.2*
Tangible assets		*0.0*
Implicit items		
Future profits	*774.0*	
Other s68 concession	*0.0*	
		774.0
Total assets		*30,451.8*
Liabilities		
Guaranteed fund on accumulating with profits policies – GAR	*4,221.2*	
Guaranteed fund on accumulating with profits policies – non-GAR	*11,343.8*	
Less discount applied to liabilities (see notes)	*(1,492.0)*	
		14,073.0
*Other with-profits liabilities**		*3,021.9*
GAR provision		*2,149.0*
GAR rectification		*250.0*
Non-profit liabilities		*4,581.3*
Misselling liabilities (estimate) ([for potential non-GAR mis-selling claims]*)*		*270.0*
Other misselling liabilities (eg Pension Review)		*205.0*
Linked liabilities (reinsured to Halifax)		*3,232.1*
Outstanding Claims		*400.0*
Resilience reserve		*0.0*
Subordinated loans		*0.0*
Provision for other risks and charges		*1.0*
Other current liabilities		*928.5*
Total liabilities		*29,111.8*
Required Minimum Margin		*1,006.0*
Excess over [required minimum margin]		*334.0*

	Equitable also enclose a comparison between policy values and allocated assets. (Note: this document does not appear to have been held on the regulator's files. However, see 07/11/2001 [**14:50**].) [**18:22**] Line Manager E circulates the information. [**18:40**] The Head of Actuarial Support comments that the report confirmed the weakness of Equitable's financial position on both the statutory and Companies Act bases.
25/10/2001 [17:46]	Line Manager E informs Chief Counsel A, the Head of Life Insurance and the Head of Actuarial Support that he had arranged a meeting with Equitable's solicitors to discuss how the Society proposed to deal with the non-GAR classes issues. (Note: the meeting did not go ahead (see 29/10/2001 [**20:56**]).)
c25/10/2001	FSA's Equitable supervisory file includes a comparative table of payouts on personal pension policies for 36 companies.

26/10/2001 [09:57] Equitable's Chief Executive formally responds to FSA's request under section 32(4) of ICA 1982 for the submission of a plan for the restoration of a sound financial position. Equitable say that their letter constituted a draft plan. This reads:

> *The Reinsurance Treaty with Irish European Reinsurance Company (IRECO) has been evaluated by our lawyers ... A copy of their initial assessment, which was supported by opinion of Counsel, has already been forwarded to you. Their view is that the side letter is probably not legally binding but is likely to influence arbitrators should an arbitration process be entered into regarding the way forward if the claims balance exceeds £100 million. There is a good reason to believe we can rely on the treaty for the credit taken in our regulatory returns, though we accept the position is not beyond doubt.*
>
> *Scenario three in the letter of 5 October from* [the Society] *is a stress test scenario and assumes the IRECO treaty is valid only up to £100 million. We understand your conclusion that £220 million for non-GAR mis-selling provision is not sufficiently prudent, but believe that there are grounds for us to rely on the treaty. It should also be pointed out that* [Equitable] *did not include any future profits implicit item but it is likely that some allowance would be made (at least up to around £100 million).*
>
> *As you are aware we are discussing with management of IRECO and its parent Employers Reinsurance Corporation a clarification to the reinsurance treaty. The nature of the clarification will be to specify the terms under which reinsurance cover remains in force if the claims balance exceeds £100 million. Negotiations are structured around the limit of liability to be accepted (initially proposed at £1,000 million), the premium to be payable if claims balances exceed £100 million, the rate at which claims are recovered, the use of swaptions by the Society to provide further protection of the GAR liability if interest rates fall, and reassurances regarding the Society's current financial position. We are near to agreement on terms and would hope to be in a position to finalise an agreement by 31 October 2001. In this circumstance we believe we will be able to take credit for up to £750 million currently. When agreement of the clarification has been achieved we will discuss the matter more fully with you.*
>
> *To provide protection against circumstances where it becomes clear that the IRECO treaty cannot be relied upon for balances in excess of £100 million, the Society commenced a special programme of switching out of equities into UK Gilts. £790 million of switching has occurred during October to date, which should enable us to reduce liabilities by about £400 million.*

The final point of our plan for restoration of solvency is the GAR compromise scheme. You have been kept well abreast of its development so I shall not elaborate on the detail here. We hope to launch the voting process, with the posting of documents to policyholders at the end of November. The meeting for voting is now tentatively set for 11 January 2001 with Court sanction in early February.

If the scheme is sanctioned by the Court there will be an improvement in free assets of about £1.3 billion, [comprising]*:*

- *the release of the difference between the non-GAR mis-selling reserve of £300 million and the additions to guarantees of around £230 million*
- *the release of the difference between the net GAR reserve of £*[1,454 million] *and the additions to guarantees of around £680 million*
- *the related resilience reserves*
- *the £250 million Halifax monies (net of any tax payable)*

We anticipate that all three elements of our plan will succeed. However if we can only rely on the disposal of equities there are two other possible actions we will consider, in extremis; further reductions in terminal bonuses would be considered thereby reducing payouts on certain older policies where policy values continue to exceed asset shares; extension of the financial adjuster on surrender values to include discounting of guaranteed amounts (as might be considered appropriate in circumstances of mass discontinuance or the high level of guaranteed amounts).

Finally I should comment that we have applied formally for an order under Section 68 of The Insurance Companies Act 1982 to allow the maximum allowable yield on equity shares and collective investment schemes to be calculated in accordance with Regulation 69 as described in Consultation Paper 84 issued by the Financial Services Authority.

It is our intent that these actions should at current market levels provide sufficient margin for a resilience reserve based upon an equity fall of around 10% by value. This work will be confirmed in due course.

We believe these measures maintain the required minimum margin and that the implementation of the Scheme, and the reliance on IRECO until such time that a Scheme is effective, will provide free assets sufficient to protect the Society from falls in UK equity markets. We are still evaluating the degree of protection it will provide and will advise you shortly. However if equity markets were to weaken significantly then we might need to adjust down further the equity backing ratio.

Equitable then go on to discuss the level of provision for non-GAR mis-selling liabilities, saying that:

The outline above takes account of a provision for non-GAR mis-selling of £300 million, being £80 million higher than that proposed in the Compromise Scheme.

We have discussed the judicial approach to non-GAR compensation, assuming the S425 scheme is unsuccessful. [Counsel] *has expressed the view that the Society needs to be mindful of the position of a departing policyholder seeking compensation as opposed to a remaining policyholder seeking compensation. Should a scheme not be agreed exiting policyholders might claim for settlement first leaving the cost to be borne by remaining policyholders. This would prove inequitable when the process continued to the point where assets remaining were depleted and insufficient to meet the claims of remaining policyholders.* [Counsel] *was confident that the Court would be sympathetic to an increase in the financial adjuster to reflect the reduction in assets available for* *distribution as a result of the need to provide for non-GAR mis-selling. It is most likely that in the absence of a compromise the non-GAR claims would be settled by a "group" compensation process such as the Ombudsman. We consider it unlikely that such a process, affecting 75% of the members, would not have regard to the need for the members to bear their fair share of the costs.*

To address this issue the most appropriate action in the absence of a compromise would be for the Society to reserve for the fair cost of compensation, which we estimate to be £220 million, and additional costs of administration, estimated at £50 million. In order to ensure all policyholders bear their fair share of such compensation policy values could be reduced to ensure that assets were sufficient to meet the policy values in aggregate.

Accordingly we consider there is a robust basis for regulatory purposes with a non-GAR mis-selling provision of something in excess of £270 million. We have used £300 million to allow a ten percent margin for prudence. We are happy to [discuss] *this concept further with you.*

Equitable continue:

As regards non-GARs who leave after the scheme is published or who have already left, our view is that most if not all will have left as a result of the current uncertainty regarding the position of the Society. We have received opinion from Counsel that the decision to leave as a result of uncertainty is very remotely connected with the failure to disclose the existence of GARs when they took out their policy. Accordingly it is unlikely that a policyholder can seek to recover a financial adjuster as an element of loss. Non-GARs who left prior to 16th July 2001 would we believe find it difficult to demonstrate any loss when assessed against an average of similar policies. Subsequent to 16th July it might be possible for individuals to demonstrate loss, but they need to demonstrate both causation and reliance. If all such non-GARs who left up to end of August did suffer loss and were compensated on the same basis as the compromise proposals (without the Halifax money) then the cost would be around £10 million. This amount will grow until the vote, but we consider it unlikely to become a financially material problem for the Society.

As regards non-GARs compensation, our proposal is to restore their guarantees to the position they would have been in had the House of Lords not ruled as it did, i.e. we wish to restore the declared reversionary bonus that would have been allocated for 2000. The declared rate for 1999 was based on 5% for the years 1998 and 1999 when the overall rate of return allocated to policy values were 10% and 12% respectively. The Society had been bringing down declared rates to reflect falling yields on assets and falling returns. In a low return environment it would not expect to pay more than half the average overall rate of return in guaranteed form. For 2000 the overall rate of return was 8% and so it would have been expected to declare guaranteed returns at 4% for 2000. Since many policies had 3½% GIR, they only suffered ½% reduction. This approach seems to us fair. We cannot see how they sustain a claim to be in a better position than they would have been in had bonus not been suspended.

26/10/2001 [13:09] Equitable telephone FSA to inform them that progress was being made on the renegotiation of the reinsurance treaty and that a deal would be done, although not all of the problems had yet been resolved. Equitable say that IRECO's parent company were coming to London to conclude the negotiations and suggest that FSA's Chairman or Managing Director B should attend and: '*If that could be done, he thought there would be significant advantages to Equitable if they could have the use of a room here for the bilateral discussions with* [IRECO's parent company] *– he thinks the scale of the building would help get over the message that the FSA is an important body that* [IRECO's parent company] *would want to keep on side*'.

	Line Manager E says that the Director of Insurance thinks that FSA '*ought to be able to oblige*'. [**17:32**] Chief Counsel A expresses the concern that there could be any possible appearance that FSA were being used as '*a big stick*' in commercial negotiations '*although obviously we have a strong message to give about an apparent attempt to mislead the regulator and the downsides if a deal isn't struck*'. Chief Counsel A suggests that a tripartite meeting should be held, and that it should not be chaired by FSA's Chairman or Managing Director B.
26/10/2001 [entry 3]	Line Manager E writes to two FSA officials about the rectification scheme.
29/10/2001 [entry 1]	FSA, as lead supervisor, meet Equitable at their request in order to be briefed on the current situation in relation to various conduct of business issues.
29/10/2001 [entry 2]	Line Manager E provides FSA's Public Affairs and Accountability Division with some further briefing for the Select Committee hearing to be held on 30 October 2001.
29/10/2001 [entry 3]	The Financial Services Consumer Panel present the results of their Equitable Life Survey.
29/10/2001 [17:12]	FSA write to the Financial Ombudsman Service seeking confirmation that the Financial Ombudsman's jurisdiction to handle complaints relied on where the point of sale of the product had been, rather than where the policyholder was now resident.
29/10/2001 [20:56]	FSA's Chief Counsel A writes to Line Manager E, the Head of Life Insurance and the Head of Actuarial Support, noting that the planned meeting with Equitable's solicitors had not gone ahead. She explains the plans for FSA to review the compromise scheme documents over the coming weekend.
30/10/2001 [15:52]	FSA circulate an updated version of their information sheet as the last one '*became out of date very quickly when the Baird report came out*' and ask for comments.
30/10/2001 [16:30]	Equitable send FSA a revised timetable for the external review of Equitable's Creditors' Pack. [**17:19**] Line Manager E circulates the timetable to all officials involved with Equitable.
30/10/2001 [17:37]	The Financial Ombudsman Service respond to FSA's queries about jurisdiction (see 29/10/2001 [**17:12**]). They confirm that, where a policy had been sold in the UK, '*the current residential status of the policyholder is not a relevant consideration in assessing jurisdiction*'. In relation to policies sold through a branch operation (e.g. the Society's branches in Guernsey or Germany), the Financial Ombudsman Service explain that: *1) under Compulsory Jurisdiction, the residential status of the policy holder at the time of sale and the actual location of the sale is immaterial to the assessment of jurisdiction. What is important is whether the complaint relates to the carrying out of investment business in the UK and whether the activity was regulated by the PIA (post-A-day and about advice at point of sale).* *2) under Voluntary Jurisdiction, the residential status is a material consideration. Under the Ombudsman's Terms of Reference, section 6.4 (b) provides that the Ombudsman shall have no power to consider a complaint if the person bringing the complaint does not have, or did not have at the time of the events giving rise to the complaint, their main or principal residence in the UK, Isle of Man or Channel Islands.*

The Financial Ombudsman Service add that:

> *Under the new* [Financial Ombudsman Service] *rules DISP 2.7 deals with the territorial scope of the service. Briefly, this provides that the residential status of the complainant is irrelevant. The emphasis is more on the permanent place of business of the firm concerned. The territorial scope covers firms operating from a permanent place of business in the UK. Complaints relating to business conducted by branches of firms or Voluntary Jurisdiction participants outside the UK, or by firms operating in the UK on a service basis from outside the UK, are not subject to the Ombudsman's jurisdiction.*

31/10/2001 [09:49] FSA's Head of Actuarial Support writes to Line Manager E (copied to others) about the compromise scheme. The Head of Actuarial Support says:

> *Some further evidence of the lack of openness and co-operation from the Equitable team – apparently, the independent actuary has already seen a series of drafts of the report by the appointed actuary,* [Equitable's Appointed Actuary], *on this scheme. He has now written his own draft report including references to* [his] *report, and was therefore quite surprised to hear that we had not received any copies of* [the Appointed Actuary's] *report.*
>
> *I have considerable misgivings about the way that Equitable seem to be trying to bounce us here into accepting that this scheme is fair and reasonable.*

[**10:15**] Line Manager E replies: '*Indeed, and that is why I keep making the point that if they do not get their act together, we will need to consider what steps to take*'.

31/10/2001 [12:14] FSA's Line Manager E circulates a note of FSA's concerns about the timetable for the compromise scheme and the timescales in which they were expected to take a decision on their position. The Line Manager says:

> *As things stand, not only is it becoming certain that we will not have been able to satisfy ourselves that the Scheme is one we can sign up to, but it seems to me we may even be in the territory of having to make comments that will be so feeble or negative that we could bring the project down. (Indeed, until we know what they are now proposing, we cannot rule out the possibility that we might need to intervene to stop the Society going ahead.)*

The Line Manager sets out the issues to be resolved and the areas on which FSA should be focusing their efforts.

[**17:04**] The Head of Actuarial Support replies to this note, saying that:

> *I have also seen the letter of 26 October in which they argue in favour of netting down compensation, giving only a small proportion in the form of guaranteed benefits, and avoiding most of the potential claims from those who have left or may leave the society before the scheme is implemented. This really needs some advice from* [General Counsel's Division] *here on the reasonableness of their position.*
>
> *On the quantum of the non-GAR mis-selling losses, I believe that if we do not accept the above legal arguments from Equitable, then it could be argued that this loss varies from around 10 to 30% of policy value (the precise amount depending on exactly when premiums were paid in the period between 1988 and 2000) if policyholders were able to claim in full for redress to bring them up to the industry average. It is arguable of course that not all this is a direct result of the GAR problem. A significant part of this "loss" may relate to other issues, such as the risk that bonuses payable to the older policies (which happen to be largely GAR policies) may be or have been too high relative to the amount of profits that the society has earned.*

If we do though accept their legal arguments, then the redress offered of 1.5% for all non-GAR policies would seem (subject of course to seeing a copy of their actuarial report) to reflect the netted-down (and discounted for equal probability of success of all claims) value of the loss directly attributable to the existence of GARs (and ignoring for this purpose the potentially inequitable apportionment of bonuses across different generations of policies). Of this amount, there would be included an increase of 0.5% to the guaranteed benefits for those with GIRs and 3.5% to guaranteed benefits for those without GIRs.

31/10/2001 [14:27] FSA receive a query from The Consumers' Association about the security of Equitable's unit-linked policies in the light of a passage in the Baird Report.

[**17:10**] Line Manager E circulates a suggested response.

31/10/2001 [20:15] Equitable write to FSA about the information requests made at their last meeting.

Equitable set out approximate data on with-profits claims (excluding annuities):

	GAR policies	*Non-GAR policies*
August 2000 – end July 2001	*£850m*	*£2,300m*
August 2001 – end September 2001	*£150m*	*£950m*
Total	*£1,000m*	*£3,250m*

The following day FSA's Line Manager E comments '*I assume we asked for this in order to form a view about the likely scale of mis-selling claims for those who left the with profits fund after the sale announcement, and after the policy value cut*'.

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01/11/2001 [09:47] FSA's Director of GCD asks Chief Counsel A what advice, if any, had been given in response to Equitable's plan for the restoration of a sound financial position (see entry for 26/10/2001 [**09:57**]).

[**10:21**] Chief Counsel A replies that, on point 1 of the Head of Actuarial Support's list of fundamental uncertainties (see 25/10/2001 [**14:13**]), the clear advice had been that credit could not be taken in the returns for the reinsurance of more than £100m, until the uncertainty was removed. She says that point 7 was to be considered by Legal Adviser F and Chief Counsel B, who were on leave.

01/11/2001 [10:12] FSA's Head of Actuarial Support, in response to Line Manager E (see 31/10/2001 [**17:10**]), asks whether FSA had a copy of one of the Society's unit-linked policies. Line Manager E asks Scrutinising Actuary F if he had sample wording from these policies.

01/11/2001 [10:47] Further to the Director of GCD's comments on 23/10/2001 [**09:35**] about the remaining issues for FSA in relation to '*approval of the scheme*', the Director of Insurance explains that FSA were meeting Equitable the following day and, in the light of that meeting and '*sight of the scheme papers over the weekend*', FSA would discuss on 5 November 2001 what the key outstanding issues were and what FSA's attitude to them should be. He notes that: '*One of the key issues – which I suspect will affect a number of others, is how Equitable propose to resolve the voting class issues: we have not yet seen their proposals on this*'. The Director of Insurance also reports that he had made clear to Equitable's Chief Executive the previous day that Equitable '*should not rely on the tactic of bouncing us to get their way*'.

01/11/2001 [11:08] A policyholder action group send FSA a '*technical response*' to the proposed compromise scheme. [**12:41**] Line Manager E circulates the response.

[**14:42**] The Head of Actuarial Support comments that it does not seem to be a very well-informed paper '*but does include some useful pointers*', which he goes on to describe. Under the heading '*Accounting for GARs*', he says '*the accounting rules do not require explicit provision to be made for future discretionary bonuses, though some implicit provision is still made through discounting the liabilities at a very low rate of interest*'.

01/11/2001 [17:45] Equitable inform FSA that they would be unable to attend the regular review meeting planned for 2 November 2001, as Equitable were still '*deep in discussion*' with their reinsurer. The second part of the meeting, on the compromise scheme, still goes ahead.

01/11/2001 [entry 6] FSA meet a delegation from IRECO's parent company to discuss the negotiations that were taking place with Equitable on the reinsurance treaty. FSA say that the discussion had to be on a hypothetical basis, as FSA '*could not talk about the financial condition of a regulated company nor could the FSA be involved in commercial negotiations*'. FSA give an overview of the position of the compromise scheme. In response to a question as to what FSA thought their role was in terms of approving the amended treaty, FSA's note, prepared the following day, records:

> [FSA's Director of Insurance] *replied that there was no formal approval role. Our locus was that we would need to be satisfied about the integrity of the treaty when assessing the credit taken for it in the solvency calculations. For the same credit to be taken we would need to see that after the negotiations it provided the kind of protection that we had always understood that it provided.* [IRECO's parent company] *said that the treaty was always intended to be a riskless transaction.* [The Director] *said that that was very*

definitely not our view at the time, on the basis of the information we were given, since there was a clear risk for Ireco on the terms we had seen in the event the [projected] *surplus did not emerge. Had there been no risk transfer, the treaty could not* [have] *been taken into account in the solvency calculations.*

On disclosure of any amendments to the treaty, the note records:

[FSA's Director of Insurance] *noted that if the result of the revised terms was a substantial change in the terms of the treaty, we believed that proper disclosure of the facts by the Society of the changes and the surrounding circumstances would be required by us and probably by the Society's auditors.* [He] *added that if the changes were less dramatic, and amounted to little more than a clarification of the terms, then there might be less need for disclosure.*

01/11/2001 [entry 7] FSA send HMT a draft section 68 Order to allow Equitable to take account of the earnings yield (in addition to the dividend yield) on equity investments in calculating their valuation rates of interest. FSA explain:

The effect of the change described ... is generally to reduce the liabilities of life funds which hold equities. For companies whose solvency is tight, the relief could be material to their maintaining statutory solvency in a falling equities market. In current market conditions it is desirable to allow companies in this position to take the benefit of the relaxation now, in order to reduce pressure on them to sell equities for technical reasons (ie to maintain statutory solvency on the current valuation basis), as such technical selling would further depress equity values, and thus compound the problem across the industry ...

Equitable Life estimates the effect of the change to the equity yield calculation will result in an improvement in the Society's free assets of about £200 million.

FSA recommend that the section 68 Order, which they say '*is consistent with the other equivalent Orders granted for other life offices*', should be granted.

02/11/2001 [12:30] FSA meet Equitable to discuss the compromise scheme.

Following the meeting, Equitable's solicitors send FSA the text of the provision in the agreement with Halifax which said that, for the further payment of £250m to be made, requires FSA to have '*confirmed that it has no objection to the Proposed Scheme or to the draft Scheme Documents being issued to creditors entitled to vote thereon*'.

02/11/2001 [16:59] Line Manager E circulates a note of the meeting with IRECO's parent company on 01/11/2001. He says that he has spoken to Equitable about progress and had been told that the delegation had agreed to stay for as long as it took to find an agreement. He notes: '*There are indications of some progress, albeit rather slow*'.

02/11/2001 [20:54] FSA's Director of Insurance informs the Head of Life Insurance of two telephone conversations with Equitable (at 17:30 and 18:30) about the negotiations on the reinsurance treaty. He sets out, in broad terms, his understanding of the revised terms of the treaty, as they currently stood in the negotiation process:

Ireco accept that the side letter is to be treated as if it had never been issued, and could at no time have been relied on ... by them.

An addition to the Treaty is to be made as from 1/12/01. This will deal with the (arguably improbable) situation where claims under the Treaty exceed £100m, where at present the Treaty simply provides for "renegotiation".

The addition will provide that protection will be provided up to a defined limit (of around the £700m for which credit is taken for reserving purposes +20 -20% of that amount). The intention is that the limit should be sufficient to satisfy us that the full £700m credit can be taken.

The Director reports that he had told Equitable that:

... [he] *was pleased that it appeared that a satisfactory solution might be in sight. But they had to understand that we would have to scrutinise the proposal very carefully before we could confirm that it could be allowed to "count" for solvency purposes.*

02/11/2001 [entry 4] An HMT official provides the Economic Secretary to the Treasury with briefing and a draft reply to the Treasury Select Committee on the section 68 Orders granted to Equitable. As background, the official says:

Equitable Life has applied for two concessions relating to the valuation of certain of its assets. Such concessions are granted by the Treasury under section 68 of the Insurance Companies Act 1982, taking into account the advice of the FSA. Both issues have been looked at by the Insurance Supervisory Committee and senior management of the FSA. This paper reflects the FSA's view. We recommend that the appropriate section 68 order[s] be made.

On the section 68 Order relating to Permanent Insurance, the official says:

The normal approach taken when valuing a shareholding in a private subsidiary company is to use the "look through" value. That produces a very conservative valuation. On that basis, the then subsidiary of Equitable Life would be valued at around £30 million. However, Equitable Life agreed on 22 December 2000 to sell Permanent to Liverpool Victoria for £150 million. The deal was unconditional, other than for regulatory approval, and was completed on 16 February 2001. Equitable Life believes that for the purposes of the 2000 year end returns, it should report the value of the subsidiary on the basis of the agreed sale price.

We consider that as the sale was confirmed, the agreed sale price provides a sensible basis for a valuation of this asset and is consistent with the treatment in the Companies Act accounts. We believe that the equivalent concessions, requiring a proven market valuation to be used, have been given in other similar circumstances. It is also not unusual for a requirement to report on a particular basis to be imposed after the event, provided that the requirement is imposed in advance of the reporting date.

On the section 68 Order relating to rates of interest, the official explains:

Regulation 69 of the Insurance Companies Regulations 1994 specifies the basis on which future payments are to be valued. In effect, the requirement is to assume an interest rate no higher than the average yield currently being achieved on the assets supporting the long term business. The regulation specifies how that yield is to be calculated. However, there is a slight defect in the averaging method prescribed in the regulations which means that depending on economical circumstances they can place (and at the moment they are placing) an artificial strain on the company. In other economic circumstances it can lead to an artificial release of reserves. This arises because of the simplistic basis of the calculations for fixed interest assets, which averages the rates [of] *interest by* [the] *value of the underlying investments, but takes no account of ... their duration. At the time the regulations were made, more sophisticated calculations were not thought necessary.*

The problems with the valuation method in regulation 69 become evident when doing the calculations for resilience tests. Many companies just live with the consequences. However some (including [two named companies]*) have preferred to report more* *accurately and have therefore sought and been given section 68 orders requiring them to perform more sophisticated calculations. Equitable Life has asked for a similar concession. The proposal is to calculate the yield on the basis of two segments of fixed interest securities (approved and non-approved). We consider this approach to be perfectly valid and would support other companies wishing to adopt it. However, the methodology is slightly different from that which has been applied by other companies. The alternative effectively involves the company seeking to hypothecate blocks of fixed interest assets to particular areas of business in order to calculate the yield.*

There will be a need for a continued concession under section 68 (or a waiver to the equivalent FSA rule) going forward. At this stage however we are recommending that the concession granted should deal only with the reporting of the end 2000 position. This produces a more accurate reflection of the financial position than would be the case if it followed the requirements of regulation 69 and granting the order will enable the Society to complete its annual returns for 2000.

We will wish to discuss the future arrangements further with the Society. This is because the Equitable has now concluded that in future it would be able to do the calculations on the basis followed by [the two named companies]. *It is not possible for them to produce the 2000 year end figures on that alternative basis because of the complexity of the calculations involved. However, there are issues we will want to consider more carefully before agreeing to that because the nature of the business of those companies is different and we also look to companies to maintain consistency of valuation methods from one year to the next. We have not yet reached a firm view on the appropriate treatment going forward.*

However, as background, we have discussed the effects of the alternative valuation methods to that required by regulation 69. Equitable has indicated that (at least with current economic conditions) the financial effects of either methodology would be broadly similar, although the method adopted by [one of the named companies] *might produce a very slightly less favourable result. If Equitable Life goes ahead on the basis it had proposed the benefit to its solvency position will be of the order of £150-200 million as compared with the regulations. The company's actuary believes that the ... method* [adopted by one of the named companies] *would also have produced a benefit within that range.*

03/11/2001 [19:37] FSA's Chief Counsel A provides the Director of GCD with a note on the issues within the compromise scheme proposals concerning uplifts to the policyholders of both GAR and non-GAR policyholders, which she hopes '*can form a starting point first for instructing Counsel ... and then for the matters which the FSA will need to address to the Court (and perhaps before then to policyholders)*'. Chief Counsel A sets out the issues as follows:

In relation to the GAR policyholder uplifts, the Chief Counsel says:

From page 83 of Draft 4A (15.10.01) of the Scheme of Arrangement ... examples of how the scheme will affect policyholders are set out. Examples 1 and 2 illustrate that the same uplift will attach to the GAR guaranteed value (basically premiums minus costs etc plus annual bonus) and GAR policy value (which should be very close to asset share). Thus the uplift will attach proportionately to the guaranteed and non-guaranteed parts of the policy value which seems appropriate. The Halifax uplift of 1.3% attaches only to the policy value since it is not guaranteed. This seems fair even in cases where those whose guaranteed amount is higher than policy value will potentially lose out because Equitable paid out too much to them in previous years by way of guaranteed annual bonus.

In relation to the non-GAR policyholder uplifts, she says:

> *Examples 5 and 6 on page 86 show the addition of the non-GAR uplift. Those who have GIRs of 3.5% get an uplift of .5% to the non-GAR guaranteed value for a total return of 4% and those without GIRs who would not otherwise have received any annual bonus at all, get an uplift of 4%. (I assume this works out to 1.4% overall.) The uplift on the non-GAR policy value is 1.4%. This seems right on Equitable's theory since compensation is for (guaranteed) annual bonus forgone due to the GAR risk. Again the Halifax uplift is not guaranteed with the potential result that those whose guaranteed value is higher than policy value will lose out.*

Chief Counsel A also says:

> *On page 129/130 the "after the uplift" percentage without the Halifax £250m is lower than the "before the uplift" percentage. I do not know why (and see also page 132).*
>
> *We need to confirm that Equitable are proposing to calculate policy value for voting purposes by taking either the guaranteed amount or policy value (whichever is higher), and in the case of GARs, adding the uplift (as a proxy for the value of the GAR). The draft creditors pack is not clear.*
>
> *We have already indicated that the FSA is content with the size of the pot for the GAR uplift, but more work is needed on the analysis of the impact of the uplift for relevant groups of GAR policyholders. More work is needed too on the size of the non-GAR misselling pot and whether a uniform uplift is fair.*

04/11/2001 [16:43] HMT's Director of Financial Regulation and Industry informs an HMT official of a conversation with FSA (the Director of Insurance, as Managing Director B had not been available). The HMT Director's note records that the FSA Director had:

> *... said that FSA had written to* [Equitable] *shortly after* [September] *11 to ask them for a recovery plan as they appeared to have breached their solvency margin. (This did not amount to insolvency.) The letter you've just seen is presumably this.* [Equitable] *disputed the position. The FSA's view assumed the "side letter" to the reinsurance agreement meant the reinsurance was worth a max of £100m.*
>
> [FSA's Director of Insurance] *also said that* [Equitable] *had subsequently negotiated an additional premium they would pay if claims covered by the reinsurance agreement exceeded £100m. On this basis the side letter was regarded as "never having existed". (I commented that* [Equitable] *had in effect bought their way out of the side letter;* [he] *disagreed although acknowledged he was perhaps making a distinction without a difference.)* [He] *felt that on this basis* [Equitable] *had never breached its margin, and was certainly not currently breaching its margin, although he added there remained uncertainties about provisioning for mis-selling. When pressed, he also added that FSA had not yet seen the* [revision] *of the reinsurance agreement.*
>
> *Lets discuss on Monday. Regarding Baird I'm re-inforced in the view that we must look to the FSA for advice on s68 orders as they cannot be judged in isolation, but* [especially] *given* [the Baird Report] *I'm equally sure we need to be crystal clear what the FSA advice is and that they've considered the situation properly before giving it. We'll probably need a session with FSA early next week on this.*

05/11/2001 [10:31] FSA's Director of GCD comments on the reinsurance treaty: '*Don't think it helps much to put in place a riskless deal for the future-hope that's not what's intended*'. He asks whether FSA should write to other companies, seeking confirmation that there were no side letters to their reinsurance agreements.

[**10:41**] In reply, the Head of Actuarial Support says that FSA were about to write to another insurance company which had an almost identical reinsurance treaty with the same reinsurer to ask '*some searching questions*'. On other companies with similar reinsurance agreements, he goes on to say: '*Most of these though include Ireco as a partner with other reinsurers ... in these arrangements, and generally* [they] *seem to be documented rather more fully*'.

05/11/2001 [16:21]	FSA's Director of Insurance informs Line Manager E of a telephone conversation with the Guernsey Financial Services Commission, who wanted their help on two jurisdictional issues. These were the powers of the Financial Ombudsman Service and the legal position in other jurisdictions.
05/11/2001 [17:06]	FSA thank the Financial Ombudsman Service for the advice provide on 30/10/2001 [**17:37**]. FSA seek clarification of the jurisdiction of the Financial Ombudsman Service in relation to overseas residents.

06/11/2001 [entry 1] FSA meet Equitable for a regular review meeting. According to FSA's note of the meeting, issues discussed include the following:

Reinsurance
Equitable report that a verbal agreement had been reached and say that they would, in due course confirm the full details of the proposals. The note records:

> [FSA's Director of Insurance] *asked about their proposals for disclosing the recent events, suggesting that it might be wise to be reasonably open about what had happened and setting out what the Society had done when it had identified the problem.* [The Director] *pointed out that this was bound to come out at some point and failure to give adequate and managed disclosure now might lead to accusations later. We also discussed what effect the proposed treatment of the side letter might have when assessing whether or not* [there] *had been a breach of the solvency margin.* [Equitable's Finance Director] *acknowledged that this was awkward and said he would consider it further for the purposes of the statutory returns and the accounts. He noted that the Society no longer referred to compliance with the regulatory requirements and now only talked of being solvent.*

Financial condition
In response to FSA's Head of Actuarial Support, Equitable say that they agreed that the end-October solvency position appeared tight. Equitable comment that they had sold £1bn of equities in October, reducing the equity backing ratio of the with-profits fund to 49% (including property).

In response to a question by FSA about the ratio of policy values to asset values, the note records that:

> [Equitable] *said that this was last reviewed at the end of October when the FTSE 100 was at 5050. At the time, maturity payouts were at about 103-4%, and early surrenders at about 93%. This meant that overall, departures were taking about 98% of their share of the assets. He said that* [they] *would review the position if aggregate policy values reached 105% of the asset value.* [FSA's Director of Insurance] *said we had a particular concern ... to ensure that policyholders would not be asked to vote on the scheme on the basis of misleading information about the value of the company.*

Halifax Equitable Clerical Medical
The note records that Equitable had informed the FSA of '*serious problems*' in their relationship with Halifax Equitable Clerical Medical, and '*that there was even a risk that the compromise would have to be either delayed or abandoned*'.

Section 425 scheme
Equitable provide an update on progress on the compromise scheme and confirm that the court hearing was set for 26 and 27 November 2001. Equitable explain their thinking behind the different uplift and voting values being given to non-GAR policyholders.

06/11/2001 [entry 2] An HMT official seeks advice from HMT's Director of Financial Regulation and Industry concerning FSA's recommendation that HMT should approve Equitable's application for a section 68 Order. He says that '*FSA were in touch with me this morning to urge us to make a quick decision ...*'. The official explains:

> *The concession that has been asked for relates to the rate of interest used to discount future liabilities. Under the Insurance Companies Regulations 1994, this effectively requires the dividend yield to be used. One of the side-effects of this is that a company such as Equitable, which has few free assets, is forced into holding a high level of fixed interest securities because they have a relatively high yield compared to equities. The more assets with high discount rates the company has the quicker it can cover its liabilities, then any surplus income not utilised in discounting can be used to declare reversionary bonuses. This was recognised as a possible distortion to investment behaviour by the Myners review, since it leads to a bias away from equities and towards fixed interest securities which may act against policy holders' long term interests.*
>
> *The FSA has been consulting on a revised method of discounting which incorporates an element of earnings yield. This will be introduced at N2. Rule 5.11(5) of the Interim Prudential Sourcebook allows a company's post-tax profit to be taken into account. Essentially companies will be able to use the average of the dividend and earnings yields where this is higher than the dividend yield itself, subject to a limit of twice the dividend yield.*
>
> *The FSA argues that the terms of the Section 68 order are consistent with similar orders given to other insurers and allows Equitable Life to take into account now changes which will in any event be available from 1 December. Equitable's free assets will increase by around £200 million and the amount of any future profits that the society might want to take advantage of under previous Section 68 orders will be reduced. According to the 26 October letter from* [Equitable to FSA]*, it is also one of the actions identified by Equitable Life as being necessary to "provide sufficient margin for a resilience reserve based upon an equity fall of around 10% by value".*
>
> *Taken in isolation, the FSA's recommendation is reasonable and we would normally accept it. However, the circumstances surrounding Equitable Life make this request exceptional. The order could have a direct impact on the company's ability to meet its required minimum margin and I assume that Ministers will also have to be told that a new Section 68 order has been requested/granted.*

07/11/2001 [14:39] The Financial Ombudsman Service provide FSA with answers to their queries of 05/11/2001 [**17:06**].

07/11/2001 [14:50] Equitable send FSA details of policy values compared to allocated assets, which are as follows:

	31 July 2001 £m	*30 August 2001 £m*	*30 September 2001 £m*	*22 October 2001 £m*
With-profits available assets	*22500*	*22475*	*21589*	*21974*
Cost of GARs	*(1257)*	*(1257)*	*(1257)*	*(1257)*
Available assets to pay policy values	*21243*	*21218*	*20332*	*20717*
Aggregate policy values	*20643*	*20745*	*20846*	*20923*
PV/AS	*97.2%*	*97.8%*	*102.5%*	*101.0%*

07/11/2001 [entry 3]	FSA's Chairman asks for comments on a statement in which he would disclose the existence of the side letter and of the renegotiation of the reinsurance treaty. The Chairman says that he proposed to make that statement to the Treasury Select Committee when giving evidence on 13 November 2001. [**20:31**] The Director of Insurance says that he believed that it would be appropriate to make the statement proposed but suggests informing Equitable of this, in order '*to put pressure on them to ensure that the documentation is finalised before the* [Treasury Select Committee] *hearing*'. The following day (at 08:51), FSA's Chairman agrees that FSA should warn Equitable. [**19:07**] The Director of Insurance informs Equitable, who '*did not protest*'.
08/11/2001 [10:16]	FSA's Line Manager E sends officials a risk assessment entitled '*Appendix B*', which gives a description of risks or problems in relation to Equitable and the statutory objectives of FSA that those risks would impact on. The note states that Equitable's '*Impact Rating of Firm*' is '*A*' (although it did not describe what this rating signified). Under the heading '*Description of risk or problem (including likelihood of crystallisation and time horizon)*', the assessment states: *1. Movements (downwards) in long term interest rates.* *2. Potential claims for mis-selling of policies on the grounds that GAR risks were not adequately disclosed.* *3. Continued volatility in equity markets. This is unpredictable, however equities have stabilised somewhat in recent weeks.* *4. Policyholders withdrawing funds from the Society, whether by way of contractual or early terminations, at rates higher than their asset share.* Under the heading '*Description of potential impact of the risk or problem*', the assessment states: *1. GAR costs will ultimately be determined by the long term interest rates at the time of the retirement of GAR policyholders. The lower interest rates fall, the higher the realistic cost and the reserving requirements.* *2. The precise value of claims is not known, although estimates suggest their value to be manageable, particularly if they can in effect be met by a reduction in the policy values of all investors in the with-profits fund, including those claiming. However there is uncertainty.* *3. Further equity falls could reduce the value of the Society's assets, thus impacting on the Society's solvency position and ability to meet future liabilities. This could result in future uncertainty and policyholders being disadvantaged. The Society's equity backing ratio is however significantly reduced after managed disposals through 2001 so the risk is now less than it has been historically.* *4. Equitable has been paying contractual terminations at the full notional policy value (effectively smoothed asset share) at a time when aggregate policy values are slightly higher than the available assets. Non-contractual terminations are subject to a financial adjuster, which means that they are currently being paid at slightly less than asset share. If payments get out of line with the value of the assets, this has the effect of reducing the value of the investments of those staying in the fund.*

Under the heading '*Which statutory objectives will it impact on?*', the assessment states:

- *Maintain confidence in the UK financial system. The financial weakness of a significant participant in the financial system (particularly the oldest Life Assurer in the world) is causing widespread lack of consumer faith and negative publicity. A further deterioration in the position will aggravate matters.*
- *Secure the appropriate degree of protection for consumers. A further weakening in the financial position of an institution could result in policyholders being disadvantaged.*

Under the heading '*What are you doing about the risk or problem?*', the assessment states:

> *The FSA are actively liaising with the Society, the policyholders and various action groups to ensure that active communication and dialogue is taking place between the relevant parties. FSA are holding regular meetings with the Society's board to review its proposed action. In addition, the financial position is being closely monitored, for example by requiring the Society to submit monthly returns.*
>
> *The FSA is also working closely with the Society on its proposals for a compromise scheme under section 425 of the Companies Act which it is hoped will compromise both the rights of certain policyholders to take an annuity at a guaranteed rate and the potential claims that some policyholders may have if they can demonstrate that the risks of the GAR costs were not adequately disclosed to them and they have a loss as a result. This would remove some of the most significant uncertainties facing the with-profits fund and enable it to be managed more strategically.*

Under the final heading '*What is the desired outcome (including time horizon for mitigating the risk or addressing the problem)?*', the assessment states:

> *The FSA has made clear that it believes an appropriate compromise along the lines described above will be the best way for the Society to deal with its problems in the interests of all its policyholders. General improvements in market conditions, and steady (or rising) interest rates will also help the Society manage its financial position.*

08/11/2001 [11:15] Equitable send FSA an amended copy of the proposed addendum 3 to the reinsurance treaty.

[**12:24**] Line Manager E circulates the addendum and asks for comments from the Head of Actuarial Support and Scrutinising Actuary F.

08/11/2001 [11:34] FSA's Head of Actuarial Support says that he was not sure how the policy value figures supplied by Equitable the previous day reconciled with ones supplied earlier. He notes that an earlier balance sheet had showed with-profit assets of £23.2bn (excluding reinsurance and future profits) as at 31 July 2001, whereas the latest figures state assets of £22.5bn at that date.

08/11/2001 [12:11] FSA's Line Manager E circulates a note of a conversation he had had the previous day with Equitable, in which he had sought to check the basis on which '*values would be assessed for voting purposes*' in the compromise scheme. He acknowledges that: '*Clearly, it is very late in the day for us to be asking for further changes to their approach, but it would be better to raise concerns now rather than wait for the court to throw the scheme out!*'.

Line Manager E records that Equitable's intention was now that:

> *GARs will have their voting values assessed on the basis of policy value or guaranteed value (whichever is the higher) after the uplift. This will mean that the value of the GARs under the individual contracts will be reflected in the voting value ... I discussed this with* [Chief Counsel A] *before she went away and she agreed that the method they are now using is the right one.*

For the purposes of agreeing the GAR uplift, non-GAR votes will be weighted according to the higher of policy value and guaranteed value, ignoring any uplift. This would appear to be justified on the basis that any claims individuals might have are not contractual and therefore outside their relationship with the Society on the basis of which they vote. Instinctively I find that logical, but I wondered if the distinction between the different rights (contractual and rights of action under s.62 or common law) might be artificial ... Working on the basis of uplifted values makes no difference because everyone is being uplifted by the same amount.

For the purpose [of] *compromising mis-selling claims, non-GAR votes would be weighted by the size of the claims ie policy value multiplied by 0.71% or 1.42% depending on whether the policy was taken out pre or post 3 October 1988. That seems sensible to me.*

Line Manager E asks if anyone had any '*violent objections*' to these current proposals.

08/11/2001 [12:44] FSA's Director of GCD provides the Director of Insurance with a detailed note of the meeting with Equitable on 02/11/2001 about the compromise scheme and on the follow-up to the issues raised. The Director of GCD says that he understood there to have been '*a very constructive meeting on 7 November at which a process was agreed for addressing the issues necessary to be able to give Equitable the view it needs on its documentation by 19 November*'. The Director of GCD sets out the issues discussed at the meeting as follows.

On '*Weighted voting*', the Director of GCD explains that Equitable's proposals '*would operate on a date basis, so that policies bought after a particular date in 1988 would carry twice the votes in the compromise as policies bought before that date*'. He says that FSA had raised four concerns about Equitable's proposals.

First:

... why if such an arrangement was needed to reflect the view that post-1988 policyholders had a better prospect of a successful claim, there should not be an increase in the uplift, as well as an increase in the number of votes. We also asked whether there should be further break points in 1993, on the basis of the ... advice [from Counsel for FSA], *and for the most recent purchases, where the claim would arguably be strongest of all.*

In response, the Equitable and their advisers said that:

- *their systems would accommodate not more than one breakpoint;*
- *their systems would not accommodate a variation in uplift, only in votes;*
- *the number of non-GAR policyholders who had bought before 1988 was small, and would not justify reducing their uplift.*

Overall, we were not quite convinced, and asked for them to verify these points particularly in light of further discussion.

We asked why it was appropriate to have differential voting rights in that, as we recalled, part of the justification for a flat rate uplift had always been said to be to those who had been policyholders for the longest period would have weaker claims, but for larger amounts. The response on this was that they had calculated that these policyholders would have proportionately the same claim, of 4.5%.

Secondly:

... [FSA] *asked whether they were satisfied that operating a differential voting system here, and not in other areas of the scheme, was consistent. They said that they currently thought it was. We should ask them to satisfy themselves thoroughly on this point.*

Thirdly:

> [FSA] *then asked about another point relating to consistency in their approach. It appeared that they were working on the basis, for the purposes of the compromise, that all purchasers after 1988 had a claim. Was this consistent with their approach to valuing the aggregate of their misselling liabilities, if that was based on the ... view* [of Counsel for FSA]*that the disclosure obligation bit only after 1993? They said that they believed that their approach was consistent. They had calculated the overall loss not on the basis that liability started in 1993, but on the basis that it was limited to the transfer of value made when they provisioned fully for the liabilities to GAR policyholders. This caused us to ask what provision had been made in their accounts for those who had purchased after the House of Lords decision. It was not clear that provision had been made for these purchases, either in the accounts, or in the calculation of the amount available for compensation. In response, the Equitable indicated that they thought that it was right to keep these claims in the scheme, but that the amounts involved were likely to be small.*

FSA's Director of GCD asks the Director of Insurance whether FSA were content with this.

Fourthly:

> [FSA] *then asked for clarification of how the dateline operated for those who purchased a series of single premium policies, or topped up existing policies. We were told that the relevant date for top-ups was the date on which the original policy was purchased. We noted that this helped to justify providing a flat rate uplift, since many of those who purchased pre-1988 would have topped up their policies subsequently, in circumstances where they might be entitled to redress as if they had bought a new policy. But we thought that this argument would be equally valid as a justification for flat rate voting rights. In sum, we thought that it would be important for the Equitable to be able to explain to the Court why it made sense to operate variable voting rights, but a flat rate uplift. But the advice from* [Counsel]*, which we accepted, was that so long as we were happy with the fairness of the uplift, the issue of the voting rights was a matter for the Court.*

On the '*Structure of voting arrangements*', the Director of GCD records:

> *Their papers indicated that policyholders would have votes in different capacities. There would be one calculation of votes on whether to agree the uplift for the GARs, and another on giving up rights to claim for misselling. Would the effect be that it was possible for a non-GAR to vote in favour for an uplift for misselling, but against an uplift to compensate the GARs? In response, it was said that each policyholder would be asked to vote either for or against the scheme as a whole. However, the value attributed to their votes would depend on the capacity in which the vote was being counted.*
>
> *This led us to ask whether there would be guidance to policyholders on the exercise of their voting rights. It was confirmed that there would be such guidance. In this context, it was also mentioned by the Equitable that policyholders would be entitled to an uplift in respect of misselling rights only if they were prepared to confirm that they believed that they had been missold. We thought that this might cause people to worry, and in particular, cause trustees to be concerned about their position, and what due diligence they needed to undertake before giving such a confirmation. In discussion, it was thought possible that it was not necessary to require a specific confirmation along these lines.*
>
> *At this point, we asked about the arrangements for trustees generally. The Equitable indicated that trustees would be able to split their votes according to value. In order to assist them to do this, they would be told the value of the votes they are able to exercise, and the proportion by value of their beneficiaries who were GAR or non-GAR policyholders. No issues were raised on this account.*

On '<u>*Those who had lost GAR rights*</u>', the Director of GCD records:

> *It was then mentioned by* [Counsel] *that he was aware of someone who believed that he had been misadvised by the Equitable to transfer from a GAR to a non-GAR policy. This individual was concerned that his rights might be forfeited if the scheme were to go through. If that was indeed the effect, it was a vulnerability of the scheme because someone could appear in court and argue that he should not be asked to give up such rights without any compensation, which would be the effect of the scheme as described.*
>
> *In response, the Equitable said that anyone in this situation would be able to get the uplift payable to a GAR policyholder on showing that he had given up his GAR rights as a result of misselling by the Equitable. Such an individual would not be treated as a GAR holder for purposes of the vote, because the position would not be established at the time of the vote. But he would be treated as a GAR holder for purposes of the uplift, assuming a successful vote.*
>
> *We said that it was important that this mechanism should be created by a legally binding means. This could be by incorporation into the scheme itself, or by an undertaking to the Court. But it should be dealt with formally in advance, rather than depending on a policyholder making representations at the Court. It was agreed that this mechanism was only to be provided for those who had been persuaded to give up GAR rights. It was not appropriate for those* [who for] *example, whose GAR rights had lapsed.*

On '<u>*International policyholders*</u>', Equitable reported that '*in their view international policyholders had the same rights to claim for misselling as anyone else*'. FSA '*expressed surprise that 1988 should be a key day for them, as well as for UK policyholders, but were told in response that no or virtually no overseas policies had been sold before 1988*'.

On '<u>*Retirements after vote but before implementation*</u>', FSA's Director of GCD records that there had been:

> *... a discussion initiated by the Equitable of the position of those who wished to retire after the announcement of the result of the vote. It was suggested that these people would be in a position to exercise their guarantee rights in the knowledge of the outcome of the vote, but before the compromise took effect. The suggestion was that this would be a drain on the resources of the company. In response, colleagues said that we thought that this was a problem only if the policy values were not properly aligned. We also had difficulty in seeing by what authority the company would suspend people's rights to retire.*

FSA's Director of GCD says that, following on from this, Equitable's use of a market value adjuster had been discussed and records that:

> *I said that we had been advised that the MVA was vulnerable to challenge in its present form because of lack of public clarity as to the basis on which it would be exercised. Our understanding of the position was that it would be possible for them to make the MVA robust, if they were to clearly commit to exercising it on limited grounds. The confirmation they had given us so far about the basis on which the MVA would be operated did not achieve this result, because it did not constitute a public commitment which would bind the company. It would be in our view wise for them to consider again making such a public statement.*

(Note: this view had been previously expressed by the Director of GCD on 14/03/2001 [**16:15**].)

08/11/2001 [17:08] FSA's Line Manager E distributes an amended copy of the note of the meeting with Equitable held on 06/11/2001.

[**18:29**] The Director of GCD thanks him for the note and says that Legal Adviser E would prepare a summary of the revised reinsurance treaty. The Director of GCD also comments that:

> [The IRECO] *agreement cannot have effect of changing the past for purposes of determining whether capital requirements were met on a particular date*;

and the Director asks:

> *Is it publicly understood that the misselling uplift will be even lower if no money from Halifax? What happens if deal delayed so that* [Halifax] *money not paid – must not end up* ***needing a new vote because this not properly clear.***

09/11/2001 [10:47] Further to his request of 08/11/2001 [12:24], Line Manager E seeks actuarial advice from the Head of Actuarial Support and legal advice from Legal Adviser E on the revised terms of the reinsurance treaty. The Line Manager says:

> *One issue on which Equitable are seeking our views is the provision in article IV that limits the cover available. It is done on the basis that there is a ratchet that means the amount claimed can only ever go down, and the amount available is restricted to the lower of 120% of the reduction of reserves needed because of the Treaty or the amount shown in the schedule.*

To the Head of Actuarial Support, he says:

> *As far as I can see (and I assume the reduction in the reserves means the full amount rather than the amount in excess of £100m), that means there is from the outset a cap of £840m (1.2 x £700m) on the amount that can be claimed, so the amounts shown in the Schedule for the first ten years are meaningless.* [Head of Actuarial Support], *I would welcome your advice on what we would find acceptable.*

To Legal Adviser E, he says:

> *... I notice that there is provision in Article VI that says in effect the treaty is only valid so long as there is no change in the policy of paying GARs, and that Ireco has the sole discretion in deciding whether there has been a change. I was worried by that – and how it relates to the arbitration provision, if at all.* [Legal Adviser E], *I would be grateful for your advice on whether, if Ireco were to use some obscure issue to determine that there had been a material change, there is any effective mechanism for Equitable to challenge what otherwise appears to be an absolute discretion of the reinsurer. If there is not, I think we would have to reject that term.*

09/11/2001 [15:43] FSA's Head of Actuarial Support provides comments on the amended reinsurance treaty, having discussed the issue with Equitable. The Head of Actuarial Support says that they had mainly discussed Article IV '*Cover and Limit*' of the treaty, 'although I also made the key point to them that they will need to consider carefully the value that may be placed on this reinsurance, taking full account of all the various premiums and fees that may be payable to the reinsurer'. He says that he told Equitable that FSA would have no objection to the amended agreement but Equitable would need to consider carefully the value that could be placed on it.

09/11/2001 [16:20] FSA's Legal Adviser E sends the Director of GCD, the Director of Insurance, Line Manager E and the Head of Actuarial Support a document setting out his understanding of each clause of the addendum to the reinsurance agreement and initial comments on the drafting.

[**17:29**] The Director of GCD says that Adviser E's note: '*indicates that the net effect is formally to limit the amount payable to £100m in the first year. On that basis surely its real effect is not that the side letter will have no effect, but that it will have full effect, so not desirable that they should sign it*'.

	[**17:33**] Line Manager E disagrees because: '*the GAR liabilities will arise over time, not all in the first year. Therefore, if the maximum funding available under the treaty is £1000 million, and that needs to cover a period of at least 30 years, I do not think we would expect more than 10% of the total to be due in any particular year*'.
09/11/2001 [16:26]	Line Manager E provides officials with a revised brief for FSA's appearance before the Treasury Select Committee on the line to take on the guidance about reserving for annuity guarantees issued on 18/12/1998. A part of the response includes the statement: *The Equitable Life's position was that it had significant exposure to GARs, but it was dealing with that exposure by adjusting bonus payments to minimise the impact. It considered that was an appropriate practice and that it was a lawful practice. With the benefit of hindsight, we – and indeed the High Court that endorsed the policy – now know that view to be incorrect. It seemed therefore, at least until the Court of Appeal, and indeed until the House of Lords gave its judgment, that there was no need for the company to consider demutualisation (or any other such strategy) because of the GARs. That said, it was clear the Society was fundamentally weakened and would need to consider its position in the medium term.* *It is certainly true that notwithstanding the position in the Courts, Equitable Life was having to set aside significant reserves to comply with the Insurance Company Regulations. By definition, that reduced the surplus assets but it certainly did not eliminate them (the 1999 year end returns show a surplus over the statutory requirements of about £3 billion).* *The guidance by the Treasury, which in effect was inherited by the FSA which subsequently withdrew it, was issued to give practical advice to companies about how the cost of GARs should be met and highlighting the potential impact on the reasonable expectations of policyholders. It was not directed at any particular company and was not intended to endorse the approach adopted by any particular company. It was given on the basis of our understanding of the legal position – and clearly we acted immediately* [when] *we realised our understanding was incomplete. We have no evidence to suggest that the guidance encouraged or discouraged any demutualisations or sales.*
12/11/2001 [08:28]	FSA's Director of GCD gives the Head of Actuarial Support, Scrutinising Actuary F, Line Manager E and the Director of Insurance his comments on the maximum benefit which he believed Equitable could claim in their returns for the reinsurance treaty, based on the interpretation he and Legal Adviser E shared as to the revised addendum. The Director of GCD says that the maximum benefit that Equitable could receive on a claim of £1bn would be a loan of £250m, for which Equitable would have to pay back £375m. He adds: '*Sounds of doubtful benefit to me, though these figures have not benefited from actuarial input*'. [**10:02**] The Head of Actuarial Support comments: '*I am not sure how the £250 million is derived, but I think it must depend on the interpretation of the limit in article IV. We have already advised* [Equitable's Finance Director] *and* [Appointed Actuary] *that the wording of this article is dubious and should in our view be amended*'. [**10:29**] The Director of GCD explains that he had derived the £250m figure from Article IV '*which allows for up to 10 per cent pa of aggregate of claims outstanding and payments made*'. He says that FSA's Chairman would like the Head of Actuarial Support to pursue with Equitable how their advisers saw the position.
12/11/2001 [09:57]	FSA's Head of Actuarial Support sends Chief Counsel B and Legal Adviser F a copy of his note of their discussion the previous week about the comments on mis-selling liabilities made in Equitable's letter of 26/10/2001 [**09:57**].

The Head of Actuarial Support records that they had reached the following conclusions in four areas. First, FSA note that:

> *Equitable are arguing that a discount needs to be applied to the gross value of the claims for mis-selling to allow for (a) the strength of the various individual claims and (b) the contribution that all policyholders would have to make towards meeting these claims.*

The conclusion reached by FSA was that they:

> *... accept that a discount for (a) is correct in principle. For (b), the effect is also acceptable in principle.*

The Head of Actuarial Support states:

> *The reason for the conclusion in (b) is that arguably they should really have set aside through provision an amount for the gross cost of mis-selling which would have impacted at that stage on policy values – non-GARs would thus have "contributed" to that provision. An uplift would then be offered as a second step for the mis-selling – which would act as a release of the provision for bonuses and the general fund. However, we accept that in practice, it is acceptable to combine these two steps and offer a single net uplift to the non-GAR policyholders with mis-selling claims. This approach is only appropriate for non-GAR policyholders who remain with the Society.*

Secondly, FSA note that:

> *Equitable are offering an uplift (before discounting) on policy values corresponding to the adjustment made in 2000 to policy values to cover the cost of GARs (ie the withholding of any final bonus in respect of the first 7 months of 2000).*

The conclusion reached by FSA on this point was:

> *Since part of the loss sustained by non-GAR policyholders relates to their expected benefits rather than the guaranteed benefits, it seems reasonable that part of the compensation offered should likewise take this form. In addition, though, Equitable suggest that in the absence of the GAR issue, they might have declared a 4% bonus addition to the guaranteed benefits in 2000. Therefore, they are also offering alongside the uplift to the policy value a 4% (or 0.5% for those pre-96 policyholders who have already received the contractual minimum 3.5% increase) to the underlying guaranteed part of their benefits, and this seems appropriate.*

Thirdly, FSA note:

> *Equitable have not specifically answered the question that we asked about the rights of policyholders who leave before the scheme becomes effective (though the latest scheme documents suggest that they do now accept that they would have possible claims).*

The conclusion reached by FSA on this point was that they:

> *... would concur with them that such policyholders are unlikely to be able to claim for recovery of any financial adjuster as such (the question is whether the policyholder received less than the "comparable policy", but subject to not compensating for market conditions). However, it does seem likely that they could recover the gross value (without discounting) of their GAR-related loss, and they will then need to provide accordingly for mis-selling claims by all those policyholders who leave the Society before the scheme becomes effective. For most pre-16th July leavers, we accept that there may not be any loss to be recovered when measured against an industry comparator, but for subsequent leavers, it is likely that a loss can be identified – though the loss by reference to an industry average comparator is likely to be larger than the direct GAR-related loss, and*

the latter should therefore be the sum recoverable on a successful claim (all else being equal) to avoid compensating for market conditions.

Fourthly, FSA's Head of Actuarial Support records:

There is a potential presentational issue arising out of [the issue]. *Policyholders ought to be made aware of the nature of what they are giving up and what they are receiving in return. The misselling claims are rights which are subject to proof (their value is also uncertain and in some cases may be zero). In return for giving up those rights the policyholders are asked to take a combination of rights (the reversionary bonuses being "reinstated") and of hope/expectation (the "uplift" in the policy values). The references to uplifting policy values might be misleading as suggesting that policyholders are swapping one type of right for another.*

[**21:39**] Legal Adviser F gives comments to the Head of Actuarial Support on his note, having discussed the matter with Chief Counsel B.

12/11/2001 [11:40] Further to a telephone conversation that morning, the Financial Ombudsman Service write to FSA setting out further details about their jurisdiction in relation to complaints made about policies sold, and written, in Guernsey.

12/11/2001 [14:06] FSA's Director of Insurance informs Line Manager E of a conversation he had had with Equitable about: reinsurance; the cover for the required minimum margin; disclosure of the initial hearing date for the compromise scheme; and the financial position set out in Equitable's Chairman's letter to policyholders about the compromise scheme. This is copied to Managing Director B, the Director of GCD, the Head of Actuarial Support, the Head of Life Insurance and Legal Adviser E. On the cover for the required minimum margin, the Director of Insurance records:

[Equitable] *thought that without more than £100m* [reduced reserving from the reinsurance treaty] *it would be "very thin at best".*

On the financial position set out in the Chairman's letter, Equitable had: '*said that the latest draft ... had two paragraphs on this. He would consider what more could be done, but said that there was a limit to what was practical*'. The Director suggests that FSA should ask for a copy and discuss this further.

The Director of Insurance also informs the Line Manager of a conversation that he had had with HMT:

... to ask whether HMT had made progress on the s68 order allowing the Society to apply the post N2 valuation rules. [HMT's Director of Financial Regulation and Insurance] *said that it had not. It was pretty clear HMT have no appetite for taking a decision on this.* [The Director] *said that they would need more information before they could consider it. In particular how many other companies had applied; would the new rules apply to the Equitable "in toto" and would they be compliant with them; was there any interaction with other s68 order extent. He could not say that the application would be processed this afternoon if we could supply this information (it would depend on what else "turned up"). Equally he did not say that they would not deal with it.*

[**14:47**] In response, the Head of Actuarial Support informs recipients of the note of a further concern about the revised reinsurance treaty which he had. This was:

In addition to the points raised by [Legal Adviser E] *(and my earlier concerns expressed to Equitable on article IV), I am puzzled by Articles II and XII. This appears to make Equitable liable in the event of cancellation of the agreement to payment in cash of the balance of the Additional Fee and Risk Amount, but the reinsurer does not seem to have any liability in that event to Equitable. I could understand the reinsurer wishing to use this mechanism to recover any cash advanced under Article V, but otherwise, this does look potentially quite onerous.*

12/11/2001 [14:06]	FSA's Head of Press Office asks the Director of GCD and the Director of Insurance for comments on what FSA could say about Equitable's reinsurance treaty and the side letter. [15:18] The Director of GCD provides some comments but says that he believed that most of this would need to come from the Director of Insurance and his team. [**16:40**] The Head of Life Insurance provides some of the responses to the Head of Press Office's questions but explains that they were waiting for further information from Equitable and further analysis on the solvency cover from the Head of Actuarial Support.
12/11/2001 [14:23]	HMT's Director of Financial Regulation and Insurance informs an HMT official that FSA's Director of Insurance had telephoned him about Equitable's section 68 Order. The FSA Director had said that the Order would simply mean that Equitable were complying with the new rules to come into effect from 1 December 2001. HMT's Director says that he had asked FSA how many other insurance companies had been given similar concessions and whether this meant that Equitable were complying with the post-1 December 2001 regime completely or were being given an opportunity to '*pick and choose*' from the two regimes. The HMT Director says that FSA's Director of Insurance had agreed to get back to him as he did not know the answers and comments that: '*The subtext here seems to be* [FSA's Chairman's] *appearance tomorrow before the* [Treasury Select Committee]*, & further doubts about the reinsurance agreement which (in the absence of the s68 order) could/might mean* [Equitable] *are below their regulatory solvency margin, at least under the old rules*'.
12/11/2001 [15:15]	FSA's Scrutinising Actuary F lists for the Head of Actuarial Support some of the possible problems with the reinsurance treaty which had been identified so far. The Scrutinising Actuary points out that his review was not complete and says that he was providing the comments so that Line Manager E could give some preliminary feedback to Equitable that afternoon. The list of possible problems includes: • *There appear to be 2 caps which limit the overall potential exposure of the reinsurer. One is a "Limit of Cover" schedule which decreases from year to year, starting at £1,000m. for calendar year 2001. The other is that the limit in any year will not exceed 120% of the reassurance offset which applied in the previous year. It seems to me that the treaty therefore provides very limited protection against falling long term gilt yields, and that* [Equitable] *remain exposed to the risk of a further sustained increase in GAO costs. I therefore question what allowance* [Equitable] *can make in their Returns for this sort of arrangement.* • *Article 4 refers to the Reinsurer being liable for any Reinsurance Claims Amount as at 31 December each year. Is it not liable at any other time during the year?* [Equitable] *needs continuous protection, and needs to meet solvency requirements throughout the year. What is the Reinsurer's liability during the year if at that point the GAR take-up rate over the year to date has been less than 60%, but the Actuary would set a valuation assumption well in excess of 60%?* • *In Appendix 1, there are conflicting definitions of the "Reinsurer's Liability". Under the subheading "Reinsurance Claim", the first and last sentences give different definitions.* • *Also in Appendix 1, I do not understand what the re-definition of "Current Annuity Rate" (when the £100m. threshold is passed) is seeking to achieve. It refers to a 15 year gilt yield – at what date? What is the impact of this clause on the reserves held in the resilience test?*

- *Also in Appendix 1, the "Claims Recovery Premium" is defined. This is due for simultaneous payment by the Reinsured to the Reinsurer should a Reinsurance Claim event occur. In this case, shouldn't* [Equitable] *reduce the reinsurance offset on Form 52 by the amount of the Claims Recovery Premium? This could depress the Reinsurer's overall limit and potentially lead to the collapse of the treaty?*
- *What is the rationale for* [Equitable] *agreeing to purchase £40m of hedging instruments should the compromise scheme fail?*
- [Legal Adviser E] *has identified, in his earlier note, several areas where the "Termination" Clauses may be unsatisfactory, as well as many other points which need to be worked through.*

Scrutinising Actuary F concludes that his: '*overall reaction is that this arrangement is little more than "window dressing" and the reinsurer has no intention of assuming any serious risk at all*'.

[**15:42**] The Head of Actuarial Support replies:

> *In reply to your first indent, we would expect to see* [Equitable] *make provision for a reduction in interest rates to the regulation 69(9) level with possibly a further fall in the resilience test, so that along with the 120% ratio, there would be some modest protection against further falls in interest rates.*
>
> *I think the Claims Recovery Premium is designed so that in the event of no final bonus being paid, as is likely to occur if the compromise is rejected, the full cost of the GAR would be included in the reinsurer's liability.*

12/11/2001 [23:49] FSA's Director of GCD informs officials of a telephone conversation with Equitable's solicitors about his concern that the only value from the reinsurance treaty should be the cash payment available. The Director of GCD says:

> *They indicated, and I agree, that the agreement provides for benefit over and above the cash payments, in the sense that it creates an entry to the credit of the reinsured in the books of the reinsurer. This never becomes payable to the insured. On liquidation of the insured, for example, it is automatically extinguished. But if this is sufficient to create an actuarial benefit, it is there.*

The following day [**at 08:35**], the Director of Insurance thanks him for the '*helpful*' comments. The Director of Insurance sets out his understanding of the reinsurance treaty, saying that:

> *... the revisions to the Treaty now proposed would reduce the effect of the various limitations in the version we saw last week. While the annual cash limit remains the overall benefit of the asset held by the reinsurer on the reinsured's account (net of the various payments that would have to be reserved for)* [that] *would be of significant benefit to the reinsured. It would, in this respect, be consistent with the original treaty (absent the side letter) which we accepted for reserving purposes at the time. The main difference, if the amendments are accepted, is that it sets out in definite terms how the treaty operates above the £100m level and what payments from the reinsured have to be made in those circumstances.*

13/11/2001 [09:25] FSA's Head of Actuarial Support thanks Legal Adviser F for his comments of 12/11/2001 [**21:39**]. The Head of Actuarial Support points out, however, that: '*There is no requirement for companies to make any provision for final bonuses. Therefore, I am not quite sure if we are saying that they should though have made a provision for the gross mis-selling claims, but then allowed this to be reduced because a significant part of the compensation is being added as an increase in their discretionary (ie non-guaranteed ...) bonuses rather than as an increase to their guaranteed benefits*'.

Legal Adviser F replies that he thought he had: '*meant that they would have provisioned for the whole (gross) misselling liability which inevitably impacted on the ability to pay final bonuses across the board. That provision would be released by compromising the misselling claims – again across the board. They are reinstating what they would have done – ie declaring reversionary bonuses, which takes up some of what is released, leaving the rest in the "pot", which impacts on the "policy value"*'.

The Head of Actuarial Support asks:

> *Does that then mean that they would have to provide for the full gross mis-selling costs if the compromise were not to succeed?*

The Legal Adviser replies: '*I suspect yes*', although adding that '*the discounts for probability of success could still be applied*'. Legal Adviser F states that:

> *This is only a reflection of the comments I made when we met that (with the benefit of hindsight) one might reasonably have expected the Society to have done this for some time now.*

The Legal Adviser adds, however, that: '*I'm afraid I don't know enough about life company accounting to know whether they could achieve the same result differently. (But in favour of that approach is that the impact of the provisioning must be that leavers also "pay" for a share of their misselling claim – which is part of my rationale for agreeing that the effect is appropriate in the scheme.)*'.

[**12:46**] The Head of Actuarial Support sends Line Manager E a copy of his note on the conclusions that had been reached about the comments on mis-selling liabilities made in Equitable's letter of 26/10/2001 [**09:57**]. (See 12/11/2001 [**09:57**].) The Head of Actuarial Support also send him the record of his discussions with Legal Adviser F of that morning. He also sends copies of all of this correspondence to the Head of Life Insurance, Scrutinising Actuary F, the Director of Insurance, Chief Counsel A and Legal Adviser F.

The Head of Actuarial Support explains:

> *This is where we have now reached here on the subject of the provisioning for mis-selling claims and hence the reasonableness of the compensation offer being made as part of the compromise scheme. I think this means that we would expect to see a rather larger provision of closer to £500 million (as opposed to their suggested figure of £300 million) for mis-selling claims.*
>
> *However, we would not object in principle to their proposed offer of compensation for giving up their "GAR-related rights" in the compromise being discounted for both the probability of success of the claims and also the payment by all policyholders of a proportionate share of the cost of this compensation so that an average uplift of 25% of policy value (including the Halifax money) would seem to be defensible.*

13/11/2001 [17:57] Equitable's solicitors send FSA some amended text concerning the reinsurance agreement.

The following day [**at 17:29**], the Director of GCD circulates the text, saying that it aimed to meet the points made by the Head of Actuarial Support.

14/11/2001 [entry 1] The Head of Life Insurance sends FSA's Chairman a paper on '*What view FSA should take on the Compromise Scheme and how and when that view should be promulgated*'.

The paper sets out the '*Background*', including '*Recent Developments*' and the latest '*Scheme Timetable*', the latter being:

21 November 2001	*Equitable Board meets to approve the Scheme documents*
26/27 November 2001	*Court hearing on application to convene Scheme meetings*
From beginning of December 2001	*Receipt by Policyholders of Scheme documents*
11 January 2002	*Scheme meetings and vote counting*
Feb 2002	*Substantive court hearing, and registration of Scheme at Companies House (Scheme becomes effective)*
1 March 2002	*Deadline for Halifax money*

The Head of Life Insurance says that the decisions FSA needed to make were:

1) By 21 November, two related decisions are needed:

(i) We need to be able to indicate to the Equitable Board whether we see any "Show Stoppers" or whether there are any aspects of the Scheme which we might need to criticise publicly.

(ii) As a condition of Halifax's approval of the Scheme, Halifax want confirmation that the FSA has no objection to the proposed Scheme or to the draft Scheme documents being issued to those entitled to vote. A form of words is needed for inclusion in the Scheme documents. This will be needed in time for the 21 November Board Meeting.

2) The FSA could be represented at the convening hearing, either to make a statement, or to be ready to respond to any questions the court may have.

3) We are publicly committed to making our views known to policyholders before they vote. Although the voting meetings will not be held until January, voting papers will go out from the beginning of December and we believe we need to be ready with our statement at the beginning of this period.

4) FSA may wish to be represented at the substantive court hearing in February 2002, and submit a witness statement. The substance of any such statement would have to be the same as in any statement to policyholders before the vote, but the argumentation may need to be fuller.

FSA's Head of Life Insurance explains that FSA had been in regular contact with Equitable over the development of the scheme and that the latest version took account of most of their concerns and questions. He says that '*Equitable have explained that some of our suggestions cannot be met fully (eg there are constraints on their ability to provide updated financial information)*'.

Under '*Assessment*', the Head of Life Insurance says that FSA were still reviewing the scheme documentation as it was received from Equitable and that this '*is not yet final, but on the basis of the drafts seen to date, we have assessed the proposals under two broad headings*', these being the fairness of the scheme and the clarity and accuracy of its communication.

Under '*Fairness*', the Head of Life Insurance writes:

Policyholders are divided into three classes for voting purposes. The classes are primarily a matter for the court to adjudicate and are not strictly an issue for the FSA. But we have reviewed the reasoning behind the creation of three classes and see no reason to object to it.

We set out the criteria against which we would assess any Scheme in a letter to the Equitable of 3 September 2001 ... using these criteria as a basis, we have considered whether what policyholders are being offered is a fair exchange for what they are being asked to give up, and whether within each group of policyholders, the distribution of sacrifice and reward is broadly fair.

For GAR policyholders, the Head of Life Insurance says that FSA:

... believe that the uplift, which they are being offered, is a fair exchange for giving up their rights to GARs. We also believe that the variation in uplift is a fair reflection of the differences in value of different GAR policies. We had some concerns that those close to retirement were not receiving a sufficient uplift to reflect the value of their GARs; but we believe that the latest uplift figures, combined with the other less tangible benefits flowing from the Scheme (such as greater flexibility in the types of annuity available) mean that this group are being treated fairly.

For non-GAR policyholders, FSA's Head of Life Insurance writes:

Following representations by [lawyers appointed to act] *on behalf of the non-GAR policyholders, non-GARs will be divided into two voting classes:*

- *In respect of the uplifts offered to GAR policyholders; and*
- *In respect of the uplifts offered to non-GAR policyholders in return for giving up any mis-selling claims they may have.*

As regards the proposals for non-GAR policy uplifts we applied the same analysis as for the GARs. We believe that the 2.5% uplift offered represents a fair exchange for the surrender for any GAR related mis-selling claims; taking into account the uncertainty involved and the fact that non-GAR policies represent 75% of the with-profits fund, so that effectively they must meet 75% of their own compensation. The flat distribution of the uplift is more difficult: it can be argued that the strength, nature and hence quantum of claims varies according to the date and circumstances of the sale. However, there are two arguments for accepting a flat uplift. First, and most powerful, is that the costs of constructing a more refined mechanism for uplift (in terms of resource devoted to detailed research, delay and consequent loss of the Halifax money) was so great that policyholders would lose more than they gained. Secondly, the most significant difference is the strength of claims as between pre 1988 and post 1988 policies (which became subject to the FS Act & LAUTRO rules): and this is recognised by giving different voting weights to pre and post-1988 policies.

FSA's Head of Life Insurance says that FSA had considered the position of policyholders who had already left or who left before the scheme became effective and had mis-selling claims, noting that their rights to pursue any claim were unaffected by the scheme. He also explains that FSA had:

... discussed with Equitable the financial implications of claims for mis-selling by policyholders who have left the fund, and the possibility that awards by the court or the Ombudsman could be higher than the 2.5% uplift provided for in the Scheme. Equitable explicitly disclose in the Interim Report that should each policyholder (instead of accepting the Scheme) choose to pursue a claim and succeed in claiming compensation, then the costs of the Society could be substantially higher than the aggregate £850 million which they have estimated as a starting point (before discounting) for calculating uplifts in the Scheme. However, Equitable have confirmed that they consider that the aggregate cost of claims by policyholders who have left the fund or who may leave before the Scheme becomes effective, would not be material, and they have made no provision for these claims.

The Head of Life Insurance also explains that FSA had:

... considered with the Equitable whether the fund could withstand large scale departures after the conclusion of a successful Compromise Scheme. At present, policy values are sufficiently close to asset shares to mean that the fund is not currently being damaged by departures (payouts on maturity are approximately 102% of asset shares and policies on surrender approximately 92% of asset share; the average of all payouts is about 98% of asset share). However, in the event of large scale departures final bonus rates may need to be cut across the board.

Lastly, FSA's Head of Life Insurance states that FSA had considered whether the scope of the rights being compromised was fair and clear, which FSA believed was the case.

Under the heading '*Communications*', the Head of Life Insurance sets out FSA's assessment of '*the overall clarity and intelligibility*' of the scheme documentation. He says that the documentation was thorough and comprised:

- a letter from Equitable's Chairman to policyholders;
- '*The Scheme Document*';
- question and answer material, including frequently asked questions and directions to where more detailed information could be found within '*The Scheme Document*';
- Equitable's '*Interim Report for the Half Year ended 30 June 2001*';
- a report by Equitable's Appointed Actuary; and
- a report by the Independent Actuary.

The Head of Life Insurance continues:

Our basic approach has been that the Equitable's material should be sufficient to give policyholders a clear and balanced picture, and that the FSA should not need to put out any supplementary statement of its own to achieve that clarity and balance. Specific issues which we have discussed with Equitable are:

(i) Adjustments to the summary of the Scheme, to present a fair and balanced summary.

(ii) Presentation of the financial position. We are concerned that policyholders should have enough financial information to be able to make an informed decision when they vote. There is an Interim Director's Report for six months to 30 June 2001, which stresses the fundamental circumstances. In addition the Scheme document will contain a proforma balance sheet (based on 30 June 2001 figures) which will show in broad terms the effect of the Scheme on these figures: and the Chairman's letter contains additional financial information (size of fund, value of surrenders, proportion of the fund invested in equities) as at the end of September 2001. We discussed with Equitable whether a balance sheet as at 30 September could be produced. However, their view is that the Directors have an obligation to verify any information included in the Scheme documents, and they would want the auditors to review it. This could not be done in the time available before the launch of the Scheme. This issue remains under discussion.

We have been particularly concerned that the policy values quoted to policyholders in connection with the Scheme should not give a misleading impression (for example, if aggregate policy values were significantly higher than asset shares, there must be a serious prospect of a future cut in policy values (by way of a reduction in final bonus); and policyholders would need to understand this when they voted on the Scheme).

The Head of Life Insurance sets out a fuller analysis of these issues in an annex to the paper. This analysis is largely the same as that produced as a result of the meeting held on 14/08/2001.

The Head of Life Insurance then turns to '*Contingency Planning*' saying that, should the scheme fail for any reason, FSA:

> *... would need to monitor the ongoing financial position even more closely than at present. We would also need to decide how to deal with claims for mis-selling by non-GAR policyholders in the absence of a Compromise Scheme. Rather than leave individual policyholders to seek redress through the courts or through the Ombudsman, we envisage requiring the Equitable to set up a process for review and redress, in consultation with* [the Financial Ombudsman Service].
>
> *We are also reviewing the options for Equitable if the Scheme were to fail (the immediate fallback is to soldier on, but this will need to be kept under review against the possible alternatives (eg administration or provisional liquidation).*

He lists the '*Outstanding Points*' for FSA as:

- *We need to take a view on whether to press (or require) Equitable to publish more financial information as at 30 September, despite their arguments against this.*
- *The Reinsurance Treaty has been renegotiated, but is not yet signed. We have been asked to provide a "comfort letter" to IRECO that we do not object to the revised terms.*
- *Equitable are resisting our request that they make known publicly the date of the Convening Hearing.*
- *Our assessment has been made on the basis of rapidly changing draft texts. We are still reviewing the latest draft (received today), but we have taken account of the significant changes.*

Finally, the Head of Life Insurance gives the '*Issues for decision, and recommendations*' as:

1. *Statement of FSA's view on the Scheme documentation*

   Subject to resolution of the outstanding points listed above, I recommend a short and low key form of words, [such] *as*

   "FSA has been kept informed as the Scheme has developed. FSA has powers to intervene to object if it believes that the Society is acting without due regard to the interests of policyholders. It sees no need to exercise these powers, and considers that the proposed Scheme is a reasonable one for the Society to put to policyholders to vote on."

2. *Representations at the convening hearing on 26 November*

   I recommend that FSA should not be represented. There is nothing further we need to say: and Counsel has advised that the judge in this case would be likely not to welcome any representations from the regulator.

3. *Statement of FSA's views before policyholders Vote*

   I recommend that this should draw on the analysis given above, and should be put out in the form of a statement to the press and on the FSA website. (An alternative would be to seek to put an information sheet in the material which the Equitable themselves put out; but this would have the presentations disadvantage of appearing to link the FSA too closely with the Equitable's Scheme. There would also be severe practical difficulties over timing.) If you agree with the approach we will submit a draft for approval by the end of November.

14/11/2001 [entry 2] FSA provide HMT with further information on the extent to which Equitable would continue to require waivers from requirements under the new regulatory regime coming into force on 1 December 2001. FSA set out the concessions which had been granted to Equitable.

14/11/2001 [16:01] Equitable send FSA a draft copy of their '*Interim Report for the Half Year ended 30 June 2001*' prepared under the Companies Act 1985. [**16:42**] FSA's Head of Life Insurance circulates the draft accounts.

14/11/2001 [20:16] Equitable send FSA what IRECO had said they believed was the final wording of the reinsurance treaty.

15/11/2001 [09:23] FSA's Director of Insurance writes to the Head of Life Insurance, Line Manager E and the Head of Actuarial Support about Equitable's solvency margin, ahead of a meeting with FSA's Chairman the following day to discuss FSA's views on the compromise scheme. The Director of Insurance notes that the Chairman was also due to meet Equitable to discuss FSA's outstanding concerns on both the reinsurance treaty and the compromise scheme.

The Director says that, against this background: '[Managing Director B] *feels that we must be able to give* [FSA's Chairman] *definitive advice on the Society's solvency position with which we are all content. He recognises that this is* [inevitably] *a matter of uncertainty and judgement rather than demonstrable fact, but feels, quite responsibly, that we must have a united position on which we would, if necessary stand publicly*'.

The Director suggests '*something like*':

> *The Society's financial position is subject to considerable uncertainty. It depends critically on assumptions about:*
>
> - *the amount which should be reserved for misselling claims, only some of which would be resolved through the compromise scheme*
> - *outflows of cash (and liabilities) since the most recent figures provided to us*
> - *the reliance which may reasonably be placed (beyond the £100m initial limit), on the Ireco Treaty.*
>
> *We understand that the view of the Society's appointed actuary is that the Society's position is likely to be "just the right side of the line". There is some justification for this. In particular advice provided to the Society and (separately) to us is that there are arguments for believing that the "letter of understanding" may not be relied on by the reinsurer to avoid liability under the treaty above the £100m initial limit. The Appointed Actuary also believes, based on his work on comparative performance of Equitable and "industry average" products, that the quantum of misselling claims that would not be settled through the compromise is likely to be relatively small.*
>
> *In our view, this assessment does not apply the degree of prudence which, consistent with the regulations, we would expect. In particular we think it would be imprudent (notwithstanding the legal advice) to make any allowance for reinsurance above the £100m initial limit. We also believe that more allowance should be made for misselling claims than the Appointed Actuary does. On this basis we believe that a prudent assessment of the Society's financial position would indicate that, while its assets continue to exceed its liabilities (subject to the fundamental uncertainty to which we and the Society have consistently drawn attention), the Society currently fails to meet its required margin of solvency by some £xxxxx. We note however that the position will be improved by some £yyyy on 1 December 2001, when new valuation rules come into force, or earlier if HMT make an order under s68, in response to an application which the*

Society has made (and which we have recommended should be granted) allowing the Society to value its liabilities in accordance with the new rules.

The Director of Insurance seeks comments on this and asks the Head of Actuarial Support to provide the missing figures.

15/11/2001 [09:50] FSA's Head of Life Insurance asks the Head of Actuarial Support and the Director of GCD whether they were content with the revised reinsurance treaty received from Equitable the previous day.

[**10:01**] The Director of GCD says that it was necessary to meet the Head of Actuarial Support's concerns and so it was for him to comment, unless he needed advice.

[**10:16**] The Head of Actuarial Support does not say whether or not he is content but outlines an outstanding concern. This is:

The wording of the agreement, including Article IV is still very convoluted, so there must be some legal risk of potential dispute over its interpretation. However, my understanding continues to be that the Equitable could claim an amount of cash each year equal to 10% of the cumulative Reinsurance Claims Amount, as calculated under Appendix I (ignoring any earlier cash payments), subject to the overall limit in article IV. This aggregate limit would then apply to the sum of the Reinsurance Claims Amount (whether withheld by the reinsurer or advanced in cash) and the amount described at paragraph (1) of Article IV.

If so, then I think this would allow a reasonable value to be placed on this reinsurance agreement as I indicated earlier. I note though that the reinsurer does seem to have considerable discretion in Article VI to determine whether Equitable has altered its practice in relation to GAOs.

15/11/2001 [11:28] Equitable send FSA the final wording of the renegotiated reinsurance treaty.

15/11/2001 [12:55] FSA's Director of Insurance sends FSA's Chairman a draft letter for him to consider sending to the Economic Secretary to the Treasury about Equitable's application for a section 68 Order.

The Director highlights three points to note, which were:

- *the draft indicates that we believe the Society to be £200m below its margin requirement. This is* [the Head of Actuarial Support's] *latest estimate this morning. He is doing further work so that we may give you a definitive view at our meeting tomorrow. It does not include allowance for the s68 order concession or for the reinsurance treaty beyond the £100m initial limit.*
- *the effect of the s68 order, if granted, would just about restore the Society's margin. (It follows that this will happen at N2 anyway, subject to any developments between now and then).*
- *we received last night further documentation from the Society on the renegotiated reinsurance treaty which they tell us is what the Reinsurer believes to be the "final wording". After review by* [the Head of Actuarial Support] *and* [the Director of GCD] *we have now told them that ... we have no further objection to it ...*

[**14:02**] FSA's Chairman writes to the Economic Secretary to the Treasury along the lines suggested. The Chairman's letter reads:

As you will be aware Equitable Life expect shortly to present their formal proposal for a compromise agreement between the Society and its members. The vote on the scheme is expected to be in early January with a court hearing in February. If the scheme is in place by 1 March 2002 Halifax will put in an additional £250m by "forgiving" repayment of £250m already put in by way of loan.

Meanwhile the Society's financial position is very tight. Information which has recently come to light about a "letter of understanding" sent by their previous appointed actuary to their reinsurers, Ireco, makes it imprudent in our view, for the Society to rely on their reinsurance Treaty to the extent they have done previously. The Society are seeking to resolve their position with ... Ireco's parent [company], *but the matter is not yet settled. Meanwhile the effect on their regulatory reserving position is, in our view, to reduce their admissible assets by some £500m.*

This problem, together with the effect of various market movements, and the need to reserve for potential mis-selling claims following delivery of the Opinions of [Counsel for Equitable and Counsel for FSA], *result, on our assessment, that the Society could be in breach of its solvency margin requirement by some £200m.*

This position would be ameliorated, at least in part, if the Society were able to value its liabilities under the rules which will apply from 1 December, rather than under current rules. The Society have applied for a concession under s68 to allow this. You will recall that, with HMT agreement, the FSA announced in September that it would support such applications. The Society's application was passed to your Department on 1 November, with advice from this Authority, which I had personally endorsed, that it be granted. I understand that your officials have asked my staff for various supporting information which they have supplied.

While it is, of course, for your Department to determine whether the application should be granted, it seems to me that it would be unfortunate if a decision was delayed. May I ask therefore that a decision be taken on this as soon as is reasonably possible.

15/11/2001 [13:19] Equitable also send FSA a draft '*comfort letter*', which IRECO had requested that FSA should send.

[**14:26**] FSA's Head of Life Insurance seeks confirmation from the Director of GCD that he was content for FSA to indicate that they have no objections to the reinsurance treaty.

[**17:55**] The Director of GCD says that he had no objections.

FSA write to IRECO to confirm that they did not object to Equitable entering into the renegotiated reinsurance treaty.

15/11/2001 [13:20] Following the Director of Insurance's note, FSA's Head of Actuarial Support sends the Director of Insurance and FSA's Chairman his latest assessment of Equitable's solvency position. This takes into account information received from Equitable that morning. It is presented as follows:

	FSA Estimate £ Million	*Equitable Estimate £ Million*
Estimated Free Reserves at 30 September	*330*	*330*
Reduce Credit for Reinsurance	*-550*	*-100*
Allow for Post-N2 yield on Equities	*0*	*175*
Reduction in Future Profits	*-450*	*-450*
Additional Mis-Selling Provision for Leavers	*-200*	*-100*
Effect on Liabilities of Reduction in Interest Rates in October	*-400*	}
Increase in Value of Bonds	*600*	} *750*
Switch of £1 billion from Equities to Gilts	*500*	}
Estimated Free Reserves at 31 October 2001	*-170*	*605*

The notes to the assessment were:

> *1) Estimated Position at 30 September comes from Society's last reported full monthly figures.*
>
> *2) Reinsurance credit is reduced from £650 million to £100 million on the FSA estimate to reflect uncertainties over the application of side-letter, but on the Equitable estimate, this is reduced to around £600 million on the assumption that the renegotiation of the agreement is completed shortly.*
>
> *3) Adjustment is made by Equitable for an FSA rule change from N2 on the assumed equity yields that may be taken into account in valuing the liabilities. The FSA figures do not allow for this as we have not yet reached N2 and Equitable have not yet received a concession to allow this item in advance of N2.*
>
> *4) Future Profits item is reduced as a result of (a) anticipation of higher equity yields and (b) the lower yields on fixed-interest securities.*
>
> *5) An increase in the mis-selling provision (mainly in respect of the notional £10 million set aside for leavers), from £275 million to £375 million is assumed by Equitable. The FSA estimate includes a further £100 million as a result of the fundamental uncertainties involved.*
>
> *6) Allowance is made approximately for the effect on both assets and liabilities of the reduction of around 0.5% in yields on fixed-interest securities.*
>
> *7) Equitable also allow for a substantial reduction in the liabilities as a result of switching £1 billion from equities to fixed-interest securities.*
>
> *8) The combined effect of items (6) and (7) above is believed by Equitable to be around £750 million. We are not entirely convinced by this figure given that the assumed yields on equities and fixed-interest securities are now much closer so that the effect of (7) should be fairly low, but have allowed this adjustment for the present.*

15/11/2001 [13:33] FSA's Head of Actuarial Support informs Line Manager E and the Head of Life Insurance that he had asked Equitable to send FSA a letter that afternoon, setting out their understanding of the reinsurance treaty and the credit that could be taken for it in the returns. He says: '*We shall then need to consider carefully the terms in which we respond*'.

15/11/2001 [14:18] Line Manager E asks the Head of Actuarial Support for '*a paragraph*' on the quantification of mis-selling liabilities.

[**16:06**] The Head of Actuarial Support provides the following:

> *For the principal part of their business which comprises pension policies, published survey data indicates that Equitable's performance relative to the market has been gradually declining over the last 10 years.*
>
> *For regular premium policies, the payouts have declined from around 110% of industry average in 1990 to 98% in 2000 and 78% in August this year. For single premium policies, the position has declined from around 115% of industry average in 1990 to 98% in 1999 and 93% in 2000 and 71% in August this year. (The figures for August 2001 come from our own unpublished survey and include estimates for the Equitable policies.)*
>
> *A report was also commissioned by Equitable from* [the Appointed Actuary's company] *into their recent payouts. This report suggests that for policies becoming claims before 16 July, the Equitable payouts were likely to have been close to the market average for regular premium policies (slightly higher for shorter terms but slightly lower for longer terms) and around 5 to 12% lower for single premium policies than the market average. This is in line with the above findings from market surveys.*

In addition, the [company's] *report suggests that the Equitable payouts since 16 July this year for policies with terms of up to 15 years are between 4 and 13% lower for regular premium policies, and between 13 and 21% lower for single premium policies than the market average. They therefore conclude that payouts on all policies (which they would regard for this purpose as being a blend between single and regular premium) would be at least 5% lower than the market average. This is slightly more flattering than our figures since it assumes that most insurers will be reducing their payouts by a further 5-10% to reflect recent investment market movements.*

It may be noted though that none of the above figures make any allowance for the flexibility of these Equitable contracts on retirement, though Equitable have always claimed to be offering this flexibility at no additional cost to policyholders.

In practice, Equitable propose to offer an uplift of 2.5% to policy values. This appears to be rationalised by them roughly as follows:

Loss in policy value as a result of cost of meeting GAR claims	*5%*
Discount for variable strength of mis-selling claims	*-1.5* [to] *-2%*
Discount to allow for self-funding of claim	*-1.5* [to] *-2%*
Add Halifax money	*1%*
Net uplift	*2.5%*

If all non-GAR policyholders were able to sustain a claim for compensation to the level required to bring their payouts up to the present industry average, then this could result in a total provision of as much as £3 billion being required. This would clearly then have to be offset by a significant reduction in the policy values attributed to all policyholders. The net effect could be that non-GAR policies were offered an uplift of around 6-7% of their policy values and GAR policies a similar amount of uplift to replace their GAR benefits.

15/11/2001 [14:21] FSA's Insolvency Practitioner provides comments on Equitable's draft interim report and accounts (see 14/11/2001 [**16:01**]). Those comments include:

- that the fund for future appropriations was £1,114m, rather than £1,511m reported to the FSA in the Society's monthly reporting;
- whether it was true that no actuarial valuation had been carried out since 31 December 2000;
- that there was an important disclosure in the notes that: '*Should each policyholder choose to pursue a [misselling] claim and succeed in claiming compensation, then the sums payable by the Society, including associated legal costs could be substantially higher than this amount [£850m].*';
- that no provision had been made for mis-selling claims of former policyholders; and
- that no mention had been made of the problems with the reinsurance treaty, but '*the auditor's conclusion is draft pending resolution of the issue*'.

[**18:08**] Scrutinising Actuary F adds:

The main thing to strike me was the repeated reference throughout the Report to fundamental uncertainties (essentially on GAR liabilities, non-GAR mis-selling claims and other potential mis-selling costs), the possible resulting understatement of technical provisions and therefore overstatement of the fund for future appropriations (effectively *the "free assets" in Companies Act Accounts terminology), and the differing legal opinions on Article 4, which were also explained ... No reader of the Accounts could be left in any doubt as to the seriousness of these issues.*

The Scrutinising Actuary also comments on some of the points made by the Insolvency Practitioner:

The fund for future appropriations has declined further, and significantly so, over the 3rd Quarter 2001. Presumably the difference between the figures at 30.06 (£1,511m. as previously advised, and £1,114m. in the Accounts) is due to the greater rigour which would have been applied to determining the figures in the Accounts. It is difficult to say what it is now, but we understand the Society believed it to be of the order of £300m. at 30.09 ...

... It is conceivable that no further "full" actuarial valuation will have been carried out since last [December]. *The reduction in policy values is likely to have been driven by a comparison of "aggregate asset shares" with the total value of assets. These "aggregate asset shares" are likely to be modelled and tracked on internal spreadsheets (with an element of approximation), whereas a "full" valuation involves downloading data on a policy-by-policy basis from the policy administration systems, and valuing each policy individually.*

... The reduction in GAR liability from £1,668m. (at 31.12.00) to £1,454m. (30.06.01) will reflect retirements/surrenders over the period. Had gilt yields remained stable over the 3rd Quarter, the figure would no doubt have been lower still at 30.09. Unfortunately for the Society, recent falling gilt yields will have led to an increase in the GAR liability, but we understand that the Society now believe it is too late for them to rework the figures underlying the compromise scheme.

He concludes that there were '*some helpful numbers in these Accounts. Apart from anything else, they serve to reinforce the dire situation the Society is in*'.

15/11/2001 [17:08] FSA send Counsel a copy of Equitable's draft interim accounts for comment.

16/11/2001 [09:07] Counsel provide FSA with advice on Equitable's draft interim accounts.

16/11/2001 [10:58] Equitable write to FSA to explain their understanding of the effect of the reinsurance treaty (see 15/11/2001 [**13:33**]). In relation to the credit they believed could be taken for it in the returns, Equitable say that they estimated that '*if this draft Addendum 3 had applied on 31 October 2001, the Society's reassurance reserves for the Business Covered would have been about £600m after a reduction in those reserves of about £100m for future Deposit Premiums, the Additional Premium, and the Additional Fee as described ... above*'.

Equitable ask for confirmation that FSA agreed with this interpretation of the draft addendum and the effect that it would have on Equitable's reserves.

16/11/2001 [15:20] An FSA official circulates a revised version of FSA's information sheet on Equitable which had been substantially overhauled by the Plain Language Commission. She seeks comments by 10:00 on 19 November 2001.

[**15:41**] The Head of Life Insurance says that one paragraph would need to be amended but this could only be done on 19 November 2001, after FSA had decided their substantive position on the compromise scheme.

16/11/2001 [15:36] FSA's Director of GCD writes to Legal Adviser F and Legal Adviser E (copied to Line Manager E and Chief Counsel A), following a meeting that morning where FSA's Chairman had indicated that, in relation to the compromise scheme, he thought FSA's website should include material on:

- *compensation issues, which I understand to include the impact of the compromise on the scope for claiming compensation under the* [Financial Services Compensation Scheme] *and the way in which the* [Financial Services Compensation Scheme] *would work in the absence of a compromise: this will need to include a treatment of the position under the Equitable's Article 4;*
- *the impact of the scheme on the scope for claiming redress from third parties: for example, would the amount that could be claimed from the government in relation to any maladministration be affected by the compromise, either in a claim by the company, or by the policyholder.*

The Director of GCD asks them to ensure that the legal issues are considered.

16/11/2001 [15:48]	FSA's Head of Actuarial Support drafts a letter to Equitable in response to theirs of 16/11/2001, to be sent out under his name by Scrutinising Actuary F.
16/11/2001 [17:13]	Equitable send FSA information comparing guaranteed annuity rate benefits to current annuity rate benefits with the proposed uplift in total policy fund. Equitable provide two comparisons, the first of which does not take account of the cost of non-GAR mis-selling liabilities.
16/11/2001 [18:11]	FSA write to Equitable (the letter is dated 15 November 2001) in advance of a meeting planned for 19/11/2001. FSA outline the outstanding issues in relation to the compromise scheme. (Note: see FSA's letter of 19/11/2001 for details of the outstanding actions required if no objections were to be raised by FSA.)
19/11/2001 [entry 1]	Equitable reply to FSA's letter of 08/11/2001 about the implications of the side letter. Equitable say that, now the uncertainty over the status of the reinsurance treaty had been resolved, their attention had turned to investigating the circumstance in which the side letter had been conceived and issued. Equitable say that the preliminary and unaided response from the two actuaries involved to the question: '*"Why did you not disclose the side letter to anyone else?" has been to the effect that, since it was not legally binding, it did not form part of the agreement about the Treaty and therefore did not require disclosure*'. On 22 November 2001, the Director of Insurance comments to FSA's Head of Regulatory Enforcement Department: '*This doesn't take us very far. Could we discuss next steps please*'.
19/11/2001 [entry 2]	FSA meet Equitable at FSA's request to discuss outstanding issues on the compromise scheme. The discussion largely follows the issues set out in the Head of Life Insurance's letter of 16/11/2001 [**18:11**]. <u>Non-GAR uplifts and voting rights</u> FSA note that the drafting changes to deal with their concerns had been agreed. Equitable say that their approach had been driven largely by commercial and practical considerations. However, they had been advised that: '*the reality was that a more scientific approach to valuing mis-selling claims would not be possible until there had been a reasonable number of test cases to establish some precedents*'. <u>Financial information</u> FSA repeat their view that Equitable needed to disclose information relevant to the compromise scheme. Equitable say that they believed that information about the current value of the with-profits fund would be of little use to policyholders. FSA point out that their criteria for evaluating the scheme '*referred to fairness and an important part of that was that policyholders should have the information they needed to be able to form a judgement*'. Equitable's Chairman says that he was sympathetic to the point FSA were making, '*felt sure the Society could do better*', and agreed to take the matter up with the Society's advisers.

GAR costs
FSA raise concerns about the calculations for compensating GAR policyholders, as the position had changed since June, when the '*best estimate*' of the cost of annuity guarantees had been made. FSA's Director of GCD: '*invited the Society to consider whether it would be possible to include in the scheme some provision that would require the directors to certify to the Court that there had been no material change to the financial position at the time of the sanction hearing.* [Equitable] *agreed to consider it but thought it would be problematic (and they subsequently confirmed that they could not do this)*'.

Scope of claims being compromised
FSA raise concerns about the treatment of cases where GAR policyholders had been wrongly advised to transfer to non-GAR policies as these seemed to be different from the generic mis-selling claims. FSA say that they believed that such cases should not be caught by the compromise scheme. Equitable say that it would be difficult to '*carve those claims out*' but agreed that, if the wording of the scheme could not be clarified, they would give an undertaking to the court and ensure that the position was made clear to policyholders.

Court hearing
Equitable's Chief Executive undertakes to provide FSA with a copy of his witness statement to the court.

IRECO
Equitable say that the revised terms of the reinsurance agreement had been agreed by the boards of Equitable and IRECO's parent company and would be considered by IRECO that morning. FSA express their concern that the position should be clearly explained to avoid potential misunderstandings.

Other
Managing Director B notes that both FSA and Equitable had been '*focusing very much on getting things in place so that the scheme could be issued*'. It is agreed that some contingency planning should be done concerning a scenario where the scheme did not go ahead.

19/11/2001 [entry 3] FSA write to Equitable, following their meeting earlier that day, to give Equitable their view on what the Society needed to do if the FSA were not to object to the compromise scheme. The actions required included:

- the inclusion of additional information about Equitable's financial position to '*enable policyholders to judge both the fairness of the offer made for their rights, and what the Society's financial position might be if the Scheme does not go through*'. FSA envisage two elements to this. First, a statement from Equitable that they were satisfied that changes to their financial position and the economic environment did not affect the fairness of the offer made based on information as at 30 June. Secondly, a statement that their overall financial position '*remains adequately reflected by the 30 June figures; or if this is not the case, indicating significant respects in which it is different*'.
- under '*Scope of Claims Being Compromised*', FSA state:

> *We discussed the treatment under the Scheme of those who had been mis-sold out of their GAR rights into a non-GAR policy. You said that you wanted to "carve them out" of the Scheme. We believe that the Scheme as currently drafted does compromise their rights; and that in order to achieve your objective, it is necessary either to change the Scheme, or to put in place a parallel binding undertaking to the court, under which they will be able to claim redress for any such mis-selling on the same basis as if the Scheme had not become effective.*

FSA say that they were happy with this approach, so long as: this was a small number of policyholders; it did not affect the Halifax agreement; and any approach adopted was adequately disclosed.

- that Equitable, contrary to advice they had received that there was no need to allow policyholders to be represented at the convening court hearing, in answer to enquiries, should tell people the date of the hearing. FSA say that it would then be for the court to decide whether to hear any representations.
- that Equitable, as indicated: '*introduce wording into the interim accounts and the Scheme circular to the effect that there had been some scope for doubt about the effect of the Treaty which has now been clarified, and to summarise the effect of the new Treaty*'.

FSA provide the wording of a statement of their position to be used in the documentation, should their points be addressed.

19/11/2001 [entry 4]	FSA's Head of Life Insurance asks Scrutinising Actuary F to advise on Equitable's letter of 16/11/2001 and on how much credit FSA believe Equitable could prudently take for the revised reinsurance treaty.
19/11/2001 [entry 5]	The Economic Secretary to the Treasury writes to FSA's Chairman to inform him she had agreed FSA's recommendation that Equitable's section 68 Order should be granted.
19/11/2001 [11:14]	FSA's Legal Adviser E writes to the Head of Life Insurance, Line Manager E, the Head of Actuarial Support, the Director of GCD and Chief Counsel A, having been passed a copy of the final reinsurance treaty on 16 November 2001. The Legal Adviser says that: *This email is to record for our files my understanding that GCD has not been asked to advise on either the final version of the IRECO treaty as attached to this message, or (as yet) on any legal issues arising out of the credit to be taken for the agreement (as signed) in the Equitable's returns. I understand that the reinsurance agreement is now in place.*
19/11/2001 [12:41]	Line Manager E circulates information received from Equitable on 16/11/2001 [**17:13**] on the value of the proposed uplift for GAR policyholders relative to the current value of the annuity guarantees being given up, following recent falls in current annuity rates. Line Manager E says that: *There are two presentations – one before mis-selling claims are taken into account, and one after they have been built into the uplift factor. In my view the relevant numbers are those before mis-selling since mis-selling liabilities have not yet been factored into policy values and there could well be a* [policy value] *cut if the scheme is not successful.* *While I think we accept that there has to be cut off somewhere, and that there may well be other factors that would also have to change if the issues were to be reopened to deal with falling annuity rates, it is helpful to see what the current offer means in practice.* Line Manager E explains that the comparisons show: *The worst case illustrated is a person aged 65 with a retirement annuity. Post scheme, if they wanted to take 100% GAR, their income would be 86.8% of what it would otherwise have been. If they took maximum tax free cash, this would increase to 91.6%. The position is only very slightly better for a male of 60, where the numbers are 87.8% and 92.1%. For women with the same policies, they would be a bit better off. As a rule of thumb, add 2½ to the percentages above.*

For flexible GARs, the position is better for men, with the value of the market option at around 90-92% GAR if the fund is taken entirely in annuity form, and 96-98% if maximum tax free cash is taken. For women, the corresponding figures are again plus 2-2½.

From the information we have about people who could retire now, only where the policyholder would have taken a joint life annuity would they be better off without the GAR. (Of course, those who would not have exercised the GAR at all are clearly in the money.)

Line Manager E concludes by pointing out that:

Previously when we have undertaken this analysis, it was essentially the case that only those with retirement annuities and who would have taken 100% GAR would be any worse off (give or take 1 or 2%). Those with flexible products would have been slightly better off.

19/11/2001 [15:35] FSA's Head of Life Insurance provides some revised wording for FSA's information sheet on Equitable.

19/11/2001 [17:01] Equitable send FSA proposed wording on the reinsurance treaty to be included in their Interim Report and compromise scheme documentation. The wording is:

The Society entered into a reinsurance contract with Irish European Reinsurance Company ("IRECO") in 1998. The treaty provided relief from the full solvency cost of Guaranteed Annuity Options in circumstances where GAR take-up rates exceeded 25% of the maximum exposure (subsequently amended to 60%). The effect of the treaty was to provide additional capital from the Reinsurer for the purpose of regulatory capital adequacy, which is reimbursed to the reinsurer out of future surplus.

The new Board became aware of a side letter in August 2001, which cast doubt as to the reliance that could be placed on the GAR reinsurance contract (notwithstanding the side-letter purported to be of no legal effect). An agreement has been reached with IRECO whereby the uncertainty has been removed and the GAR reinsurance contract remains in full force and effect. The Financial Services Authority was kept informed of the negotiations which resulted in the agreement.

[**18:04**] FSA's Head of Life Insurance circulates the proposed wording, saying he thought it met FSA's request and fitted with FSA's Chairman's '*game plan*' for informing the Treasury Select Committee of events before the convening hearing takes place.

20/11/2001 [entry 1] HMT send Equitable a section 68 Order to permit the calculation of the valuation interest rate in accordance with the approach in the Interim Prudential Sourcebook rather than the requirements of Regulation 69 of ICR 1994.

20/11/2001 [09:56] FSA write to Equitable to highlight a concern about what they had said in the scheme documentation about the Financial Services Compensation Scheme. FSA say that they thought that the policyholder documentation needed to refer to Consultation Paper 108 on the draft transitional rules of the compensation scheme, which:

... makes it (relatively) clear that the FSA view is firmly that the [Financial Services Compensation Scheme] *would be required to exercise its jurisdiction. As* [the documentation] *is presently drafted we are in no doubt that chapter IX inappropriately makes too much of the contrary argument and as such could mislead investors (and I am told could fall foul of Part XIII of the Companies Act 1985).*

FSA set out the amendments that Equitable should make and note that there should be no contradictory statements made elsewhere in the compromise scheme documents. FSA's amendments include the insertion of the following text:

> *The* [Financial Services Compensation Scheme] *may be challenged in the courts on this and other issues by eg other creditors or other life companies (who are liable to fund the* [Financial Services Compensation Scheme] *through a levy). However, although there can be no legal certainty, the FSA considers that the operation of the* [Financial Services Compensation Scheme] *would not be negatively affected by* [Article] *4.*

20/11/2001 [13:39] FSA's Head of Life Insurance sends Scrutinising Actuary F the comments made by the Director of GCD on the reinsurance treaty (see 12/11/2001 [**08:28**]).

20/11/2001 [13:47] In response to the Head of Life Insurance's request of 19/11/2001, Scrutinising Actuary F sends the Head of Life Insurance and Legal Adviser E a draft response to Equitable's letter of 16/11/2001, which the Head of Actuarial Support had drafted.

20/11/2001 [14:41] Equitable respond to FSA's list of issues on the compromise scheme which needed to be addressed. (See 16/11/2001 [**18:11**].)

On '*Financial Information*', Equitable enclose a revised version of their Chairman's letter.

On the other issues, Equitable repeat what they had said in an email to Managing Director B the previous day, which was:

> *Scope of Claims being Compromised. Page 47 of the Circular has been amended to retain rights for GAR uplift if any Non-GAR can exert a claim that he was missold to switch. Such person will not retain the right to a GAR, but to the Scheme uplift. Thus they do not fall to be* [a] *separate class. An understanding is to be given to the Court.*
>
> *Convening Hearing. The Society fully accepts the FSA's position with regards to the publication of the Convening Hearing. I understand from your lunchtime call with* [Equitable] *that if questioned the FSA will refer the issue to the Society, though expressing your regrets at the lack of public disclosure. You will appreciate that the Society will not share your sentiment in expressing regret.*
>
> *GAR Uplifts. The two actuarial reports will contain words referring to the interest rates used. A draft of the* [Appointed Actuary's] *words can be with you later today.* [Equitable's solicitors] *and I have discussed the fundamental change issue, as it appeared in* [a named] *case.* [Equitable's solicitors'] *view is that this would be a hostage to fortune and though the realistic estimate might change the true economic value is unlikely to alter fundamentally in a manner that results in greater uplift. At this very late stage the inclusion of a directors' review process of economic factors is not considered feasible by* [Equitable's solicitors]. *We will insert a Q & A on changes in interest rates.*
>
> *Overseas Policyholders. I am advised that the wording of 5.1 of the Scheme is legally correct. It is standard practice to attempt to exert worldwide rights. However the Circular makes it clear that rights under local laws remain intact.*

Equitable also say that the wording to be included about the reinsurance treaty would be sent to FSA that afternoon. Equitable thank FSA for the statement of their position, which was to be included in the scheme documentation.

[**16:47**] Line Manager E circulates Equitable's response and the Chairman's letter. The Line Manager says that, other than the issue of Equitable informing policyholders of the date of the convening hearing, '*I believe our points are dealt with*'.

Line Manager E goes on to say that, on the Chairman's letter:

> *... they have tried to be constructive. I thought the tone and effect of the letter was quite good and met its objectives very well. However, since this arrived, I have taken a call from* [Equitable's Appointed Actuary] *who is* [concerned] *about the inclusion of estimates of the fund for future appropriates, since the numbers are incorrect and he does not believe that they can be disclosed. He is talking to* [Equitable] *now. I did not comment on the substance of his concerns, but warned him that* [Equitable's Finance Director] *had been seeking to respond to the concerns of the FSA by including "estimates" of key information of relevance to policyholders.*

Line Manager E asks for any comments on this, and notes that: '*At some point today, we were due to give comfort to Halifax. That is looking increasingly difficult at the moment, so we might need to suggest to Equitable that their board might have to take a decision subject to confirmation being received from us and Halifax*'. He says that he would inform Halifax that they were making progress but '*are not yet there*'.

20/11/2001 [18:53] Line Manager E informs Chief Counsel A, Scrutinising Actuary F, Chief Actuary C and the Head of Life Insurance of a further telephone conversation held with Equitable about the reinsurance treaty. Equitable's solicitors had confirmed to the Society that, while there had been a change to the wording to reflect the different structure of the payment arrangements, the economic effect of the treaty '*is as before*'. Line Manager E notes that: '*It would seem therefore that if we are to raise objections to the current effect of the Treaty, we are in effect saying we have changed our view*'.

20/11/2001 [20:29] FSA have a telephone conversation with Equitable's solicitors about the termination provisions in the revised reinsurance treaty. Following that discussion, Equitable's solicitors provide FSA and Equitable with their observations:

> *1. Unless and until the Reinsurance Claims Amount at any 31 December exceeds £100 million, the rights of long-term policyholders in the event of the insolvency of the Society take priority over those of IRECO. This is exactly as before.*
>
> *2. If the Reinsurance Claims Amount at any 31 December exceeds £100 million, then as part of the additional amounts payable to IRECO, a one-off Additional Premium of 12% of the credit taken by the Society at that 31 December is payable. This is available to IRECO as security in the event of the Society's insolvency against:*
>
> *(a) any outstanding basic annual premiums (likely to be no more than £700,000 adjusted for* [the Retail Prices Index]*);*
>
> *(b) any cash payments advanced (no more than 10% in any one year); and*
>
> *(c) any outstanding Reinsurance Claims Amount (already the subject of set-off in the original).*
>
> *Any balance must be returned to the Society – see the penultimate paragraph of Article XII.*
>
> *In every other respect apart from the security over items (a) and (b), which we suggest is an entirely reasonable and foreseeable element of the renegotiation, the rights of long-term policyholders are as before.*
>
> *In any event, we suggest that the existence of the security is no reason to alter the credit which the Society is entitled to take for the reinsurance, for the following reasons:*
>
> *1. The "security" nature of the Additional Premium means that appropriate provision will presumably be required (by the FSA if by nobody else) to be made for its non-return in the Society's accounts as soon as it becomes payable. If that is done, and any*

> *loss likely to result to long-term policyholders is factored in, there is no reason for any reduction in the credit taken, because no further detriment will result on insolvency.*
>
> *2. At most, the detriment* [to] *long-term policyholders from the provision will be the extent of the one-off Additional Premium, and no greater reduction in the credit permitted can be justified. The absolute maximum would be 12% of the sum for which credit is sought to be taken. Given that the FSA has already required the Treaty to cover 120% of the amounts for which credit is to be taken (there was no such provision before), even this would seem hard to justify.*

We are confident that the point was understood by those at the FSA who looked at the revised treaty before it was signed, particularly given some of the changes that we asked to make, but we appreciate that you have been required to look at this afresh, and it is a complex arrangement.

[**23:40**] FSA's Head of Actuarial Support informs Chief Counsel A that he believed that there was only one Additional Premium payable under the contract and it did not recur every year.

20/11/2001 [23:19] Further to Line Manager E's note of [**18:53**] about the credit that could be taken for the reinsurance treaty, Chief Counsel A writes:

[FSA's Head of Actuarial Support] *has reviewed the ... note* [by Equitable's solicitors of 20/11/2001] *and confirmed to me that he is happy that we tell Equitable that we will accept a provision. We cannot yet say what amount we will accept, but can say it will be at least £250m (although probably no more than £600m). Because the analysis is not yet complete, we cannot be more definitive. If you are content to accept this for the purposes of the Equitable's Board meeting tomorrow at 10am, you would also be accepting reliance on* [the solicitors'] *legal view of the meaning of the Treaty. We do not know whether Equitable management would be prepared to recommend to the Board that it decide to proceed to the convening hearing on this basis. Their position so far is that the need to disclose any negative information concerning the Treaty (including reduced provision) will mean that the Scheme cannot go forward. This seems to* [the Head of Life Insurance] *and me unreasonable, but we cannot be sure to what extent this is a bargaining position. Clearly it would be undesirable in the extreme to be labelled as having brought the scheme down, but on the other hand we have told the Equitable repeatedly that we will not be bounced.* [Equitable's Appointed Actuary] *first wrote to FSA about the amount of provision which could be taken by letter dated 16 November to* [the Head of Actuarial Support]. *I do not know when the letter was received by FSA, but it appears it may not have come in (or been seen) until 19th.*

21/11/2001 [08:43] In response to Chief Counsel A's last note of the previous evening, the Head of Life Insurance says that the relevant issue for FSA was whether they should let their non-objection to the compromise scheme stand, despite their remaining doubts about the credit that could be taken, or whether this was sufficiently important to justify FSA being the cause of the failure of the scheme.

[**09:09**] Chief Counsel A prepares a draft Notice to deal with the possibility that Equitable decided not to proceed with the compromise scheme until the matter was resolved in a situation in which FSA wished to require them to do so.

21/11/2001 [10:35] PIA write to FSA's Scrutinising Actuary F, saying that: '*I don't know if you recall but back in March you raised a number of queries following a review of the original offer documentation produced by Equitable (copy attached for easy reference). The firm responded in April saying that they would liaise with you directly on these points. Can you confirm whether these queries were satisfactorily concluded?*'.

21/11/2001 [10:47]	FSA's Head of Life Insurance writes to Managing Director B, following an internal meeting and subsequent conversation with Equitable about the current position on the documentation for the compromise scheme.

The Head of Life Insurance records:

> *We said that the FSA stood by my letter of the 19th November to* [Equitable's Chief Executive]*; if the Board was satisfied that the Society had met the points set out in that letter, then the documentation could include the statement of the FSA position set out in that letter but we had not yet seen the revisions to the documentation which reflected those changes, so the onus would be on the Board to satisfy itself that our points had been met. We ourselves could not confirm that until we had sight of the revised documentation.*

The Head of Life Insurance continues:

> *The most difficult issue was the terms in which the amended Reinsurance treaty was described. We believed that the wording proposed by the Equitable was misleading, since they implied that the amount of credit which could be taken for the reinsurance was exactly the same as under the original version. The wording needed to describe accurately the effect of the Treaty.* [Equitable's Finance Director] *said that he believed their latest formulation did this, but we had not yet seen it. We said that it was important for us to reach a firm view on the quantum of credit which could be taken; we asked, and* [Equitable's Finance Director] *agreed, that* [Equitable's Appointed Actuary] *would come to FSA as soon as possible after the Board Meeting to discuss this with our actuaries and lawyers, with the aim of reaching agreement today. We added that it was our view that it was not necessary for the wording on the Reinsurance Treaty to be in the documentation which went to the convening hearing provided that it was made clear to the court that additional information on this point would be made available in the documentation before it was sent to policyholders.* [Equitable] *took note of that suggestion; but added that a letter of non-objection from the FSA to the Halifax would still need to be sent before the court hearing, otherwise Halifax's Agreement (and with it the extra £250 million) would not be obtained.*

21/11/2001 [11:27]	Equitable send FSA the latest version of the compromise scheme circular on which approval was sought that day.

[**15:08**] Line Manager E replies with fourteen comments.

[**18:46**] FSA's Insolvency Practitioner provides observations and comments, which included the following:

> *Financial position: I think there is just about adequate disclosure although it would help if three facts were pulled together in one place. The Society says ... that there is no material change in financial position since June (ie the fund for future appropriations is still about £1bn); the Appointed Actuary says that the GAR costs increase by £350m for each 1% fall in interest rates ...; and the Interim Accounts disclose that misselling costs could be in excess of £850m. Taken together I think policyholders can adequately assess the risks of "struggling on" compared to voting for the scheme.*';
>
> *... do you think that your/the Society's calculations of how much worse off GAR policyholders close to retirement might be (87% to 92%) If no cash is taken (10% of GARs) will be disclosed to the court at either the convening hearing or the sanctioning hearing either by us or the Society. I think it should be*.;
>
> and,

Finally, I wondered whether there is another class of misselling ...

I had not appreciated until now that about 75% of policyholders have a 3.5% guaranteed return. As policy values have been or are at risk of being cut to fund these guarantees (since on maturity it is the higher of the guaranteed sum and policy value which the Society pays) there is an argument that the 25% of policyholders without such a guarantee have been missold because they were not informed that 75% of other policyholders had such rights. ie another example of mixed bathing. The quantum of such a "loss" might fall away as solvency improves, but this might be an issue if it does not.

21/11/2001 [11:35] FSA's Director of GCD provides comments to Chief Counsel A about set-off rights in relation to the reinsurance treaty. (Note: set-off rights, in general terms, was a defence which could be asserted by a party to resist an action for payment by a claimant.)

[**12:17**] Chief Counsel A passes the Director of GCD's note about set-off rights to Counsel.

[**12:42**] Counsel sends Chief Counsel A his own note on the issue of set-off rights.

21/11/2001 [11:36] Equitable send FSA a draft paper by their Chief Executive on the risks arising from different investment approaches. The paper includes an analysis of those risks, followed by an assessment under four scenarios, those being:

- scenario 1 – exiting equities at £1bn per month;
- scenario 2 – exiting equities at £0.5bn per month;
- scenario 3 – maintaining equities in current proportion; and
- scenario 4 – following current investment call.

In conclusion, the Society's Chief Executive says:

i. PRE has been shaped in recent months by the proposed compromise pack, the roadshow and statements to the media. These do not flag up a declining proportion in equities – rather the reverse.

ii. Because of (i) above, the possible investment scenarios are 2, 3 and 4. Scenario 1 would require a significant restatement of investment intentions.

iii. The recommended central route is scenario 3 with scenarios 2 and 4 available to the Investment Committee depending on their conviction of the accuracy of the current investment call.

iv. The Board needs to be aware that this investment stance is not appropriate unless they believe the market to be relatively low, with a greater upside than downside potential. The degree of risk would be inappropriate for a long term insurer in normal markets. By contrast, this or a greater degree of risk would have been entirely appropriate in 1974.

v. If scenario 1 is followed, the fund will be locked into, effectively, a weak non-profit style. Guaranteed bonuses may be secure and it may be possible to pay final bonus up to nearly 5%. The downside and upside potential of equities would be reduced. If the next equity upturn is missed, it is likely that the fund will be permanently under-performing in the way alleged by [a named Member of Parliament], *(presumably having been briefed by* [Independent Financial Advisers]*). The rate of exit through legitimate churning in those circumstances would lead to high exit rates. There is also an increased risk that the Society could not cope if litigation and mis-selling risks increase still further.*

vi. A negative FFA (Fund for Future Appropriation) does not constitute insolvency [This needs to be checked] but it is clearly highly undesirable unless it is for a very brief period.

21/11/2001 [15:03]	FSA's Chief Actuary C informs the Head of Life Insurance and Managing Director B that he had completed his review of the reinsurance treaty and had also received a telephone call from Equitable's Appointed Actuary about the treaty. He sets out two ways in which the treaty differed materially from the original one and states that: *In summary we believe that it is reasonable to assume that the amended treaty has a slightly reduced effect (about 12% reduction currently) compared with the original treaty but the effect could be greater in future, depending upon the future course of investment conditions, as a result of the cap* [to the reinsurer's liability should the cost of providing GAR benefits increase]. *Equitable have told us that they believe that they can take £600m credit for the amended treaty and, in the light of our review and the discussions, we have no reason to challenge that.*
21/11/2001 [17:08]	FSA's Scrutinising Actuary F sends Chief Counsel A and Legal Adviser E a revised draft of the response to Equitable's letter of 16/11/2001, amended in the light of Chief Actuary C's and Scrutinising Actuary F's further review of the treaty and their telephone conversations that afternoon with Equitable. The Scrutinising Actuary says that the draft now took account of the Chief Actuary's concerns (expressed in an email earlier that day) that the detailed calculations carried out by Equitable did not appear particularly robust. Scrutinising Actuary F asks for legal clearance of the draft.
21/11/2001 [17:57]	Equitable's solicitors send FSA a note on set-off and subordination of the reinsurance treaty, as had been promised in a conversation earlier that day. The solicitors say that they remained of the view that there was no justification for any disallowance in the credit taken by Equitable for the treaty up to the self-imposed limit of £833.3m. [**18:55**] FSA send Counsel a copy of the note.
21/11/2001 [19:10]	FSA's Chief Counsel A tells Scrutinising Actuary F that the letter to be sent to Equitable could not be cleared by legal advisers that night, as they were not going to hear from Counsel about the treaty until the following day.
21/11/2001 [19:35]	FSA write to Equitable, in advance of a formal reply to Equitable's letter of 16/11/2001, to explore in more depth the effect of Article 4 of addendum 3 on the credit that could be taken for the reinsurance.
21/11/2001 [19:37]	Chief Counsel A sends Scrutinising Actuary F a copy of Equitable's solicitor's note on set-off and subordination of the reinsurance treaty. She suggests that he would wish to take into account the material on the Additional Premium in his analysis of the credit that could properly be taken for the treaty.
22/11/2001 [09:56]	In response to Scrutinising Actuary F's note of 21/11/2001 [**17:08**], the Director of GCD says that he found it hard to see why FSA proposed that no account should be taken of the future liabilities to IRECO '*but must accept your statement that this is consistent* [with] *established actuarial practice*'.
22/11/2001 [14:37]	Equitable send FSA a draft version of their interim report for the half-year ended 30 June 2001, prepared under the Companies Act.

22/11/2001 [15:13]	Further to his comments the previous day, Chief Counsel B sends the Insolvency Practitioner a note which sets out FSA's views on whether there was scope for mis-selling claims from policyholders without guaranteed investment returns. [**15:44**] The Insolvency Practitioner agrees that: '*any "loss" will only really arise if the Society becomes insolvent or stops paying bonuses (perhaps because of a "No" vote) in the sense that it must then raid the fund to pay GIRs at the expense of non-GIRs' reasonable expectations. It is therefore a future loss rather than one which has already crystallised*'.
22/11/2001 [entry 4]	FSA hold a telephone conference with Counsel to receive his preliminary oral opinion on the reinsurance treaty. Scrutinising Actuary F's handwritten notes of the conversation include the following: • *Purpose of* [the original] *treaty was to enable* [Equitable] *to meet* [the solvency requirements] *but not to provide cash ... cash only expected to be needed to meet reserving* [requirement] *but such cash* [would] *need to be repaid from future surplus.* • [Counsel's] *view: that side-letter adds nothing to* [Article] *XIII as was; there was no need to* [renegotiate] *if* [the Reinsurance Claims Amount exceeded] *£100m; if IRECO got awkward when* [the Reinsurance Claims Amount exceeded] *£100m, could end up in arbitration in Ireland. Likely outcome unknown.* • *Could* [Equitable] *call* [in the Reinsurance Claims Amount] *in cash?* [Equitable's solicitors] *said no.* [Chief Actuary C] *said makes treaty worthless then.* [Counsel] *agreed.* • *Need clarity that* [the Reinsurance Claims Amount would] *be* [payable] *in cash by IRECO on* [liquidation, otherwise] *only thing you can take credit for is the 10%.*
22/11/2001 [entry 5]	FSA (Chairman, Managing Director B, Director of GCD, Director of Insurance, Chief Counsel A, Head of Life Insurance, Scrutinising Actuary F and Chief Actuary C) meet to discuss the preliminary opinion received from Counsel, which had cast doubt on the amount of credit that could be claimed by Equitable for the renegotiated reinsurance treaty. It is agreed that some credit could be claimed and that FSA should decide on how this should be calculated. It is also agreed that FSA should suggest that Equitable needed to amend the compromise scheme documentation so that it was not misleading. FSA state that '*the value ascribed to the reinsurance treaty for statutory reserving purposes did not weaken the arguments in favour of the compromise scheme*'.
22/11/2001 [afternoon]	FSA telephone Equitable and leave a message about the reinsurance treaty.
22/11/2001 [18:15]	Equitable complain that FSA had changed their view on the effectiveness of the reinsurance treaty, after giving their consent for the compromise scheme documentation to be approved by Equitable's Board. Equitable say: *For us to proceed with the Scheme we require clear guidance as to what amendments are needed to the Scheme to enable the FSA to withdraw today's objections. We need this in writing as a matter of considerable urgency. We need the FSA's concerns in writing no later than close of business today.* *From the telephone message received from* [The Head of Life Insurance] *this afternoon are we right to conclude that the attached letter* [the 'no objection' letter sent to IRECO on 15/11/2001] *was sent before the FSA completed its internal sign off procedures?*

22/11/2001 [19:01]	Scrutinising Actuary F provides FSA's Chairman and Managing Director B with a '*ball park*' indication of the amount that Equitable could claim for the reinsurance within their returns. The Scrutinising Actuary explains that the calculation '*is based on the cash amounts which Equitable can request from IRECO under the treaty*'. The Scrutinising Actuary then explains: *We have assumed that the value of the liability passed to IRECO is £700m, and that the value of the premiums due from Equitable under the treaty is £100m.* *On the assumption that the cash amounts are drawn down evenly over a 10 year period and discounted at 7.5% p.a. representing a valuation rate of interest of 4% + the interest "turn" of 3.5% on the amounts drawn down (i.e. assuming that LIBOR can be earned on the cash drawn) then the £700m. is only worth 68% of its face value i.e. £480m.* *The maximum amount that we believe can be taken credit for is therefore £380m. (i.e. £480m. less the premiums due of £100m.).* On a copy of his note, Scrutinising Actuary F writes: *We concluded during the* [telephone conference] *with* [Counsel] *et al that no credit could be taken for* [the] *Reassurance Claim Amount itself for reserving purposes because that was always held back by IRECO and never paid across, even on termination.* *The only thing for which credit can be taken for provisioning purposes is the cash which can be drawn down, even though the treaty wording is poor.*
22/11/2001 [21:23]	FSA's Director of GCD seeks clarification from Scrutinising Actuary F, asking: *... you explained that the* [£]*700m was your calculation of the amounts that could be claimed in cash under* [clause] *4. I take it that in reaching your view on provisioning, you were happy that no account needs to be taken of the points made by counsel that:* • [clause] *9b means that on termination these amounts are to be repaid, and* • *post termination, no future amounts can be claimed.*
22/11/2001 [evening]	FSA reply to Equitable, saying that they had informed IRECO that FSA had no objection to Equitable entering into the renegotiated treaty and that this remained their position. However, FSA say that they had not committed themselves to the level of credit that could be taken. FSA state that Equitable should not take credit in their returns of more than £350m for the reinsurance arrangement. FSA provide a form of words for describing the situation, that FSA would be happy with, while noting that it would be a matter for Equitable to decide how to present the issue. FSA say: *The FSA believes the treaty does not call into question the promotion of the Scheme by the Board, but recognises that proper disclosure of the issue should be made so that members are not misled as to the financial position of the Society for regulatory purposes.*
23/11/2001 [10:01]	Line Manager E sends Chief Counsel A a copy of the note prepared by the Head of Actuarial Support on 12/11/2001 [**09:57**], setting out where FSA had got to in their assessment of potential mis-selling liabilities. [**12:25**] Chief Counsel A forwards to Legal Adviser E the note received from Line Manager E earlier that day on mis-selling. She says: '*I have now started "screaming" about the need to get this work done, but nothing can happen now until* [the Head of Actuarial Support] *is back from leave*'.

23/11/2001 [11:08]	Chief Actuary C writes to FSA's Chairman, Managing Director B and Director of Insurance about Equitable's current financial position, following discussion with Scrutinising Actuary F and Equitable. The Chief Actuary says:

We were told that the financial position at the end of October 2001 had been estimated to be £605m of assets in excess of the required minimum margin. Since making that estimate the Society had undertaken a more detailed analysis of the position and as a result the £605m had reduced to £410m. This figure assumes £695m credit for the IRECO treaty and £800m credit for the Implicit Item.

Since the end of October the position has changed as follows:

End October 2001	*£410m*
Reduction in IRECO value	*£(345m)*
Increase in resilience reserve as a result of [reduction] *in IRECO value*	*£(100m)*
Adjusted end October free assets	*£(35m)*
Effect of market movements in [November]	*£200m*
Effect of sale of £500m equities (see below)	*£200m*
Estimated current financial position	*£365m*

We were told that the Board had decided to sell £500m of equities over today and Monday. This would reduce their equity backing ratio from 35% to 31%.

We explained to [Equitable's Appointed Actuary] *the underlying basis that we had adopted in assessing the revised value of the treaty and he did not appear to have any problem with the principle.*

23/11/2001 [11:52] In response to the Director of GCD's queries (of 22/11/2001 [**21:23**]), Scrutinising Actuary F explains:

£700m. was calculated by Equitable and represents the amount of the liability removed from Equitable's balance sheet and passed to the reassurer. This is the present value of the Reassurance Claims Amount. Our understanding of the treaty is that this £700m. could all be drawn down in cash. However because only 10% of the withheld reassurance claims amount can be drawn down in any year, there is an additional time lag of up to 10 years before the cash can be fully extracted. Allowing for this, the discounted value of the cash payments is £480m. Against this amount needs to be offset the premiums payable by Equitable to IRECO.

I confirm that we have disregarded the obligation of Equitable on termination to repay the amounts drawn down. The actuarial valuation does not address the position on insolvency since it is done on a going concern basis and presumes that insolvency will not arise.

I also accept that post termination no future amounts can be claimed. This does not affect our calculations because termination is not expected to take place on the actuarial basis used.

[**12:04**] Chief Counsel A asks the Actuary whether, by premiums payable, he had meant the Adjustment Premium and the Deposit Premium.

[**12:27**] Scrutinising Actuary F informs Chief Counsel A that he had been referring to the Deposit Premiums, which were not dependent on future surplus, and the parts of the Adjustment Premiums which were also not contingent on future surplus, those being the Additional Premium and the Additional Fee.

[**14:47**] Scrutinising Actuary F also tells Chief Counsel A that the Additional Premium was payable only once.

23/11/2001 [12:23] FSA's Head of Life Insurance seeks comments on a draft letter from FSA's Chairman to the Treasury Select Committee about Equitable and the reinsurance issue.

[**14:28**] Chief Counsel A comments that:

> *There is a further matter for all to think about. This letter does not mention that as* [a] *result of further advice from Counsel, the actuarial advice has been revised (possibly subject to further input from Equitable on the underlying numbers) and provisioning taken at a lower level. Does that make this letter misleading? Perhaps not. Arguably the first reinsurance agreement was worth (and always was worth) only £100m as a result of the uncertainty raised by the side letter. And in any event we have still not come to a final view on the implications of* [Counsels'] *further advice. But the further legal advice and its implications will undoubtedly become public at some point so we should think about how others may view this letter in the light of that now.*

[**14:57**] Chief Actuary C says: '*It is true that as a result of further advice from Counsel we now believe that the treaty is worth less than we previously believed to be the case (prior to disclosure of the side letter). If you wish to disclose this change of view then it would fit most naturally in the paragraph on page 2 that begins "The Equitable has now advised ..."*'.

23/11/2001 [15:31] FSA inform PIA that they did not believe that their questions had ever been answered and suggest that PIA should chase Equitable. (See 21/11/2001 [**10:35**].)

23/11/2001 [16:27] FSA's Head of Life Insurance sends his Chairman a draft letter to the Treasury Select Committee.

23/11/2001 [17:01] Counsel send FSA a draft joint opinion regarding the IRECO reinsurance treaty.

(Note: the opinion was finalised by Counsel on 3 December 2001 and sent to FSA the following day. I have seen that final version. I am satisfied that the final version of the opinion does not differ substantively from either the preliminary oral opinion provided by Counsel to FSA on 22/11/2001 (see entry 4 for that date) or from this version.)

The draft says that the scope of the opinion sought by FSA was as follows:

> *We have been asked to advise as to the meaning of the provisions in the new treaty with the rights and obligations of IRECO and the Society on termination of the agreement. In particular we have been asked to consider whether the provisions in the new treaty are the same or materially different from the corresponding provisions in the original treaty.*
>
> *We have been asked not to advise on the general effectiveness of the original or the new treaty, either as between the Society and IRECO, or in relation to the reserving obligations imposed upon the Society under the Insurance Companies Act and associated regulations. We have also been asked not to consider in any detail the meaning and effect of the provisions of the new treaty which apply in the event that the cumulative Reinsurance Claims Amount for which IRECO is liable under the new treaty exceeds £100 million.*

Under the heading '*Summary of the original treaty provisions*', the draft includes that:

> *The effect of termination of the original treaty under paragraph 2 of Article X would have been that for the future IRECO would be under no further obligation to make any annual cash payments to the Society under Article IV. Moreover, no further Reinsurance Claims Events would occur and IRECO would not be "liable" for any further increase to the Reinsurance Claims Amount.*
>
> *So far as any Reinsurance Claims Amount outstanding as at the date of termination is concerned, we believe that notwithstanding the use of the word "liable" in the first sentence of Article IV, there is no basis under that Article for concluding that IRECO could be called upon to pay any such amount to the Society, either during the lifetime of the original treaty, still less after its termination. This is because Article IV also states that the Reinsurance Claims Amount will be "withheld" by IRECO.*
>
> *IRECO's only payment obligation under Article IV was to pay on request on any 31 December what was described as an "interest amount" or a cash payment of up to 10% of the Reinsurance Claims Amount. This obligation could not be triggered by any requests for payment made after the contract had come to an end.*

The draft opinion says that:

> *In short, the true analysis of Article IV is that whilst the original treaty remained in existence, it contained a mechanism for calculating an annual liability of IRECO to pay cash to the Society, which was expressed either as an interest amount or as a cash payment of up to 10% of the Reinsurance Claims Amount. It did not create any obligation on IRECO, either during the life of the treaty or after its termination, to pay to the Society the larger amount, namely the Reinsurance Claims Amount.*
>
> *The provisions of Article X as to termination do not affect this analysis.*

On what would happen in the event of a liquidation, the draft opinion says:

> *... the term of Article X providing for the subordination of IRECO's right to a refund from the Society only applied in the case of termination following a <u>liquidation</u> of the Society. The effect of the subordination provision in that event was that IRECO's rights to claim a refund of the interest/cash payments which it had made to the Society would be subordinated to the claims of the Society's long-term policyholders in the liquidation. In other words a liquidator of the Society could resist a claim by IRECO for payment of such amounts (or for a distribution in respect of them) until after the Society had discharged its liabilities to its long-term policyholders.*
>
> *The drafting of the original treaty is obscure and these key provisions are difficult to interpret. We are, however, confident that if it had been intended that termination of the original treaty following liquidation of the Society would result in the liquidator being able to demand payment of the Reinsurance Claims Amount from IRECO to meet the claims of the Society's long-term policyholders, the treaty could and would have said so in terms.*

Turning to the renegotiated reinsurance treaty, Counsel note that '*the new treaty contains a number of new provisions designed to deal with the situation which will apply in the event that the cumulative Reinsurance Claims Amount exceeds £100 million*'. The draft opinion says that:

... it seems to us that paragraphs (a) to (f) of Article XII have the following effect:-

1. under the first sentence of paragraph (a), upon termination of the new treaty, the Society will be obliged immediately to pay to IRECO in cash any unpaid Deposit Premium and Risk Amount;

2. under the first sentence of paragraph (b), upon termination of the new treaty, the Society will be obliged immediately to repay to IRECO in cash any cash payments which were made to the Society under Article IV and to pay any accrued fee interest thereon under Article V;

3. any other rights and obligations existing as at the date of termination between the Society and IRECO will be immediately subjected to the creation of equal and opposite obligations under paragraph (d) which will be set off against each other under paragraph (e). This will have the effect that except for the Society's obligations under (a) and (b), no other sums will be owing between the Society and IRECO following termination; and

4. paragraph (f) expressly confirms that following termination of the new treaty, apart from the Society's debts to IRECO created under paragraphs (a) and (b), the Society and IRECO will be mutually released and discharged from any further rights and liabilities under the new treaty.

Accordingly, leaving aside the proviso, upon termination of the new treaty, IRECO will be discharged from any liability to the Society in respect of the Reinsurance Claims Amount, but the Society will be obliged to make payment of any arrears of premium owed and to repay any cash received under the treaty.

This means that the provisions of the new treaty do not differ from those of the original treaty if termination occurs on the giving of notice following the occurrence of any of the events set out in paragraphs 3, 4, 5 or 6 of Article XII.

Counsels' draft opinion then sets out their views on what would happen if the reinsurance treaty were terminated following the insolvency of Equitable. The opinion concludes, in summary, that:

Under the original treaty, IRECO could not claim payment or a distribution on account of arrears of premium or refunds of any amounts which it had actually paid to the Society on request under Article IV unless or until the Society had paid its liabilities to the holders of its long-term policies in a liquidation.

However, under the new treaty, its seems to us that there is no such subordination, and in a winding up of the Society, IRECO could claim such amounts in competition with the claims of the Society's long-term policyholders.

The draft opinion also concludes that:

In our view, the entire Reinsurance Claims Amount never became due and owing by IRECO to the Society under the original treaty. The position is the same under the new treaty. The situation after termination of either treaty following the insolvency of the Society would be no different.

26/11/2001 [09:06] FSA's Chairman's Office circulates the final version of the letter from FSA's Chairman to the Chairman of the Treasury Select Committee, which had been sent on 23/11/2001, along with a press notice to be issued later that day.

26/11/2001 [09:42]	Further to Scrutinising Actuary F's comments on reinsurance of 23/11/2001, the Director of GCD states that Counsel had advised that the Reinsurance Claims Amount did not constitute a liability and so must be left out of account and that only the income stream could have a value in the returns. [**10:45**] The Director of Insurance says that he did not see the difference between the two positions and that: '*I had thought that what was being valued was an annual income stream of 10% of £700m. The actuaries are prudently (over prudently?) assuming that this should be calculated by reference to £700m rather than £1bn, which is the maximum permissible under the treaty because presumably £700m is 100% of the amount for which credit was previously taken*'. [**10:56**] Chief Actuary C explains that the £1bn represented the maximum claim against the reinsurer should economic conditions vary adversely in future and that it would not, therefore, be appropriate to place a value on this amount unless and until the adverse condition arose.
26/11/2001 [10:26]	Equitable send FSA a copy of the revised text of part 11 of the scheme documentation, showing changes in relation to the reinsurance treaty.
26/11/2001 [10:48]	FSA's Scrutinising Actuary F informs the Head of Life Insurance that the Chairman's letter to the Treasury Select Committee might not have been correct on one point, being that the reinsurance treaty did not have any impact on the value of the with-profits fund. The Scrutinising Actuary agrees that the treaty had not added any value to the fund but points out that it did have a negative impact on the fund in the premiums that had to be paid. He suggests that the letter should have said that the treaty has '*no beneficial impact*' on the fund. The Scrutinising Actuary points out that this statement had not been included in the version of the draft that he and Chief Actuary C had reviewed. [**11:45**] The Head of Life Insurance thanks him for the explanation.
26/11/2001 [11:00]	FSA issue a press statement about the disclosure of the side letter to the reinsurance treaty. The statement says that FSA: *... took the view that the contents of the letter raised questions about the true value of the reinsurance contract that Equitable Life had entered into in early 1999 and which was shown in its regulatory returns. The FSA concluded that, had it been aware of the letter at the earlier stage, it would not have been prepared to accept the reinsurance arrangements as providing as much security for reserving purposes as was in fact taken.* The statement goes on to say that FSA: *... has seen and reviewed the terms of a renegotiated reinsurance agreement and has confirmed that it has no objection to them.* However: *... in the light of advice from leading Counsel, the FSA has taken the view that the value that Equitable Life should reasonably ascribe to the reinsurance contract is lower than it previously took. The FSA has made clear to Equitable Life that it must properly disclose the effect of the revised agreement, so that policyholders are made aware of the impact on Equitable* [Life's] *financial position for regulatory purposes.*

	FSA state: *On the basis of the information received by the FSA, Equitable Life continues to meet its regulatory solvency requirements even taking account of the lower credit for the revised reinsurance policy.* [**11:26**] FSA's Press Office circulates Q & A notes, setting out the line to take on the announcement.
26/11/2001 [11:28]	Equitable send FSA the revised text of section 11 of the compromise scheme documentation on the reinsurance treaty.
26/11/2001 [11:48]	FSA's Chairman's Office asks Chief Actuary C, in response to his note of 23/11/2001 [**11:08**], to clarify whether the section 68 Order added anything to Equitable's financial position. [**12:16**] Scrutinising Actuary F replies, having spoken to Equitable's Appointed Actuary, saying that the figures already anticipated the effect of the section 68 Order and included the benefit estimated at £200m. He adds: '*The effect of the S68 Order is that credit is now taken in the main valuation result for profits which would have emerged in the future. I therefore asked* [Equitable's Appointed Actuary] *whether the implicit item for future profits (estimated below to be currently worth £800m.) has been reduced accordingly.* [The Appointed Actuary] *is checking that out, and will confirm the position a.s.a.p. He did say though that he thought there were margins present in the implicit item*'.
26/11/2001 [18:11]	Equitable's solicitors send FSA a copy of a statement by the Society's Chief Executive, which had been filed with the court. [**21:02**] Chief Counsel A comments that the changes which FSA had requested on Article 4 in relation to the policyholders' compensation schemes had not been made.

26/11/2001 [19:08] Equitable send FSA a balance sheet, profit and loss statement and a comparison of policy values to allocated assets as at 31 October 2001. This provides the following information:

	Insurance Act Basis	
	£m	*£m*
Assets		
Investments		
Property	*2,113.4*	
Equities	*6,118.7*	
Fixed Interest Securities	*13,616.5*	
Short Term Deposits	*2,073.1*	
Unquoted Investments	*975.6*	
		24,897.3
Reinsurers share of technical provisions		
GAR liabilities	*695.0*	
Unit linked liabilities	*3,373.6*	
Other liabilities	*359.1*	
		4,427.7
Current assets		*565.5*
Tangible assets		*0.0*
Implicit items	*802.8*	
Future profits	*0.0*	
Other s68 concession		*802.8*
Total assets		*30,684.3*
Liabilities		
Guaranteed fund on accumulating with profits policies – GAR	*4,181.6*	
Guaranteed fund on accumulating with profits policies – non-GAR	*10,603.2*	
Less discount applied to liabilities (see notes)	*(806.5)*	
		13,978.3
*Other with-profits liabilities**		*2,660.4*
GAR provision		*2,271.0*
GAR rectification		*250.0*
Non-profit liabilities		*4,743.8*
Misselling liabilities (estimate) ([for potential non-GAR mis-selling claims]*)*		*375.0*
Other misselling liabilities (eg Pension Review)		*200.0*
Linked liabilities (reinsured to Halifax)		*3,373.6*
Outstanding Claims		*500.0*
Resilience reserve		*0.0*
Subordinated loans		*0.0*
Provision for other risks and charges		*1.0*
Other current liabilities		*936.2*
Total liabilities		*29,289.3*
Required Minimum Margin		*985.0*
Excess over [required minimum margin]		*410.0*

** The figure for the other with-profits liabilities shown is after a discount of £436m. The full value was £3,096.8m.*

	31 July 2001 £m	*30 August 2001 £m*	*30 September 2001 £m*	*31 October 2001 £m*
With-profits available assets	*22,500*	*22,475*	*21,589*	*22,196*
Cost of GARs	*(1,257)*	*(1,257)*	*(1,257)*	*(1,257)*
Available assets to pay policy values	*21,243*	*21,218*	*20,332*	*20,939*
Aggregate policy values	*20,643*	*20,745*	*20,846*	*20,946*
PV/AS	*97.2%*	*97.8%*	*102.5%*	*100.0%*

26/11/2001 [17:53] Following a request from Chief Counsel A, Chief Actuary C provides comments on Counsel's opinion on the renegotiated reinsurance treaty. Having checked the opinion with Scrutinising Actuary F, he says that the opinion did not conflict with their recollection of the advice that had been given over the telephone last week and that FSA would not change their view on the credit that could be taken in the returns for the treaty. Chief Actuary C continues:

> *We have one comment to make on the draft Opinion in paragraphs 19 and 20. Those paragraphs refer to the Society being required to repay any interest amount or cash which the Society had earlier been paid. We are surprised that this obligation requires the Society to repay interest amounts based on the construction of Articles IV and X. In Article IV cash payments appear to be defined as the 10% amounts and Article X appears to refer explicitly to the cash balance. Why therefore do interest payments fall to be repaid under Article X? I believe that this point is less ambiguous under the new treaty wording of Articles IV and XII(b), where the latter Article refers explicitly to cash payments.*
>
> *An issue that we would prefer to see within the Opinion is whether or not there is any obligation for the Society to repay cash payments received, other than under Termination Article. We are relying upon the fact that no other obligation for repayment exists.*

[**18:13**] Chief Counsel A thanks him for the comments and says she would forward them to Counsel.

The following day [**at 14:14**], Chief Actuary C sends the correspondence to the Head of Life Insurance.

27/11/2001 [06:57] FSA's Head of Press Office provides Managing Director B with information on the press coverage of the disclosure of the side letter. The Head of Press Office says: '*From their reaction yesterday, the bit the Equitable will be most fussed about is the possible creation of a new class of "missold" policyholder to make claims on them – ie anyone after 1 April 1999 – on the grounds that we are bound to have closed Equitable earlier had we known of the impaired reinsurance*'.

[**09:32**] The Head of Life Insurance adds: '[Equitable's Chief Executive] *told me last night that he was surprised and (by implication) upset at the sentence in our* [press notice] *about not allowing so much credit had we been aware of the letter at the time – for exactly the reason that it might open a line of claim for misselling by late joiners. He seemed to think that this sentence was a "toughening up" of the* [press notice] *from the version they had seen. I said I was not aware of that; indeed, we had removed another sentence to meet concerns expressed by* [Equitable's Finance Director] *over the weekend*'.

	[**09:35**] Managing Director B states that this was his understanding. [**10:37**] The Director of GCD comments that '*the risk of claims is inherent in the underlying reality*'. He explains that there had in fact been a small change to the final text, which '*was needed to ensure* [it] *was not misleading given advice from counsel*'. The Director of GCD concludes that he did not think this made any difference to the press coverage.
27/11/2001 [10:01]	FSA's Head of Actuarial Support comments on the balance sheet provided by the Society on 26/11/2001, saying: *I see this includes an amount of £695 million for the reinsurance asset, rather higher than I would have expected. It also includes an implicit item for £805 million of future profits for which they do not have a waiver under* [FSMA 2000]*, I assume. Against this, the actuary claims that they could discount the guaranteed liabilities rather further, though this has not been demonstrated.*
28/11/2001 [13:22]	FSA's Head of Life Insurance relays to Line Manager E the details of a telephone conversation with Equitable earlier that day, about the possibility of the Halifax deal details becoming public and also information about the Financial Ombudsman's consideration of complaints that fell outside the compromise scheme.
28/11/2001 [14:28]	FSA's Chief Actuary C informs Chief Counsel A that: *We have identified a further material change to the IRECO Life Reinsurance Agreement that does not appear to have been covered by the Opinion.* *Under the original treaty, the interest payable on cash drawn down under Article IV appears to be payable by Equitable to IRECO as part of the Adjustment Premium, as set out in Appendix II. The Adjustment Premium, and hence the interest payable on the cash draw downs, is payable out of emerging surplus and hence the Appointed Actuary needed to make no provision for the interest payments in setting his mathematical reserves.* *Under the new treaty, the interest payable on cash draw downs is separated out from the Adjustment Premium and is shown in Article V under the Heading "Fee if interest or cash paid by the Reinsurer under Article IV". It appears that this fee is payable in cash each year whether or not surplus emerges to cover it.* *This change is significant and could have a further adverse effect on the amount that Equitable could claim for the treaty in their regulatory returns because full provision for the future interest payment cost may be necessary until the eventual termination of the treaty. In assessing the £350m provision we had provided for the interest cost for a 10 year period.* [Scrutinising Actuary F] *is trying to assess the effect of this but it may result in the treaty being of little value.* [**15:22**] Chief Counsel A says that she: '[does] *not read the fee of LIBOR plus 3.5% as forming part of the Adjustment Premium under Appendix II of the original agreement. I can see however that there is a contrary argument which arises primarily as a result of the placement of the fee obligation in the middle of* [Appendix] *II. I will run this by Counsel*'.
28/11/2001 [16:21]	FSA's Scrutinising Actuary F sends the Head of Actuarial Support a spreadsheet which tracks how the reinsurance treaty might operate in practice. The Scrutinising Actuary says: '*The value of the treaty to Equitable would be represented by the entries in the final column. However, as these figures decrease to zero over years 15 – 30, I wonder whether any value can be ascribed to the treaty in the first place*'.

	The Scrutinising Actuary also attaches a draft letter to Equitable in response to theirs of 16/11/2001.
29/11/2001 [11:47]	FSA's Line Manager E circulates a short note on the proceedings in court which had occurred on 26 November 2001.
29/11/2001 [13:45]	FSA's Chief Counsel A sends the Head of Press Office a copy of the Insolvency Practitioner's comments about the compromise scheme of 21/11/2001 [**18:46**]. She says: *The two issues which seem to me most likely to arise now on the section 425 scheme (for press office) are the risk posed by* [Article] *4 for compensation of Equitable policyholders in the event of insolvency and the risk to solvency of GIRs (75% of policyholders have them) and of misselling claims by non-GIRs.*
29/11/2001 [15:21]	FSA's Scrutinising Actuary F asks Chief Counsel A and the Head of Life Insurance to review a revised draft of the letter to Equitable, in response to his letter of 16/11/2001 in relation to the credit to be taken for the reinsurance treaty. The Scrutinising Actuary explains that he had: '*worked up a draft response ... last week, but we felt unable to issue it at that time. I have now adapted the response to explain our view that credit can only be taken for the cash payments available under the treaty, and attach a copy herewith*'. The opening section of the draft letter reads: *We have consulted with leading Counsel on the legal interpretation of the treaty, and have concluded that no credit can be taken for the Reinsurance Claims Amount itself when determining the amount of the Reinsurer's Liability for the purposes of the regulatory Returns. This is because, under Article IV, all Reinsurance Claims Amounts will be withheld by the Reinsurer, and never paid to the Society. Indeed, on Termination under Article XII, paragraph (d) of that Article would have the effect that an equal and opposite obligation to the Reinsurance Claims Amount would be created, and the two would then be set off against each other under paragraph (e) of that Article. So no sums would be owing between the Society and IRECO following termination.* *It is therefore our view that the only benefit under the treaty for which credit can be taken for reserving purposes is the stream of cash payments of up to 10% of the outstanding (withheld) Reinsurance Claims Amount which can be drawn down under Article IV. It would be necessary though to allow for any premiums payable by the Society and any interest payments which are not subject to surplus emerging...* [**19:35**] Chief Counsel A says that officials should meet the following day to discuss the matter.
30/11/2001 [11:50]	FSA's Scrutinising Actuary F informs senior FSA officials that, in reply to his query to Equitable of 26/11/2001, Equitable's Appointed Actuary had confirmed that the figure for the future profits implicit item of £800m took account of the use of post-N2 equity yields in the valuation.
30/11/2001 [16:56]	FSA's Head of Life Insurance asks Chief Counsel B to examine the possibility of a 'Restitution Scheme' in the event of the compromise scheme failing.
30/11/2001 [17:25]	Scrutinising Actuary F sends Managing Director B a revised draft of a response to Equitable's Appointed Actuary regarding the IRECO reinsurance treaty. The Scrutinising Actuary explains that this version of the draft incorporated the comments of Chief Counsel A. The opening section of the revised draft letter reads:

> *It seems to us that the only benefit under the treaty for which credit can be taken for reserving purposes is the stream of cash payments of up to 10% of the outstanding (withheld) Reinsurance Claims Amount which can be taken under Article IV. It would be necessary though to allow for any premiums actually payable by the Society, and fees and any interest payment which are not subject to surplus emerging ...*

The draft letter also sets out a number of technical questions about the treaty. These include the comment that:

> *Your interpretation appears to be based on the assumption that credit could be taken in the valuation for the future Reinsurance Claims Amounts. As indicated above, we do not accept this.*

(Note: the final version of this letter, which I have seen did not differ substantively from this draft, was sent by FSA to the Society on 13 December 2001.

Equitable responded to FSA on 9 January 2002. In response to FSA's question above, Equitable says:

> *The Society's interpretation is based on the assumption that credit can be taken in the valuation for the future Reinsurance Claims Amounts. I am not persuaded that the basis you set out in your letter, which is based on the stream of possible cash payments, is the only appropriate basis for valuating the reinsurance claims.*
>
> *The Reinsurance Claims Amounts have been valued in full as shown in Form 52 of the Society's statutory returns for the years 1998, 1999 and 2000. This basis was agreed at meetings of the Society with the FSA and the GAD in the first quarter of 1999 (where the GAD was represented by* [the Head of Actuarial Support (who had at that time been GAD's Directing Actuary B), Chief Actuary C and Scrutinising Actuary E] *when the final terms of the Reinsurance Agreement were being agreed with IRECO to provide the required reserving credit for the reassurance. Apart from the level of GAR take-up required for a reinsurance claim, which was amended to 60% (from 25%) following the House of Lords' ruling on 20 July* [2000]*, the basis on which reinsurance claims arise under the Agreement has not been changed since the Agreement came into force and, in particular, nothing has been changed in this respect by Addendum 3 to the Reinsurance Agreement. It is clear from the Society's statutory returns that it is this interpretation which has been used.*
>
> *I therefore cannot see that Addendum 3 should require any change in the interpretation of the credit that can be taken for future Reinsurance Claims Amounts from that used in previous returns to the FSA and, that being the case, it is on this established basis that I should prepare the 2001 returns.*

It appears that FSA conclude the correspondence on this matter with a letter, dated 19 February 2002, in which they state that: '*For the record, we would mention that we do not agree with your contention that the basis that you describe in your letter, of taking credit in the valuation for future "Reinsurance Claims Amounts" rather than cash payments under the treaty, was agreed with us in early 1999*'. However, FSA conclude: '*now that the High Court have approved the Section 425 Compromise Scheme, we assume that the above reinsurance arrangement has been cancelled by Equitable. In addition we understand that the 2001 Returns are being prepared taking account of post-balance sheet adjustments in respect of the S425 Scheme. We do not therefore intend to pursue the matter of the value to be placed on the reinsurance any further*'.)

30/11/2001 [entry 4] FSA write to Equitable about complaint and enquiry monitoring, as they had not received information for some weeks.

30/11/2001 [entry 5]	FSA write to every insurance company, setting out details of their policy in relation to future profits implicit items.
30/11/2001 [entry 6]	FSA write to Equitable about their outstanding application for a section 68 Order for a future profits implicit item.
30/11/2001 [entry 7]	FSA meet the Financial Ombudsman Service to discuss the handling of complaints from former Equitable policyholders.

01/12/2001 [entry 1] Equitable's Chairman and Chief Executive send out to the Society's policyholders the final compromise scheme documents, which include:

- a booklet entitled 'Your questions answered';
- a '*Scheme Circular*', setting out in full detail the compromise scheme proposals;
- the Society's Interim Accounts for the half-year 30 June 2001, prepared under the Companies Act 1985.

In their letter, the Chairman and Chief Executive discuss the Society's financial position. They write:

> *Interim Accounts for the half year ended 30 June are enclosed and are the first ever published by your Society. They provide you with financial information relevant to your voting decision. In the time available it has not been possible to produce third quarter interim accounts, but we should draw to your attention the financial impact on your Society during the third quarter of policyholder claims and the aftermath of September's terrorist attacks in America which saw interest rates and stock markets fall.*
>
> *Your Society is and remains solvent. This has in part been achieved by reducing our investments in the stock market and increasing holdings in lower-risk investments. At 30 June, some 48% of the with-profits fund was invested in the stock market. At 30 September that had reduced to 35%.*
>
> *Since 30 June we have experienced an increase in policyholder maturities and surrenders as a result of the painful but necessary reductions in policy values. In the three months to 30 September these claims were £1.7 billion, though the rate of new claims has fallen since then. At 30 September, the with-profits fund was estimated to stand at £20.1 billion against £22.8 billion at 30 June 2001. This reduction was due to the claims and the decline in stock market values over the quarter exacerbated by the 11 September attacks.*
>
> *At the end of September the Fund for Future Appropriations (which is available to pay bonuses) had fallen to an estimated £300m, but the total policy value for all with-profits policies compared to the value of the with-profits fund was within the 5% bounds set by the Appointed Actuary for the financial management of the Society.*
>
> *The low level of free assets makes your Society financially unstable and vulnerable to market risks.*
>
> *Your Board believes that adopting the compromise scheme is essential to make the Society more stable and place it on a stronger financial footing.*

On '*The benefits of compromise for policyholders*', the Chairman and Chief Executive say:

> *The adoption of the compromise scheme will see your current policy value increased in exchange for you giving up some of your rights. An indication of the uplifts are in your indicative statements of value, contained in your Voting Documents.*

The successful completion of the compromise agreement by 1 March 2002 sees the Halifax £250 million used to uplift your policy funds. We believe that the compromise is still preferable to continuing as we are, even if this deadline is missed and uplifts are lower.

The compromise scheme will reduce uncertainty and worry for all policyholders and means we can invest the with-profits fund without the current abnormal constraints. The resulting improved financial position of the Society should ultimately lead to a less constrained bonus policy.

A successful compromise will not stop us from pursuing those who caused the Society's problems, if that is in policyholders' interest. However, any compensation is years away. We cannot wait – we must solve the Society's problems now.

On '*The dangers of no compromise*', the Chairman and Chief Executive say:

We have examined all the alternatives to a compromise. Either they do not work or would greatly reduce the value of your policy.

Liquidation would be very bad. All non-guaranteed bonuses could be lost. There is a risk that guaranteed benefits could be scaled back. Annuity payments including GAR pensions would be suspended and the competing claims of GARs and non-GARs might well delay payments for years.

No compromise means we do not gain the Halifax £250 million.

Without a compromise the Society would have to maintain a very restrictive investment policy, investing much less in stocks and shares. Bonus policy would need to be very cautious; payments might not include any non-guaranteed bonuses. A bleak outlook for policyholders.

The Government is clear that there will be no lifeboat for us and compensation for policyholders, if any arises, is years away. We cannot afford to wait. We must sort out our own problems now.

Finally, without a compromise the instability, uncertainty and worry will continue, and may well get worse for everyone, whatever their policy, whatever their age. We have listened to and read the views of many policyholders and know that this is rightly unacceptable to the vast majority.

Equitable's Chairman and Chief Executive, on behalf of the Society's Board, urge policyholders to vote for the compromise scheme.

01/12/2001 [entry 2] FSMA 2000 comes into effect, changing the system of the regulation of insurance companies. The actions of the prudential regulators of insurance companies no longer fall within the jurisdiction of the Parliamentary Ombudsman.

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Report enquiries
Tel: 020 7217 3904
Fax: 020 7217 4061

Email: equitable.investigation@ombudsman.org.uk

General enquiries
Tel: 0845 015 4033
Fax: 020 7217 4000

Email: phso.enquiries@ombudsman.org.uk

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Fourth report

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This report contains references to, and extracts from, legal opinions and advice and their contents obtained by the Equitable Life Assurance Society and provided by it to -

(a) the public bodies responsible for the prudential regulation of insurance companies in the course of normal exchanges between a regulated body and its regulators for the specific purpose of allowing those regulators to fulfil their regulatory functions; and

(b) Lord Penrose in the course of normal exchanges between the Society and Lord Penrose and his Inquiry team for the specific purpose of allowing Lord Penrose to fulfil his terms of reference.

After the House of Commons had ordered the report of Lord Penrose to be published on 8 March 2004, all the documents obtained by Lord Penrose were retained by the Treasury.

In turn, I obtained this material from the Treasury for the specific purpose of carrying out my investigation into the prudential regulation of the Society, following my decision to carry out such an investigation which was reported to Parliament on 19 July 2004.

I acknowledge that the Society has waived privilege in this material only for the above specific purposes and that the Society does not intend any wider or general waiver of privilege by not objecting to the inclusion of, or extracts from or references to, this material in this report as published.

Contents

Section 1

Introduction

Introduction

In this Part of my report, I have reproduced or included certain documents which are relevant to the subject matter of the investigation which led to this report.

The primary and secondary documents which are reproduced or included are grouped in six sections other than this introduction. Those sections contain:

- documents related to the investigation process, including the terms of reference for the investigation and the initial response of the bodies whose actions were under investigation to the heads of complaint which were set out in those terms of reference – these are set out in Section 2;
- information regarding complainants and direct contacts, produced as a result of a survey we conducted of those whose interest in our investigation we had registered – this is set out in Section 3;
- the responses, in whole or in part, of certain parties to my report, including those from an individual former GAD actuary and from action groups representing the lead complainants – these are set out in Section 4;
- documents, such as service level agreements between, and internal and public guidance produced by, the prudential regulators and/or GAD, which help to explain the statutory and administrative context for the discharge of their functions which existed at the time covered by this report – these are set out in Section 5;
- reports produced by those responsible for the scrutiny of the Society's regulatory returns, setting out the results of that scrutiny – these are set out in Section 6; and
- other primary documents which are either relevant to specific heads of complaint or which otherwise provide context for the subject matter of the investigation – these are set out in Section 7.

The purpose of the reproduction and inclusion of these documents is to assist the reader by placing before them material which may add to their understanding of the context in which I have reached the conclusions contained in this report.

The reader should be aware that, within some of the documents reproduced in this Part of my report, reference is made to annexes or appendices. Not all of those have been reproduced here, with only those directly relevant to the subject matter of the report being included.

Section 2

Key documents related to the investigation process

Excerpts from *A Further Investigation of the Prudential Regulation of Equitable Life?* (19 July 2004 – HC 910)

Assessing whether I can and should investigate

12. When considering whether I should investigate a complaint referred to me by a Member of Parliament, I make four assessments.

13. First, I determine whether the body (or bodies) complained about are **within my jurisdiction** and, if so, whether the actions that form the subject of the complaint are ones within my remit. While I understand why a perception might have arisen that I have jurisdiction over anything done by any government or other public body, that is not the case. I may only investigate the administrative actions of those bodies listed in Schedule 2 to the Parliamentary Commissioner Act 1967 (the 1967 Act) – or those acting on behalf of such a body, if those actions are taken in the exercise of the listed body's administrative functions. Furthermore, I may not consider complaints about the actions of bodies within my jurisdiction where such actions are of a type specifically excluded from my remit, principally by Schedule 3 to the 1967 Act. Neither can I consider complaints where I believe that an alternative remedy is available to the complainant through the courts or a statutory tribunal, unless I am satisfied that in the particular circumstances it is not reasonable to expect the complainant to resort or have resorted to that alternative remedy.

14. Secondly, assuming that both the bodies and matters complained about are ones that I have the legal power to investigate, I then assess whether I have been shown any **prima facie evidence of maladministration** by the relevant body or bodies. Many people come to my Office with a profound sense of outrage at the content of government policy or by the effects on them of the relevant legislative framework. However, I am not empowered to question the merits of legislation or of government policy formulated without maladministration or to question the merits of a decision taken without maladministration by a government department or other body in the exercise of a discretion vested in that department or body.

15. Thirdly, if it appears to me that there is evidence pointing to administrative fault on the part of the body or bodies complained about, I consider whether it appears that any such maladministration, if established, may have **caused an unremedied injustice** to the person making the complaint. However strongly felt a sense of outrage or injustice may be as a result of what appears to be administrative error, if other factors have caused the injustice complained about, then it is not for me to investigate such complaints.

16. Finally, I consider whether an investigation by my Office may produce a **worthwhile outcome** to the complainant. This might be achieved by the production of a suitable remedy, which can comprise an apology, improvements to administrative systems, or financial redress, or by the provision of an authoritative explanation of past events or the resolution of outstanding issues.

17. There are three important principles underpinning the work of my Office should I decide, on the basis of the tests described above, that a statutory investigation of a complaint, or of part of a complaint, is appropriate.

Excerpts from *A Further Investigation of the Prudential Regulation of Equitable Life?*
(19 July 2004 – HC 910)

18. I consider that it is particularly important on this occasion for me to set these principles out as clearly as possible:

- first, my Office is **impartial** between the parties to a complaint: I am neither advocate for the complainant nor apologist for those under investigation. I always seek to conduct a rigorous and independent scrutiny of the relevant events in the light of all of the available evidence. If injustice caused by maladministration is found, I consider it the role of my Office to pursue appropriate redress vigorously;

- secondly, my approach to any investigation **cannot benefit from the use of hindsight** or be influenced by my personal opinion – or that of my staff – on what should have been the relevant statutory or policy frameworks. I cannot substitute my view as to what would have been an appropriate policy or consider the merits of a decision taken without maladministration. Instead, I assess whether the relevant public body did what it ought to have done; whether it did anything that it should not have done; and whether it otherwise acted without maladministration; and

- thirdly, a decision to conduct an investigation does **not mean that I have prejudged the outcome** of that investigation. My initial assessment is based on the often limited material available when the complaint is put to me and on whether such material discloses indications that maladministration might have occurred. A decision that a complaint is worthy of investigation does not mean that a finding of maladministration causing injustice will follow. The outcome of a detailed investigation by my Office may be that I do not uphold the complaint.

Decision

19. In the light of the evidence before me and, having applied the tests described above to that evidence, **I have decided, subject to what I say in paragraph 20 below, to conduct a statutory investigation of the prudential regulation of Equitable Life in the period prior to 2 December 2001.**

20. That investigation will focus on the actions (including failures to act) of the government departments responsible under the relevant legislation for the prudential regulation of Equitable Life. My investigation will, subject to approval of a request I have made of the Government (Annex C), also include the actions of GAD, for reasons that I explain below. **However, should approval of my request not be forthcoming, I will, in the absence of the ability to consider the actions of GAD, review my decision to investigate.**

21. The rest of this report deals with the scope of my decision – the bodies whose actions I propose to investigate and the time period to be covered by my investigation – and the reasons for my decision. The report will also outline the next steps that I propose to take.

Scope of my decision

Jurisdiction

22. It is evident to me – from the substance of many of the complaints about Equitable Life

Excerpts from *A Further Investigation of the Prudential Regulation of Equitable Life?* (19 July 2004 – HC 910)

referred to me, from many of the representations I received during the consultation process and from press and public comment – that my jurisdiction in relation to the events at Equitable Life is not understood by many people.

23. Many of the complaints and representations I have received concern the actions of Equitable Life itself, the actions of its salesforce and directors, or are about the Society's auditors or accountants. I must make it very clear again that I have no role in considering complaints about mis-selling of policies or about the conduct of the Society. Neither do I have the power to investigate the actions of the FSA, except where it acted on behalf of the Treasury from 1 January 1999 to 2 December 2001, as it is not listed in Schedule 2 to the 1967 Act (paragraph 13). Nor are the actions and judgment of the House of Lords, which I have been asked by some people to 'review', within my remit.

24. My staff will, over the coming weeks, identify those complaints on file and those representations made in the consultation process which raise issues outside my jurisdiction. We will then write to those individuals to ensure that they are aware of the extent of my remit and, where appropriate, we will identify which other bodies might assist them.

25. I will now outline my current jurisdiction in relation to the regulators of Equitable Life and the reasons why I have asked the Government to empower me to investigate the actions of GAD in relation to the prudential regulation of Equitable Life. I will also deal with the request that has been made to me that I should consider asking that the conduct of business regulators – that is, those responsible for overseeing the sale of policies to individuals and for sales communications between Equitable Life and its potential and existing policyholders – are brought within my jurisdiction.

The prudential regulator

26. I have jurisdiction to investigate the administrative actions of those government departments – the Department of Trade and Industry and the Treasury and their Ministers – responsible in law for the prudential regulation of life assurance companies before 2 December 2001. Both of these bodies were at all the relevant times listed in Schedule 2 to the 1967 Act. The focus of my further investigation will include the actions of those Departments.

The Government Actuary's Department

27. I consider, and am advised, that GAD is not within my jurisdiction. It is not listed in Schedule 2 to the 1967 Act and, indeed, the Notes on Clauses on the Act, prepared at the time of its passage through Parliament, clearly demonstrate an intention to put GAD outside my jurisdiction.

28. That said, it has been put to me in some of the key representations I have received that any future investigation by my Office should include the actions of GAD. Indeed, EMAG put it to me in their written submission (Annex B) that 'any further investigation would be meaningless without such jurisdiction'.

29. My decision to ask for the inclusion of GAD within my jurisdiction has been informed by the assessments of the role and performance of

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GAD, made with the benefit of hindsight, in the Penrose report. These assessments may or may not be correct but they provide material that makes it arguable that there was maladministration by GAD. Examples include:

- the 'key finding' of Lord Penrose that 'there was a general failure on behalf of the regulators and the GAD to follow up issues that arose in the course of their regulation of the Society' (paragraph 240 (11) of chapter 19); and
- Lord Penrose's specific assessment that 'although GAD brought in a more detailed style of scrutiny in the early 1990s, the standards of scrutiny still impress me as complacent, lacking challenge and hesitant in criticism and in following up on any criticism made. This was, indirectly, reflected in a lack of robustness in the regulatory process' (paragraph 160 of chapter 19).

30. These observations by Lord Penrose seem to me to indicate that the advice provided by GAD, and the actions it took in support of that advice, may have been important to the way in which the prudential regulator undertook its functions. In addition, Lord Penrose's criticisms of GAD might indicate that GAD was, at least arguably, maladministrative in performing its functions.

31. I recognise – as does Lord Penrose himself – that Lord Penrose was applying different tests in relation to GAD to the ones that I must apply, and that his approach was informed by hindsight. I also recognise that the role of GAD has changed substantially since 26 April 2001, when its role in relation to advising the regulators of the insurance industry was transferred to the FSA. I am also aware that some of the current work of GAD is not of the type normally subject to my scrutiny.

32. However, I consider that there is sufficient initial evidence to suggest that the actions of GAD are key to an assessment of whether maladministration by the prudential regulator caused an unremedied injustice to complainants. I believe therefore that GAD's actions must be brought within my jurisdiction if my investigation is to be meaningful.

33. I consider that the recent change in GAD's responsibilities does not constitute an insurmountable problem. As explained in my letter requesting the addition of GAD to my jurisdiction (Annex C), if it is considered that such an addition by Order in Council would be undesirable in relation to GAD's current responsibilities, the relevant entry in Schedule 2 to the 1967 Act could be accompanied by a Note to that Schedule. This Note could limit my jurisdiction to GAD's actions before 26 April 2001.

Conduct of business regulation

34. It has been put to me – not least by EMAG – that I should also consider whether my jurisdiction should be extended to include those bodies responsible prior to December 2001 for the regulation of the conduct of life insurance companies' business.

35. I understand why this is considered important. Many of the representations I received during the consultation exercise – and the referred complaints we hold on file – focus on conduct of business issues. Such complaints particularly

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concern alleged mis-selling, alleged failures to provide clear information to existing and prospective policyholders, and the performance of the regulatory bodies in exercising their responsibility to oversee such matters.

36. However, I am advised that the relevant regulatory bodies – the Designated Agency to which the Secretary of State transferred his responsibilities, the Securities and Investments Board (SIB – now renamed the FSA), and the self-regulatory organisations (particularly the Personal Investment Authority) – are not bodies which can be brought within my jurisdiction by Order in Council.

37. Section 4(3) of the 1967 Act provides that only public bodies that meet certain criteria can be added to my jurisdiction by Order in Council. Bodies not meeting these criteria – which include the SIB-FSA and the nowdefunct self-regulatory bodies – could only be added to my jurisdiction by primary legislation.

38. While the Government has said that it will consider a request from me for the addition of GAD to my jurisdiction, it has made no such statement in relation to the conduct of business regulators. Moreover, I do not think that it would be in the public interest – or in the interest of policyholders – to delay my investigation with the aim of bringing the conduct of business regulators within my jurisdiction.

39. Furthermore, while many people have suggested that it would be desirable for me to have jurisdiction over those bodies historically responsible for regulating conduct of business matters, it does not appear to be a widely-held view that the absence of such powers would render worthless any investigation conducted by me.

40. In any case, my powers to obtain evidence, under sections 8 and 9 of the 1967 Act, are wide. I would use those powers to interview witnesses and examine documents related to conduct of business matters should I consider that that would assist my investigation.

Timeframe of investigation

41. Respondents to the consultation suggested a number of timeframes for any future investigation:

- most Members of Parliament and many policyholders suggested that any further investigation by me should cover the same period as that covered by the Penrose report;
- the action group representing with-profits annuitants suggested that any investigation should start ‘at least from 1973’ as this was the time they allege that ‘Equitable’s estate began to be dispersed’;
- EMAG suggested ‘at least from 1987’; and
- some MPs and individual policyholders suggested that ‘no artificial limits’ should be placed on the timeframe for any investigation.

42. I recognise that all of the timeframes outlined above are based on an assessment of when Lord Penrose suggests that Equitable Life’s problems originated. I am minded to focus on events

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relevant to the closure of Equitable Life to new business. I propose to invite further representations on this point. In the interests of fairness I shall keep in the forefront of my mind the impairment of recollection – which is the inevitable consequence of the passage of time since the material events – and the extent of the availability of material documentation.

43. That said, I have no jurisdiction over the actions of the prudential regulators on or after 2 December 2001 and therefore my investigation must conclude at the latest with that date. I will revisit the findings of my first report in the light of the inclusion of GAD within my jurisdiction, should approval of my request be forthcoming, and in the light of the evidence disclosed by my proposed second investigation.

Prima facie evidence of maladministration

44. As explained in paragraphs 1 and 2 of Part I of my first report to Parliament, The Prudential Regulation of Equitable Life, many of the complaints about Equitable Life referred to me or my predecessor by Members of Parliament were about matters that were not within my jurisdiction.

45. In addition, many complaints, understandably, disclosed more information about the perceived injustice suffered by complainants than about any alleged maladministration, by bodies in my jurisdiction, which may have caused this injustice.

46. When seeking to identify whether there is sufficient material before me to indicate that there may have been maladministration on the part of the prudential regulator and GAD, I have sought to focus my attention on two principal sources: the Penrose report and the representations made to me in the consultation exercise.

Penrose

47. I do not intend to repeat here all of the criticisms of the regulators contained in the Penrose report – or begin to assess whether these were directed at the adequacy of the regulatory system or towards operational failures by regulators. I will consider all of the relevant material in that report as part of my investigation.

48. However, I consider that the general criticisms of prudential regulation made by Penrose (in addition to those mentioned above at paragraph 29), which can be viewed as prima facie evidence of maladministration, include:

- **that the regulators were not adequately resourced to fulfil their obligations:** the 'DTI insurance division was ill-equipped to participate in the regulatory process. It had inadequate staff, and those involved at the supervisor level in particular were not qualified to make any significant contribution to the process... were not individually equipped with specific relevant skills or experience to assess independently the Society's position' (paragraph 158 of chapter 19);

- **that the regulators as a result did not properly undertake their functions:** 'it is difficult to avoid the view that regulation was falling between two stools, the major player in discussions having no regulatory power and the empowered regulator having little part in the processes that would have

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instructed regulatory action' (paragraph 252 of chapter 16);

- **that on several specific occasions information that might have led to regulatory action was ignored or not actioned by the regulators or GAD** (examples throughout the report);

- **that the regulators and GAD allowed the chief executive of Equitable Life also to hold the post of appointed actuary:** 'regulation was based on an overreliance on the appointed actuary who... was also the chief executive over the critical period from 1991 to 1997, despite a recognition for the potential for conflict of interest inherent in this position' (paragraph 240 (7) of chapter 19);

- **that the regulators and GAD did not keep pace with developments in the industry** and that thus 'regulatory solvency became an increasingly irrelevant measure of the realistic financial position of the Society';

- **that the regulators and GAD did not properly assess the impact and adequacy of measures being used to improve Equitable Life's solvency position:** 'the regulators... failed to give sufficient consideration to the fact that a number of the various measures used to bolster the Society's solvency position were predicated on the emergence of future surplus' (paragraph 240 (10) of chapter 19); and

- **that the regulators and GAD failed to assess the reasonable expectations of policyholders in terms of the effect of these on Equitable Life's ability to meet its liabilities or to assess properly the impact of the House of Lords' judgment:** 'there was... no consistent or persistent attempt to establish how [Policyholders' Reasonable Expectations] should affect the acknowledged liabilities of the Society' (paragraph 240 (9) of chapter 19) and 'it appears that the regulators proceeded on the assumption that, if anyone were disadvantaged by the [Court's] decision, compensation would be available' (paragraph 115 of chapter 18).

Other criticisms

49. EMAG, in their formal submission and in the template letters prepared for their members and supporters, also made the following specific criticisms of the regulators and GAD:

- 'Equitable were permitted by the various Government regulators to publish financial results and projections that were grossly misleading to its members and to prospective new customers';

- that the regulators were aware of the true, weak financial position of the Society – for example, it is alleged that GAD knew about the 'practices of dubious actuarial merit' employed by the Society as far back as 1990 – and 'did nothing about it and by their silence connived in the Equitable Board's misleading representation of its finances';

- that the regulators permitted over-bonusing 'which was a contributory factor in the Society's demise and in the losses sustained by those who held policies on 16 July 2001'

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and 'did not identify that guaranteed annuity rates would become a problem'; and

- other 'questions raised by Lord Penrose's report', as set out in Part IV of EMAG's written submission (Annex B).

50. Andrew Tyrie MP, in his submission on behalf of the Official Opposition (Annex B), concurred with much of the above, as did the Liberal Democrats in their submission. Mr Tyrie also said that the regulators 'failed to recognise the inadequacy of the reinsurance policy negotiated to cover reversionary bonuses for [Guaranteed Annuity Rates] in late 1998 and early 1999'.

51. In my view, the criticisms contained in the Penrose report and the evidence put forward by the action groups and by opposition spokespeople constitute sufficient material to warrant an investigation into the way in which the prudential regulators and GAD discharged their responsibilities.

Unremedied injustice

52. It is very clear to me that many thousands of policyholders and former policyholders feel greatly aggrieved by events at Equitable Life. When reading the 1,603 representations from individual policyholders, I could not but be struck by the considerable distress caused by these events to many people from very diverse backgrounds, not all of whom have other sources of income.

53. The representations I received cited significant financial hardship and loss caused, in particular, by cuts in annuity rates and in the value of individual policies and pension funds. One respondent said that he had lost almost 40% of his savings; another that more than 35% of her income had been lost as a result of the cuts progressively imposed since July 2001 on Equitable Life annuities. These individual stories are not by any means unique. The consultation process gave me a valuable opportunity to hear directly from the many people most acutely affected by the situation at Equitable Life.

54. I have received many representations, describing the situations in which individual policyholders now find themselves – whether suffering reduced current income, a likely reduction in future retirement income, or uncertainty and financial instability – and the outrage felt by many at the events that precipitated these situations. Most of these share a sense of anger that government bodies did not protect them from the unfolding events.

55. Section 5 of the 1967 Act allows me to consider complaints in cases where a member of the public claims to have suffered an injustice in consequence of maladministration by a body in my jurisdiction. It is clear to me, from the individual representations I have received, that a large number of people claim to have suffered such an injustice, which they believe has been caused by maladministration on the part of the prudential regulators and GAD.

Worthwhile outcome

56. I now turn to the arguments about whether a further investigation by my Office would be likely to provide a worthwhile outcome.

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Arguments for my intervention

57. During the consultation process, there were broadly five arguments put forward in favour of my conducting a further investigation:

- first, it was suggested to me that only the Parliamentary Ombudsman has sufficient standing and expertise to adjudicate on whether maladministration by government bodies has caused an injustice to individual citizens. Therefore, a further investigation by me was necessary to resolve this question;

- secondly, it was put to me that, even were this not the case, Lord Penrose either could not, or chose not to, address questions of maladministration and of redress for any such maladministration, although he had identified instances of regulatory failure – and that, accordingly, only I could now recommend compensation from public bodies;

- thirdly, it was submitted that, although my remit might be limited to certain government bodies, there were no alternative remedies available to policyholders for regulatory failure. It was unreasonable to expect them to pursue the one potential alternative course of action – uncertain and costly litigation against the Government or the regulators;

- fourthly, it was argued that, unless finality was brought to the Equitable Life affair, public confidence in the financial services industry would continue to be eroded and younger generations would be dissuaded from investing in pension provision; and

- finally, it was put to me that a failure to act would lead to a loss of public confidence in, and respect for, my Office and that this would reflect badly more generally on the wider reputation of Parliamentary oversight of government bodies and of the protection afforded to consumers by Parliament.

Arguments against my intervention

58. Six broad arguments were put to me as reasons for not conducting a further investigation:

- first, it was suggested that to conduct a full investigation would be costly to the public purse, involve complex matters about which my Office was not best placed to make judgments, and would take many years to complete;

- secondly, it was argued that other bodies – principally the courts or the Financial Ombudsman Service (and the Financial Services Compensation Scheme) – were more appropriate channels for resolving individual claims or complaints;

- thirdly, it was put to me that my jurisdiction was so limited as to make any worthwhile outcome impossible and that I would only be raising expectations falsely were I to conduct a further investigation;

- fourthly, it was suggested that there was no evidence of operational regulatory failure but rather failure of an inadequate system established by Parliament – matters about which it was said that I could not comment, or on which I could not adjudicate;

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- fifthly, it was put to me that to conduct a further investigation would be 'oppressive' to the staff and former staff of regulatory bodies who would have to undergo a fourth scrutiny of the same matters (the Baird report, my first investigation, and the Penrose inquiry being the other three) and would, for the FSA in particular, be a distraction from its current core business; and

- finally, it was suggested that, by conducting a further investigation, I would be 'opening the floodgates' to a range of other complaints about failures in the financial services industry and allied sectors, which would divert my Office from its core business.

The Penrose report as the basis for my investigation

59. Before detailing my assessment of each of the principal arguments put to me as outlined above, I wish to deal with one related aspect of some of the representations I have received – namely, the degree to which the Penrose report provides a factual basis on which to draw upon in my investigation.

60. The choice before me is either to conduct a further statutory investigation of the relevant events or not to conduct any such investigation. Where Government Departments or officials accept findings of fact by Lord Penrose, this may shorten my process of investigation. However, I cannot, as has been suggested by some, simply take the Penrose report as 'findings of fact' and then apply an assessment of whether those 'findings' disclose maladministration on the part of the prudential regulators and GAD.

61. Lord Penrose, when introducing his conclusions in paragraph 2 of chapter 19 of his report, said:

> *As throughout this report, I have not qualified my comments by reference to professional standards current at the time events occurred: that is a matter for the courts and the professional bodies exercising disciplinary functions. Further, I have the benefit of hindsight, and I have not restricted the comments made to those matters that can be shown to have been within the knowledge or contemplation of individuals or groups at material times. In seeking material from which lessons can be learnt for the future it would be impossible to restrict oneself to what individuals knew or ought to have known at any time in the past.*

62. However, that is exactly what I must do: abandon hindsight and assess whether the actions of the bodies under investigation complied with the relevant statutory and regulatory provisions current at the time. In his letter to me (Annex B), Lord Penrose himself recognises this critical difference:

> *In carrying out your function you will, I think inevitably, have access to different evidence from the evidence I had available, and the issues you will have to consider, within the terms of your remit, will, equally inevitably, be different from those that engaged my attention as reporter. It would have been, and remains, outside the scope*

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of my remit as reporter to form and express views on the issues you have to consider.

63. In addition, the representations I have received make it clear that key parties to the relevant events do not accept that Lord Penrose's narrative is correct in important respects and/or represents an undisputed understanding of events.

64. Thus, while I would have regard to all relevant evidence, including the papers of the Penrose inquiry, I have to conduct a full, statutory investigation based on the approach I have outlined in paragraph 18 above.

Assessment

65. Turning first to the arguments put forward in favour of a further investigation by my Office, as set out in paragraph 57 above, it is clear to me, with respect to the first two arguments, that the Penrose report did not – for whatever reason – deal with questions of maladministration or of redress. Given my statutory function, I find the arguments that only the Parliamentary Ombudsman can now address such complaints, and deliver a verdict on whether maladministration has occurred, highly persuasive.

66. I recognise that there are other potential remedies available to policyholders with respect to the other actors central to events at Equitable Life. For example, there is legal action by Equitable Life pending against the Society's former directors and auditors and the Financial Ombudsman Service is dealing with thousands of complaints about mis-selling by the Society's staff. I also understand that action groups are considering legal action against the Society in relation to the position in which with-profits annuitants find themselves. However, it does not seem to me reasonable to suggest that individual policyholders, often now in straitened financial circumstances, should be expected to take uncertain and expensive legal action against the prudential regulators or GAD. My Office was created to provide access to administrative justice that is free to those seeking it and I can see no reason why the existence of courts, whether domestic or European, should preclude me from assisting citizens whose complaints are ones that I can investigate. Moreover, I am not persuaded that an alternative remedy exists in those courts to which it would have been reasonable, in these particular circumstances, to expect the complainants to resort or to have resorted. The legal advice to me, in relation to the prudential regulators, is that those with a claim to have suffered an injustice in consequence of maladministration are unlikely to have any legal remedy available to them.

67. In relation to the arguments about public confidence both in my Office and in the financial services industry and about the protection afforded to consumers by Parliament, I have some sympathy with the latter arguments. However, I do not think that it is necessary to deal with them in detail here as the other arguments I have already discussed are, in my view, sufficient in their own right. I would say two things about these arguments. First, it is a matter of speculation as to what effect any decision I might make will have on the stability of Equitable Life and of the wider financial services sector. Secondly, with respect to the standing of my Office, while I recognise the strength of feeling that underpins such

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matters, as Parliamentary Ombudsman my role is to discharge my statutory responsibilities having regard both to the circumstances of each case and to the wider public interest. It would be entirely inappropriate for me to be influenced by current or prospective press comment or indeed by any other form of external 'pressure'. Such factors have had, and will continue to have, no influence on my judgment.

68. I now turn to the arguments put forward for my not conducting a further investigation into the regulation of Equitable Life, as set out in paragraph 58 above.

69. I accept that any further investigation by my Office will have a cost to the public purse. However, administrative justice, like any other kind, has a cost. I will address issues about the costs that will inevitably be involved when asking Parliament via the Treasury to provide the resources necessary to conduct my investigation.

70. Similarly, I do not find persuasive the argument that I should not conduct a further investigation purely because the matters which would be the subject of that investigation are complex or controversial. Resolving complex and controversial complaints is at the core of the role of all Ombudsmen. I also recognise that any investigation I conduct will take some time. However, that is not in my view a compelling reason for not conducting it.

71. I have already explained in paragraph 66 above why I do not think that alternative remedies exist to which it would have been reasonable to expect complainants to resort to seek redress for any alleged maladministration on the part of prudential regulators or GAD.

72. I am acutely aware that, among the relevant players, I have jurisdiction only over the prudential regulators and, subject to approval of my request for it to be included in my jurisdiction, over GAD. I also would not wish to raise the expectations of complainants that I will inevitably find in their favour – that is only one of a range of possible outcomes.

73. I recognise that it may be more difficult to assess questions of causality and redress, should I find maladministration, without being able to judge the actions of other key players. However, I have already explained that I consider that I should not avoid involvement in issues purely because they are complex. Furthermore, I am not persuaded by these arguments that a worthwhile outcome to a further investigation by me is impossible.

74. The question of whether there may have been regulatory system failure, as has been argued, rather than operational failure is something that I can only determine by conducting a full investigation. In my view such arguments only serve to reinforce the desirability of such an investigation.

75. I recognise that staff and former staff of regulatory bodies will not welcome another inquiry into events at Equitable Life. However, I must balance the interests of individual public servants against the wider public interest and the interests of the hundreds of thousands of people affected by the events at Equitable Life. I will take reasonable steps to mitigate the effects of any further investigation on the staff

Excerpts from *A Further Investigation of the Prudential Regulation of Equitable Life?* (19 July 2004 – HC 910)

involved and will have regard to the passage of time since the relevant events took place. While I recognise that time will be required by FSA staff to respond to enquiries from my Office and that this will have resource implications for the FSA, I consider that such implications do not outweigh the public interest arguments underpinning my decision to conduct a further investigation.

76. Finally, I am not persuaded by the argument that, in deciding to conduct a further investigation into the regulation of Equitable Life, I would somehow be 'opening the floodgates' to many more similar classes of complaint. First, I have no jurisdiction over any of the bodies responsible for financial services regulation after 2 December 2001. Secondly, although I have discretion to investigate complaints put to the referring Member of Parliament more than twelve months after the complainant first had notice of the matters complained about, there need to be compelling reasons for such delay before I will exercise that discretion. It therefore does not strike me as likely in this context that I will receive considerable numbers of complaints about other financial services issues that I could be persuaded to investigate. Even were this to happen, it is not a persuasive argument that I should refrain from undertaking an investigation into one situation because I might be asked to conduct another investigation into other situations. I must treat each complaint on its merits.

77. Furthermore, it is clear to me that Equitable Life is a 'special case' in relation to complaints about regulatory failure – a position recognised by the Treasury when it commissioned the Penrose inquiry to look at these significant and exceptional events. That inquiry, as I have explained, did not address questions of maladministration and redress. My investigation will address these important questions.

Next steps

78. I have explained why I consider that there is sufficient material before me to indicate that there may have been maladministration and sufficient indications of unremedied injustice to merit a further investigation of the prudential regulation of Equitable Life. I have also considered the arguments about whether such an investigation is in the public interest or is likely to produce a worthwhile outcome. In the light of that, I have decided, subject to agreement that GAD is brought within my jurisdiction, to conduct a further investigation.

79. In conducting that investigation, my aim is to be as transparent and flexible as possible, given the legislative framework within which I work. Although I am required by section 7(2) of the 1967 Act to conduct my investigations in private, I intend that, where possible, all relevant parties will be invited to produce evidence to assist me in the process of establishing the facts. I will consider the degree to which I can publish background information and other evidence in due course and will involve those submitting such evidence in that consideration.

80. In the coming weeks, as indicated above, my staff will write to those individual complainants with issues outstanding from their representations or on their current complaint file. I will also engage in discussions with Government over the extension of my jurisdiction to cover GAD and on the additional

Excerpts from *A Further Investigation of the Prudential Regulation of Equitable Life?* (19 July 2004 – HC 910)

resources I will need to support my investigation. I will also invite further representations on the timeframe to be covered by my investigation (paragraph 42).

81. I intend to establish a full, designated team of experienced investigators, supported, where appropriate, by expert actuarial, accounting, legal, regulatory and insurance advisers.

82. I will consult MPs and policyholder action groups on the selection of individual policyholders as lead complainants, representing the principal different classes of Equitable Life policyholder, and will inform all interested parties of the process for conducting the investigation, once it has been determined.

83. I cannot at this stage be specific about how long my investigation will take. While much can be done to prepare for an investigation immediately, the central question of whether GAD will be brought into my jurisdiction will undoubtedly take some time to resolve.

84. However, I hope that this investigation can be conducted within a reasonable timetable, as I am conscious that significant numbers of people – many of them elderly – are in difficult financial circumstances now.

85. To that end, I do not intend to produce a wide-ranging, academic survey of the performance of the broader regulatory system within which Equitable Life sold and managed its policies. My investigation will be focused instead on assessing the validity or otherwise of what I consider to be the key criticisms of the prudential regulators and GAD against the evidence contained in the Penrose papers and in the other evidence submitted to me.

86. This I will do with a view to determining whether maladministration by those bodies caused policyholders and former policyholders of Equitable Life an unremedied injustice.

87. I will keep Parliament informed of progress.

Ann Abraham
Parliamentary and Health Service Ombudsman
19 July 2004

Statement of complaint and terms of reference for the investigation

Parliamentary Commissioner Act 1967
Terms of Reference and Statement of Complaint
for the Equitable Life Investigation
December 2004

Investigation terms of reference

The terms of reference for the investigation are:

> *To determine whether individuals were caused an injustice through maladministration in the period prior to December 2001 on the part of the public bodies responsible for the prudential regulation of the Equitable Life Assurance Society and/or the Government Actuary's Department; and to recommend appropriate redress for any injustice so caused.*

Statement of complaint

Summary of complaint

The complainants complain that the public bodies responsible for the prudential regulation of insurance companies (successively the Department of Trade and Industry, Her Majesty's Treasury and the Financial Services Authority, collectively referred to in the rest of this statement as 'the regulators') and the Government Actuary's Department (GAD) failed for considerably longer than a decade properly to exercise their regulatory functions in respect of the Equitable Life Assurance Society (ELAS) and were therefore guilty of maladministration.

Specific complaints

1. Organisational issues

   a. The regulators were not sufficiently resourced, and did not all possess the necessary skills, to contribute effectively to the overall regulatory process and to responsibly exercise their discretionary powers as intended by Parliament and by the European Community (now the European Union). Administrative decisions as to resourcing, priorities and methods contributed to a position in which the regulators did not properly undertake their functions as prudential regulator of ELAS.

Statement of complaint and terms of reference for the investigation

b. The regulators failed to liaise and to co-operate effectively with those responsible for the regulation of the conduct of business by insurance companies. In particular, they failed to ensure that proper assessments were made of ELAS's individual practices and its communications with policyholders, and of the expectations that these generated, in the light of the information that was, or should have been, known to the prudential regulators.

2. General operational issues

c. The prudential regulators did not operate the regulatory regime as it was intended to be implemented by Parliament and in conformity with EC Directives. The regulators instead chose to regulate ELAS with a 'light touch' – a concept not evident from or provided for under the Insurance Companies Act 1982 and the EC Third Life Directive nor one consistent with these statutory provisions. The approach to the regulation of ELAS was exceptionally and unjustifiably lenient when compared to that adopted with other companies, with inadequate investigative site visits and lack of liaison with conduct of business regulators. Much more rigorous standards of supervision and better co-operation with conduct of business regulators were adopted for smaller and unit-linked companies. This demonstrated that the regulators applied a two-tier standard of regulation.

d. The regulators and GAD allowed successive chief executives or managing directors of ELAS also to hold the post of appointed actuary, despite recognising the potential for conflict of interest in this position. These decisions were not consistent with the basis of the regulatory regime.

e. The regulators and GAD failed to keep pace with developments in the pensions and life insurance industry and to assess and adapt their methods to reflect those developments. This was particularly critical in a situation in which narrow, technical interpretations of regulatory solvency were becoming an increasingly irrelevant measure of any insurer's realistic financial position as the industry moved more and more towards non-guaranteed bonus declarations.

f. GAD had recommended ELAS as a pension plan or additional voluntary contribution scheme provider in its advice to the administrators of the Principal Civil Service Pension Scheme and to other public sector pension schemes. This led to a lack of proper separation of its responsibilities and to a clear conflict of interest between GAD's role in providing advice to government bodies in relation to public sector pensions and in assisting the prudential regulators of ELAS. This conflict of interest compromised the proper discharge of GAD's regulatory functions.

3. <u>Supervision of regulatory solvency</u>

g. From the mid 1980s until 1997, the regulators failed to evaluate the potential effect of Guaranteed Annuity Rates (GARs) on the solvency of ELAS in a context where current annuity rates were falling steadily, in line with the Bank of England's base rate, to below contracted GARs. The regulators learned explicitly in November 1993 of the degree of ELAS's exposure to risks associated both with the GAR issue and with ELAS's lack of prudent reserves. The regulators' failure to take action then or to impose reserving until 1999 played a direct part in the closure of ELAS to new business and to subsequent cuts in policy and annuity values. The regulators did not prepare a study on the extent of GARs in the industry until 1997: a decade too late.

h. From about 1990 onwards, the regulators and GAD failed to give sufficient consideration to the fact that some of the measures used to bolster ELAS's solvency position were predicated on the emergence of a future surplus. As a consequence, they did not properly assess the overall impact and adequacy of those measures. The regulators also allowed ELAS to mis-use the term 'surplus' and failed to consider the use of that word in the context of policyholders' reasonable expectations.

i. Over this same period, the regulators allowed ELAS to publish financial results and projections that were misleading in that they did not reflect the Society's true position. In particular, ELAS was allowed to habitually report growth rates alongside bonus rates, which gave the impression of a prudent margin for error, whereas the true position was that:

- assets were consistently less than policy values so that higher rates of growth were needed to cover any given rate of bonus; and
- as part of the growth was needed to cover expenses and the contractual liability for conventional annuities, the growth available to meet with-profits bonuses was always materially less than the rate quoted in ELAS literature. This was never made clear.

j. During this period, the regulators and GAD failed to act when ELAS adopted what Lord Penrose described as practices of *'dubious actuarial merit'*. These included valuing future liabilities at an inappropriate rate of interest between 1990 and 1996; treating selling costs as an asset; making no provision for GARs until much too late; valuing a financial re-insurance policy (which proved to be of no value) at over £800 million; allowing credit for 'aspirational' (i.e. effectively unrealisable) assets; responding too slowly to widely evidenced changes to mortality expectations; and the issuing of a subordinated debt worth £346 million which did not count as a liability.

k. On several specific occasions, as set out in the Penrose report, the regulators and GAD ignored or failed to act on information that might have led to formal or informal regulatory action against ELAS, thus also failing to alert new investors to the risks of investing. These include when ELAS board papers were sent to GAD by the appointed actuary on 11 June 1991, and when information was provided to GAD on 10 September 1992 which showed that, for the years 1989 to 1991, the aggregate policy values very significantly exceeded the value of the underlying assets.

4. Payment of excess bonuses

l. Over a period of many years the regulators and GAD permitted ELAS to operate an unsound business model, of which they were aware. ELAS had made public its policy of reliance on 'goodwill' in a 1989 actuarial paper *With Profits Without*

Mystery, but the regulators never addressed the issue or challenged ELAS about it or about the consequences of the model. Instead, they allowed ELAS to operate the model, which entailed declaring bonuses in excess of admissible assets, while at the same time operating without a significant estate and with a smoothing fund persistently in deficit. These were major contributory factors to ELAS's development of what Lord Penrose quantified as a £3 billion asset deficit at the time of closure to new business and to the losses incurred by all those who held policies on 16 July 2001.

m. The regulators failed to ensure any satisfactory correlation between the total of declared policy values and ELAS's admissible assets in a context where ELAS, uniquely in the industry, had declared total policy values that included terminal bonuses and had, without exception, always paid all claims (both contractual and non-contractual) in accordance with these declarations.

5. Policyholders' reasonable expectations (PRE)

n. Ministers and officials decided that regulatory activities in relation to safeguarding PRE should be based solely on the regulatory returns, but failed to put in place adequate procedures and Regulations to enable this to be achieved. This failure was particularly critical in respect of ELAS, which had unique practices that elicited PRE.

o. As a result, the regulators and GAD failed over many years properly to monitor and assess ELAS's asset position and its practices in the light of PRE. The regulators and GAD did not properly determine PRE or act to protect them as intended by Parliament and to the standards set by EC Directives.

p. During the course of the *Hyman* litigation, the regulators failed in their duty to all policyholders in respect of PRE and postponed consideration of issues related to assets and reasonable expectations, both for GAR and non-GAR policyholders, until after the House of Lords judgment (20 July 2000). In addition, the regulators totally failed to assess properly either the impact or the scope of the judgment and to evaluate the range of scenarios for ELAS following it. They failed to take appropriate action to mitigate the adverse affect of the judgment on the majority, non-GAR policyholders, and on new investors into the same with-profits fund. Their judgement that there was a 99.9% probability that ELAS would be sold demonstrated that, despite the extensive information that they possessed, the regulators failed to understand the parlous state of ELAS which was apparent to all prospective bidders.

q. In March 2001, the regulators permitted ELAS to declare a bonus for 2000 and an interim bonus for 2001 that were both inappropriate and unjustifiable given the then state of ELAS's finances, thus raising misleading expectations about the true state of ELAS just prior to significant across-the-board cuts that were imposed only four months later. Instead, ELAS's asset deficit of 13% at year-end 2000 in a closed fund should have precipitated regulatory intervention at that time.

r. In July 2001, the regulators failed to protect PRE by permitting policy value adjustments worth more than £4,000 million in the form of an inequitable uniform percentage cut across all with-profits policies, rather than the fairer alternative of reducing policy values by cutting only non-guaranteed bonuses. The regulators also refused to comment meaningfully on this to policyholders while discouraging independent financial advisers from giving proper advice to policyholders.

Remedy sought

The complainants seek full financial redress for the losses they have incurred in consequence of the maladministration outlined above.

Responses to the statement of complaint:

Joint response from Her Majesty's Treasury (the Treasury), the Financial Services Authority (the FSA) and the Government Actuary's Department (GAD) – maladministration

THE PARLIAMENTARY COMMISSIONER FOR ADMINISTRATION'S INVESTIGATION INTO THE PRUDENTIAL REGULATION OF THE EQUITABLE LIFE ASSURANCE SOCIETY LTD

RESPONSE OF HM TREASURY, THE FINANCIAL SERVICES AUTHORITY AND THE GOVERNMENT ACTUARY'S DEPARTMENT TO THE STATEMENT OF COMPLAINT

INTRODUCTION

1. In her report to Parliament on 19 July 2004, the Parliamentary Commissioner announced her decision to conduct a second investigation into the prudential regulation of the Equitable Life Assurance Society Ltd ("ELAS").

2. The terms of reference of this investigation, together with a statement of the complaints made by certain ELAS policyholders which are the subject of the investigation, have been set out in a document enclosed with a letter from the Parliamentary Commissioner dated 9 December 2004 ("the Statement of Complaint").

3. During the period prior to 1 December 2001 to which the investigation relates, three different public bodies were involved in the prudential regulation of insurance companies. Until the end of 1997, the prudential regulator was the Department of Trade and Industry ("DTI"). In January 1998, responsibility was transferred from DTI to HM Treasury ("HMT"). With effect from January 1999

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Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – maladministration

until 1 December 2001 (when the Financial Services and Markets Act 2000 came into force), HMT contracted out its role to the Financial Services Authority ("FSA"). Throughout the relevant period actuarial advice and assistance was provided to the prudential regulator by the Government Actuary's Department ("GAD").

4. This is the formal response of HMT[1], FSA and GAD to the Statement of Complaint.

<u>The Statement of Complaint</u>

5. The complainants complain that DTI, HMT, FSA (collectively "the regulators") and GAD "*failed for considerably longer than a decade*" properly to exercise their functions in respect of ELAS and were therefore guilty of maladministration.

6. In brief summary, the response of HMT, FSA and GAD to the complaints is that:

(1) There was no failure on the part of any of the regulators or GAD properly to exercise their functions in respect of ELAS. At all times the regulators and GAD acted reasonably and properly, in the context of and having regard to the regulatory regime as it was at the relevant time.

(2) The nature and scope of that regime were determined by legislation and by regulatory policies which informed and were adopted under the applicable legislation. At all times the policies adopted were proper ones and were the result of choices which Parliament and Ministers were fully entitled to make.

[1] DTI has not responded directly to the complaints because the function of prudential regulation of insurance companies (and responsibility for actions previously taken under the regulatory regime) was transferred to HMT in 1998 by means of the Transfer of Functions (Insurance) Order 1997 (SI 1997 No 2781).

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Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – maladministration

(3) None of the complaints made by the complainants discloses reasonable grounds for concluding that any of the public bodies responsible for the prudential regulation of ELAS or GAD was guilty of maladministration.

7. Each of the specific complaints made in the Statement of Complaint is answered individually below using the headings specified in it. Before setting out the response to each individual complaint, however, there are two topics on which it may be helpful to make some initial general observations. They are:

(1) The regulatory context; and

(2) The relevance to this investigation of the Penrose Report.

<u>The Regulatory Context</u>

8. In a situation where policyholders' interests are alleged to have been harmed or put at risk, it is unsurprising that some policyholders will believe that they have been "let down" by the prudential regulator. But no system of prudential regulation can prevent, nor should it be designed to prevent, all financial difficulties that may be experienced by insurance companies operating in a competitive market economy.

9. Prudential regulation of insurance companies requires a balance to be struck between protecting policyholders against the risk that a company will act imprudently on the one hand and, on the other, allowing the maximum freedom to the company and its management to pursue their chosen commercial strategy in the way they consider best.

10. The way in which that balance is struck is a matter of policy for Parliament in enacting the applicable legislation, and, within the statutory framework laid down by Parliament, for the Government of the day to decide, reflecting values and priorities as set by Ministers. It follows that any assessment of whether the

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Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – maladministration

regulators and GAD properly exercised their functions can only be made by reference to the statutory framework of powers and duties which governed the prudential regulation of insurance companies during the period covered by the investigation and to the policy context in which prudential regulation took place - especially as regards the degree of intrusiveness seen as appropriate and the level of public resources allocated to such regulation.

11. Submitted with this Response is a paper ("the Regulatory Paper") which describes in detail the regime for the prudential regulation of life insurance companies pursuant to which Equitable Life was regulated during the period under investigation.

The Penrose Report

12. Almost all of the complaints made in the Statement of Complaint are derived from the Report of the Equitable Life Inquiry by the Right Honourable Lord Penrose ("the Penrose Report"). However, the Penrose Report cannot be used to support a case of maladministration. There are two basic reasons for this.

13. The first reason is that the observations and criticisms made by Lord Penrose were made with the benefit of hindsight. By contrast, in carrying out the present investigation the Parliamentary Commissioner must consider the relevant events and actions solely in light of the circumstances and knowledge of those involved at the relevant time. This is a critical difference between the nature of the exercise which Lord Penrose carried out and the investigation now being conducted.

14. The adoption of hindsight was permitted by the terms of reference of the Penrose Inquiry, which was asked to discover what had led to the situation of ELAS at 31 August 2001 and to identify any lessons to be learnt. In the Foreword to the Report, Lord Penrose said:

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Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – maladministration

> *"It was inevitable that hindsight would instruct much of the inquiry's work and many of its findings."*

As Lord Penrose further explained:[2]

> *"I have not qualified my comments by reference to professional standards current at the time events occurred……Further, I have the benefit of hindsight, and I have not restricted the comments made to those matters that can be shown to have been within the knowledge or contemplation of individuals or groups at material times…The lack of knowledge may itself be an important source of material pointing to lessons for the future."*

15. As mentioned below, the criticisms made in the Penrose Report of particular decisions and actions alleged to have been taken, or omitted to be taken, by the regulators and GAD in exercising their functions are in fact few. The PCA will wish to form her own view of whether these criticisms are both well founded and relevant to her investigation. Whether those criticisms are accepted or not, HMT, FSA and GAD take the view that they are dependent on the use of hindsight. If hindsight is disregarded, there is no reasonable basis for a finding of fault.[3]

16. The second reason why the Penrose Report cannot be used to support a case of maladministration is that, although the Report is on occasion critical (with the benefit of hindsight) of the performance of the regulators and GAD, its criticisms are essentially directed at the regulatory regime which was in force at the relevant time rather than at particular decisions and actions taken, or not taken, in operating that regime. The gist of these criticisms is not that the regulators and GAD failed properly to discharge their functions under the regime as it stood; it is rather that the regulatory regime as it stood was, in the view of Lord Penrose, unsatisfactory in various respects and required to be changed.

17. Thus, near the end of the Report, Lord Penrose said:[4]

2 See Penrose Report, Chapter 19, paragraph 2.
3 See in particular the Responses below to Complaints G and J (ii).
4 See Penrose Report, Chapter 20, paragraph 69; and see also paragraph 83.

Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – maladministration

> *"In this report I have been critical of the regulatory system, and on occasion critical of the performance of regulators and their advisers. But the thrust of my criticism is that for the most part it was the system that failed to provide the regulation that changing circumstances in the industry required, not that there was failure to implement what was fundamentally a satisfactory system".*

18. It is evident from the Report that the regulatory approach advocated by Lord Penrose would have required a much greater degree of intervention and intrusion by the prudential regulator than obtained, or was seen as politically desirable or appropriate, at the relevant time.

19. However, criticism of the regulatory regime as it stood is not material for present purposes. In judging whether maladministration has occurred, the present investigation is not concerned with whether the regulatory regime that existed was the optimum one, or with the merits or demerits of the policies adopted. Rather, the issue is whether, given the regime that existed, and the policy choices made, there was a culpable failure on the part of the prudential regulator or its advisers to apply the provisions and policy of the regime.

20. It is apparent that the Parliamentary Commissioner is already aware of these important differences and recognises that in her investigation she must not use hindsight but instead assess whether the actions of the regulators and GAD complied with the relevant statutory provisions and regulatory policies current at the relevant time.[5]

<u>Injustice alleged by the Complainants</u>

21. This response is submitted without seeing a finalised copy of the statement of injustice alleged by the complainants. HMT, FSA and GAD may wish to make representations on the finalised statement of injustice at a later date.

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[5] See "*A Further Investigation of the Prudential Regulation of Equitable Life?*" (July 2004) at paragraph 18.

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Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – maladministration

Conclusion

22. For the reasons indicated above, and developed in detail below in the response to the individual complaints, the regulators and GAD wholly reject the allegation that during the period under investigation they were guilty of maladministration.

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Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – maladministration

RESPONSE TO INDIVIDUAL COMPLAINTS

1. Organisational Issues

Complaint A

"*The regulators were not sufficiently resourced, and did not all possess the necessary skills, to contribute effectively to the overall regulatory process and to responsibly exercise their discretionary powers as intended by Parliament and by the European Community (now the European Union). Administrative decisions as to resourcing, priorities and methods contributed to a position in which the regulators did not properly undertake their functions as prudential regulator of ELAS.*"

23. Two broad allegations are made by this complaint: (i) that the prudential regulators were not sufficiently resourced and (ii) that they lacked the necessary skills to enable them properly to exercise their powers. Neither assertion is justified.

The Resources available to DTI and HMT

24. Given that Government resources are finite, there is always scope for debate about their allocation. A decision to make more resources available for a particular function of Government is, of its nature, a policy decision, which reflects an assessment of the relative importance of competing needs, priorities and values. If at any relevant time more resources had been allocated to the prudential regulation of insurance companies than were in fact allocated, that would necessarily have had implications for other areas of Government. Ministers took the view, reasonably, that the balance of resources was correct.

25. As with all Government departments, the level of resources allocated to DTI and HMT was determined by Parliamentary vote (under annual Appropriation Acts). Within DTI and HMT, the level of resources allocated to prudential insurance regulation was a decision that was influenced by competing departmental priorities, budgetary constraints and the regulatory climate of the day.

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Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – maladministration

26. Running cost budgets in DTI were determined from December 1992 by a priority cost management system known as MINIS. Each Management Unit used MINIS to describe how its local objectives and targets would support the department's objectives, how it intended to improve its efficiency and effectiveness and what resources it judged necessary to support these proposals. After detailed discussions with Ministers, Directors General and Heads of Management Units and Finance and Resource Management Directorate, the Departmental Management Group submitted proposals to the President of the Board of Trade who decided on the budgets and output measures for the coming financial year.

27. Statistics on the cost of prudential insurance regulation and the level of fees charged were reported to Parliament in the Insurance Annual Reports (made in accordance with section 98 of the Insurance Companies Act 1982 ("the 1982 Act")), following the implementation of the Insurance (Fees) Act 1985.[6] Table 1 below shows that between 1986-87 and 2000-01 the cost of carrying out relevant functions[7] increased by over 240% in real terms. This was against a backdrop of efficiency savings and pressure to reduce running costs and manpower.

Table 1 – Prudential Insurance Regulation Costs 1986 - 2001

Year	Costs (nominal)	Costs (2000-2001 prices)[8]
1986-87	£2,652,000	£4,350,675
1987-88	£2,782,000	£4,761,623
1988-89	£3,011,000	£4,761,448
1989-90	£3,303,000	£4,986,404
1990-91	£4,277,000	£6,023,423
1991-92	N/A	N/A
1992-93	£6,846,000	£8,432,766

6 The Insurance (Fees) Act 1985 enabled the Secretary of State to recover from authorised insurance companies certain costs incurred in exercising relevant functions connected with insurance supervision. However, these costs were limited, and deliberately so, in order not to impose too high a burden on the regulated sector (and therefore, indirectly, on consumers).

7 "Relevant functions" include the costs of EC and UK regulatory policy work together with the associated overheads, legal and actuarial costs, but excludes costs associated with the authorisation of new companies.

8 Calculated using the RPI All Items Index.

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Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – maladministration

1993-94	£7,548,000	£8,985,825
1994-95	£7,613,000	£8,900,045
1995-96	£8,103,000	£9,244,722
1996-97	£7,389,000	£8,166,688
1997-98	£7,748,000	£8,358,410
1998-99	£9,696,000	£10,171,958
1999-00	£12,318,000	£12,576,678
2000-01	£14,984,000	£14,984,000

28. Statistics were also quoted in the Insurance Annual Reports to Parliament as to staff levels. A review of these statistics shows that, although the total number of long-term business (i.e. life insurance) companies fell by 25% during the period 1981 – 2001 (see Table 2), the number of staff employed within DTI's Insurance Directorate increased modestly by about 15% over the same period (see Table 3), notwithstanding the prevailing political climate of deregulation. GAD staff levels also increased (see paragraph 30 below).

Table 2 – Number of authorised insurance companies

Year (at 31/12)	Long term business	Composites	General business	Total
1981	213	79	560	852
1982	212	77	560	849
1983				848
1984	218	72	557	847
1985	212	70	559	841
1986	212	69	553	834
1987	213	68	557	838
1988	209	65	564	838
1989	206	64	562	832
1990	205	64	570	839
1991	202	64	570	836
1992				823
1993	194	59	575	828
1994	191	57	573	821
1995	174	58	594	826
1996	177	59	578	814
1997	177	65	599	841
1998	176	62	594	832
1999	171	62	596	829
2000	165	60	597	822
2001	160	56	592	808

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Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – maladministration

Table 3– Staff employed in DTI Insurance Directorate (excluding DTI's other directorates involved in insurance regulation (such as legal services) and GAD staff)

Year (at 31/12)	Total staff employed
1981	88
1982	87
1984	84
1985	84
1986	83
1987	76
1988	74
1989	73
1990	91
1991	93
1993	107
1994	105
1995	112
1996	103
1997	94
1998	101
1999	105

29. As further discussed below, during the relevant period certain services were 'outsourced' by DTI and HMT to GAD. Until April 1989, the level of GAD's resources was determined by Parliament (under annual Appropriation Acts), without any recovery of costs from GAD's client departments. From the 1989 – 1990 financial year onwards, GAD's clients were required to pay for the actuarial services they received. GAD agreed a budget with DTI for its insurance related work in each financial year. The amount of this budget was a policy decision, influenced by the competing priorities within DTI[9], budgetary constraints, and the regulatory climate of the day. There is annexed a version of a memorandum from the GAD Directing Actuary to an official at DTI in October 1994, as an illustration of this process.[10]

[9] This would have included regulatory priorities. For example in the early/mid 1990's emphasis was required on problems with the Lloyds market.
[10] See pages 346 – 347 of the Annex.

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Responses to the statement of complaint:

Joint response from the Treasury, the FSA and GAD – maladministration

30. The number of GAD staff assigned to life insurance work increased significantly from two actuaries at the beginning of the 1970s to 10 actuaries, 2 trainee actuaries and 2 support staff by the time of the transfer of GAD staff to FSA in 2001 (with additional actuarial resources available to support the regulation of general insurance companies).

31. Although Lord Penrose expressed the view in his report that the prudential regulators were under-resourced,[11] this opinion needs to be seen in the context of his advocacy of a more interventionist regulatory regime – for example the faster scrutiny of regulatory returns, and calling for the production of more information from life insurance companies in the regulated sector. Further, at no point does Lord Penrose consider the resource implications of such increased regulation and the additional costs that it would have imposed, both on Government and on businesses within the regulated sector.

32. While there is inevitably room for argument about whether it would have been desirable to allocate more resources to prudential regulation, there is no objective basis for concluding that the decisions taken at the time were improper or that there was any reason at the time to believe that the resources allocated were inadequate.

33. The Complaint also refers to decisions as to "*priorities and methods*".[12] Again there is no objective basis for considering that any such decisions were improperly taken. The system of priority ratings, which was used to prioritise resources for the detailed scrutiny of regulatory returns, is described in the response to Complaint C below.

[11] See in particular Penrose Report, Chapter 19, paragraphs 157 – 163.

[12] Such decisions are wrongly described as "*administrative*". In fact, they involved policy choices as to the relative importance of different policy objectives and as to the optimum level and manner of government intervention to seek to achieve those objectives.

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The Skills available to DTI and HMT

34. In addition to the skills available within DTI and HMT themselves, throughout the period under review the prudential regulators also were able to look to GAD for expert actuarial advice and assistance.

35. Given that the legislature had decided to make the Appointed Actuary system the cornerstone of prudential insurance regulation, it was inevitable that DTI and HMT would have to work closely alongside the UK actuarial profession. The Government of the day was faced with a choice: either it could try to incorporate the necessary actuarial expertise within the prudential regulator (as now happens with FSA); or it could obtain the benefit of such expertise by 'outsourcing' certain functions.

36. From an early stage, a policy decision was taken within Government that 'outsourcing' to GAD was the more attractive option; and this was confirmed by subsequent reviews. In particular it was seen to be the most cost-effective way to ensure that the skills and resources of leading actuarial professionals were made available to the prudential regulator without incurring substantially greater levels of cost.

37. Thus, in 1978 DTI's Common Services carried out a review of the Insurance Division.[13] This review involved an in-depth study of the process of regulating insurance companies, leading to a general study of the relationships between regulation and the other activities of the division. The review concluded that the supervisors within the Insurance Division must continue to rely heavily on GAD in most aspects of their work in relation to life insurance companies, and that there could be no simple division of responsibility between the two organisations. It highlighted a need to clarify the respective responsibilities of the Insurance Division and GAD to avoid duplication of effort.

13 A copy of the review can be found at pages 97 – 179 of the Annex.

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38. In 1983 an efficiency scrutiny of the regulation of insurance companies took place, as part of the then Government's programme of Rayner efficiency exercises.[14] The 1983 efficiency scrutiny considered whether DTI's regulation of insurance companies could be carried out more effectively by fewer staff if a greater number of them had professional qualifications. Its overall conclusion was that most of the work undertaken in the Insurance Division should continue to be carried out by generalist civil servants, though in smaller numbers, with the help of additional specialist advisers.

39. The efficiency scrutiny also recommended that GAD should take the major share of responsibility for the examination of regulatory returns submitted by life insurance companies, with an obligation to provide DTI's Insurance Division with a full report, involving solvency and compliance, on the returns as a whole. It also suggested that GAD should be permitted to deal directly with companies in order to clarify points of uncertainty affecting solvency before reporting back to DTI's Insurance Division which, as prudential regulator, retained sole responsibility for taking formal action.

40. The efficiency scrutiny also recommended that a clear and detailed statement of the respective roles of the two organisations should be drawn up. This led to the 1984 Service Level Agreement (SLA) between DTI Insurance Division and GAD, which was followed by further SLAs concluded in 1995 and 1998[15].

41. These 'outsourcing' arrangements did not result in any improper delegation of prudential regulation to GAD. At all times (pursuant to the SLAs) both DTI and HMT were careful to maintain control of the prudential regulation of the insurance industry and retained the necessary expertise for that purpose. The same

14 A copy of the efficiency scrutiny can be found at pages 209 – 297 of the Annex.
15 Copies of the SLA's are annexed to the Regulatory Paper (annexes 13, 14 and 15).

14

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was true when subsequently HMT outsourced various functions to FSA. As the Parliamentary Commissioner has already concluded in her first report:[16]

> *"Although they had contracted out their prudential regulatory functions to FSA, the Treasury remained responsible to Parliament for prudential regulation throughout the period investigated. I was satisfied that the Treasury retained sufficient in-house expertise in order for them to be able properly to monitor FSA's effectiveness in carrying out these functions to the standards set in the service level agreement. I was also satisfied that, although there was little documentary evidence of their routine contacts with FSA during this period, the Treasury had kept abreast of the developing Equitable situation and had had regular discussions with FSA about the prudential regulator's position."*

42. As Lord Penrose recognised in his report, although there were arguably some disadvantages, there were also a number of positive advantages arising from the decision to 'outsource' certain technical functions to GAD. As he put it:[17]

> *"...[GAD] had access to current and developing thought within the profession. They participated in discussions, and in particular took part in professional committees reviewing practice and recommending future policy. Individual members of the department participated in professional projects aimed at developing actuarial methodologies appropriate to changing circumstances."*

43. In addition to the skills sourced from GAD, steps were taken throughout the relevant period to improve the skills and resources that were available within DTI and HMT. Thus, accountants and individuals on secondment from the insurance industry were brought into the department; and postings to the Insurance Division were frequently for longer than would be typical in DTI, in recognition of the need to develop experience to work effectively as a supervisor.

16 See "*The Prudential Regulation of Equitable Life*", Part I, Appendix, paragraph 23.
17 See Penrose Report, Chapter 19, paragraph 159.

15

Conclusion

44. The allegations that during the period under review the prudential regulators were insufficiently resourced or lacked necessary skills to contribute effectively to the regulatory process and responsibly exercise their discretionary powers under the regulatory regime as it then stood are rejected by HMT, FSA and GAD. In any event the decisions taken during the period as to "*resourcing, priorities and methods*" were themselves discretionary policy decisions;[18] and whilst there is inevitably scope for argument about whether the decisions taken represented the optimum policy, there is no ground for suggesting that any such decisions were taken in an improper manner.

Complaint B

"*The regulators failed to liaise and to co-operate effectively with those responsible for the regulation of the conduct of business by insurance companies. In particular, they failed to ensure that proper assessments were made of ELAS's individual practices and its communications with policyholders, and of the expectations these generated, in the light of the information that was, or should have been, known to the prudential regulators.*"

45. This Complaint is expressed in entirely general terms, without specifying any concrete instance in which there was supposedly a failure of liaison or co-operation by the prudential regulator with the conduct of business regulator or any particular steps which (according to the complainants) the prudential regulator ought to have taken at any particular time but did not take.

46. It is also not clear even what general allegation the second sentence of this complaint is intended to make. There appear to be two possibilities: (i) that the prudential regulator failed to acquire information from the conduct of business regulator which might have been relevant to PRE; or (ii) that the prudential

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18 Contrary to the suggestion in the Complaint, such decisions were policy decisions not merely "*administrative*".

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regulator failed to pass on information to the conduct of business regulator which might have been relevant to the latter's functions.

47. The issue of PRE is considered below, in the response to Complaints N and O. The second point is considered here.

48. The regime did not require extensive co-ordination between the prudential and conduct of business regulators as appears to be envisaged by the complainants and it is not accepted that the prudential regulator was under any obligation to pass on information to the conduct of business regulator. The two regulators were addressing separate issues, and had their own areas of focus and policy approach. It would be wrong to say that there was a failure of necessary liaison between the prudential and conduct of business regulators.

49. As Lord Penrose recognised in his report, there was a routine exchange of information at a junior level between the two regulators during the 1980s; communications were not considered to be bad; and the interaction between the prudential and conduct of business regulators was put on a more formal footing from 1992 onwards. He said:[19]

> *"Interaction between the regulatory bodies seems to have been relatively limited in the 1980s. [redacted] told the inquiry that during his period as head of the life side his contact with the conduct of business regulators tended to be on policy issues, and only occasionally over concerns about individual businesses, but there was also routine exchange of information at more junior level. Although more might have been done to improve communications more quickly, [redacted] did not consider that communications were bad, especially considering the fact that the regulators operated under separate legislation and in separate buildings. Spencer also told the inquiry that he did not think that there were significant areas that fell between the two sets of regulators.*
>
> *From 1992 there was some additional formalisation of the interaction through the mechanism known as a 'college of regulators'; regular meetings between various financial services regulatory bodies, hosted and chaired by the body perceived as the 'lead regulator' for a certain type of*

19 See Penrose Report, Chapter 15, paragraphs 28 – 29.

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firm. For life insurers, this was DTI. [redacted] told the inquiry that the stimulus for these meetings mainly came from the banking and insurance supervisors, but other regulators were involved and did contribute."

50. In May 1997 the Chancellor of the Exchequer announced that a single regulator for financial services would be put in place; and in due course it was confirmed that the single regulator would have responsibility both for prudential regulation and conduct of business regulation of insurance companies.

51. This marked a major change in financial services regulation, and could not be achieved overnight. The FSA was launched in October 1997, and pending enactment of the new legislation (which was only brought into force from 1 December 2001) FSA assumed day-to-day responsibility for conduct of business regulation. Responsibility for prudential regulation of insurance companies was transferred from DTI to HMT on 5 January 1998, and FSA assumed day-to-day responsibility from HMT on the basis of a contracting-out order with effect from 1 January 1999.

52. As noted in the Baird Report, after 1 January 1999 reporting arrangements were put in place so as to encourage bilateral interaction between the prudential and conduct of business regulators.[20] These included "ChairCo" meetings, "ExCo" meetings, meetings of the Firms and Markets Committee, Bilateral Liaison Meetings, Financial Supervision and Management meetings, and Supervisory Co-Ordination Meetings. In addition, a system of "lead supervision", which included "college meetings" between the regulators, was implemented and led to a regular and formalised exchange of information between the team in FSA's Investment Business Division responsible for carrying out the functions of the PIA (IB-PIA) and FSA's Insurance and Friendly Societies Division (IFSD).

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20 See Baird Report, paragraphs 2.33 – 2.34.

18

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53. The result was that, as the Parliamentary Commissioner has already found in her first report, there was a considerable amount of communication between the two regulators from 1 January 1999 onwards, in which the prudential regulator kept the conduct of business regulator adequately informed of the position of ELAS.[21]

54. In three short paragraphs in his report,[22] Lord Penrose expresses the view in general terms that (viewed with the benefit of hindsight) there was insufficient liaison between the prudential and conduct of business regulators. It is not clear to what period of time Lord Penrose is referring in this passage of his report: the only example he mentions is an (unspecified) occasion "*in the autumn of 1999*".[23]

55. This seems to be a reference back to an earlier passage of his report, where Lord Penrose considered communications that took place between the two regulators in September 1999 in relation to ELAS's bonus notices.[24] As there described, the prudential regulator had a concern that ELAS's bonus notices were potentially misleading, and drew this to the attention of the conduct of business regulator. The response received was that the bonus notice for 1998 was not poorly presented or inaccurate, and that the conduct of business regulator would have to have serious concerns about the bonus notices before it took action, which it did not. The prudential regulator accepted the conduct of business view.

56. This particular episode has already been considered carefully by the Parliamentary Commissioner in her first report. She said:[25]

> *"Another issue which surfaced during this period (from 1 January 1999 to January 2000) was the role of the conduct of business regulator in relation to the continuing information provided to policyholders after the sales process had been completed. As I have already indicated, the prudential division raised the matter with their conduct of business colleagues in*

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21 See "*The Prudential Regulation of Equitable Life*", Part I Appendix paragraph 22; and Part II, paragraph 219.

22 See Penrose Report, Chapter 19, paragraphs 229 – 231.

23 Ibid, paragraph 231.

24 See Penrose Report, Chapter 18, paragraphs 29 – 30.

25 See "*The Prudential Regulation of Equitable Life*", Part II, paragraph 186.

19

> *connection with bonus notices, which they considered might have given policyholders unrealistically high expectations of the terminal bonus pay-outs they could expect. Subsequent exchanges between the prudential and conduct of business regulators indicated that, while the prudential division clearly believed the content of post-sales information to individual policyholders to be a matter for their conduct of business colleagues... the latter for their part did not consider that such matters 'fitted comfortably within their remit' and said that they would therefore have to have serious concerns about a document before taking action...That suggested a potential gap in the regulatory framework, and it might be argued that (given the importance of the issue in question, not least for policyholders and their reasonable expectations), both the prudential and conduct of business regulators could have done more to clarify their respective responsibilities. In the event, at this point the prudential division appear to have accepted conduct of business colleagues' view that, from a PIA perspective, the notices were not misleading, and taken that as a sign that no further action was necessary. I do not consider that that was a wholly unreasonable decision in itself for the prudential regulator to have reached, given the advice they had received..."*

57. This episode does not reveal any failure of liaison between the prudential regulator and the conduct of business regulator. To the contrary, they did liaise with each other, and there was an exchange of views. The most that can be said is that this episode indicates that there may have been a potential gap in the regulatory framework. However, that was not a result of any improper decision by the prudential regulator but a function of the framework in which the two sets of regulators were required to operate, prior to their merger under the Financial Services and Markets Act 2000. At the time of this exchange the regulatory regime to be implemented under that legislation was being actively considered.

2. General Operational Issues

Complaint C

"*The prudential regulators did not operate the regulatory regime as it was intended to be implemented by Parliament and in conformity with EC Directives. The regulators*

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instead chose to regulate ELAS with a 'light touch' – a concept not evident from or provided for under the Insurance Companies Act 1982 and the EC Third Life Directive nor one consistent with these statutory provisions. The approach to the regulation of ELAS was exceptionally and unjustifiably lenient when compared to that adopted with other companies, with inadequate investigative site visits and lack of liaison with conduct of business regulators. Much more rigorous standards of supervision and better co-operation with conduct of business regulators were adopted for smaller and unit-linked companies. This demonstrated that the regulators applied a two-tier standard of regulation."

58. This Complaint makes two allegations: (i) that the prudential regulators operated the regulatory regime in a way that was contrary to the relevant provisions of UK statute and of the EC Life Insurance Directives, by choosing to regulate ELAS with a 'light touch'; and (ii) that a different approach was adopted to the regulation of ELAS compared to that adopted with other companies – being one which was "*exceptionally and unjustifiably lenient*".

59. Neither allegation is well founded.

<u>"Light touch" Regulation</u>

60. The regulatory regime applied by the prudential regulator to ELAS was precisely that which informed, and was enabled by, the relevant statutory provisions. Furthermore, the relevant UK legislation at all times complied with the EC Life Insurance Directives. The regime, and the philosophy which underpinned it, are described in detail in the Regulatory Paper submitted with this Response.

61. As there described, the guiding policy of the regime was the doctrine of "freedom with publicity". The concept was that, provided that accurate and sufficient information was made available in the public domain to enable consumers to make informed choices, consumers' needs would be best met by the operation of market forces.

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62. The description of this approach as a 'light touch' approach is not one that was generally used by the prudential regulators (in relation to the regulation of ELAS or otherwise) at the time of the events under review. HMT, FSA and GAD believe, however, that that description is a proper one and that the nature of the regime was fairly described by the Parliamentary Commissioner in her first report, as follows:[26]

> *"The principal actuarial and accounting provisions of the regulatory framework, including the key statutory requirements, are described in paragraphs 8 to 37 of Part II of my report. These clearly demonstrate that the requirements placed on the prudential regulator were firmly grounded in a 'light touch' approach to regulation. The philosophy underpinning the regime was that market forces would provide the best means of ensuring that an industry met the needs of its customers. The detailed regulatory provisions were framed to reflect that approach and to avoid over-interference in a company's affairs. It was never envisaged that that regime would provide complete protection for all policyholders. ...*
>
> *It is not for me to comment on whether or not the statutory provisions (as set out in the Insurance Companies Act 1982 and the Financial Services Act 1986), in establishing such a regulatory regime, are or were appropriate. That was, and is, a matter for Parliament itself. However, it is important to recognise that the nature of the regime established to protect policyholders determined what the FSA could and could not do in relation to Equitable. It is clear to me from my investigation that the framework within which the prudential regulator was required to work simply did not envisage or allow for the sort of intervention into a company's affairs which complainants have contended should have happened in this case."*

63. Whether others agree with the description of the regulatory requirements as reflecting a "*light touch*" approach is not for present purposes material. Nothing turns on the choice of label. What matters is that the prudential regulators operated precisely the regulatory regime of "freedom with publicity" that underlay the UK statutes, which was permitted by, and in full compliance with, the EC Life Insurance Directives. The criticism that the regulators did not operate the regulatory regime as it was intended, by Parliament or the European Union, is therefore wholly inconsistent with the facts.

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26 See "*The Prudential Regulation of Equitable Life*", Part I, paragraphs 11-12.

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Alleged Double Standard

64. The prudential regulators adopted exactly the same approach to the regulation of ELAS as they did to the regulation of other life insurance companies. They did not, as the second element of this head of complaint suggests, adopt a "*two-tier standard of regulation*".

65. Any regulatory regime needs to target its resources and to afford a higher priority to cases perceived to be of greater or more urgent concern. During the period under consideration, the prudential regulator sought to achieve this through a system of priority rating. Under this system, every life insurance company was assigned a priority rating, based on an initial scrutiny performed by GAD each year of the regulatory returns.[27] There were originally 4, and later 5, levels of priority rating, ranging from Priority 1 (Urgent) to Priority 4 or 5 (Low Priority). The rating assigned to a company determined the speed and frequency with which the company was targeted for detailed scrutiny by the regulator and GAD.

66. In most years during the relevant period ELAS was assigned a priority rating of 3.[28] This rating denoted companies where there were sufficient concerns to warrant early attention or other reasons to require scrutiny early in the cycle.

67. Priority ratings were assigned by GAD on the basis of objective criteria set out in its Service Level Agreement and took account of a number of indicators. A key performance indicator was the level of cover for the required solvency margin[29] disclosed by analysis of the regulatory returns.

68. During the 1990s ELAS's required solvency margin remained reasonably well covered, as Table 4 (and the explanation of the figures it contains accompanying

27 See GAD paper on priority ratings at pages 355 – 358 of the Annex.

28 Under the descriptions introduced in 1995, this rating was classified as "Medium Priority".

29 In essence, this was a measure of the extent to which the company's assets exceeded its liabilities, compared with the minimum margin of such assets over liabilities required by regulations: see paragraph 57 of the Regulatory Paper.

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it) below shows. This was reflected in ELAS's priority ratings. As also shown by Table 4, these ratings were in line with those given to other companies with similar reported levels of cover. Thus, there was no exceptional or different treatment accorded to ELAS, as compared to other life insurance companies, in determining when and to what extent it should be the subject to detailed scrutiny.

Table 4 – Priority ratings of ELAS as compared with other life companies, 1992 - 2000

Priority	1		2		3		4		5		Total	ELAS	
Year	*Number of companies and average cover for required solvency margin*										Number of companies	Priority and cover for required solvency margin	
1992	8	3.4x	45	2.0x	80	3.1x	87	4.3x	48	5.6x	268	3	2.4x
1993	5	0.2x	30	3.3x	89	3.5x	88	5.2x	53	7.6x	265	3	3.8x
1994	2	1.1x	39	2.2x	78	2.3x	129	4.1x	6	3.4x	254	3	2.4x
1995	1	3.8x	24	2.4x	60	3.9x	111	4.7x	50	5.3x	246	4	2.9x
1996	3	1.5x	20	2.0x	68	3.5x	125	4.9x	35	5.7x	251	3	2.5x
1997	2	4.0x	22	1.2x	86	4.3x	121	4.6x	28	5.4x	259	-	2.5x
1998	5	1.0x	27	1.9x	74	4.6x	113	4.3x	29	4.9x	248	2	2.5x
1999	3	-1.7x	23	3.0x	62	3.7x	119	5.3x	41	2.4x	248	2	3.5x
2000	1	0.6x	20	1.5x	84	3.0x	106	4.2x	32	4.2x	243	2	1.3x

The cover shown is that reported by companies with in force life business, including those closed to new business and composites. It also includes friendly societies with in force life business – which is the reason for the somewhat greater numbers in this table compared with the total life companies and composites shown in Table 2 in the Response to Complaint A. The higher level of cover for some years for the small number of priority 1 companies reflects the fact that the reported level of cover was misleading, e.g. calculated on a basis not in compliance with the regulations. The average level of cover quoted for each priority is in fact not the arithmetic average of the individual companies' levels of cover but rather the sum of the available assets (i.e. assets in excess of liabilities) of those companies over the sum of their required solvency margins. The priority rating was set having regard to GAD's assessment of actual cover if the regulations were properly followed; however, there was a considerable degree of variation in the level of cover reported by individual companies within a priority by comparison to the average level of cover for that priority. The table shows that ELAS was but one of about 250 life insurance companies that were subject to regulation during this period. In terms of long-term business assets ELAS accounted for an average of about 3% of the industry total.

69. Furthermore, the supervision of ELAS was not limited to the scrutiny of the regulatory returns alone. As is clear from the departmental files, there was much ongoing contact between the prudential regulator, GAD and ELAS outside the

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formal scrutiny process in most years referred to in the table, and this increased markedly from around 1998 (when the regulator raised issues in relation to ELAS's reserving practice and GAR liabilities).

70. An important part of this contact was the system of company site visits. These were not prescribed by the statutory framework, but were introduced by DTI from the end of 1991. They were intended to follow a 3-year cycle. The visits provided an opportunity for discussions with members of the senior management team about the strategic direction of the company and, where appropriate, about specific aspects of its operations. They also allowed the prudential regulator to provide the company with information on regulatory issues, including any impending changes in the regulations or associated guidance. The meetings usually lasted one day and tended to have a fairly standardised and wide-ranging agenda, covering governance, business and financial issues. Both GAD and DTI attended the meetings.

71. There was some sensitivity in the life assurance industry when site visits were first introduced, with a number of companies expressing opposition to them. This partly reflected fears over confidentiality, but also concern over the perceived increase in the level of supervision of companies which the introduction of such visits represented.

72. Against this background, the visits were deliberately designed to be relatively low key. Whilst they had a set agenda, the style of visits was to gather information in an informal way and not to be inquisitorial. They were not, and were not seen as, an inspection visit of any kind. They relied on the voluntary cooperation of the companies concerned, as they were not carried out in exercise of statutory powers. It is therefore wrong to describe the purpose of the site visits (as the Complaint does) as "*investigative*"[30].

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30 The prudential regulator's only specific investigative powers were in relation to the sound and prudent management criteria, from 1994 onwards (pursuant to section 43A of the 1982 Act). There

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73. ELAS was one of the first companies to be visited pursuant to this system, with the first site visit being made on 19 May 1992. Subsequent site visits were made to ELAS on 9 December 1994 and on 8 November 1996. The frequency of these visits was in line with that for life insurance companies generally in this period, with both the second and third visits taking place well within the 3 year cycle. These site visits were in addition to other meetings that were held with ELAS during the period (with the frequency of meetings increasing from around 1998, as indicated above).

74. Thus, with regard to both the prioritisation given to the scrutiny of its regulatory returns and the frequency with which it was visited by the prudential regulator and GAD, ELAS was treated no differently from other companies. If anything, the intensity of exchanges between GAD and the regulator and between the regulator and the company, as well as the frequency of meetings, was higher than for other companies of a comparable priority level during the 1990s.

75. There was also liaison with the conduct of business regulators to the extent necessary throughout the relevant period.[31] No different approach or standard was applied to ELAS in this regard than to other life insurance companies.

76. It follows that the allegation that the prudential regulator applied a "*two-tier standard of regulation*", and adopted an approach to ELAS that was "*exceptionally and unjustifiably lenient*", is simply not supported by the facts.

were in addition powers to compel production of documents and to obtain them via search warrant if necessary (sections 44 and 44A).

31 See further as to this the response to Complaint B above.

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Complaint D

"The regulators and GAD allowed successive chief executives or managing directors of ELAS also to hold the post of appointed actuary, despite recognising the potential for conflict of interest in this position. These decisions were not consistent with the basis of the regulatory regime."

77. It is not true, as alleged in this Complaint, that during the period under review "*successive*" Chief Executives or Managing Directors of ELAS also held the post of Appointed Actuary. During the period from 1982 to 1991, [redacted] was the Appointed Actuary of ELAS, and the Chief Executive was [redacted]. In 1991, [redacted] succeeded [redacted] as Chief Executive while remaining the Appointed Actuary. It was said by [redacted] that this arrangement would be temporary, but in the event it continued until 1997, when [redacted] became the Appointed Actuary of ELAS and [redacted] succeeded [redacted] as Chief Executive.

78. Although the regulator regarded the dual role of [redacted] as undesirable and sought to discourage it, the combination of roles was not contrary to established industry norms at the time, nor was it prohibited by the regulatory regime.

Industry Perspective

79. It was not unusual in the early days of the Appointed Actuary system, in mutual life insurance companies in particular, for the same individual to be both Chief Executive and Appointed Actuary. Indeed, in a number of cases this arrangement effectively represented a continuation of existing practice at that time.[32] Specific examples included:

[32] The title of "General Manager and Actuary" was commonplace amongst such companies in earlier years.

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(1) [redacted] the first Appointed Actuary in 1973 was the Chief Executive, and the same individual continued to hold both posts until his retirement 1988;

(2) [redacted] the first Appointed Actuary in 1973 was the Chief Executive, and the same individual continued to hold both posts until his retirement in 1975;

(3) [redacted] the same person held the posts of Chief Executive and Appointed Actuary from September 1977 to December 1978.

80. More recent examples include the following:

(1) [redacted] the same person held the posts of both Appointed Actuary and Chief Executive from March 1983 to 1988;

(2) [redacted] the same person held the two posts from 12 December 1994 to 1 January 1998;

(3) [redacted] the same person held the posts of Appointed Actuary and Chief Executive from 19 November 1997 to 30 April 2001;

(4) [redacted] the same person held both posts from January 2000 to January 2002;

(5) [redacted] the same person held the posts of Appointed Actuary and Chief Executive from January 2000 to January 2002.

81. These examples demonstrate that the dual role seen in ELAS in the case of [redacted] was far from being unique in the industry.

82. Furthermore, from an industry perspective there were arguments both for and against allowing an Appointed Actuary concurrently to hold office as Chief

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Executive.[33] With his background and professional training as an actuary, a "General Manager and Actuary" could be a force for good prudential management, and a powerful voice to act as a restraining influence on the Board. Moreover, in the case of mutual companies such as ELAS, there could be no conflict between shareholders' and policyholders' interests – so that the potential for any conflict of interest to arise was significantly less than in the case of a proprietary insurance company.

Absence of Prohibition

83. It is important to note that, reflecting the position in the UK insurance industry, under the 1982 Act the holding of both offices of Chief Executive and Appointed Actuary was not expressly prohibited (by contrast to the prohibition against the Chief Executive also being an auditor - or a partner or an employee of an auditor - of the accounts of any insurance business carried on by the life insurance company[34]).

84. Under the 1982 Act, life insurance companies had to appoint an actuary as the Appointed Actuary within one month of commencing life insurance business, and notify the prudential regulator of the same pursuant to section 19 of the Act; but the regulator had no statutory power to oppose the appointment of an Appointed Actuary.

85. Pursuant to section 60 of the 1982 Act, the prudential regulator was given the power to object to the appointment of a person as chief executive – but only on the ground that the proposed chief executive was not a "*fit and proper*" person (see section 60(3) of the 1982 Act). Although the 1982 Act did not provide any definition of this phrase, it was commonly understood that an objection on this ground was required to be based on factors such as dishonest conduct,

33 The arguments on each side were rehearsed in a paper presented by Sir Edward Johnston to the Institute of Actuaries on 28 November 1988: his own opinion in this debate was in favour of keeping the two roles separate.

34 See section 10(4) of the 1982 Act.

29

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commission of a serious criminal offence, former bankruptcy or financial mismanagement, or age or inexperience.[35] As [redacted] pointed out in correspondence with the regulator, in terms of fitness and propriety he was amply qualified for the post of Chief Executive; and there was therefore no legal basis on which the regulator could refuse his appointment, or seek to impose conditions on it.

Appointment of [redacted]

86. In the case of ELAS, there were particular circumstances that were relevant. There was no person of suitable maturity, seniority and stature to take over the role of Appointed Actuary from [redacted] when it was proposed that he become Chief Executive following the retirement of [redacted] in 1991. [redacted] explained at that time that it was intended that he should remain the Appointed Actuary only for 12 months or so until one of ELAS's in-house actuaries had acquired sufficient experience to replace him in that position. The DTI expressed the view that it was undesirable that the same person should hold both positions, but was compelled to accept that it could not impose a condition on his appointment that [redacted] would relinquish the role of Appointed Actuary at the end of this period.

87. By the same token, the prudential regulator had no power in law to bring the dual appointment to an end once it persisted longer than the regulator had first understood it would. Nevertheless, DTI and GAD continued to express their concern about [redacted] holding both roles, even though they could not require him to step aside as Appointed Actuary. Examples of this include the following:

35 See the extract from the 1993 DTI Guidance Notes, Guideline 4.4, for example, pages 322 – 327 of the Annex.

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(1) GAD's note dated 14 May 1992 sent to the prudential regulator in preparation for the first site visit to ELAS on 19 May 1992, in which GAD suggested that the issue of the dual role be raised;[36]

(2) The concerns on this issue expressed to [redacted] by both the regulator and GAD at that visit on 19 May 1992;[37]

(3) The reference to this issue in the briefing note dated 6 December 1994, prepared by the regulator in preparation for the second site visit to ELAS on 9 December 1994;[38]

(4) The references to this issue in GAD's detailed scrutiny reports for 1993, 1994 and 1995;[39] the 1995 report also formed background material as part of GAD's briefing for the regulator for the third site visit to ELAS on 8 November 1996.

88. [redacted] response was that he did not perceive any conflict of interest arising from his dual role but undertook to drop one of the roles if such a conflict were to arise. He also continued to present his holding of both roles as a temporary expedient, and reiterated that there was not currently anyone suitable in ELAS to take over from him as Appointed Actuary.[40]

89. To criticise the prudential regulator, as Complaint D seeks to do, for "*allowing*" [redacted] to hold the post of Appointed Actuary implies that it was within the regulator's discretion to prohibit his appointment to, or to remove him from, that post. It was not. The criticism is accordingly misplaced.

90. It should be added, even with the benefit of hindsight, that it is not clear what the advantage of avoiding the dual role would have been in practice; or that [redacted]

36 Referred to in the Penrose Report, Chapter 16, paragraphs 62 and 63.
37 A copy of the note of that meeting can be found at pages 314 – 318 of the Annex.
38 See Penrose Report, Chapter 16, paragraph 152.
39 Ibid, paragraphs 144, 179 and 197.
40 See paragraphs 3 and 4 of the note of the meeting, page 314 of the Annex.

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[redacted] replacement as Appointed Actuary by [redacted] in 1997 resulted in a significant change in the strategic thinking of, or the actions taken by, ELAS from that date.

<u>Complaint E</u>

"The regulators and GAD failed to keep pace with developments in the pensions and life insurance industry and to assess and adapt their methods to reflect those developments. This was particularly critical in a situation in which narrow, technical interpretations of regulatory solvency were becoming an increasingly irrelevant measure of any insurer's realistic financial position as the industry moved more and more towards non-guaranteed bonus declarations."

<u>Alleged failure to keep pace with developments</u>

91. It is wrong to suggest that, in the period under consideration, the regulatory regime remained static, or that the prudential regulator did not take steps to adapt to developments in the pensions and life insurance industry.

92. The prudential regulator was actively involved in keeping abreast with the latest actuarial thinking and developments within the regulated sector, and in promoting changes to the regulatory regime. The changes made during this period are set out more fully in the Regulatory Paper submitted with this Response. In summary:

(1) Throughout the period from 1974 to 2001 successive legislative changes were made which progressively strengthened the regime.

(2) For example, the valuation of life insurance companies' assets and liabilities was subject to ongoing consideration, and changes were made which strengthened the applicable regulations and increased the amount of information and level of detail required in the regulatory returns.[41]

[41] See paragraphs 92 – 96 of the Regulatory paper.

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(3) In 1990 DTI consulted on proposals to strengthen the Appointed Actuary system in the light of policy concerns as to whether such an important part of the regulatory regime should continue to rest largely on non-statutory professional rules, custom and practice. This led to the introduction of requirements that the Appointed Actuary should specifically certify certain facts in the regulatory returns.

(4) A rolling programme of site visits to life insurance companies within the regulated sector was introduced by DTI from the end of 1991.

(5) In 1994 the requirement for "*sound and prudent management*" was introduced which brought corporate governance issues under the remit of the prudential regulator.[42] Following these reforms the regulator issued new guidance notes setting out performance standards which companies' systems were expected to achieve.

(6) In 1995 a new Service Level Agreement between GAD and DTI was put in place following an initiative to improve the regulatory process generally. The initiative was driven through a GAD internal working party, which included a representative from DTI. The SLA extended the scope of the services which GAD was required to provide to DTI, and contained revised provisions relating to the scrutiny process. The 1998 SLA which replaced the 1995 SLA further enhanced this process[43].

(7) From 1995 GAD began to prepare an annual report for DTI on the life insurance industry. The purpose of the report was to act as an internal reference document for both DTI and GAD, providing commentary on significant developments within the industry during the year and an indication of likely future developments. The report provided detailed

[42] See paragraph 94 of the Regulatory Paper.
[43] The 1995 and 1998 SLA's are annexed to the Regulatory Paper (as annexes 14 and 15).

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comparative information between insurance companies and groups to allow potentially weak companies to be identified, and to attempt to identify any significant variations between different sectors of the industry.

(8) GAD also responded proactively to emerging regulatory issues: for example by arranging the 1993 survey of bonus distributions[44] and the 1998 GAR survey.[45] Three working parties were set up at the instigation of the Joint Actuarial Working Party ("JAWP") in the 1990s and they reported, respectively, on the meaning of PRE; the net premium method of valuation; and the impact of GARs on the industry.[46]

(9) There were also successive changes to the mandatory guidance issued by the UK actuarial profession to Appointed Actuaries during the material period, in part due to pressure exerted by GAD through JAWP. These included, for example, the introduction of GN2, which established as best practice the production of financial condition reports and the use of dynamic financial analysis.[47]

(10) From time to time GAD issued additional guidance in the form of 'Dear Appointed Actuary' letters to Appointed Actuaries to supplement the regulations and professional guidance, for example relating to the resilience test.

93. Thus, as a result of a number of initiatives taken by DTI, GAD, HMT and FSA, throughout the 1980s and 1990s, steps were taken to keep the regulatory system up to date with developments in the pensions and life insurance industry. Furthermore, the level of regulation increased considerably, notwithstanding the policy of deregulation which prevailed throughout that period.

44 See Penrose Report, Chapter 16, paragraphs 105 – 106.
45 See paragraph 130 below.
46 See paragraphs 77, 98 and 99 of the Regulatory Paper, along with its annexes 6, 11 and 12.
47 See paragraph 97 and annex 10 of the Regulatory Paper.

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Regulatory solvency

94. As already noted, and described more fully in the Regulatory Paper submitted with this Response, regulatory solvency was a crucial yardstick by which the balance was struck in the governing legislation (both at the UK and European level) between policyholder protection on the one hand and the freedom for businesses to compete and develop new products on the other. Whatever view is taken about the merits or demerits of the legislative approach, the prudential regulator cannot fairly be criticised for applying and scrutinising regulatory returns by reference to the criteria for solvency prescribed by the statutory provisions. Nor is it accepted that the interpretations of regulatory solvency applied by the regulator and GAD were "*narrow*" or unduly "*technical*".

95. The real complaint appears to be that, in the context of a life insurance industry that was moving increasingly towards non-guaranteed terminal bonus declarations, the prudential regulator should have required ELAS explicitly to reserve for terminal bonus. But it was not open to the regulator to require ELAS to do this under the regime in force and the legislation which it was required to apply:

(1) The Third Life Directive gave Member States a discretion whether to require explicit or implicit reserves to be set aside for bonuses: see Article 17(1)(D). The circumstances in which it was decided, at a European level, to make explicit reserving for bonuses optional rather than mandatory are set out in some detail in the Penrose Report.[48]

(2) Having consulted with the industry prior to implementing the Third Life Directive, the UK Government decided not to adopt the option of requiring explicit reserving for terminal bonuses. The view was taken that implementation of this option would have constrained the ability of life

48 See Penrose Report, Chapter 10, paragraphs 21–33.

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insurance companies to invest in equities, and therefore have led to consumer detriment in the form of potentially lower overall long term investment returns and a reduction of consumer choice.[49] This was a reasonable decision for the UK Government to make; and one that it was fully entitled to make in accordance with the discretion granted to it under European law.

(3) Instead, the preferred approach was that an implicit allowance for terminal bonus should be made, through a deliberately prudent and cautious approach to valuation of both assets and liabilities, which would create implicit margins to provide for future bonuses. This was achieved in particular by: (i) requiring the use of conservative valuation assumptions (including not taking any credit for future capital appreciation on equity investments[50]); and (ii) using a net premium method of valuation in the regulatory returns.

(4) In circumstances where the UK Government had made the decision not to require explicit reserving for terminal bonus, it was not open to the prudential regulator to introduce a similar requirement by the back-door, by reference to PRE and threatening to use powers of intervention under section 45 of the 1982 Act if the company in question failed to set up explicit reserves for terminal bonus. Had the regulator sought to do this:

(i) It would have been flying in the face of a policy decision already taken by the UK Government; and

(ii) The regulator would also have been using section 45 powers impermissibly (contrary to both section 45(2) of the 1982 Act and Article 21 of the Third Life Directive) to prevent a company from

49 See also Penrose Report, Chapter 10, paragraphs 34 – 38.

50 This was the case until the amendment of the relevant regulations in 2000 from which date some limited allowance was permitted within the assumed investment return on equities.

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disposing of its assets even though the test of regulatory solvency had been met.

96. Lord Penrose did not have regard to most of the above points when criticising the treatment of ELAS's terminal bonus in his report. Whilst Lord Penrose did address the effect of section 45(2) (but only that point) in his Report,[51] his arguments overlooked the facts that:

(1) The restriction on the prudential regulator's powers of intervention was imposed at a European level, and therefore all the regulator's powers of intervention under the 1982 Act (and not just its section 45 powers) were impliedly subject to the Article 21 limits (so as not to contradict the Directive);

(2) Given that the UK Government had decided against explicit reserving for terminal bonuses, requiring ELAS to reserve for terminal bonuses would have impermissibly restricted a freedom to dispose of its assets that it would otherwise have enjoyed under UK law; and

(3) Although the prudential regulator might from time to time have acted as though it were entitled to investigate PRE with a view to taking action, quite correctly (in the light of the foregoing) the prudential regulator never did require ELAS to reserve for terminal bonus on the grounds of PRE[52].

97. Moreover, the argument advanced by Lord Penrose in this regard makes the assumption that, if ELAS's policyholders had a reasonable expectation that they would be paid their discretionary terminal bonuses, ELAS's policyholders also had a reasonable expectation that ELAS would set aside explicit reserves for them. It is not clear from what particular communication with policyholders the

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51 See Penrose Report, Chapter 15, paragraphs 15 – 19.

52 See Penrose Report, Chapter 10, paragraph 88, where he concluded: "In my view, the Society was not required by statute, nor by recognised accounting or actuarial principle or practice, to value and to set up reserves for accrued terminal bonus payments that were likely to be made in the future, notwithstanding the accrual of those future benefits in is office valuation".

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latter expectation (as to the setting aside of additional reserves) could be said to be derived. Most of the ELAS literature that was sent to policyholders made it clear that ELAS had a policy of "full distribution", and of not reserving beyond what was technically necessary to meet the UK statutory requirements. Given that those statutory requirements did not include a requirement of explicit reserves for terminal bonuses, it is hard to see how ELAS policyholders could have had a reasonable expectation that nonetheless ELAS would set up explicit reserves for its terminal bonuses. Indeed, given its much vaunted policy of "full distribution", had ELAS gone further than UK statutory requirements and set up explicit reserves for terminal bonus, arguably it would have been acting contrary to the reasonable expectations of with-profits policyholders who would have then not received their "full distribution".

98. On analysis, the complaint must be, not that the prudential regulator failed properly to administer the regulatory regime as it existed, but rather that the regime itself needed to be reformed in the light of developments in the insurance industry (in particular the increased use of non-guaranteed terminal bonus declarations). Whatever can be said for or against this argument, it is not an argument that discloses any case of maladministration on the part of the regulator.

99. It is also noteworthy that, even now, under the regulatory regime operated by FSA, the approach to realistic balance sheets does not change the way that terminal bonus works: the changes are more about the transparency of the position rather than the substance. Where the 'realistic peak' in the new regulatory regime exceeds the 'regulatory peak', the excess only results in an additional *capital* requirement, and not an additional *reserving* requirement, of that amount for the company. So even now, there is no requirement to reserve for future awards of discretionary terminal bonus. This further undermines the suggestion that the failure to adopt an approach of requiring explicit reserves for terminal bonus in the past was a policy decision that was wrong, let alone one that constituted maladministration on the part of the prudential regulator.

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Complaint F

"GAD had recommended ELAS as a pension plan or additional voluntary contribution scheme provider in its advice to the administrators of the Principal Civil Service Pension Scheme and to other public sector pension schemes. This led to a lack of proper separation of its responsibilities and to a clear conflict of interest between GAD's role in providing advice to government bodies in relation to public sector pensions and in assisting the prudential regulators of ELAS. This conflict of interest compromised the proper discharge of GAD's regulatory functions."

100. It is correct that the Government Actuary's Department advised the Principal Civil Service Pension Scheme ("PCSPS") and a number of other public sector pension schemes[53]. But it is wrong to suggest, as the Complaint does, that there was a lack of proper separation of GAD's responsibilities or that there was a conflict of interest between GAD's role in advising public sector pension schemes and its role in assisting the prudential regulator of ELAS.

101. In GAD's capacity as adviser to the PCSPS, it fell to actuaries of GAD to recommend possible providers for the in-house additional voluntary contribution (AVC) pension scheme.[54] The selection process took place in 1988. Expressions of interest were elicited by advertisement. GAD analysed the responses and provided HMT (who were the managers of the PCSPS) with a short list of possible candidates. Selection from this short list was carried out by means of an interview panel, which included a senior GAD actuary, as well as other members from HMT (which made the decision). ELAS was one of two life insurance companies selected as AVC providers by HMT.

102. GAD was subsequently involved in carrying out three paper reviews of the appointed providers. The first such review was carried out in 1992, with more

[53] These included those covering the NHS, teachers, police, firemen, judges and members of parliament as well as the PCSPS. GAD provided actuarial advice on all aspects of these schemes, including scheme and benefits design; employer contribution rates; actuarial tables for transfer payments and other things. Advising on possible AVC providers was only a very small part of this work.

[54] This was subject to a requirement that the providers should offer with-profits, managed funds and building society linked pensions and also death-in-service provision.

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substantive reviews in 1993 and 1995. The review process involved comparing the performance of the two appointed providers, both with each other and with a wider population of AVC providers, as analysed in available market surveys. Comments were also obtained from the scheme administrators regarding the standards of service of the appointed providers.

103. From January 1996, GAD ceased to be involved in this activity, following a market test by the Cabinet Office which resulted in [redacted] being appointed to give advice on AVC providers for the PCSPS. GAD has no knowledge of the advice given subsequently by [redacted] but it can be assumed that the new advisers did not recommend the removal of ELAS from the panel, at least until ELAS ceased to take on new business. It is understood that a third company was added to the panel.

104. It is not accepted that GAD's role in advising on the suitability of ELAS as an AVC provider (or any other aspect of its advisory role) gave rise to any conflict of interest in performing its functions in assisting the prudential regulator of ELAS – still less that the former role in any way compromised the proper discharge of GAD's insurance regulatory advice function.

105. Plainly, any AVC provider for the PCSPS would be an authorised life insurance company whose financial affairs were subject to scrutiny by another division of GAD in the course of assisting the prudential regulator. It was accordingly recognised by GAD that it was essential to keep the two functions separate so as to ensure that no use was inadvertently made of any confidential information. To remove any such risk there was a strict "Chinese wall" separation between the carrying out of the insurance regulatory advice function and the discharge of GAD's other functions to Ministers, government departments and the managers or trustees of public sector pension schemes.

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106. Thus there was no exchange of confidential information about the affairs of individual insurance companies between GAD actuaries advising the prudential regulator and those advising pension schemes. The actuaries advising the PCSPS had to rely solely on publicly available information about life insurance companies and on their own independent analysis of the products, the performance and the standards of service of AVC providers.

107. No professionally improper conduct took place, and the Complaint is without substance.

<u>Complaint G</u>

"From the mid 1980s until 1997, the regulators failed to evaluate the potential effect of Guaranteed Annuity Rates (GARs) on the solvency of ELAS in a context where current annuity rates were falling steadily, in line with the Bank of England's base rate, to below contracted GARs. The regulators learned explicitly in November 1993 of the degree of ELAS's exposure to risks associated both with the GAR issue and with ELAS's lack of prudent reserves. The regulators' failure to take action then or to impose reserving until 1999 played a direct part in the closure of ELAS to new business and to subsequent cuts in policy and annuity values. The regulators did not prepare a study on the extent of GARs in the industry until 1997: a decade too late."

<u>ELAS's GAR liabilities</u>

108. The Guaranteed Annuity Rates ("GARs") provided for under ELAS's with-profits policies varied depending on the type of policy as well as the age and sex of the policyholder. After June 1988 GARs were not included in policies sold by ELAS, but policies with GARs sold before that date remained in force, and policyholders could continue to pay recurrent single premiums into those policies.

109. The statutory regulations required GARs to be valued on prudent assumptions. The value placed on them depended on whether, and to what extent, the GARs would be "in the money" (i.e. have a clear value) if the mortality and interest rate assumptions used in the valuation were borne out, and on the assumed take-up

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rate of the GARs.[55] Otherwise, the GARs represented only a contingent liability and, as such, were a matter which the Appointed Actuary was expected to take into account in analysing the overall future financial condition of the company with regard to his or her professional advice to the Board.[56]

110. GAR liabilities were not explicitly reserved for by ELAS, after GARs began to exceed current annuity rates (as happened first in 1993 and then again from May 1995). As subsequently emerged, the Board of ELAS adopted a policy whereby they decided to award a different level of terminal bonus to a policyholder who elected to take an annuity at the guaranteed rate from that which would otherwise have been awarded, calculated so as to ensure that the total benefits received were the same in each case. On the basis of this policy ELAS took the view that it was unnecessary to set up a reserve for the cost of meeting GAR liabilities even where these were "in the money".

111. It was the professional duty of the Appointed Actuary to disclose, in the regulatory returns, his company's liabilities and to justify how they were reserved for. The regulatory regime relied on him to carry out this function properly - this was the essence of the philosophy of "freedom with publicity", referred to above.[57]

Non-disclosure by ELAS

112. Regrettably, ELAS's regulatory returns simply did not disclose its exposure to GARs or the policy adopted in relation to terminal bonus in anything approaching a satisfactory way. The prudential regulator could not reasonably have been expected to identify the extent of the problem which GARs potentially

55 There was no guidance to Appointed Actuaries regarding the take-up rate assumption before January 1999; but take-up, in principle, depended on the extent to which the GARs were in the money on the valuation basis as well as the relative attraction of other benefits that might be more flexible or have some tax or other advantage over the GARs.

56 This point is recognised in paragraph 163 of the Parliamentary Commissioner's first report.

57 See the response to Complaint C.

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represented for ELAS from the information provided (nor, given the lack of any proper indication in the regulatory returns that there was a potential issue, the time and resources available, and the prevailing policy approach towards prudential regulation, described in the response to Complaint C above, could there be any reasonable expectation that the regulator or GAD would have sought additional information which would have brought the situation to light).

113. Lord Penrose's report provides powerful support for this view. In his conclusions, Lord Penrose expressly found:[58]

> *"...the Society's regulatory returns failed to identify and value the growing guaranteed obligations that resulted from a combination of falling interest rates and lightening mortality experience. Such references as were made to these guarantees in and after 1994 (relative to the 1993 return) failed properly to disclose their nature and extent to the regulators."*

114. Lord Penrose went on to refer to the "*obscurity of the references*" in ELAS's regulatory returns.[59] In short:[60]

> *"The returns were opaque and uncommunicative."*

This is to be contrasted with the response to the prudential regulator in September 1998, when ELAS claimed that it had disclosed its differential terminal bonus policy in its regulatory returns since 1993.

The November 1993 meeting

115. It is not right that (as the Complaint asserts) the prudential regulator "*learned explicitly in November 1993 of the degree of ELAS's exposure to risks associated both with the GAR issue and with ELAS's lack of prudent reserves.*" It is assumed that this assertion has its genesis in Lord Penrose's conclusion that:[61]

58 See Penrose Report, Chapter 19, paragraph 128.
59 Ibid, paragraph 129.
60 Ibid.
61 Ibid, paragraph 189.

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> *"...regulators and GAD were told in November 1993 that the Society did not reserve for its guarantees, considering that they did not "bite". The information was not followed through ..."*

116. It is this November 1993 meeting which provides the only detectable basis for criticising the prudential regulator for having "*no insight*" into the impact of the GAR issue on ELAS until 1998.[62] HMT and GAD do not accept that the regulator's reaction to what was said at this meeting forms any proper basis for complaint.

117. The meeting in November 1993 was attended by GAD, DTI and [redacted]. The nature and purpose of such meetings has been described above. They were not confrontational or inquisitorial occasions. Their purpose was to inform the prudential regulator's approach to the next scrutiny report, which would of course be based on the next regulatory returns.

118. As the note of the meeting demonstrates,[63] there was not in any way a clear disclosure of ELAS's differential terminal bonus policy, nor the extent of its exposure to GARs. The note of the meeting records [redacted] as remarking that the GAR in ELAS's old policies was not as onerous as it appeared because "*it would be reasonable (in his view) for the allocation of final bonus to be conditional on the waiving of this guarantee*".

119. It is important to put the reference to GARs which was made by [redacted] at the November 1993 meeting into its proper context. The reference was made in the context of the *resilience test*, which required a life company to assume (for the purpose of testing the resilience of its reserves) a further 3% reduction in interest rates. Resilience reserves were identified as the fourth item on GAD's agenda for the meeting.[64] The clear inference from the fact that GARs were mentioned in this

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62 See Penrose Report, Chapter 16, paragraph 132.
63 A copy of the note can be found at pages 328 – 329 of the Annex.
64 See Penrose Report, chapter 16 paragraph 114.

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context is that while they may have been "biting" in the resilience test (i.e. in the reduced interest rate scenario assumed for that purpose), they were not biting in the base valuation. There was no reason, therefore, for any conclusion that a GAR reserve was needed in the base valuation.

120. The impression given by [redacted] was misleading. The regulator's principal concern would have been that the GARs were being reserved for in accordance with the regulations. It is important to appreciate that the position as presented by ELAS was quite different from ELAS suggesting that while, prima facie, a GAR base valuation reserve *was* needed, such a reserve was not in fact being held due to the differential terminal bonus policy (i.e. that the GARs were regarded as being covered by a first charge against terminal bonus). That this had in fact been ELAS's position emerged only in 1998, as explained below.

121. The subsequent lack of disclosure in respect of the GARs in the 1993 (and indeed subsequent) regulatory returns was consistent with, and reinforced, the false impression given by [redacted] at the November 1993 meeting that the GARs were not biting in the base valuation. In these circumstances, the criticism made in Chapter 19, paragraph 235 of the Penrose Report is misplaced: the fact that the impression given by [redacted] at the meeting was false is known only with hindsight following the 1998 GAD survey (see below).

<u>The study on the extent of GARs in the industry</u>

122. HMT, FSA and GAD do not accept that there is any justification for the claim made in Complaint G that the study of the extent of GARs in the industry was prepared "*a decade too late*". The genesis of that study is explained below.

123. The existence of contracts with GARs within the life insurance industry generally was well known. However, it was not until the late 1990s that, because of falling interest rates and improving mortality, such guarantees became of significant value to policyholders. GAD and the prudential regulator were keen to obtain

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information on the implications of this new development for life insurance companies.

124. In these circumstances, JAWP (at the suggestion of GAD) considered that the problem was important enough to merit specific study; and this led to the setting up of the Working Party of the Life Board of the Faculty and Institute on Annuity Guarantees.

125. The Working Party was established in January 1997 to consider the issue of annuity guarantees. The Working Party's terms of reference noted that there was "*no accepted practice for reserving for these guarantees*" and that there was "*no published research to guide Appointed Actuaries in setting reserves*".

126. The Working Party's report was published in November 1997[65]. The Working Party reported that it had found considerable variations in practice among companies as to reserving for annuity guarantees. This was not surprising given that the falling interest rates and improving mortality that had led to the GAR problem were relatively recent phenomena and given the extent of the variation which existed between companies both as to the level of interest rates underlying their respective guarantees (i.e. their relative generosity) and the volumes of the contracts carrying these guarantees which had been sold by each company.

127. The Working Party did not provide definitive recommendations as to the correct approach to reserving for the guarantees. The report concluded, among other things, that there was no industry consensus on reserving for guarantees, and that current practice was very varied. The report identified a number of possible approaches to reserving and set out three approaches "*for consideration*", albeit that none was considered "*entirely satisfactory*". One of the approaches was:

> "*Review whether and to what extent the guarantee will be covered by terminal bonus adjustments. Providing that terminal bonus adjustments will*

65 A copy of the report can be found at annex 12 to the Regulatory Paper.

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be used and are sufficient to cover guarantees in all circumstances, there is an argument for not reserving for such guarantees – no explicit provision is made for terminal bonuses and hence the provision for guarantees is simply part of this implicit provision subject to the existence of appropriate terminal bonus margins."

The Working Party commented that this approach "*could be viewed as unsound because terminal bonus was not reserved for explicitly and hence no explicit provision would be made for an explicit guarantee*". However, the Working Party also made criticisms of the other two approaches put forward for consideration and did not recommend that this approach should be banned.

128. The report concluded that, because of falling interest rates and improving life expectancy, companies would need to work out how to reserve for guarantees. The Working Party's conclusions reflected the fact that, once the GAR issue had come to prominence as a result of rises in current market annuity prices beginning to make the GARs more attractive options, there simply was no straightforward solution for life insurance companies - especially for a mutual such as ELAS which had no shareholders to call on and had limited free assets.

129. The Working Party report was published at a meeting in the spring of 1998. Companies which had taken part in the Working Party's survey were not identified (having been promised anonymity). GAD, however, was keen to learn more about the position of individual companies.

130. Although GAD had been represented on the Working Party, it was not in a position to provide the Working Party's confidential working papers to the prudential regulator, or otherwise to go behind the confidence and anonymity of the Working Party's procedure. GAD therefore initiated its own survey of life insurance companies' approach to reserving for annuity guarantees, in order to determine the level of exposure of different companies to the problem. This survey was carried out in June 1998. The reason for this date was that most insurance companies were obliged to submit regulatory returns by 30 June. So

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June 1998 was the most sensible time to conduct the survey, since 1997 regulatory returns would have been finalised or almost finalised by then, and so the information received back by GAD in response to the survey was likely to be as up to date as possible and could be considered by GAD along with the information set out in the 1997 regulatory returns.

131. There was nothing in any way inappropriate about the timing of this survey. It was an appropriate follow-up to the report of the Working Party, which was itself a sensible response to the emergence of the GAR issue through the combination of falling interest rates and improving mortality position in the 1990s. There is no reasonable basis for the suggestion that the study made at that time ought to have been carried out a decade sooner.

Disclosure of ELAS's exposure

132. The extent of ELAS's exposure to GARs and its lack of reserves to meet that exposure became evident in consequence of its response of 29 July 1998 to GAD's survey. ELAS's Appointed Actuary now explained the differential terminal bonus policy in clear terms. He said:

> *"For any policy for which the annuity guarantee is biting, the amount of terminal bonus is reduced to pay for the cost of the guarantee. For all but a few small policies, the "cost" of the annuity guarantee is covered by this adjustment."*

133. This response showed that ELAS had made no explicit provision for annuity guarantees in setting its reserves. The problem for ELAS was that it had significantly more exposure than any other life insurance company because of the amount of GAR business written. It had also not separated the business from non-GAR policies, so that there was no separate fund or even a separate series of policies for bonus purposes.

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134. By contrast, for most other companies GARs were not a major issue, because their scale was either substantially smaller or because the companies had written this business in a separate bonus series from the business without guarantees, and they were therefore free (even after the *Hyman* judgment) to apply different bonus policies to the contracts with guarantees compared to those without guarantees. Some companies had an "estate" to which the GAR cost could be charged (which ELAS did not). Some companies were already reserving for their guarantees on a proper basis.

135. The prudential regulator and GAD reacted swiftly and firmly to the information provided by ELAS in July 1998. In November 1998 GAD sent to HMT a preliminary report on the survey results. This identified ELAS as particularly vulnerable on account of its exposure to GARs because the relevant business was a substantial part of its total book.

136. As soon as the prudential regulator had identified this problem, it took steps to ensure that there was proper reserving on a sufficiently prudent basis. It took the view that the policy that had been adopted by ELAS of not reserving for the guarantees on the basis that these could be covered by a first charge against terminal bonus was unsound, for the reason which had been indicated in the Working Party's report.

137. The regulator's response began with correspondence in September 1998. Subsequent events are recounted in the Baird Report, from paragraph 4.14.1 onwards.

138. As is clear from the narrative set out in the Baird and Penrose Reports, ELAS resisted the approach urged by the prudential regulator. ELAS doggedly maintained that it would be excessively and unnecessarily prudent to reserve for close to 100% of policyholders deciding to exercise the guarantees to which they might be entitled, because of the highly restrictive nature of the guarantee option

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and the experience they had had so far of very few policyholders exercising the guarantee. ELAS was persistently very reluctant indeed to accept the regulator's view of the reserving that was required, as demonstrated, for example, by its threat of judicial review proceedings at a meeting on 3 December 1998,[66] and the events of January 1999.[67]

139. ELAS even tried to persuade the Economic Secretary to the Treasury to intervene on its behalf on the reserving question. This attempt failed.[68]

140. Correspondence and debate continued between the prudential regulator and ELAS until the judgment of the House of Lords was given on 20 July 2000, which conclusively resolved the issue of whether the differential terminal bonus policy adopted by ELAS was lawful.

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

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66 See Baird Report at paragraphs 4.15.11 & 4.15.14; and Penrose Report, Chapter 17, paragraphs 63 & 72.
67 See Penrose Report, Chapter 17, paragraphs 103-104.
68 Ibid, paragraphs 130-132.

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142. No maladministration is disclosed by these events. GAD and the prudential regulator acted promptly once the problem in relation to ELAS became known. GAD and the regulator took an appropriately firm line with ELAS on reserving, as evidenced, for example, by [redacted] memo to [redacted] of 3 November 1998 which stated, by reference to ELAS's position, that:[69]

> *"It is not acceptable....to regard these guarantees as covered by a "first charge" against a final bonus for which no provision is made. This has clearly not yet been recognised by Equitable Life (and they have not even attempted as we requested at the meeting to quantify the reserves on this basis)."*

143. It is one thing to say now, with the benefit of hindsight, that ELAS could have been quizzed about its approach to guaranteed annuities at an earlier stage. But in each of the 1993 – 1996 regulatory returns, received each following June (i.e. 1994 – 1997), ELAS's presentation of its methodology did not disclose that they were not setting up reserves for guarantees. Nor was there anything in these regulatory returns to indicate that the level or extent of the guaranteed annuities was significant. Relevant references in the regulatory returns were brief in the extreme, and did not disclose the reserving method, the rate of guarantee or the volume of business affected.

<u>Alleged Effect</u>

144. It is suggested by the complainants that the prudential regulator's failure to impose reserving until 1999 played a direct part in ELAS's closure to new business and the subsequent cut in policy values. This suggestion is also refuted by the regulator and GAD.

145. In early January 1999 FSA prepared draft guidance, to be sent out by the Government Actuary to all Appointed Actuaries of companies authorised to carry out life insurance business, relating to reserving requirements for guaranteed

[69] See Penrose Report, Chapter 17 paragraph 35.

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annuity options ("GAOs"). The guidance asked Appointed Actuaries to reserve for the guarantees on prudent assumptions. This guidance was published, as a "Dear Appointed Actuary" letter, on 13 January 1999. The letter was copied to Managing Directors who were reminded that it was they who bore ultimate responsibility for establishing proper reserves. As the discussion above, and the account set out in the Baird Report,[70] explains, ELAS was very reluctant to accept that any significant reserve was needed for GARs.

146. It is important to understand that the result of the *Hyman* litigation did not impact on ELAS's gross reserving requirements: it had been required to reserve for GARs regardless of the outcome of the litigation.[71]

147. Once the House of Lords' judgment was delivered, the most commercially attractive option in order to fund the GAR costs, as ELAS saw it, was to seek to raise outside capital by putting itself up for sale. If the sale proved impossible, closure to new business was inevitable. In the event, for various reasons (not all related to the financial state of ELAS[72]), the sale did not succeed and ELAS had to cut policy values anyway.

148. The circumstances which led to ELAS closing to new business were therefore the result of a complex chain of events and it is far from clear what role, if any, ELAS's delayed introduction of full reserving for GARs played. Setting up additional reserves at an earlier point would most likely have been at the expense of showing a weaker reported statutory solvency position or of slimming down

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70 See e.g. paragraph 4.15.3 and especially paragraph 4.15.9. See also Penrose Report, Chapter 17 paragraph 44, recording ELAS's view that reserving for what was payable under the contract, as regulators were demanding, was "unrealistic" and "excessive"; and Penrose's Report, Chapter 17, paragraph 50.

71 The judgment did, however, have an indirect effect on ELAS' net reserves because of the GAR reinsurance treaty. This had to be renegotiated as a result of the judgment, leading to a reduction in the reinsurance offset and hence an increase in ELAS' net reserves. However, this renegotiation was completed smoothly (within a month of the judgment) and ELAS' required solvency margin remained covered throughout.

72 See *The Prudential Regulation of Equitable Life*, paragraph 213.

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margins elsewhere in the valuation basis, so it is not clear that it would have forced ELAS significantly to change its bonus policy.

149. The cuts in policy values made in July 2001 were largely attributable to the low or negative rates of investment return earned by ELAS during 2000 and 2001, against the background of (i) substantial falls in equity markets at that time and (ii) the well publicised commercial policy which ELAS had pursued of distributing investment returns to current policyholders and not maintaining an estate. The absence of an estate had the necessary consequence that in the event of adverse investment conditions policy values might need to be cut, unless additional capital could be raised. There is no clear, let alone direct, link between the cuts in policy values and the GAR issue.

Complaint H

"From about 1990 onwards, the regulators and GAD failed to give sufficient consideration to the fact that some of the measures used to bolster ELAS's solvency position were predicated on the emergence of a future surplus. As a consequence, they did not properly assess the overall impact and adequacy of those measures. The regulators also allowed ELAS to mis-use the term 'surplus' and failed to consider the use of that word in the context of policyholders' reasonable expectations."

150. The "*measures*" criticised in this Complaint are not specified. It is assumed, however, from the description of the measures as "*predicated on the emergence of a future surplus*" that the measures referred to are the taking of credit by ELAS in its regulatory returns for 'future profits implicit items' for the purpose of demonstrating cover for its required solvency margin during this period. The credit taken for such items is considered here. It may be that the complainants also intend to refer to other steps taken by ELAS such as the arrangement of a subordinated loan in 1997 and of reinsurance at the end of 1998.[73] However, those

[73] The subordinated loan and reinsurance agreement gave rise to future liabilities, but the credit taken for them in calculating ELAS's solvency position was not "*predicated on the emergence of a future surplus*".

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matters are specifically referred to in Complaint J and are accordingly addressed in response to that complaint.

Future profits implicit items

151. Throughout the relevant period (and still) both European and UK legislation permitted a value to be placed on the projected future surplus of a life insurance company for the purpose of demonstrating cover for its required solvency margin. This value was referred to as a "future profits implicit item". The term "future profits" in this context did not refer to "profits" in the conventionally understood sense, but to future surplus which could be expected to be disclosed in subsequent actuarial valuations, arising from the prudential margins contained in the assumptions used for the current actuarial valuation.

152. Regulation 22(3) of the 1994 Regulations[74] (and its equivalent under the 1981 Regulations[75]) required that, of the items covering a life insurance company's required solvency margin, at least 50% of the "guarantee fund"[76] had to be covered by "explicit items". For most life insurance companies, including ELAS, the guarantee fund was equivalent to one-third of the required solvency margin. In other words, one-sixth of the required solvency margin had to be covered by explicit items. The remaining five-sixths of the required solvency margin could, in principle, be covered by implicit items.

153. Thus, the regulations made it quite plain that implicit items, including future profits implicit items, could play a very substantial role in the valuation of a life

[74] The Insurance Companies Regulations 1994 (SI 1994 No 1516).
[75] The Insurance Companies Regulations 1981 (SI 1981 No 1654).
[76] Defined in regulation 22 of the 1994 Regulations as one-third of the required solvency margin, subject to a minimum of the minimum guarantee fund as defined in Schedule 4 to those Regulations (and equivalently under the 1981 Regulations).

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insurance company's assets for the purpose of demonstrating cover for its required solvency margin[77].

154. These provisions derived from the First Life Directive[78], which provided that, at the discretion of the prudential regulator of the relevant Member State, a life insurance company could count implicit items, including future profits implicit items, against five-sixths of its required margin of solvency[79].

155. There was a sound economic rationale for such provision, since the valuation regulations specified that, in calculating liabilities, the Appointed Actuary had to make a prudent assumption about future rates of investment return, so it was sensible to permit some of this future return to be brought into account as an item available to cover the required solvency margin.

156. In order to include implicit items towards cover for the required solvency margin, an order under section 68 of the 1982 Act (and its equivalent under the Insurance Companies Act 1974) had first to be obtained[80]. This section permitted the prudential regulator to disapply, or modify the operation of, certain provisions of the Act and to grant an order for this purpose (a "section 68 order"). In some cases, it was the regulator's practice (as set out in prudential guidance to companies) to require that an application for a section 68 order be supported by a certificate from the Appointed Actuary. An application for an order in respect of a future profits implicit item fell into this category.

157. The value of future profits implicit items for which such an application could be made was limited by law. Pursuant to the First Life Directive and the regulations, a future profits implicit item could take account only of profits expected to arise

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77 It should further be appreciated that the requirement for one-sixth of the required solvency margin to be covered by explicit items did not restrict the amount of implicit items that was permitted to be shown in the regulatory returns to five-sixths of the required solvency margin.

78 See paragraphs 42 – 49 of the Regulatory Paper.

79 Articles 18(3)(a) and 20

80 Regulation 23(5) of the 1994 Regulations (and its equivalent under the 1981 Regulations).

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on business that was already in force, and the maximum value of such an item could not exceed one half of the expected full amount of those profits. The regulations provided that the level of future profits should be determined by multiplying the estimated annual profit by the average number of years – to a maximum of ten – remaining to run on policies. For this purpose, the estimated annual profit was to be taken as the average annual profit achieved over the preceding five years (known as the retrospective calculation)[81].

158. In fact the UK's approach to future profits implicit items was more cautious than the regime demanded by the Directive. The requirements for calculation prescribed by the Directive, which as explained above were largely retrospective, were supplemented in the UK by an additional prospective requirement that the amount applied for was less than the present value of profits expected to arise on the in force business. This was in order to ensure the robustness of the approach, especially in cases where the composition of the business might be changing or where there was a significant proportion of single (or recurrent single) premium business (as was the case with ELAS), and to ensure that any future profits implicit item granted was truly justifiable in terms of the margins contained within the valuation of the liabilities at the valuation date.

159. The UK's approach to this issue was set out in guidance on applying for implicit items, which was issued by DTI in 1984[82]. The guidance emphasised the requirement for a certificate signed by the Appointed Actuary to the effect that the amount claimed did not exceed the lower of the amount calculated in accordance with the requirements prescribed by the Directive and the "*present value of the profits that may be expected to arise in the future on the long term business in force on the valuation date*". The Actuary's assessment of the latter was required to be, as the guidance made plain, based on "*cautious assumptions in regard to the future experience, in many respects similar to those required for the minimum*

[81] Article 18(3)(a) of the Directive and regulation 24 of the 1994 Regulations (and its equivalent under the 1981 Regulations).

[82] A copy of the guidance is at pages 298 – 313 of the Annex.

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basis for calculating mathematical reserves." The guidance explicitly stated that the future profits taken into account for the purpose of the certificate must be assessed only by reference to the business in force at the valuation date, and must not extend to potential future profits in respect of new business after that date. Some account was allowed to be taken for future premiums payable under policies in force at the valuation date where a company had the contractual right to receive them. However, this was not the case for the bulk of ELAS' business, which was recurrent single premium business, and consequently future premiums were not taken into account in the calculations made in support of its future profits implicit items.

160. The policy at the material time towards section 68 orders was set out in the guidance, which stated that section 68 orders in respect of future profits implicit items "*will be readily available, provided that the relevant requirements set out in this Guidance Note have been satisfied*".

161. The prudential regulator's role was, on the advice of GAD, to determine whether the application for a section 68 order could be justified under the relevant regulations and guidance. In exercising this function, the regulator placed, and was entitled to place, considerable weight on the certificate of the Appointed Actuary, both because of its source and of the expressly cautious basis on which it was required to be given.

162. In practical terms, if the Appointed Actuary's calculations were justifiable, the applicant company had, especially in the light of the terms of the guidance referred to above, a legitimate expectation that the section 68 Order would be granted. A refusal to grant such an order would have been highly unusual and, absent very good reason, may well have been vulnerable to successful legal challenge.

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163. Moreover, as Lord Penrose noted, when the First Life Directive was implemented, there was positive encouragement from the Government Actuary and from the prudential regulator for the use of the future profits item.[83] Given such past encouragements, the rejection of a section 68 application to permit the use of such an item would have been all the more difficult to justify.

164. It is also important to note that the granting of a section 68 order was, in itself, of little or no consequence. It was the duty of the Appointed Actuary, once the order had been granted, to judge whether and to what extent it was appropriate to take account of the benefit of the section 68 order when preparing the company's regulatory returns and when considering the future financial condition of the company and, indeed, when considering its continuing ability to meet its contractual liabilities and its PRE.

165. The 1984 guidance allowed, but did not require, the prudential regulator to request details of the assumptions used in the Appointed Actuary's certificate. Given that regulation of insurance companies at that time was based predominantly on information provided in the regulatory returns, it would not have been proportionate for the regulator (or GAD) to request details of the Appointed Actuary's calculations, except where there was clear evidence from information provided in the regulatory returns (and particularly in the "matching rectangle", Form 57) to suggest that the application might not be adequately supported. That was not the case for any of the applications made by ELAS.

<u>Section 68 orders granted to ELAS</u>

166. There is no evidence that the prudential regulator at any time wrongly granted any application made by ELAS for a section 68 order to permit it to take credit for a future profits implicit item. Lord Penrose in his report expressly accepted that the

[83] See Penrose Report, Chapter 10, paragraph 10.

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section 68 order made in September 2000 (and by implication each earlier order) "*was proper and in accordance with the regulations*".[84]

167. The criticisms made by Lord Penrose in his report appear principally to focus on the regulatory regime itself for allowing the use of such measures, at least on the basis then prevailing. But that was the policy of the time, reflected in the EC Life Insurance Directives, and, as explained above, it was a rational and defensible policy.[85] The only basis for an allegation of maladministration would be if the prudential regulator had improperly granted any section 68 order and thereby allowed improper credit to be taken in ELAS's regulatory returns as a result. No section 68 order was improperly granted.

168. Lord Penrose commented, rightly, that "*future profits implicit items were there to be used: the regulations provided for them.*"[86] However, he went on to say that "*... the second aspect of the certificate* [i.e. to the effect that the amount claimed was less than the present value of projected future surplus] *was not supported by the kind of extensive or penetrating analysis and projections of future trends that might have been expected.*" At the time in question, under the regulatory regime in force, such supporting material would not have been expected. The thrust of regulatory policy was antithetical to such an approach. It is a matter for argument whether a different policy would or would not have been preferable, but there is no reasonable basis, given the policy then in operation, for suggesting that such supporting material ought to have been demanded by the prudential regulator.

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84 See Penrose Report, Chapter 19, paragraph 179.

85 It appears that part of Lord Penrose's concern was that when these surpluses were released as policies matured they in part funded the terminal bonus payouts. It is correct that some of the surplus which could be expected to emerge in subsequent actuarial valuations could, and in practice likely would, be used to finance terminal bonus payments. But this fact was not altered by the granting of a section 68 order in respect of a future profits implicit item. The amount of bonus (both reversionary and terminal) that could be declared by the company was constrained by the surplus emerging in the statutory valuation. But the surplus emerging in any year was unaffected by the implicit item, which was not an asset of the company and had no bearing on the valuation result reported in Form 58. Nor did the implicit item have any impact on the company's realistic solvency position, because this item was used only as an allowable item towards cover for the required margin of solvency in the regulatory returns, and so was relevant only to the statutory solvency position.

86 See Penrose Report, Chapter 7, paragraph 12.

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169. So far as the period after 1 January 1999 is concerned, the Parliamentary Commissioner concluded in her first report (at paragraph 177) that it was difficult to see on what grounds FSA could reasonably have refused ELAS's applications, and that had they done so ELAS may have had strong grounds for complaint that they were being singled out unfairly for action which would almost inevitably have put them in jeopardy of failing to cover the required margin of solvency. It is suggested that this analysis is absolutely correct, and that its logic applies throughout the material period covered by the current complaints.

Alleged failure to assess overall impact

170. It is alleged by the complainants that the prudential regulators and GAD "*did not properly assess the overall impact and adequacy of those measures*". There is no justification for this allegation, as the regulators and GAD fully took into account the overall impact and adequacy of the measures and properly decided that there was no reason at the time to be concerned[87].

171. First, ELAS on all occasions until 2000 applied for and used less (and generally substantially less) by way of credit for future profits implicit items than they were entitled to under the regulations.

172. Second, the taking of credit for such items was not a matter unique to ELAS. Far from it. Figure 1 below shows that significant use of future profits implicit items was made by life companies during the period between 1985 and 2001. The aggregate value of these items increased markedly during this period. ELAS was by no means the first company to take credit for such an item, and the significant increase in its use of such items in the period 1995-2000 was not out of line with the increase in the aggregate amount for the industry. There was accordingly

87 In addition to the points made in the response to this Complaint, see also the response to Complaint J.

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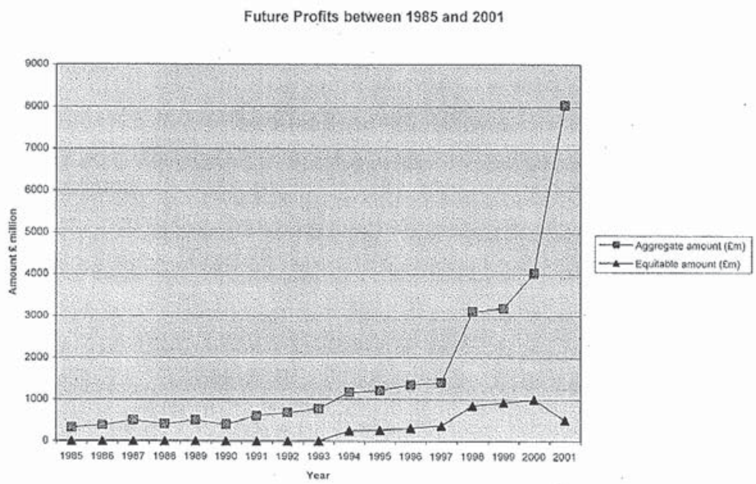
nothing untoward or surprising in the applications for section 68 orders made by ELAS in respect of these items.

Figure 1



Source: GAD Synthesis database

173. Similar considerations apply to the use of subordinated debt in 1997, if this is included in the measures to which the complainants intend to refer.

174. Figure 2 below shows that subordinated debt liabilities were left out of account by a significant and increasing number of life insurance companies from 1995. The aggregate value of these excluded liabilities increased markedly during the period 1995-2001. ELAS was not the first company to leave such a liability out of account, and its excluded liability, whilst initially a high proportion of the aggregate amount for the industry in 1996, reduced to only some 15% of this amount by 2001.

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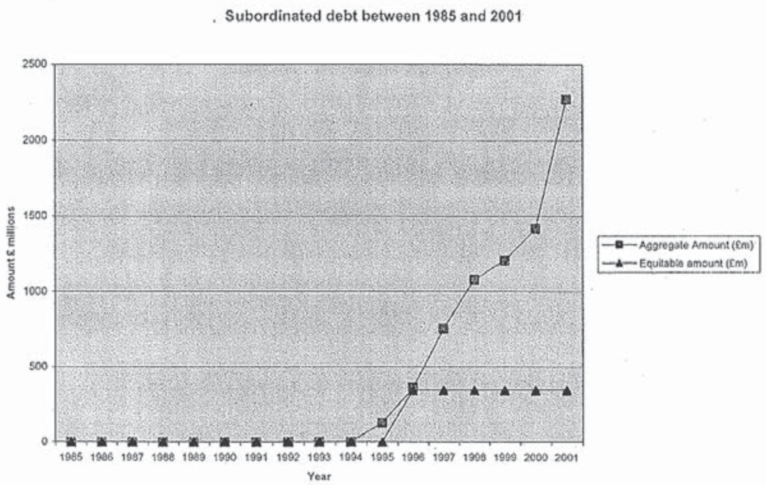
Figure 2



Source: GAD Synthesis database

As is clear from Figure 3, the combined value of the use of these measures by ELAS was not out of line with trends in the industry generally.

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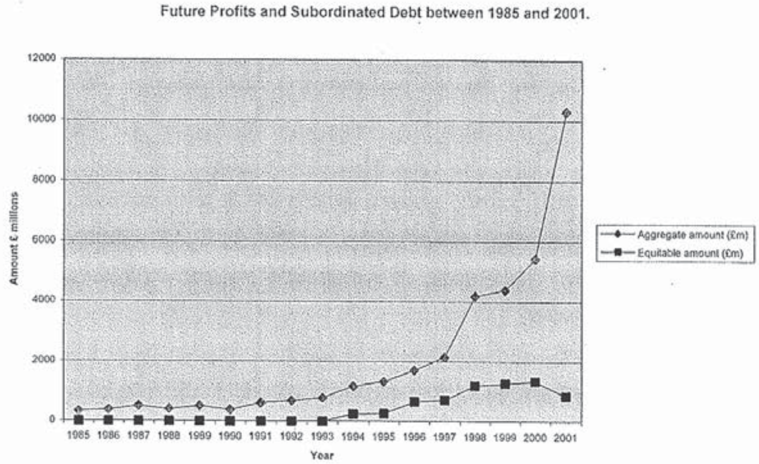
Figure 3



Source: Combined figures from Figure 1 and Figure 2

Use of the term 'surplus'

175. Complaint H also contains an allegation that the prudential regulators "*allowed ELAS to mis-use the term 'surplus'*". This allegation is not understood. 'Surplus' is a standard term used by life insurance companies, which takes its meaning from the relevant legislation; and there is no evidence of which the regulator is aware that ELAS used the term in any different sense from the standard sense or from the rest of the industry.

Complaint I

"Over this same period, the regulators allowed ELAS to publish financial results and projections that were misleading in that they did not reflect the Society's true position. In particular, ELAS was allowed to habitually report growth rates alongside bonus rates, which gave the impression of a prudent margin for error, whereas the true position was that:

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- *assets were consistently less than policy values so that higher rates of growth were needed to cover any given rate of bonus; and*
- *as part of the growth was needed to cover expenses and the contractual liability for conventional annuities, the growth available to meet with-profits bonuses was always materially less than the rate quoted in ELAS literature. This was never made clear.*"

176. The complainants' primary concern, as reflected in this Complaint, appears to relate to financial results and projections included by ELAS in literature supplied to its customers. The accuracy of such material was not within the remit of the prudential regulator.[88]

177. ELAS reported growth on its with-profits policies in the form of a guaranteed reversionary bonus and a non-guaranteed terminal bonus. The aggregate "growth", being the total of these amounts, was sometimes higher and sometimes lower than the rate of return on the fund.[89] This reflected a deliberate policy which the management of ELAS and its Appointed Actuary elected, and were entitled, to adopt. It was not for the prudential regulator to prescribe or restrict the approach to be followed, provided it complied with statutory requirements.

178. In characterising what they say was ELAS's "*true position*", the complainants assert that "*assets were consistently less than policy values*". It is not clear on what the complainants base this assertion; but it may be based on calculations which were carried out by Lord Penrose by reference to ELAS's internal office valuation accounts. Those accounts were not seen at the time by the prudential regulator or GAD. Moreover, it is unclear from the presentation of these results in the Penrose Report, or from similar calculations carried out by Burgess Hodgson, how these calculations ensure proper consistency of assets and liabilities, since

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88 When the prudential regulator had concerns that bonus notices issued by ELAS might be misleading, those concerns were communicated to the conduct of business regulator: see the response to Complaint B above.

89 This was illustrated in the with-profits guide for policyholders, which showed how, on average and over time, policy values grew in line with the value of the fund.

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the issue is confused by different methods of assessing the value of the assets, including factors which are not permitted to be taken into account for statutory purposes but which could reasonably be taken into account on a realistic basis. The value of policies was also dynamic, since terminal bonus, even if regarded as an entitlement, is only paid out when a policy becomes a claim and a proper analysis would therefore need to take the form of a full future financial condition report.

179. Comparison of policy values against asset values is of course a complex actuarial exercise where different professional opinions are possible and which depends on the methodologies and assumptions underlying the calculations[90]. However, it is not necessary to expand further on this for two reasons:

(1) The prudential regulator approached the issue on the basis of the valuation requirements set out in the regulations. Under these requirements ELAS's coverage of the required solvency margin (as shown by its regulatory returns) never dropped below 1.34 (i.e. still a third more than the required level) between 1989 and 2000.

(2) In the absence of a breach of these requirements, the relationship between asset values and policy values in "realistic solvency" terms was a matter for the professional judgment of the Appointed Actuary and the commercial judgment of ELAS's Board.

180. No instances have been identified in which the prudential regulator or GAD allowed any financial results or projections to be disclosed in the regulatory returns, or any bonuses to be declared, that were contrary to the statutory regulations.

[90] Smoothing policy is also a relevant factor – as to which please see further discussion under Complaint L below.

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181. The only potential relevance of literature supplied to customers for the prudential regulation of ELAS was in relation to PRE: as to which see the Response to Complaints N and O below. It was recognised by the regulator that ELAS's practice of presenting total policy values to with-profit policyholders in bonus notices, which included an accrued terminal bonus element, potentially raised PRE issues. The key issue was the extent, if any, to which this presentation gave with-profits policyholders a reasonable expectation that the accrued terminal bonus element, and thus potentially their total policy value, would not go down in future years. Because the bonus notices clearly stated that the terminal bonus element of the total policy value was not guaranteed it was reasonably open to the prudential regulator to conclude that this was not a reasonable expectation[91]. Nevertheless concerns about the risk of expectations being created were discussed with ELAS, for example on the 1996 regulatory returns[92].

Complaint J

"During this period, the regulators and GAD failed to act when ELAS adopted what Lord Penrose described as practices of 'dubious actuarial merit'. These included valuing future liabilities at an inappropriate rate of interest between 1990 and 1996; treating selling costs as an asset; making no provision for GARs until much too late; valuing a financial re-insurance policy (which proved to be of no value) at over £800 million; allowing credit for 'aspirational' (i.e. effectively unrealisable) assets; responding too slowly to widely evidenced changes to mortality expectations; and the issuing of a subordinated debt worth £346 million which did not count as a liability."

Actuarial practices adopted by ELAS

182. Lord Penrose was critical in his report of the merits of certain actuarial practices adopted by ELAS, and (with the benefit of hindsight) expressed concern about the regulatory response to six such practices.[93] At the same time Lord Penrose

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91 It is worth noting that Lord Penrose felt that there would be no constructive obligation either – see Chapter 10 paragraph 83 of his Report.

92 See Penrose Report, Chapter 16, paragraph 242.

93 See Penrose Report, Chapter 19, paragraph 166.

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acknowledged that most of the steps taken by ELAS were "*within the limits allowed in the valuation regulations and published guidance*".[94]

183. The prudential regulators' reaction to ELAS's use of these actuarial practices must be seen in the context of the relevant requirements of the statutory regulatory framework and the reliance that the system placed on the role of the Appointed Actuary. Fundamentally, the actuarial practices employed by ELAS were a matter for the professional judgment of the Appointed Actuary, acting of course within the limits allowed in the regulations. Provided the practices adopted were within these permitted limits, the regulators and GAD cannot properly be criticised for not taking regulatory action.

184. Having said that, as explained below, not all of the actuarial practices adopted by ELAS were permissible, and when practices which were impermissible came to the regulator's attention, they were dealt with. See, in particular, the discussion below of ELAS's use of the 'quasi-Zillmer adjustment'.

185. The seven actuarial practices specified in Complaint J (which include five of the six areas of concern identified by Lord Penrose[95]) are discussed in turn below.

(i) Valuing future liabilities at an inappropriate interest rate

186. Lord Penrose criticised the practice adopted by ELAS, between 1990 and 1996, of using different interest rates for projecting gross bonus rates and for discounting liabilities, with the result that "*the liabilities in respect of recurrent single premium business were valued at less than face value*".[96]

187. The prudential regulator was appropriately concerned at all times to ensure that the interest rates used by ELAS for its statutory valuation were permissible under

[94] Ibid, paragraph 167.

[95] The other area of concern identified by Lord Penrose was the use of future profits implicit items, which has been addressed in the response to Complaint H above.

[96] See for example Penrose Report, Chapter 19, paragraph 102.

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the statutory regulations. They were. In particular, regulation 69 of the 1994 Regulations (and its equivalent under the 1981 Regulations) was complied with at all times. There was also no breach of regulation 65(5) of the 1994 Regulations.[97]

188. What is more, there were potentially good reasons for making valuation assumptions which valued liabilities at the lower end of the permitted range. Such a valuation enhanced investment flexibility and obtained increased investment freedom, which was a legitimate commercial objective.

189. Lord Penrose objected to ELAS's practice of using an interest rate in its bonus reserve valuation which was greater than the projected future rate of bonus, on the ground that this was contrary to "*best actuarial practice*" and to "*the accepted actuarial opinions expressed by GAD officials*".[98] In fact, there was no established best actuarial practice on this point at the time, and there was no GAD view that had been externally expressed or accepted at that time.

190. The prudential regulators and GAD were aware of the interest rate differential adopted by ELAS in its bonus reserve valuation, and considered its appropriateness at the relevant time. However, what was of prime importance from the regulator's perspective was the *net premium valuation*. The interest rate assumptions with which Lord Penrose took issue related to the *bonus reserve* valuation, in which explicit allowance had to be made for future bonuses, and *not* to the net premium valuation, which did not require any assumption regarding

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[97] This was introduced for the first time in 1994, and required that the calculation of the amount of liabilities and the assumptions used must not be subject to discontinuities from year to year arising from arbitrary changes and must be such as to recognise the distribution of profits in an appropriate way over the duration of each policy. This requirement was sometimes used by the regulator to challenge inappropriate trading off of prudential margins in demographic and economic assumptions. But given that the valuation interest rates used by ELAS evidently remained close to the supporting asset yields throughout, it would not have been possible or appropriate to argue that the changes being made were arbitrary, as they were clearly related to the actual experience of the underlying assets. There was also no breach of the requirement in regulation 65(5) to "*recognise the distribution of profits in an appropriate way over the duration of each policy*" because of the net premium test that needed to be satisfied in the valuations – this constrained the amount of surplus that could be declared in each year.

[98] See Penrose Report, Chapter 19, paragraphs 51 and 169.

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future bonus levels. Crucially, the aggregate reserves in the bonus reserve valuation were required to be no less than those in the net premium valuation, which had to comply fully with the regulations and which therefore constrained the amount of surplus reported each year. It was on the net premium valuation that the regulators and GAD necessarily had to focus to discharge their central obligation of ensuring that ELAS's reported solvency position met the statutory requirements.

191. The margins in the valuation interest rates used by ELAS in the net premium valuation were understandably modest given the adverse investment conditions prevailing at the time. However, at no time did the interest rate assumptions used contravene the regulations.

192. Lord Penrose does not dissent from the judgment reached at the time, but suggests that it is clear (with hindsight), on a review of ELAS's realistic position, that "*the contemporary view reflected a concentration on the global position of the Society that gave inadequate weight to inter-generational implications of decisions*".[99] This is not a valid ground for criticism of the prudential regulators. The focus of regulation at the time was, properly, on the "*global position of the Society*". Inter-generational effects on different cohorts of policyholder were principally a matter for ELAS's Board rather than for the regulator (subject to PRE considerations – as to which see Complaints N and O below).

193. Lord Penrose also commented that this practice "*generated surplus available for allocation by mathematical means that were inconsistent with an intuitive view of the Society's ability to pay.*"[100] In fact, the practice did not generate surplus available for allocation because, as explained above, the amount of surplus available for allocation each year was constrained by the net premium valuation. In any event regulation was not, and ought not to have been, carried out on the

99 See Penrose Report, Chapter 19, paragraph 170.
100 Ibid, paragraph 51.

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basis of an "*intuitive view*". It was carried out in accordance with the statutory regulations in force from time to time.

(ii) Treating selling costs as an asset (the 'quasi-Zillmer adjustment')

194. A 'Zillmer adjustment' allows for the uneven incidence of expenses incurred by a life insurance company writing new regular premium policies and effectively spreads the costs of writing the policy over its future life. Regulation 68 of the 1994 Regulations (and regulation 58 of the 1981 Regulations) provided for an adjustment of this nature, in recognition of the fact that where future premiums were being valued in terms of regulation 67, the maximum annual premium to be valued would not take account of the reality that the life insurance company would have priced the product on the basis that un-recouped initial or acquisition expenses would be recovered from future premiums. The adjustment was permitted, subject to applicable limits, to increase the permissible future premium by annuitising the un-recouped expenses over the remaining period during which the regular premiums were payable.

195. A 'Zillmer adjustment' is not, however, appropriate for recurrent single premium policies where the policyholder has a right but not an obligation to make further premium payments.[101] That is why the 'quasi-Zillmer adjustment' made by ELAS in respect of recurrent single premium policies in its resilience reserve calculations was inappropriate and why the regulator clamped down on the use of such an adjustment as soon as its use came to its attention.

196. Lord Penrose rightly commented that the quasi-Zillmer adjustment adopted by ELAS in calculating its resilience reserve was not "*consistent with sound and prudent actuarial practice*".[102]

[101] The adjustment was permitted where "*further specified premiums are payable by the policy holder under a contract...*": see regulation 67 of the 1994 Regulations.

[102] See Penrose Report, Chapter 19, paragraph 52.

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197. The use by ELAS of this quasi-Zillmer adjustment was not disclosed to the prudential regulators by the Appointed Actuary, as his professional obligations required him to do. In consequence, the true nature of the adjustment was not identified by GAD until its detailed scrutiny of the 1999 regulatory returns. Such previous references as had been made to the adjustment were scattered and opaque and fell well short of the disclosure required. There is one alleged exception that is disputed, as explained below.

198. There is no doubt about the failure of ELAS properly to disclose the use of this impermissible actuarial technique. Indeed, even after his exhaustive inquiry, Lord Penrose was still unable to date when it began to be used more precisely than "*some point in the 1990s*."[103] He said: "*The year in which ELAS first made use of a quasi-Zillmer adjustment in the form that ultimately became controversial is not known.*"[104] Nor could he say how the sum of £950m, which was the ultimate gross value of the adjustment when it came to light (before adjusting for other factors – see paragraph 191 below), was built up.[105]

199. The adjustment was the subject of a brief aside in the regulatory returns from 1994 onwards but its nature was not made apparent. Prior to that, there was no mention at all of any such adjustment in ELAS's regulatory returns. Lord Penrose recognised that the regulatory returns, which were the key regulatory tool, did not disclose the quasi-Zillmer adjustment in anything like appropriately clear terms. As he said in Chapter 7 of his report:[106]

> *"References were included in the regulatory returns for 1994 onwards, but not in clear terms that would have alerted the scrutinising actuary.....The only way to have identified the adjustment at that stage would have been to have examined in detail the Society's resilience calculations...."*

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103 See Penrose Report, Chapter 19, paragraph 123.
104 See Penrose Report, Chapter 7, paragraph 21.
105 Ibid, paragraph 26.
106 Ibid, paragraphs 24 and 33.

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> *"The disclosure in the 1996 returns has been generously described…as 'cryptic'. One could say no less about the 1994 and 1995 returns. Given the confused state of the information provided, it was perhaps understandable that GAD failed immediately to detect the true meaning of the disclosures."*

200. The adjustment was presented in a way that suggested (incorrectly), even to an experienced reader, that it related to an allowance for future expenses, which increased the reserve. In the circumstances, the assumption that the adjustment related to ongoing expenses was a perfectly logical one.

201. Not only was the adjustment not disclosed as it should have been, but the 1994 regulatory returns, in which an opaque reference to it first appeared, followed a meeting in December 1994 at which [redacted] had told DTI and GAD, in terms, that ELAS "*took no account that 90% of the recurrent single premiums would be renewed*"[107].

202. If that statement were true, it is very difficult to see how it could be reconciled with any Zillmer adjustment in the resilience reserve for recurrent single premium business. The prudential regulator was entitled to take [redacted] at his word and proceed on the basis that he had told the truth. It now appears that what [redacted] told the regulator was false, and that [redacted] may well have known this.

203. Use of the adjustment in the way that ELAS's Appointed Actuary turned out to be using it was completely unknown. The Zillmer adjustment had never been considered in the actuarial literature for the purpose for which the Appointed Actuary was using it and no other company had sought to use such an adjustment for this purpose. This was a further reason for GAD not to suspect that the nature of the adjustment was such as ultimately emerged.

107 See Penrose Report, Chapter 7, paragraph 30.

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204. Given the novelty and obscurity of the adjustment, and given the finite time that was available for the completion of each detailed scrutiny, it cannot be regarded as maladministrative for this opaque detail in a document of several hundred pages to have been accepted at face value and not made subject to specific follow-up. As soon as the true nature of the adjustment was discovered, it was swiftly identified as inappropriate and required by the regulator and GAD to be removed.

205. On analysis, the only basis advanced by Lord Penrose for possible criticism of regulators on this issue is a letter from ELAS of 6 November 1992 which did not form part of the regulatory return. Lord Penrose said:[108]

> *"The information provided by the Society to GAD, apart from the letter of 6 November 1992, was not clear until* [redacted] *was challenged on the 1999 return."*

206. The letter of 6 November 1992[109] included the following words:

> *"……new business did not produce a strain during 1991. This was due mainly to the fact that the valuation bases for recurrent single premium business released monies at the outset in a similar way to the release produced by a zillmer adjustment."*

It is this brief remark on which Lord Penrose founds his observation at Chapter 19, paragraph 130 of his report that "*the intimation of a quasi-Zillmer adjustment to the regulator in November 1992, affecting the valuation bases at the time, was clear, and should have caused comment.*"

207. The HMT, FSA and GAD do not accept that the remark can possibly bear the weight which Lord Penrose, applying the benefit of hindsight, attributed to it. It was very far from clear that what was being referred to in the letter of 6 November 1992 was a Zillmer adjustment to ELAS's statutory valuation basis. Indeed, there were several good reasons for naturally understanding otherwise.

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108 See Penrose Report, Chapter 19, paragraph 173.
109 A copy of which can be found at pages 319 – 321 of the Annex.

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208. In the first place, such an adjustment did not appear anywhere in ELAS's 1991 regulatory returns, which were the immediate catalyst of the correspondence of which [redacted] 6 November 1992 letter formed a part.

209. Secondly, the reference to releasing monies in a way similar to a Zillmer adjustment was made in the context of a reference to generic "*valuation bases*". There was only one statutory valuation basis. Other valuation bases would include ELAS's own internal office valuation. It was not apparent from the letter that the adjustment was relevant to the former rather than the latter.

210. ELAS's response to the 1993 bonus survey, shortly after the letter of November 1992, showed that a similar adjustment was indeed used by ELAS in the asset share calculations made for its internal office valuation. In contrast, no mention was again made of such an adjustment in the 1992 regulatory returns, which was the next return to be supplied after the 6 November 1992 letter. The subsequent 1993 return also made no mention of the quasi-Zillmer adjustment.

211. Finally, and importantly, at the time the November 1992 letter was received GAD was already aware from [redacted] letter of 12 May 1992,[110] that ELAS appreciated that there was "*no accepted method of "Zillmerising" recurrent single premium business.*" Given this clear, and entirely accurate, statement in May 1992, it is hardly surprising that the reference in the November 1992 letter, which was not reflected in any adjustment disclosed in the previous or next two following regulatory returns, was not picked up as being precisely that which [redacted] had so recently acknowledged was not possible.

212. In such circumstances, it is not surprising that GAD, charged as it was with a review of the regulatory returns, did not follow up the passing reference in this one letter to a release of monies in a similar way to a Zillmer adjustment. Lord

110 See Penrose Report, Chapter 16, paragraph 60.

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Penrose no doubt chooses his words carefully when he says that GAD had "*intimation*" of the practice in November 1992.[111] With the benefit of hindsight, of course, it is easy to say that there could have been further follow-up of the point in November 1992. But in the context at the time, GAD cannot reasonably be criticised for failing to appreciate its significance. Furthermore, given the complete non-disclosure of the adjustment in the next two regulatory returns, and given the misleading presentation by [redacted] at the 1994 meeting, it must be seriously doubted whether any further correspondence following that of 6 November 1992 would have borne any recognisable fruit.

213. It should be added that it is not accepted that the impact of the quasi-Zillmer adjustment was significant in the context of ELAS's subsequent difficulties. The adjustment was used only in the determination of the resilience reserve, and not in the calculation of policy liabilities. It may also be noted that the quasi-Zillmer adjustment, while relevant for statutory purposes, had no effect on ELAS's realistic solvency position.

214. The size of the impact on the resilience reserve is known only with hindsight. The increase in that reserve which resulted from the removal of the adjustment in the 1999 regulatory returns was £200m, made up of a £950m gross cost, offset by a saving of £750m resulting from other ways in which the Appointed Actuary was able legitimately to reduce the resilience reserve, and which had not been called upon when the adjustment had been in use.

215. Until that time, the Appointed Actuary had chosen not to take advantage, to the full extent that was permissible, of the option to hypothecate particular assets to match particular groups of liabilities under regulation 69(12) of the 1994 Regulations (and its equivalent under the 1981 Regulations) in calculating the resilience reserve. This meant that there was an implicit prudential margin in the reserve, which the Appointed Actuary was entitled to reduce.

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111 See Penrose Report, Chapter 19, paragraph 173.

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216. The figure of £200m should be viewed in the context of available assets of £3.9bn (which sum allows for the above net increase in the resilience reserve) covering the required solvency margin of £1.1bn reported by ELAS in 1999, and of the £1.6bn gross GAR reserve (reduced to a net reserve of just over £0.5bn on account of the GAR reinsurance treaty) held by ELAS in that year.

217. There is also the more general point that the various complaints relating to ELAS's regulatory solvency position – including the quasi-Zillmer adjustment – are only as important as ELAS's regulatory solvency position itself. Yet it is also complained that regulatory solvency, at least in the later years, was of increasing irrelevance and that the prudential regulator should have been focussing its attention on ELAS's realistic solvency position. There is a clear tension between these two complaints.

(iii) Failure to make provision for GARs

218. This point has been addressed in the response to Complaint G above.

(iv) The financial reinsurance policy

219. With effect from 31 December 1998, ELAS entered into a financial reinsurance treaty agreement with Irish European Reinsurance Company Limited ("IERC"). The purpose of the reinsurance treaty was, as ELAS put it in its 1998 regulatory returns, to "*provide surplus cover for the costs arising from the exercise of guaranteed annuity rates in respect of Retirement Annuity Policies, Individual Pension Plans and Transfer Plans issued before 1 July 1988.*"

220. Under the reinsurance treaty, IERC agreed to pay for the additional costs of GAOs should they be exercised on more than 25% of the funds retiring in any one year. If that were to happen, IERC would be liable to pay ELAS an amount which

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equalled the additional cost of providing an annuity at the GAR compared with the cost of an annuity at current market rates. IERC would, in return, then have a "call" on surplus emerging after the date of claim under the reinsurance treaty.

221. Taking credit for rights under reinsurance contracts did not require a section 68 order, because it was already expressly permitted under the valuation of liabilities provisions of the 1994 Regulations.

222. ELAS made proper disclosure of the reinsurance treaty in its 1998 regulatory returns, following a firm stance taken by the regulator at a meeting of 28 January 1999, when the regulator had emphasised:

> *"...any presentation [in regulatory returns] which did not show separately the gross liability and reinsurance cover would be artificial and hence potentially misleading. In view of the significance of the reinsurance agreement to the company's solvency position it was important that the level of dependence on the reinsurance was clear to readers of the returns."*

223. The reinsurance agreement was conditional on there being no change to ELAS's terminal bonus practice. This was a point which the prudential regulator was fully alive to, and had cautioned ELAS about, as recorded at paragraph 4.28.7 of the Baird Report. Following the House of Lords' judgment, such a change was indeed necessary, and the reinsurance treaty was renegotiated with the "take up" assumption rate increased from 25% to 60%.

224. It was not for the prudential regulator to decide whether or not to accept a reinsurance agreement entered into by a life insurance company as a means of complying with its statutory reserving requirements. It was the Appointed Actuary's responsibility to decide on the level of credit that could be taken in the regulatory returns for the treaty, taking into account the risk that it might be cancelled and its effect on ELAS's solvency when combined with other measures used in the solvency calculations.

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225. The Parliamentary Commissioner has dealt with these issues in her first report. She concluded that:[112]

(1) Given that reinsurance was an accounting practice which was accepted as legitimate by the profession and the industry, and backed by FSA's own professional advisers, FSA could not reasonably have refused to accept its use in ELAS's case;

(2) The FSA, with GAD's advice, took an active interest in the terms of the agreement and suggested a number of amendments in order to protect policyholders' interests;

(3) The fact that the reinsurance agreement only stood as long as the differential terminal bonus policy remained unchanged did not render the agreement imprudent or make it worthless if the policy changed, but only meant that the agreement had to be renegotiated in that eventuality – which it was.

(4) She was satisfied that FSA's acceptance of the reinsurance agreement was not maladministration.

226. These conclusions were all entirely correct.

227. Lord Penrose took the view that the reinsurance treaty did not, in fact, transfer material risk to the reinsurer and was not, in his view, a contract of reinsurance at all. His view was that in reality the transaction was a financing arrangement that established a contingent right to draw down funds, and that to treat such a right as an asset was not permitted by the regulations.[113]

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112 See "*The Prudential Regulation of Equitable Life*", Part II, paragraphs 172-173.

113 See Penrose Report, Chapter 7, paragraphs 104-5 and Chapter 19, paragraph 194. Lord Penrose felt that the premium payable was evidence that the amount of risk transferred was small. However, the premium to which Lord Penrose refers was not the totality of ELAS's obligation under the treaty. There was also included within the treaty an obligation for ELAS to pay the reinsurer a "risk amount" each year of 2% of the cumulative amount of claims made by ELAS under the treaty out of surplus emerging subsequently, which additional payments were potentially very significant.

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228. HMT, FSA and GAD disagree fundamentally with this view. FSA have sought fresh advice on this, and are satisfied – as they were at that time – that both European and domestic legislation permitted contracts in this form to be given a value in determining the regulatory solvency position of insurance companies. In acting as it did, the prudential regulator acted in accordance with the Statement of Recommended Practice subsequently issued by the Association of British Insurers in 2003.[114] Whether a contract between an insurance company and a reinsurer is properly to be regarded as a contract of reinsurance is sometimes not an easy question. Even if Lord Penrose's view is right, however, (and it is emphasised that this is disputed), the view taken by the regulator cannot be said to have been an improper one at the time.

229. Lord Penrose also thought that the contingency of ELAS losing the *Hyman* case was not reflected in the value that was taken into account.[115] HMT, FSA and GAD disagree. The risk of the treaty being cancelled if ELAS lost its court case was fully appreciated by GAD and the prudential regulator when considering the credit that was taken. The legal advice obtained by the regulator before the *Hyman* litigation was that it would be difficult to take issue with the view of ELAS's counsel that on balance its practices were valid in terms of contract and trust law. ELAS was of course successful in the High Court, so at that stage there certainly was no reason to believe that there was a high risk that the treaty would be cancelled. The amount of credit that could be taken was re-considered after the judgment of the Court of Appeal. At that stage the ring-fencing of the relevant liabilities appeared to be a potential option. Had ring-fencing been allowed by the

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This structure of payments was consistent with the nature of the treaty, which was covering a financial timing risk. The regulator considered that ELAS's *aggregate* obligation under the treaty, *including* the "risk amounts", reflected the reinsurer's perception of the risk that it was assuming under the treaty (which itself will have depended on the reinsurer's assessment of the merits of ELAS's differential terminal bonus policy). The regulator had no way of knowing that the operation of the treaty was subject to potential modification as a result of a "side letter" the existence of which was concealed from it.

114 This is quoted at Chapter 7, paragraph 66 of the Penrose Report.

115 See Penrose Report, Chapter 19, paragraph 195.

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House of Lords, the re-insurance treaty would not need to have been re-negotiated.

(v) Allowing credit for aspirational assets

230. It is not understood what actuarial practice this allegation is intended to describe.

231. There is no basis for suggesting that credit for any assets of an intangible nature was improperly taken in the course of demonstrating statutory solvency in the regulatory returns submitted by ELAS. Regulation 45(3) of the 1994 Regulations (and its equivalent under the 1981 Regulations) specifically required that any asset for whose valuation no provision was made in Part XIII of the 1994 Regulations (and its equivalent under the 1981 Regulations) had to be left out of account. Such excluded assets included intangible assets of all kinds. There is no evidence that the asset valuation regulations were not complied with fully by ELAS at all times.

(vi) Responding too slowly to changes to mortality expectations

232. The claim that the prudential regulator and GAD "*respond[ed] too slowly to widely evidenced changes to mortality expectations*" does not reflect a concern expressed by Lord Penrose about the regulatory response to ELAS's actuarial practices, but appears to be based on a comment on mortality assumptions made by Lord Penrose in relation to the conduct of the Board of ELAS.[116]

233. It is not the case that GAD or the prudential regulator failed to keep track of changes in mortality expectations. On the contrary, before the start of each scrutiny year, GAD issued internal guidelines to its actuaries as to the strength of the mortality assumptions that should be looked for in the regulatory returns,

[116] See Penrose Report, Chapter 19, paragraph 102. This comment is stated in a footnote to be based on material contained in Chapters 6, 16 and 17 of the report but no specific cross-references are provided.

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taking into account the need for these to be prudent as required by regulation 70 of the 1994 Regulations (and its equivalent under the 1981 Regulations). The purpose of these guidelines was to provide an indicator of when these assumptions should be challenged. They were set following a detailed analysis of the most recently available pooled mortality experience of life insurance companies, as collated and reported annually by the Continuous Mortality Investigation Bureau, a research body established by the UK actuarial profession and funded by the participating life companies.[117] The guidelines made allowance for future mortality improvements for annuitants.

234. These guidelines, however, were not intended to be prescriptive. GAD and the prudential regulator always recognised that each life insurance company faces unique mortality and morbidity experience according to the profile of risks on its books. It is a matter for individual firms to adapt the standard mortality tables to meet these individual risks, which only they are in a realistic position to assess. The role of the regulator, through GAD, was to ensure that relevant factors had been taken into account and that conclusions reached were reasonable. GAD was frequently at the forefront of challenging commonly held assumptions of the profession, including those relating to mortality, and seeking to ensure a prudent interpretation of the regulations.

235. This approach is illustrated by the close watch which GAD kept on ELAS's use of mortality expectations. For example, GAD specifically requested information from ELAS about the use of mortality rates that "*looked light*" as part of the process of scrutiny of the 1993 regulatory returns.[118] The following year, it challenged the mortality assumption used by ELAS's Appointed Actuary for general annuity contracts in its detailed scrutiny of ELAS's 1994 regulatory

117 GAD was represented on the Steering Committee and Mortality Subcommittee of the Bureau. The reports were received by the Government Actuary as a member of the Committee and passed on to C Directorate of GAD.

118 See Penrose Report, Chapter 16, paragraph 144; and also paragraph 145.

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returns.[119] GAD continued to have regard to the need to press ELAS to strengthen its mortality assumption for such contracts appropriately as annuitant longevity improved.[120] These consistent efforts did achieve results (see, for example, [redacted] on 22 November 1994 and 21 February 1996, accepting that strengthening of mortality assumptions was appropriate[121]).

236. It is simply not true that the prudential regulator/GAD responded too slowly to "*widely evidenced changes*" to mortality expectations. GAD always required companies to make prudent allowance for mortality, including, in the case of annuities, prudent allowance for future improvements in mortality. What is true is that the acceleration in the improvement of such expectations during the 1990s was unprecedented. The regulator cannot be blamed for not fully anticipating the extent of these changes. However, GAD reacted appropriately to what was a moving target as the progressive inadequacy of the allowance already made for mortality expectations became "*widely evidenced*".

(vii) The Subordinated Loan

237. Under the 1994 Regulations, loan capital could not generally be counted as cover for the required solvency margin, because the value of the money received was offset by a corresponding liability to repay the loan with interest. However, those same regulations provided that loan capital could be counted if the obligation to repay the loan was subordinated to the rights of policyholders and a section 68 order was obtained.[122]

119 Ibid, paragraph 184.
120 Ibid, paragraphs 199 and 201.
121 See Penrose Report, Chapter 16, paragraphs 148 and 185.
122 These provisions gave effect to mandatory requirements of Article 25(1) of the Third Life Directive, which set out the relevant criteria to be met in order for a subordinated loan to be included within capital (see also paragraph 89 of the Regulatory Paper).

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238. A £350m loan was treated as subordinated by ELAS in calculating its solvency position in its regulatory returns for 1997 and later years. This treatment was properly authorised by the regulator. As Lord Penrose concluded:[123]

> *"The Society was authorised to ignore subordinated debt in calculating its form 9 solvency position. The authorisation was within the scope of the relevant regulations and guidance. I do not criticise any of the formal steps taken or the propriety of the order granted".*

The relevant guidance note was Prudential Guidance note PGN 1994/1.

239. Lord Penrose suggests that ELAS's interest in raising this form of debt should have alerted regulators to its weakening position.[124] Putting the point at its highest, it could perhaps be said that the fact that ELAS obtained the subordinated loan *could* have been an indication that ELAS itself saw difficulties ahead. But that was not how the measure was represented by ELAS to the prudential regulator, whether in its regulatory returns or otherwise, as explained below.

240. On the contrary, it seems that when the Board of ELAS first considered subordinated loan capital, in 1993, it did so pursuant to an interest in raising capital from members on an ongoing basis, and giving members of ELAS an additional vehicle for investing on favourable terms.

241. It was in this context that [redacted] first approached DTI in 1993 about a proposal for the issue of up to £100m of redeemable individual bonds. In doing so, [redacted] told DTI that ELAS was not short of capital for its business expansion and presented a strengthening of the solvency position as a "*by-product*" of offering an attractive new investment opportunity to policyholders.[125]

123 See Penrose Report, Chapter 19, paragraph 183.
124 Ibid, paragraphs 184 and 187.
125 See Penrose Report, Chapter 16, paragraph 110.

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242. When the matter was revived with DTI in March 1997, [redacted] again expressly represented that the proposed loan was "*essentially for investment purposes*".[126] A section 68 order was issued in August 1997.

243. Nor did the market perceive the subordinated loan to be a sign of actual or impending weakness on the part of ELAS. As Lord Penrose acknowledged, the loan issue was successful.[127]

244. Although he accepted that the subordinated debt authorisation was within the regulations, Lord Penrose's criticism was that there was "*considerable difficulty in justifying the transaction on a broader basis*" on the ground that it added to the demands created by the financial reinsurance treaty and the use of future profits implicit items, thereby accelerating the benefit taken for future profits and reducing the resilience of ELAS to future events.[128]

245. It is true that subordinated debt has to be repaid out of future surplus (provided there is such surplus) and that there was an interest cost to ELAS of servicing the loan. But the relevant provisions in the regulatory regime allowed its use, and this was an accepted means for a mutual life insurance company (which did not have shareholders on whom to call for funds) to raise external capital. It should also be remembered that the calculations of future profits implicit items explicitly took account of the effect of other measures such as financial reinsurance and subordinated debt, so that the projected cost of such measures reduced the amount of future surplus available and in respect of which credit might be taken by way of future profits implicit items[129].

126 Ibid, paragraph 209.
127 See Penrose Report, Chapter 7, paragraph 58.
128 See Penrose Report, Chapter 16, paragraph 219.
129 See, for example, Chapter 18, paragraph 26 of Lord Penrose's Report, which shows that GAD explicitly required certification from ELAS's Appointed Actuary on the effect of the GAR reinsurance treaty in this respect when advising the regulator on ELAS's application for a future profits implicit item to be included in its 1998 regulatory returns.

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Complaint K

"On several specific occasions, as set out in the Penrose report, the regulators and GAD ignored or failed to act on information that might have led to formal or informal regulatory action against ELAS, thus also failing to alert new investors to the risks of investing. These include when ELAS board papers were sent to GAD by the appointed actuary on 11 June 1991, and when information was provided to GAD on 10 September 1992 which showed that, for the years 1989 to 1991, the aggregate policy values very significantly exceeded the value of the underlying assets."

246. Complaint K refers to "*several specific occasions*" when, so it is alleged, the regulators and GAD ignored or failed to act on information that might have led to regulatory action against ELAS. Two such alleged occasions are identified. They are dealt with in turn below. It is not possible to address any other occasions (if there are any) to which the complainants intend to refer, unless these are specified.

11 June 1991

247. In Chapter 16 of his report (at paragraphs 40-46), Lord Penrose refers to the provision by [redacted] to [redacted], on an expressly confidential basis, of certain Board papers relating to ELAS's 1990 valuation and bonus declaration together with a paper on investment for the March 1991 Board. These papers were provided under cover of a letter dated 11 June 1991.

248. Lord Penrose commented that:[130]

> "[redacted] *had been put in possession of critical information that disclosed the Society's precarious position, and the extreme nature of the steps taken to maintain bonus allocation in a year of severe losses."*

249. It is not accepted that the information was "*critical information*" or that it revealed any "*extreme*" steps. The adjustment to the liability valuation which

[130] See Penrose Report, Chapter 16, paragraph 42.

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ELAS had made was legitimate and well within the applicable regulations. As he explained to Lord Penrose, [redacted] saw no problem with the adjustment. Moreover, GAD was, quite reasonably, fortified in this conclusion by subsequent correspondence with [redacted] in November 1991.[131]

250. Lord Penrose was critical of [redacted] decision not to pass these papers on to DTI. He said that [redacted] was "*in error in allowing a private understanding with* [redacted] *to cloud his duties to regulators*".[132] [redacted] had, certainly, been placed in a difficult situation by the terms on which the material had been provided to him by [redacted]. But, viewed at the time, the documents did not, in fact, disclose any grounds for anyone reading them to have any significant concerns about the solvency of ELAS, which was the key focus of the regulatory regime. Lord Penrose's criticisms of [redacted] decision not to pass the documents on are made with the benefit of hindsight. It is only in the light of subsequent events and their consequences that Lord Penrose concludes that these papers may have carried clues to the future. [redacted] actions were entirely professional and understandable given the circumstances then existing and the nature of the documents he had received. It is not therefore accepted in any way that [redacted] decision was an error of judgment, nor that the information provided by [redacted] could or should have led to regulatory action against ELAS.

<u>10 September 1992</u>

251. The second occasion identified in Complaint K is the provision to GAD on 10 September 1992 of information which showed that, for the years 1989 to 1991, the present value of all bonuses which had been declared on policies in force (including terminal bonuses "*at the rates then current*") exceeded the value of the underlying assets.[133]

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131 See, in particular, Penrose Report, Chapter 16, paragraph 48.
132 Ibid, paragraph 45.
133 See Penrose Report, Chapter 16, paragraph 77.

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252. It is not accepted that this information ought reasonably to have led to any formal regulatory action. At the meeting which followed a few days later on 15 September 1992, GAD clearly expressed its view to [redacted] (recorded in the minutes of the meeting) that ELAS had "*over-distributed in the last few years, compared with the return on investments*". This had "*eroded the level of free assets available in the society, which are needed to provide for market changes in the value of assets*".[134]

253. GAD did therefore directly raise with ELAS the question of over-distribution, which was the cause of bonuses declared being in excess of asset shares at that time. [redacted] letter of 10 September 1992 was also passed to DTI.

254. Shortly after the meeting, [redacted] wrote to GAD, on 17 September 1992, acknowledging that "*the implications for bonuses would have to be considered carefully*". [redacted] was saying, in effect, that he took the point. Lord Penrose commented that GAD's minutes of the meeting of 15 September 1992 "*did not record any explanation of, or comment about the specific figures in the 10 September letter for excess of policy values over asset share*".[135] But there was no need for any such specific comment. In any case, [redacted] letter showed that the excess had fallen by 20% from 1990 to 1991, following a large rise between 1989 and 1990, when market conditions had been notoriously difficult.

255. The scrutiny report of the 1991 regulatory returns raised appropriate cautions about the recent reduction in available assets and weakening of the valuation basis. The scrutiny report was, rightly, the cause for some concern at DTI, as reflected in [redacted] note of 4 November 1992, in which he commented that the scrutiny report "*paints a worrying picture*" and recorded his decision to ask GAD for a fuller analysis of the position of ELAS.

134 Ibid, paragraph 78.
135 Ibid, paragraph 80.

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256. In response, in a memo of 3 March 1993, GAD advised that it suspected that ELAS could survive a short term fall in market levels as well as most companies, but recorded, as was the case, that its portfolio left "*room for concern*". But by this time, the 1992 regulatory returns were almost due, and so GAD, sensibly, asked [redacted] for an advance indication of the 1992 position. [redacted] reply, of 9 March 1993, indicated that the position had much improved, and this was passed to DTI immediately on receipt. As a result, and perfectly naturally, the level of concern about ELAS's excess of policy values over assets ebbed away.

257. Thus, the scrutiny report on the 1992 regulatory returns, completed in early 1994, referred to the previous concern about over-distribution and weakening of reserves, but indicated that there had been an improvement since December 1991, and that a further improvement was expected in the 1993 regulatory returns. There was indeed such an improvement. As Lord Penrose records, in his discussion of the 1993 scrutiny report:[136]

> *"The Society had experienced an exceptional year on the market [in 1993] with an investment return on the with-profits fund of 28.8%...The residual unallocated return went some way to lessening the excess of aggregate policy values over assets, which reduced from 116% on with-profits at year end 1992 to 102% at year end 1993."*

258. Furthermore, a fallacy underlying the Complaint is that it assumes that it was necessarily unacceptable for policy values to exceed the value of assets at a particular time. This is not the case.

259. It is worth remembering that, at a later stage, ELAS specifically told GAD, when quizzed on the point, that the "*normal range*" for the relationship between policy values and underlying assets was "*plus or minus 10% although there could be*

136 See Penrose Report, Chapter 16, paragraph 161.

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circumstances in which the relationship would need to move outside of that range temporarily."[137]

260. There is no reason to doubt this, nor to be concerned by it. ELAS's business model entailed that the with-profits fund would go into overdraft when smoothing during times of adverse market performance. The lack of an estate (free assets) also meant that in very unfavourable market conditions (e.g. a sudden and sharp downturn in the equity market, as was the case in the early 1990s), ELAS would be less able to smooth than some other rivals. Given how well publicised ELAS's approach was, it would be very difficult to argue that the approach which it adopted was inconsistent with its policyholders' reasonable expectations.

261. As regards the allegation of "*failing to alert new investors of the risks of investing*", it was not for the prudential regulator to alert potential policyholders to the risks of purchasing policies from a particular insurance company. The regulator and GAD strictly adhered to a policy of not giving indications of such views as they might have held about the financial strength of companies, or the wisdom or otherwise of investing in them, beyond indicating that the statutory requirements continued to be met.

4. Payment of Excess Bonuses

Complaint L

"*Over a period of many years the regulators and GAD permitted ELAS to operate an unsound business model, of which they were aware. ELAS had made public its policy of reliance on 'goodwill' in a 1989 actuarial paper With Profits Without Mystery, but the regulators never addressed the issue or challenged ELAS about it or about the consequences of the model. Instead, they allowed ELAS to operate the model, which entailed declaring bonuses in excess of admissible assets, while at the same time*

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137 See [redacted] note of a meeting with GAD on 28 May 1998 set out in the Penrose Report, Chapter 16, paragraph 244.

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operating without a significant estate and with a smoothing fund persistently in deficit. These were major contributory factors to ELAS's development of what Lord Penrose quantified as a £3 billion asset deficit at the time of closure to new business and to the losses incurred by all those who held policies on 16 July 2001."

262. The complaint that the prudential regulators and GAD "*permitted*" or "*allowed*" ELAS to operate an "*unsound business model*" is founded on a false premise. It was not the function of the regulator to judge the soundness of a company's business model, let alone to substitute its judgment for that of the Board and the Appointed Actuary. To have sought to do so would have constituted substantial interference with the normal course of competition in the market, have exceeded the regulator's legal powers and, besides, would have run wholly contrary to the policy of "freedom with disclosure" which underlay the regulatory regime.

ELAS's business model

263. Key features of ELAS's model were that it did not maintain a significant estate and that the profits of the with-profits fund were in very large part immediately transmitted to present policyholders in annual bonuses, subject to a smoothing policy. This necessarily meant that ELAS was inherently weaker in balance sheet solvency terms than its competitors with access to shareholder funds or inherited estates, and that it effectively went into overdraft when 'smoothing up'. Such a model, plainly, had its commercial risks. However, ELAS's policy was no secret. Indeed, it was well publicised and was well known throughout the financial services industry. It was, moreover, a major part of ELAS's sales strategy in marketing its policies to potential policyholders.[138] The risks therefore ought to have been appreciated by policyholders, and their advisers, when taking investment decisions.

[138] This fact was expressly recognised by the Parliamentary Commissioner in her first report: see "*The Prudential Regulation of Equitable Life*", Part II, paragraphs 187-188.

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264. ELAS characterised its own policy in respect of the distribution of surplus as one of "*full and fair*" distribution to with-profits policyholders. Indeed, ELAS made a virtue of the absence of any substantial 'estate'. Its publicly stated position, quoted at paragraph 3.11.3 of the Baird Report was that:

> *"...if part of the surplus otherwise available for distribution to policyholders was set aside for future emergencies, this would have been at the expense of policyholders whose policies were in force or maturing when those surpluses arose. In the view of the Board, such an approach would have been inconsistent with full and fair distribution."*

265. This approach provided increased present benefits for policyholders compared to other approaches, albeit at the obvious price of a concomitant lesser ability to withstand future shocks, other than by adjusting non-guaranteed terminal bonus rates.

<u>The role of the Prudential Regulator</u>

266. HMT and FSA categorically reject the suggestion that the prudential regulator should have sought to prevent or dissuade ELAS from following its chosen business model.

267. The prudential regulator did not operate a zero failure regime (and still does not to the present day) and it was not (and still is not under the current regime) for the regulator to challenge a business model on the ground that it was riskier than the market norm. It was a policy which it was open to ELAS to adopt. There was no secret about the approach. Provided that the applicable regulations were complied with, the regulator had no power to interfere, and there would rightly have been astonishment at any attempt by the regulator to seek to deter ELAS from following the business model which its Board, advised by the Appointed Actuary, had chosen to follow since the 1980s.

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<u>ELAS's smoothing policy</u>

268. Complaint L also contains an allegation that it was part of ELAS's business model to operate "*with a smoothing fund persistently in deficit*". It is not accepted that this was part of ELAS's business model, nor that this was how it did in fact operate.

269. Lord Penrose took the view (with reference to the figures in table 6.3 of his report derived from ELAS's internal office valuation accounts) that it did not seem that ELAS adopted a consistent smoothing policy.[139] Although 1998 stands out as showing an upward spike in Lord Penrose's table, it has been pointed out that his figures were inaccurate by £1 billion for that year (see [redacted] letter of 22 November 2004, forwarded to the Parliamentary Commissioner on 14 January 2005). If this were to be accepted, the period 1995 – 1999 shows a smooth decline to virtual balance.

270. ELAS had explained its approach to smoothing in 1993, in response to GAD's survey on bonus distribution. ELAS explained that in normal circumstances the smoothing cycle should be about 3–5 years. Assuming the 1998 adjustment to be a correct one, it seems that, contrary to Lord Penrose's conclusion, ELAS's smoothing policy over the period he considered was consistent.

271. A life insurance company's smoothing policy is a highly technical issue. There is no "right approach" to smoothing. It is quintessentially a field in which there will inevitably be a range of approaches of arguably equal actuarial merit. There was no basis on which the prudential regulator should, or could, have sought to induce ELAS to change its smoothing policy.

139 As explained in the response to Complaint I above, these accounts were not seen at the time by the regulator.

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Complaint M

"The regulators failed to ensure any satisfactory correlation between the total of declared policy values and the Society's admissible assets in a context where the Society, uniquely in the industry, had declared total policy values that included terminal bonuses and had, without exception, always paid all claims (both contractual and non-contractual) in accordance with these declarations."

272. This Complaint adds little to other complaints. The essential points are:

(1) The prudential regulator's central focus, as demanded by statute, was whether ELAS was meeting its statutory solvency requirements.

(2) ELAS at all times did indeed meet these requirements.

(3) Terminal bonus was a non-guaranteed element of policy values. The regulations did not require it to be reserved for.

(4) The future health of ELAS in realistic solvency terms (i.e. allowing for future bonuses, including terminal bonus) was a matter for the commercial judgment of the Board and for the professional judgment of the Appointed Actuary, and was not within the scope of statutory regulation.

(5) It was legitimate for ELAS to operate a business model which had the consequence that policy values exceeded the value of assets during times of adverse market performance.

(6) Whilst it is accepted that PRE was a relevant issue,[140] this was an area in which, inevitably, the Appointed Actuary's role was even more important than in other areas. It was not, and could not sensibly have been, a part of the role of the prudential regulator to monitor and make its own independent assessment of what, at any given point in time, were the reasonable expectations of the various classes of policyholders of the many life insurance companies.

[140] As to this, see the Response to Complaints N and O below.

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(7) There is nothing to suggest that the prudential regulator at any time failed to ensure that ELAS was meeting the obligations imposed upon it by the regulatory regime.

5. *Policyholders Reasonable Expectations (PRE)*

Complaints N and O

"*N.* *Ministers and officials decided that regulatory activities in relation to safeguarding PRE should be based solely on the regulatory returns, but failed to put in place adequate procedures and Regulations to enable this to be achieved. This failure was particularly critical in respect of ELAS, which had unique practices that elicited PRE.*

O. *As a result, the regulators and GAD failed over many years properly to monitor and assess ELAS's asset position and its practices in the light of PRE. The regulators and GAD did not properly determine PRE or act to protect them as intended by Parliament and to the standards set by EC Directives.*"

273. As these Complaints are connected, it is convenient to address them together. The criticism made is that Ministers and officials failed to put in place adequate procedures and regulations to enable the prudential regulator and GAD properly to determine or protect policyholders' reasonable expectations (PRE).

The Concept of PRE

274. The background to the concept of PRE, and how it was introduced and developed in the UK, is considered more fully in the Regulatory Paper submitted with this response.

275. As there set out, the concept of PRE was first introduced to UK law by the 1973 Act, which gave the prudential regulator power to intervene in the affairs of a

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company if there were grounds to believe that the company might be unable to fulfil PRE. The concept did not appear in any EU Directive.

276. One of the policy aims of the 1973 Act was to strengthen the degree of protection afforded to policyholders; but at the same time (in accordance with the doctrine of "freedom with publicity") Ministers were concerned to make it clear that the new powers should not be used as a means to curtail business freedoms within the insurance industry.

277. One of the Government's main policy concerns when considering the 1973 legislation was that the Boards of proprietary life insurance companies might favour the interests of shareholders over and above the interests of policyholders by "milking" the surplus accruing in the long-term business fund for the shareholders' benefit. Part at least, therefore, of the reason for introducing the concept of PRE was to ensure that the interests of policyholders were protected beyond their strict contractual entitlements.[141] PRE was not seen as a mechanism by which the expectations of different cohorts of policyholder interests within a mutual life insurance company might be the subject of detailed scrutiny.

278. When the concept of PRE was first being debated, GAD made it clear that the new power of intervention would potentially require a dramatic step-change in the level of scrutiny, and one that was potentially inconsistent with the doctrine of "freedom with publicity". Thus [redacted] reaction in 1972 to the proposed power to intervene on grounds of PRE was as follows[142]:

> *"This gives a very wide discretion and would, it seems to me, be likely to lead to a large measure of controversy if it were to be invoked other than rarely. It would certainly mean that the scrutiny procedure carried out in GAD would be very different in nature; would we not have to address ourselves to advising you, in the case of every company, whether or not the*

141 See: minute 3 November 1971 [redacted] pages 5 - 8 of the Annex; instructions dated 29 September 1972 [redacted] pages 27 – 51 of the Annex; and paragraphs 18 and 19 of the instructions to Parliamentary Counsel, pages 68 - 70 of the Annex.

142 See letter 5 November 1971 [redacted] pages 9 - 10 of the Annex.

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> *reasonable expectations of the long-term policyholders were being prejudiced? It would be a much bigger job for us, [involving] a very thorough examination of a company's affairs – very thorough indeed – to determine what we would regard as a 'reasonable' expectation for the policyholders in general, and for particular groups of policyholders."*

279. The Government took these concerns on board. Thus, when the Bill was introduced, the notes on clauses explained that the powers of intervention would only be exercised where it was "*obvious*" that the reasonable expectations of policyholders were not going to be fulfilled, and that this would "*stop well short of seeking to ensure that with profits policyholders received 'value for money' under their contracts or a particular level of bonus ... regardless of the amount of surplus revealed by the periodic actuarial investigation*"[143].

280. The Government also decided that the best way to strike a balance between increased policyholder protection and continued freedom for businesses was to ensure that PRE would be safeguarded solely by reference to regulatory returns. This was noted in a paper circulated across Government in September 1972.[144] The justification for this was that any other method was thought to involve too great a degree of control over management decisions.

281. That was a policy decision that was taken by Government, and one that it was entitled to take. In particular it was a lawful way of determining how they would normally exercise the statutory powers. It was entirely consistent with the doctrine of "freedom with publicity", and a desire to reduce the regulatory burden on business; furthermore, any wider form of evidence-gathering would have had huge resource implications, as noted by [redacted]. Throughout the period under review, there were on average around 250 companies with in force life insurance business. For the prudential regulator to have undertaken a comprehensive review of the companies' commercial communications with each of their different classes

143 See notes on clauses, pages 92 – 96 of the Annex.
144 See Penrose Report, Chapter 13, paragraph 26.

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of policyholder would have required a substantial increase in the regulator's resources (at the cost of competing Government priorities). It would also have greatly increased the regulatory burden on life insurance companies, to their cost, and the overall detriment of consumers.

282. Subsequently, the 1982 Act also made it clear (consistently again with the doctrine of "freedom with publicity") that powers of intervention on the grounds of PRE were to be extremely limited. In particular, this was spelled out by section 37(6) of the 1982 Act which made it clear that the power to take action for the purpose of protecting PRE under section 45 was a merely residual power, only to be used by the prudential regulator when other powers of intervention could not achieve the necessary goals.

283. Furthermore, in order properly to implement Article 21 of the First Life Directive, a further limitation on the power to take action to protect PRE was laid down by section 45(2), which only allowed the prudential regulator to impose a restriction on disposal of assets for this purpose if regulatory solvency was breached, or if the company was to be closed to new business.

284. Consistent with this approach, from 1994 onwards (with the introduction of the 1994 Regulations) the primary responsibility for monitoring PRE was placed on the Appointed Actuary, who was expressly required to determine and reserve for life insurance business liabilities, and to have "*due regard*" in doing so to PRE. In addition to this, the UK actuarial profession issued and kept under review guidance to Appointed Actuaries as to what PRE was, and how it should be catered for, in the form of GN1. GN1 provided, among other matters, that:

> *"It is incumbent upon all Appointed Actuaries to ensure, so far as it is within their authority, that the long term business of the company is operated on sound financial lines and with regard to its policyholders' reasonable expectations."*

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285. Hence, the structure and history of the regulatory regime shows that, from the outset, a policy decision was taken that the power to intervene on the grounds of PRE was only to be used by the prudential regulator sparingly, as a long-stop power; that it would not be used by the regulator to trespass unduly on management's discretion as to how best to run a company's life insurance business; and a legal restriction added that (unless regulatory solvency was breached) it could not be used so as to prohibit the disposal of a life insurance company's assets.

286. The prudential regulator always exercised its powers in relation to PRE in accordance with this policy. The policy was a reasonable one for Government to adopt. There can be no reasonable basis for criticising the regulator for operating the regulatory regime as it was.

Complaint P

"*During the course of the Hyman litigation, the regulators failed in their duty to all policyholders in respect of PRE and postponed consideration of issues related to assets and reasonable expectations, both for GAR and non-GAR policyholders, until after the House of Lords judgment (20 July 2000). In addition, the regulators totally failed to assess properly either the impact or the scope of the judgment and to evaluate the range of scenarios for ELAS following it. They failed to take appropriate action to mitigate the adverse effect of the judgment on the majority, non-GAR policyholders, and on new investors into the same with-profits fund. Their judgment that there was a 99.9% probability that ELAS would be sold demonstrated that, despite the extensive information that they possessed, the regulators failed to understand the parlous state of ELAS which was apparent to all prospective bidders.*"

287. In her letter of 9 December 2004 to HMT, the Parliamentary Commissioner noted that this Complaint raises issues covered in her first investigation, and that it has been included to enable her to fulfil her commitment (in her July 2004 report to Parliament) that she would revisit her findings in the light of the inclusion of GAD within her jurisdiction.

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288. HMT, FSA and GAD do not believe that the inclusion of GAD within her remit in any way affects the findings which the Parliamentary Commissioner has already made on the issues raised by the complainants. Throughout the period in question, GAD continued to provide actuarial advice to FSA, who in turn provided advice to HMT (where necessary in discharging its responsibilities as HMT's agent). However, Complaint P is not directed at such actuarial advice, but at decisions made and actions which ought allegedly to have been taken by the regulators (i.e. HMT and FSA) during this period.

289. Furthermore, taking each element of Complaint P in turn, for the reasons already set out carefully by the Parliamentary Commissioner in her earlier report, none discloses any case of maladministration. In short:

(1) *Postponement of consideration of PRE until after the outcome of the House of Lords judgment.* As the Parliamentary Commissioner has already concluded: (i) FSA's decision to await the court judgment was influenced by its view that there were legitimate arguments in support of a differential terminal bonus policy, which was a reasonable view to take, as evidenced by the decision of the Court of first instance; and (ii) given the potential significance of the anticipated court ruling to the question of PRE, and in the light of the other discussions FSA were having with ELAS at the time, it was also reasonable not to rush to a firm view in advance of the final judgment on appeal to the House of Lords.[145] Moreover, whilst awaiting the court ruling, FSA pressed ELAS hard on the issue of reserving for GAR liabilities, and referred bonus notices which they thought might be misleading to the conduct of business regulator to determine whether they provided grounds for intervention by them.[146]

145 "*The Prudential Regulation of Equitable Life*", Part I, Appendix, paragraph 14; Part II, paragraph 181.
146 Ibid, Appendix, paragraph 15; Part II, paragraphs 182–192.

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(2) *Failure to assess the impact and scope of the judgment.* As the Parliamentary Commissioner has already concluded, the fact that FSA did not consider the eventual ruling as a strong possibility did not indicate that they were not carrying out their role effectively. It would be wrong to say that FSA were totally surprised by the House of Lords judgment or ill-prepared for it. The ruling was unexpected, as it went against much accepted actuarial and industry practice, but that was not in itself a sign of poor judgment, especially in view of the legal advice previously received and the decisions of the two lower Courts; and the possibility had featured in FSA's and ELAS's scenario planning. Even if the differential terminal bonus policy were to be found not to be permissible, there was every expectation, especially in the light of the judgment of the Court of Appeal, that ring-fencing of the policies with guarantees would prove to be a satisfactory alternative. It is not accepted that earlier serious consideration by FSA of the scenario which eventually unfolded would have influenced events in any way.[147]

(3) *Failure to mitigate the adverse effect of the judgment on some policyholders.* After the House of Lords judgment, FSA had to decide whether to close ELAS to new business, or to allow its management to pursue their preferred option of trying to sell ELAS as a going concern.[148] As the Parliamentary Commissioner has already concluded, FSA's decision to allow ELAS to put itself up for sale was reasonable in the circumstances: in particular, there was no evidence to suggest that FSA should have considered from the outset that the prospect of sale was unlikely, or that it should have recognised significantly sooner that the sale process would fail.[149] Further, the decision to allow ELAS to continue taking on new business while the attempt to sell the company was made was a reasonable response to the need to balance the interests of new and existing

147 Ibid, Appendix, paragraph 16; Part II, paragraphs 199–201.
148 Ibid, Appendix, paragraph 17; Part II, paragraph 202.
149 Ibid, Appendix, paragraph 18; Part II, paragraphs 203 – 213.

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policyholders, not least as all policyholders – new and old – would have benefited from a successful sale.[150] The prudential regulator's response to ELAS's advertising campaign was also reasonable, as was its decision not to impose a "health warning" on ELAS's products[151], since ELAS continued to meet solvency and other statutory requirements and it would not have been acceptable under the regulatory regime at the time (or fair relative to other companies) to have imposed additional health warning requirements on ELAS. The prudential regulator kept the conduct of business regulator adequately informed of ELAS's position.[152]

290. The Parliamentary Commissioner's first investigation therefore fully considered all the issues raised by this head of complaint, and rightly concluded that there was no maladministration throughout this period on the part of the prudential regulator. The inclusion of GAD within her remit now does not give any cause to alter these findings.

<u>**Complaints Q and R**</u>

"*Q.* *In March 2001, the regulators permitted ELAS to declare a bonus for 2000 and an interim bonus for 2001 that were both inappropriate and unjustifiable given the then state of ELAS's finances, thus raising misleading expectations about the true state of ELAS just prior to significant across-the-board cuts that were imposed only four months later. Instead, ELAS's asset deficit of 13% at year-end 2000 in a closed fund should have precipitated regulatory intervention at that time.*

R. *In July 2001, the regulators failed to protect PRE by permitting policy value adjustments worth more than £4,000 million in the form of an inequitable uniform percentage cut across all with-profits policies, rather than the fairer alternative of reducing policy values by cutting only non-guaranteed bonuses. The regulators also refused to comment meaningfully on this to policyholders, while discouraging independent financial advisers from giving proper advice to policyholders.*"

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150 Ibid, Appendix, paragraph 19; Part II, paragraphs 214 - 215.
151 Ibid, Appendix, paragraphs 20 – 21; Part II, paragraph 216.
152 Ibid, Appendix, paragraph 22; Part II, paragraph 217 – 220.

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291. In her letter of 9 December 2004 to HMT, the Parliamentary Commissioner pointed out that, as explained in her July 2004 report to Parliament, the focus of this investigation will be on events relevant to the closure of ELAS to new business, and not therefore on subsequent events. Complaints Q and R relate to subsequent events.

292. Accordingly, it is not proposed to respond to these heads of complaint, save to make the following limited observations:-

(1) The complaint suggests that the prudential regulator allowed ELAS to declare a bonus in 2001 in respect of 2000, despite the developments during the course of that year. In fact the Board of ELAS decided not to declare a bonus for 2000 so the issue of the regulator intervening to prevent the declaration did not arise. Such a bonus, if it had been declared, would have added to ELAS's liabilities for which reserves would have had to be held and reported in the regulatory returns.

(2) If the complaint is referring to the development of policy values (by the addition of a notional "interim bonus") during the period after the House of Lords judgment, that relates to the allocation of terminal bonuses which, as is explained previously, is not something that a life insurance company was required to report to the regulator because there was no statutory requirement to reserve for terminal bonus[153].

[153] The complaint suggests that a decision was taken to uplift policy values in March by a particular amount. Policy values were disclosed in the annual statements but they were constantly developing by the addition of the interim bonus throughout the year. This meant that policy values changed from day to day so that they could be used as a starting point for calculating the benefits that would be payable in the event of a claim (contractual or otherwise) on any particular day during the year. The amount of interim bonus being added was kept under review and was changed from time to time. Whereas the complaint implies that ELAS was increasing the amount of the interim bonus, the reality was that it actually was reducing the rate of bonus that would apply going forward.

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(3) Even though this was not within the formal scope of the regulatory framework, the regulator had become aware of ELAS's realistic solvency position as a result of discussion about the GAR costs and because of information that came to light during the sales process. However, in judging what happened at ELAS in the period after it closed to new business, and more specifically the regulator's response to what happened, it is necessary to consider the entire context. An important part of this context is that this period coincided with substantial falls in equity markets. Between the end of 1999 and 2003, the FTSE 100 dropped from a high of 6930 to below 3300.

(4) As a significant part of ELAS's with-profits fund was invested in equities, these falls in the value of equities raised obvious concerns for the management of ELAS (and indeed for all insurance companies) and for the prudential regulator. However, provided regulatory solvency was maintained, it always remained for the Board of ELAS to decide on bonus allocations to policyholders.

(5) After the House of Lords judgment, in order to protect the with-profits fund from policyholders seeking to select against it (by terminating their policies so as to receive a surrender value in excess of the underlying value of the policies), ELAS introduced a financial adjuster which meant that policyholders cashing in their policies early would receive a payout that was broadly in line with the underlying performance of the fund and the "asset shares". The amount of the financial adjuster was increased after the fund closed to new business, and again early in 2001 in response to further market falls.

(6) Throughout this time, the prudential regulator kept a close watch over what ELAS was doing to manage its fund and took the view that the decisions that it was taking (including decisions as to bonus allocations) were

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reasonable[154], sound and prudent and that there was no basis for intervention.

(7) However, by the summer of 2001 it had become clear that ELAS's existing practices were no longer sustainable. The two driving factors were: (i) the continuing poor performance of the investment markets; and (ii) the fact that significant numbers of policyholders were taking benefits on a contractual basis (where no financial adjuster was applied).

(8) It was against this background that ELAS decided that the expectations of ongoing policyholders needed to be addressed, and more significantly that a financial adjustment needed to be introduced for those policyholders leaving the fund on a contractual basis. It achieved both these things by reducing policy values in July 2001.

(9) The cut in policy values had the effect of reducing the terminal bonuses being paid on maturing policies so that they more closely reflected the underlying asset shares while sending clear signals to other policyholders about the impact of market falls on the true value of their investments. All other with profits companies have also had to reduce the amount of terminal bonuses paid, although the reduction was perhaps more transparent at ELAS because of its disclosure of total policy values. Policyholders of unit-linked companies (and direct investors in unit trusts and in shares) also suffered comparable losses directly as a result of the falling stock market.

(10) There has been much debate about the approach ELAS adopted to cutting policy values. However, provided the decision taken was reasonable, the approach chosen was a matter for the management of ELAS. In particular, it was for the management of ELAS to decide what approach it considered

154 Although FSA did not allow a reversionary bonus to be declared after 2000.

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to be fairest as between different classes of policyholder (having regard to their different, and at times conflicting, expectations). It was not for the prudential regulator to design or approve the approach chosen for applying the cuts; nor could it have objected if the management of ELAS chose an approach which the regulator did not think was best.

(11) All of these issues were, of course, issues of judgment, where decisions sometimes had to be taken in a short time frame. It is clear that the prudential regulator considered these issues and connected issues, and discussed them with ELAS at the relevant times.

(12) The prudential regulator also strongly refutes the suggestion that it "*refused to comment meaningfully*" to policyholders, or "*discouraged independent financial advisers from giving proper advice to policyholders*". On the contrary, FSA at all times sought to keep policyholders informed of the situation, and to operate a transparent system. At the time of the policy value cuts, FSA prepared a statement with information for policyholders which was made available on its website and via its consumer contact centre. Even now, FSA continues to publish information for ELAS's policyholders on its website and keeps this information constantly updated.

(13) In the circumstances these complaints disclose no grounds on which an allegation of maladministration can properly be maintained.

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Government response on injustice

1. …

2. The statement of injustice contends:

   > "As a direct consequence of regulatory failure each complainant lost 16% (or 14% for life policies) of their policy values on 16 July 2001 and in some cases they lost more in market value adjustments and other costs and penalties upon subsequent departure. Had the regulators effectively undertaken their responsibilities, the crisis at Equitable Life would have been prevented by earlier intervention and appropriate remedial action."

3. For all the reasons [we have] set out … we do not accept that there was regulatory failure, in the sense of a failure adequately to operate the regulatory regime in place at the material time.

4. Moreover, the assertion that the cuts and market value adjustments were a "direct consequence" of regulatory failure is ill-founded, for the reasons set out below.

5. Paragraph 87 of Chapter 6 of the Penrose Report does not set out a clear derivation of the relative proportions of the 16% cut in policy values attributable to the adverse investment conditions prevailing in 2000 and the first half of 2001 on the one hand and to the alleged past over-distribution (and in particular overpayment of past claims) on the other. However, the reader might reasonably infer from this paragraph, and from paragraph 75 of Chapter 6 and Table 6.14, taken together, that of the £4.9bn total cut in policy values, all but £1.5bn was attributable to events before the end of 1999. This impression is reinforced by the wording in paragraph 89 of Chapter 6 that:

> "apart from the losses attributable to market movements by June/July 2001, [the 16% cut in policy values] was the result of sustained over-allocation and sustained over-distribution on claims".

6. For the reasons set out in the following paragraphs, we do not accept that the 16% cut in policy values required in July 2001 was due to any material extent to any past over-distribution. Rather, the cut demonstrably reflected the adverse investment conditions prevailing in 2000 and the first half of 2001. Nor do we accept that any past over-distribution was a material factor contributing to the lack of a sale of ELAS, which as noted in the Response, arose for a variety of reasons, not all related to the financial strength of the with-profit fund.

ELAS's 2004 paper

7. Under the stewardship of its new Board, in October 2004 ELAS published a paper entitled "The Penrose Report: Policy value reductions and alleged 'over-bonusing'". The paper explains, rightly, that more than 14% of the 16% cut in policy values made in July 2001 was in fact attributable to:

   (1) adverse investment conditions prevailing between 1 January 2000 and that date;

   (2) adjustments made to the valuation of ELAS's liabilities (on a realistic basis) by the new Appointed Actuary; and

   (3) a decision (taken by the new Board on the advice of the new Appointed Actuary) to create as at 31 July 2001 an excess in the with-profit fund of available assets over aggregate with-profit policy values of £0.6bn as a prudential measure given the uncertain outlook for the future, broken down as follows:

1. approximately 11% due to the adverse investment conditions, reflecting the difference between the actual return on the fund during that period of minus 7.9%, net of expenses and allowing for the additional cost of the GARs (including the rectification scheme) incurred by the company following the House of Lords judgment in July 2000, and the rate of growth allocated to policy values during that period of 3.3%;

2. approximately 1% due to the adjustments made to the valuation (on a realistic basis) of liabilities[1], including reflecting a continued improvement in annuitant mortality, the effect of which was to increase those liabilities by some £0.2bn;

3. some 2.4% due to the decision to create the £0.6bn excess of available assets over policy values in the fund.

8. In fact, ELAS's figures are largely reflected in Chapter 6 of the Penrose Report itself:

(1) The £0.6bn excess of available assets over policy values is the £600m item referred to in paragraphs 75 and 87 of Chapter 6 and reflected in Tables 6.15[2] and 6.17[3] and financial table H4[4]. This represented a percentage excess of available assets over policy values (following the 16% cut) of some 3%, as reflected in financial table H4, which figure is within the tolerance range

[1] See Table 6.17 of the Penrose Report at page 226.
[2] See page 224 of the Penrose Report.
[3] Ibid. page 226.
[4] Page 32 of the Financial Tables to the Penrose Report.

of plus and minus 5% quoted by [redacted] on page 4 of Appendix F to the EMAG submissions.

(2) The net investment return of (7.9%) is close to the 2.7% gross return in 2000 shown in financial table D4[5] and quoted in paragraph 69 of Chapter 6, less the estimated 4.0% negative return in the first 6 months of 2001 quoted in that paragraph, less expenses of 0.8% (calculated as an annual rate of 0.5% multiplied by 1.5 to allow for the 18 month period to 30 June 2001) less the additional cost of the GARs following the House of Lords judgment of 4.7% (calculated as 7/12 * 8%, representing the value of the allocated growth rate of 8% for 2000 suspended during the first 7 months of that year, which was almost exactly equal to the additional GAR cost: see above). The difference of 1.1% can be explained by further investment losses (and expenses) incurred by ELAS during July 2001: the FTSE fell by a further 2% in that month and close to half of the assets of the fund were invested in equities at that time. (Differences between actual claims payments made during this period and the corresponding (unsmoothed) asset shares are also relevant to the precise reconciliation, but paragraph 69 of Chapter 6 of the Penrose Report indicates that these were not very significant.)

(3) The 3.3% allocated growth rate is the annual allocated growth rate of 8% for 2000 multiplied by 5/12 because the bonus was suspended for the first 7 months of that year.

9. No growth was allocated to policy values during the first 6 months of 2001[6]. An annual rate of growth of 6% was allocated to policy

[5] Ibid. page 16.
[6] See paragraph 149 of Chapter 5 of the Penrose Report.

values from 1 July 2001[7] so that 0.5% would have been allocated during July 2001. This growth has apparently not been allowed for in ELAS's calculations, but if this is the case then an even greater proportion of the 16% cut in policy values is in fact explained than presented in the October 2004 ELAS paper.

10. The only material difference between ELAS's figures in its October 2004 paper and Chapter 6 of the Penrose Report relates to the increase in liabilities, for which paragraph 80 of Chapter 6 suggests a figure of £400m rather than some £200m. However, the latter figure relates just to the annuitant mortality adjustment and it may well be that other adjustments were also made that decreased the liabilities. In particular, it is possible that the difference of £200m reflects the consequential reduction in the GAR provision resulting from the cut in policy values of £243m reflected in the difference between the two figures for this provision shown towards the bottom of Table 6.14[8]. But this minor point does not in any way affect the thrust of our submission. On the contrary, if the correct figure is in fact £400m, then an even greater proportion of the 16% cut in policy values can be sourced than is set out in the October 2004 ELAS paper.

11. So, it can be seen that only the modest balance of 1.6% of the total 16% cut in policy values is capable of being attributed to events which took place before the end of 1999. This is consistent with the fact that, even based on the figures in Chapter 6 of the Penrose Report without any adjustment, there was only a modest excess of policy values over available assets in the with-profit

[7] Ibid.
[8] Page 223 of the Penrose Report.

fund of some 3% (in fact 2.8% based on Table 6.3) at the end of 1999[9].

Critique of Lord Penrose's analysis of the July 2001 policy value cut

12. In our view the analysis presented in paragraph 65 *et seq*. of Chapter 6 of the Penrose Report relating to the 16% cut in policy values is far from clear, especially as regards the assets side of ELAS's realistic balance sheet. It seems that Lord Penrose was unable to obtain all the information he would have liked relating to this period. In addition, Lord Penrose's analysis seems to reflect misinterpretation of certain of the figures appearing in papers to which he had access produced by the new Appointed Actuary of ELAS. In particular:

(1) The reference in paragraph 80 of chapter 6 to a £1bn reduction in assets in respect of estimated overpayments is very difficult to comprehend. The description of the £1bn assets adjustment provided in paragraph 83 of Chapter 6 is unclear. It seems likely that the point was not fully grasped by the Penrose inquiry. It is illogical in principle to make a deduction from the assets in respect of any past overpayment of claims because the assets will already have been reduced as a result of this. What is more, the adjustments presented in paragraph 80 only produce the revised "surplus of…under £400m" to which Lord Penrose refers in the last sentence if the £1bn reduction in assets claimed to have been made in respect of past overpayment of claims is in fact <u>not</u> made: opening

[9] The reason the 1.6% is 1.2% smaller than the 2.8% seems likely to be mainly attributable to the adjustments on the assets side of the realistic balance sheet of (£400m) relating to the write off of the new business loan and £590m relating to miscellaneous profits arising from disposal of parts of ELAS's business referred to in paragraph 80 of Chapter 6 of the Penrose Report, which together produced an increase in available assets of £190m or some 0.7% of policy values before the 16% cut. The 0.5% balance of the 1.2% difference is within the margins of rounding adjustments, it not being clear that the various percentages quoted in the different documents are in fact all applied to the exactly same quantum of policy values at the same dates.

surplus £600m - £400m new business loan write off + £590m miscellaneous profits from sales - £400m increase in liabilities = revised surplus £390m.

(2) For the same reasons, the accuracy of the adjustments shown in the top half of Table 6.17[10] is also very doubtful.

(3) Moreover, the revised surplus of some £400m quoted in paragraph 80 does not appear to be reflected anywhere else. Tables 6.15[11] and 6.17[12] and financial table H4[13] all show a surplus of £600m; and whilst the liabilities shown in Table 6.17 are £400m greater than those shown in Table 6.15, as expected from the increase in liabilities quoted in paragraph 80 of Chapter 6, it is wholly unclear why the assets shown in that table are also £400m higher (£22,900m compared with £22,500m). So too, the provenance of the net assets figure shown in Table 6.17 before the adjustments described above (a figure of £23,710m) is unclear. So far as we are aware, it does not appear anywhere else in the Penrose Report and no justification for it is made.

(4) The description of the aggregate figure of £4.3bn shown in paragraph 75 of Chapter 6 as the "value written off" is confusing because the total reduction in policy values was in fact the higher sum of £4.9bn quoted in that paragraph. The £4.3bn figure represents the amount by which policy values would have had to be reduced to produce an exactly balanced fund rather than the 3% excess of available assets over policy values that was in fact decided upon.

[10] Page 226 of the Penrose Report.
[11] Ibid page 224.
[12] Op cit.
[13] Page 32 of the Financial Tables to the Penrose Report.

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(5) It is not immediately clear why the revised policy values after the 16% cut shown in Table 6.16[14] are not 16% lower than those shown in Table 6.13[15] (in fact they are all some 18.8% lower), although it is possible that there is a valid explanation for this.

(6) It is far from clear that the adjustments made towards the bottom of Table 6.14[16] make sense:

1. It is correct that the GAR provision should logically be 16% lower after the cut in policy values and hence an adjustment of £243m (= 16% of the pre-cut provision of £1.5bn) is appropriate. However, it is not clear that this has not already been allowed for implicitly in the Table given that the 16% cut is applied to the total policy values including the £1.5bn original GAR provision. The adjustment in respect of the suspended bonus is similarly counter-intuitive.

2. It is unclear why, if the aggregate policy values at the bottom of Table 6.14 are as at 31 July 2001, as claimed, no allowance appears to have been made for growth allocated during July 2001. As explained above, an annual allocated growth rate of 6% was applied from 1 July 2001 following the first 6 months of 2001 in which no growth was allocated.

[14] Page 225 of the Penrose Report.
[15] Page 222 of the Penrose Report.
[16] Page 223 of the Penrose Report.

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Further points on the July 2001 policy value cut

13. We make three further key points on the July 2001 policy value cut in the context of the statement of alleged injustice… :

(1) First, it is very important to note that, even to the very modest extent (see above) to which the 16% cut in policy values did relate to events before the end of 1999, those policyholders as at 31 July 2001 who had also been policyholders throughout the period covered by Table 6.3 were no worse off overall. This is because they would also have benefited from any net over-distribution that took place in that period. The fact that such a policyholder was in a "near balanced position in cash terms" after the cut in policy values in July 2001 is acknowledged by Penrose in paragraph 57 of Chapter 6 of his Report. This is plainly a very important factor so far as the causation of any loss is concerned. The same is not necessarily the case for policyholders entering the fund in later years but, given that the aggregate deficit in available assets at the end of 1999 was only 3%, the bulk of the 16% cut in policy values for these policyholders also reflected events after and not before the end of 1999, as the above analysis demonstrates.

(2) Second, it is essential to appreciate that other companies were also making significant cuts in the values of their with-profit contracts during 2000 and 2001 as a result of the adverse investment conditions prevailing in those years. This is illustrated by the figures shown in the Appendix, which are taken from with-profit surveys published in *Money Management*. These show the actual maturity payments made by other major with-profit companies for sample 10 and 25 year regular premium life endowment contracts on 1 February

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in each of the years 2000, 2001 and 2002. These contracts are of course not directly comparable to the recurrent single premium pension contracts comprising the bulk ELAS's with-profit business, and neither are amounts paid on maturity directly comparable to the aggregate policy values intimated to ELAS' policyholders in their individual bonus notices. However, the percentage changes in these maturity payouts during this period nevertheless do provide a broad indicator of the impact of the adverse investment conditions prevailing at that time, which, as explained above, made the primary contribution to the July 2001 cut in policy values. The figures show that maturity payouts fell on average by 12% and 18% for 10 and 25 year contracts respectively between 1 February 2000 and 1 February 2002 (a proxy for the period between the end of 1999 and the end of 2001), the bulk of these reductions being attributable to the year 2001, and that the largest reductions for these contracts over that period among the companies shown were as high as 18% and 23% respectively. These figures are in line with the 16% cut in policy values made by ELAS in July 2001. Again, the point is self-evidently of great importance to any analysis of the causation of any loss suffered by [complainants]. What is clear is that policyholders with funds elsewhere than in ELAS were exposed to broadly similar policy value cuts in 2001. The figures also demonstrate the extent of variation between companies: for example, for 25 year contracts maturing on 1 February 2002, the highest maturity value shown is as much as 63% greater than the lowest.

(3) Third, it should be noted that some 2.4% of the total cut was attributable to the creation of the £600m excess of available assets over policy values decided upon by the new ELAS Board. On the basis of the tolerance range of plus and minus 5% for

the relative level of these items quoted by [redacted] on page 4 of Appendix F to the EMAG submission, it would have been possible in principle for the cut to have been reduced to a level such that a deficit of available assets of 5% existed in the fund. This would have reduced the cut in policy values by approximately 7% to just 9%. The fact that ELAS chose instead to make the larger cut of 16% is not surprising. This provided a prudential margin given the uncertain outlook for the future, and to cover the additional cost to ELAS in respect of those policyholders who could take a contractual exit with a guaranteed fund higher than the policy value (as reduced by the cut). It was also sensible, given that making any cut would be unpopular, to make the cut large enough to avoid the need to make a further material cut in the foreseeable future having regard *inter alia* to the revised investment strategy, heavily biased towards the holding of fixed interest securities, being adopted by ELAS around that time and the need for future bonus declarations to be adjusted in a way that was compatible with the likely implications (including lower investment returns) of that changed strategy.

14. For all these reasons, … we believe that:

(1) the prudential regulator and GAD undertook effectively their responsibilities;

(2) it is wrong to say that the July 2001 policy value cut was in any material respect a consequence of “sustained over-allocation and sustained over-distribution on claims” as alleged by Lord Penrose;

(3) on the contrary, more than 14% of the 16% cut in policy values made in July 2001 was in fact attributable to:

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1. adverse investment conditions prevailing between 1 January 2000 and that date;

2. adjustments made to the valuation of ELAS's liabilities (on a realistic basis) by the new Appointed Actuary; and

3. a decision (taken by the new Board on the advice of the new Appointed Actuary) to create as at 31 July 2001 an excess in the with-profit fund of available assets over aggregate with-profit policy values of £0.6bn as a prudential measure given the uncertain outlook for the future;

(4) it is not correct to say that even to the very modest extent to which the 16% cut in policy values did relate to events before the end of 1999, those policyholders as at 31 July 2001 who had also been policyholders throughout the period covered by Table 6.3 were any worse off overall;

(5) ELAS's policy value cut was not out of line with those imposed by other life insurance companies at about the same time. [Complainants] cannot demonstrate with any degree of certainty that sums invested elsewhere than ELAS would have fared better; and

(6) that there is no basis to the statement of alleged injustice.

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APPENDIX

Maturity values for 10 year regular premium life endowment contracts

Company	1/2/2000	1/2/2001	% change from 1/2/00	1/2/2002	% change from 1/2/00
Clerical Medical	10,233	9,492	(7%)	8,416	(18%)
Friends Provident	9,742	9,420	(3%)	8,755	(10%)
Legal & General	9,406	9,666	3%	8,634	(8%)
Norwich Union	9,479	9,197	(3%)	8,305	(12%)
Prudential	9,675	9,574	(1%)	n/a	-
Royal & Sun Alliance	9,023	9,070	1%	7,802	(14%)
Royal London	10,372	10,590	2%	9,488	(9%)
Scottish Amicable	10,074	10,041	(0%)	8,604	(15%)
Scottish Equitable	n/a	8,745	-	8,949	-
Scottish Provident	9,228	8,851	(4%)	n/a	-
Scottish Widows	9,804	9,309	(5%)	8,094	(17%)
Standard Life	10,544	10,596	0%	9,875	(6%)
Average % change			(2%)		(12%)

Source: *Money Management*, April 2002. Figures represent actual maturity payouts at the dates shown for a male life age 30 next birthday paying a premium of £50 pm from 1992 onwards and £30 pm in earlier years.

Maturity values for 25 year regular premium life endowment contracts

Company	1/2/2000	1/2/2001	% change from 1/2/00	1/2/2002	% change from 1/2/00
Clerical Medical	104,289	100,117	(4%)	83,175	(20%)
Friends Provident	102,341	93,145	(9%)	82,100	(20%)
Legal & General	93,678	90,324	(4%)	75,141	(20%)
Norwich Union	89,518	86,028	(4%)	73,640	(18%)
Prudential	99,994	92,809	(7%)	n/a	-
Royal & Sun	104,201	96,712	(7%)	82,690	(21%)

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Alliance					
Royal London	120,369	127,006	6%	107,745	(10%)
Scottish Amicable	96,569	91,854	(5%)	74,093	(23%)
Scottish Equitable	n/a	81,822	-	65,917	-
Scottish Provident	85,120	79,893	(6%)	n/a	-
Scottish Widows	95,482	91,538	(4%)	75,004	(21%)
Standard Life	110,373	110,136	0%	99,747	(10%)
Average % change			(4%)		(18%)

Source: *Money Management*, April 2002. Figures represent actual maturity payouts at the dates shown for a male life age 30 next birthday paying a premium of £50 pm from 1992 onwards, £30 pm in the years 1985 to 1991 and £10 pm in earlier years.

Other responses received

Response from Equitable Members' Action Group (EMAG) – available at:
www.emag.org.uk/documents/evidence.01mr05.pdf

Response from Equitable Late Contributors' Action Group (ELCAG) – available at:
www.emag.org.uk/documents/PO2ELCAG.doc

Two responses from Dr Michael Nassim – the first available at:
http://www.cookham.com/community/equitable/Penrose%20and%20Beyond%20v4a.pdf
and the second available at:
www.europarl.europa.eu/comparl/tempcom/equi/written_evidence/nassim_assessment_en.pdf

In addition, much of the written evidence submitted to the European Parliament Committee of Inquiry was also submitted to us for information. This evidence can be found at:
www.europarl.europa.eu/comparl/tempcom/equi/written_evidence/default_en.htm

Standard of regulation discussion paper issued by the Ombudsman to explain her approach to the investigation (May 2005)

ARTICULATING AN APPROPRIATE STANDARD OF PRUDENTIAL REGULATION

A discussion paper (May 2005)

Introduction

1. This paper seeks to initiate discussion about what might constitute an appropriate standard of regulation in the context of the regime for the prudential regulation of insurance companies that was in place at the time relevant to the Parliamentary Ombudsman's current investigation into the prudential regulation of the Equitable Life Assurance Society.

2. The paper outlines that regulatory regime, with particular emphasis on the statutory powers of intervention available to the prudential regulator and on the circumstances in which it was open to the regulator to exercise those powers. It then goes on to suggest, with regard to this regime, in what way the Ombudsman is minded to make an objective assessment of the reasonableness of the actions (or omissions to act) of those operating the regime.

3. The outline of the regime provided here is necessarily only that - it does not purport to be a comprehensive or detailed description of the prudential regulatory regime. That will be provided elsewhere.

4. This paper is not intended for circulation at this stage beyond those to whom the Ombudsman deems it appropriate to circulate it. Those persons are listed in the annex to the paper. However, once the comments of those persons have been considered (and, if appropriate, incorporated) it is intended that this paper, suitably amended, will be placed in the public domain. At this stage, it is distributed solely for the purpose outlined in paragraph 1 of the paper. It should not be further distributed without the express permission of the Ombudsman's office. Nor should it be quoted in whole or in part for other purposes without such permission.

The structure of the regulatory regime relevant to insurance companies

5. The regulatory regime in place at the relevant time has been characterised as one based on the doctrine of 'freedom with publicity' - i.e. life insurance companies were free, so long as they otherwise acted

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lawfully, to develop their services and products, subject only to requirements to make certain aspects of their affairs public and to comply with supervision of two areas of their activities by regulatory bodies that were part of, or were created on the initiative of, central government.

6. The first area of regulation was broadly aimed at protecting customers against investing in financially unsound or unfit insurance companies - requiring a company to demonstrate that it met certain solvency standards that would enable it to meet its contractual commitments and empowering the regulator to take action if it were concerned that a company might be unable to do so or if it had concerns that other 'reasonable expectations' of its policyholders or potential policyholders might not be fulfilled.

7. The second area of regulation required honesty and clarity in the basis on which insurance companies offered their services and products to customers and was broadly aimed at ensuring that customers were not misled and did not invest unknowingly in products which were unsuitable for their needs.

8. Supervision of insurance companies' compliance with the former requirement was the responsibility of a 'prudential' regulator and the supervision of compliance with the latter requirement lay with a 'conduct of business' regulator.

9. By the end of the period under consideration by the Ombudsman's investigation, the key underpinning legislation was the Insurance Companies Act 1982 (ICA 1982) for prudential regulation and the Financial Services Act 1986 (and part III of the ICA 1982) for conduct of business regulation. Until their repeal on 1 December 2001, both Acts were subject to amendment by primary and secondary legislation; in addition, secondary legislation was made under both Acts, giving greater detail to the regulatory regimes. Legislative change was in part to give effect to EC legislation.

10. The prudential and conduct of business regimes gave the regulators a number of powers of intervention should they be concerned that the relevant requirements, outlined above, were not being met. The

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legislation also specified the circumstances in which these powers of intervention were available to the regulators.

11. This paper - and the Ombudsman's investigation - is solely concerned with the regime relevant to prudential regulation, for reasons given elsewhere on a number of occasions.

The objective of prudential regulation

12. The regime that existed under the ICA 1982 had its roots in legislation enacted in the 1970s, which had strengthened the regulatory regime that had existed before then. When the new regulatory regime governing prudential regulation was introduced in 1973, the objective of the enabling legislation was stated by the then Minister to be:

> *Not primarily to penalise* post facto *dishonest or incompetent managements, but to protect policyholders by taking or requiring suitable corrective action in time to avert the consequences of imprudent or misguided policies...* [the intention was to] *strike a proper balance between, on the one hand, allowing the industry so much freedom that it can be exploited by rogues, and on the other hand, creating for the industry such shackles that it cannot give efficient, competitive and forward looking service to consumers here and abroad* (Hansard, House of Commons, 21 May 1973, column 118).

13. In introducing the 1981 Bill, which updated the regime to take into account developments in EC legislation, the then Minister said:

> *A phrase often used to describe the United Kingdom approach to regulation by the Government of its insurance industry is 'freedom with publicity'. The phrase serves to bring out some clear and continuing features of that regulation over the past century. In general there has been no Government control of premiums or other conditions of contract between insurers and policyholders; there has not been Government direction of the investment of insurance companies; there has been a wish to see the insurance industry expand the range and volume of its business in the United Kingdom and in other countries; but there have been requirements for insurance companies to make substantial returns to the Department of Trade and its predecessors, for those returns to give details of*

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companies' business in a form allowing position and performance to be assessed, and for those returns to be available to policyholders and to the public at large.

Quite properly, the freedom I have referred to has its limits; the Secretary of State has a clear duty to intervene if it appears that all is not well. The need for supervision of the insurance industry is one of record. There have been cases in the past where failures of insurance companies have done policyholders and interested third parties great harm, and, indeed, done the industry no good. Although no system of supervision can avoid completely all risks of difficulty or failure of an insurance company, Government responsibility for a systematic approach is to be found not just in the United Kingdom, but throughout the countries of the developed world and in many others [Hansard, House of Commons, 2 February 1981, column 103].

The process of regulation

14. Section 19 of ICA 1982 continued the requirement (dating from the 1973 legislation) that each life insurance company appoint an actuary, who became known as the Appointed Actuary. The identity of this person, who was required to hold prescribed qualifications, had to be notified to the regulator within fourteen days of appointment and each Appointed Actuary was normally invited on first appointment to meet the Government Actuary in person to discuss their role in the regulation of insurance companies.

15. Section 18 of ICA 1982 required the Appointed Actuary to make an annual investigation of the company's financial position and the company was then required to cause an abstract of the Actuary's report to be published in a prescribed form. That investigation had to include a valuation of the liabilities of the company attributable to its life assurance business and a determination of any excess over those liabilities of its assets representing the fund or funds maintained by the company in respect of that business. The valuation of assets and the amount of liabilities were to be determined in accordance with Regulations made for the purposes of these provisions.

16. Section 32 of ICA 1982 required companies to hold assets which exceeded their liabilities by at least the margin prescribed in the Insurance

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Companies Regulations 1981 and thereafter in the 1994 Regulations which replaced them. This requirement - known as meeting the required minimum margin of solvency - had to be maintained throughout every year although, in general, it was only required to be demonstrated to the regulator at each year-end.

17. The way in which the calculation of technical reserves was to be undertaken was prescribed in the 1981 Regulations and later in the 1994 Regulations. The responsibility for undertaking this calculation lay with the Appointed Actuary who, from 1 July 1994, was required to use actuarial principles that had due regard to policyholders' reasonable expectations (and appropriate margins for adverse deviations of relevant factors) when determining the amount of the company's long term liabilities (regulation 64(1) of the 1994 Regulations).

18. Each insurance company was required by section 22 of ICA 1982 to submit to the prudential regulator, within six months after the close of the period to which the documents related:

   a. a copy of its annual accounts and balance sheet, prepared under section 17 of the Act;

   b. the abstract of the Appointed Actuary's report and any statement of its long term business, prepared under section 18 of the Act;

   c. its annual statement of business, prepared under section 20 of the Act; and

   d. any auditor's report on the accounts, prepared under section 21 of the Act

19. The format and content of these submissions were prescribed in great detail in secondary legislation. For the purposes of this paper, these provisions are not important; however, they will be covered in detail elsewhere.

20. The annual regulatory returns were the main source of information from which the prudential regulator (which for our purposes was the Department of Trade and Industry, then Her Majesty's Treasury, then the Financial Services Authority on behalf of the Treasury), each acting on the advice of the Government Actuary's Department (GAD), formed a

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view as to whether a company met the statutory requirements applicable to all authorised life insurance companies, and whether or not the regulator should exercise any of its statutory powers of intervention or should take any other action. However, the regulator and/or GAD were not restricted to considering information made available through the annual returns. They could seek their own information and, in November 1990, the regulator announced that site visits would be introduced as part of the regulatory process. The first of these visits took place in late 1991.

21. In addition, the following formed part of the context for, and complemented, the statutory regime:

(a) policy and prudential guidance notes and letters issued by the prudential regulator and GAD to assist officials to undertake their regulatory responsibilities appropriately, to outline to Appointed Actuaries and to insurance companies their responsibilities in complying with the regulatory regime and to inform the insurance industry as to the approach that would be adopted by the regulators and/or GAD;

(b) agreements made between the prudential regulator and GAD to govern the provision of services and advice to the regulator by GAD and, in the latter years relevant to the investigation, between the then prudential regulator and the Financial Services Authority to govern the exercise of contractual duties on the latter to undertake the day-to-day supervision of insurance companies on behalf of the regulator; and

(c) guidance developed by the actuarial profession for the Appointed Actuaries of insurance companies on the discharge of the key role which Appointed Actuaries played in the prudential regime.

22. These guidance notes, letters and agreements fulfilled various functions but in general embodied then current professional standards and accepted good practice, were aimed at giving effect to the provisions of the statutory regime and in certain respects supplemented that regime. The guidance notes, letters and agreements will be considered by the Ombudsman as being relevant, as appropriate, to the discharge of administrative functions relating to that regime - and as explanatory

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material and standards set for themselves and others by the regulator, GAD and the actuarial profession. However, the guidance, letters and agreements cannot be seen as replacing or amending the legislative provisions. If guidance or advice issued by the prudential regulator or GAD, or agreements entered into between them, were inconsistent with the statutory regime, that itself may be capable of constituting maladministration. However, such guidance notes, letters and agreements were considerations to which the regulator and GAD should have had regard.

<u>The powers of the prudential regulator</u>

23. The powers of intervention available to the prudential regulator were set out in statute and included:

- powers to withdraw authorisation from a company to conduct new business if it appeared that the company was not fulfilling its statutory obligations under ICA 1982 (e.g. to maintain a specified margin of solvency) or if it no longer met the criteria necessary for the authorisation of companies to carry out insurance business (section 11, ICA 1982);
- powers, in the event that a company failed to meet its statutory solvency margin, to require the company to submit a plan for the restoration of a sound financial position and to require modifications to that plan if it was inadequate, which the company was then required to implement (section 32, ICA 1982);
- powers, if the margin of solvency fell below the 'guarantee fund' of one third of the required margin of solvency (or below £400,000 if that sum were the greater), to require the submission of a short-term financial scheme and to require modifications to that scheme if it was inadequate, which the company was then required to implement (section 33, ICA 1982; and the Insurance Companies Regulations 1981 and 1994);
- powers to intervene in the affairs of a company in specified circumstances in the form of:

    a. a requirement for the company not to make, or to realise, certain investments (section 38, ICA 1982);

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b. a requirement for the company to maintain certain assets within the UK and to require that all or part of those assets be placed in the custody of an independent trustee (sections 39 and 40, ICA 1982);

c. a requirement for the company to limit its aggregate premium income (i.e. the amount of money paid into a company by its customers) (section 41, ICA 1982);

d. a requirement for the company to arrange for its Appointed Actuary to investigate all or part of the affairs of the company and to deposit an abstract of the Actuary's report with the regulator (which was then sent to the Registrar of Companies and which was open to public inspection) (sections 42 and 65, ICA 1982);

e. a requirement for the company to accelerate the deposit of its regulatory returns with the regulator (section 43, ICA 1982);

f. a requirement for the company to produce specified information or documents, verified in any way specified by the regulator (section 44, ICA 1982); and

g. a residual power to take such other action as appeared to be appropriate for the purpose of protecting policyholders or potential policyholders against the risk that the company might be unable to meet its liabilities or otherwise to fulfil their reasonable expectations (section 45, ICA 1982).

24. The power in g. above could not be used in such a way as to restrict a company's freedom to dispose of its assets (e.g. by preventing the distribution of assets to policyholders through bonuses) unless authorisation to conduct new business had first been withdrawn from the company; or unless the regulator believed that the company did not meet the statutory solvency margin; or unless the regulatory returns by the company showed the company's liabilities had been determined otherwise than in accordance with the valuation regulations or generally accepted accounting practices (section 45(2), ICA 1982).

25. In addition, the power under section 45 was only to be used in the event that protecting policyholders (or potential policyholders) from the risk

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that their reasonable expectations might not be fulfilled could not be appropriately achieved by the exercise of the regulator's other powers, the most important of which are summarised in sub-paragraphs a. to f. of paragraph 23 above (section 37(6), ICA 1982).

<u>The circumstances in which intervention was permitted</u>

26. The prudential regulator was empowered to use its powers of intervention in the following circumstances (section 37, ICA 1982):

a. where the regulator considered that intervention was desirable for protecting policyholders or potential policyholders against the risk that the company might be unable to meet its liabilities;

b. in the case of long-term business, where the regulator considered that intervention was desirable for protecting policyholders or potential policyholders against the risk that the company might be unable to fulfil their reasonable expectations;

c. (with effect from 1 July 1994) where it appeared to the regulator that any of the criteria of sound and prudent management of an insurance company (see below) was not or might not be fulfilled by the company (or had not or might not have been fulfilled in the past);

d. if the company failed to satisfy an obligation to which it was subject by the terms of the ICA 1982 (e.g. the maintenance of an appropriate solvency margin);

e. if the company furnished misleading or inaccurate information to the regulator;

f. if the regulator was not satisfied that adequate arrangements were in force or would be made for the reinsurance by the company of any risks that the regulator considered should be reinsured;

g. if there were grounds on which, were the company a new company, the regulator would not have granted it authorisation to carry on insurance business;

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h. if it appeared to the regulator that the company had substantially departed from any business proposal or financial forecast submitted at the time of its authorisation; and

i. in relation to non-UK based companies, if the company had lost authorisation in its 'home country'.

27. Other powers granted to the regulator from 1 July 1994 included the power to appoint one or more 'competent persons' to conduct a general investigation and to report to the regulator on two matters: first, whether the criteria of sound and prudent management were being fulfilled by the company; and secondly, whether those criteria would be fulfilled if an intended new controller of the company were to become such a controller (section 43A, ICA 1982).

28. The criteria for sound and prudent management were set out in Schedule 2A to the ICA 1982 (having been inserted by the Insurance Companies (Third Insurance Directives) Regulations 1994). These criteria included:

- that the business of the company was carried on with integrity, due care and the professional skills appropriate to the nature and scale of its activities;

- that each director, controller, manager or main agent of the company was a fit and proper person to hold that position;

- that the company was directed and managed by a sufficient number of persons who were fit and proper persons to hold the positions they held; and

- that the company conducted its business in a sound and prudent manner.

29. A company was not to be regarded as conducting its business in a sound and prudent manner:

(i) unless the company maintained adequate accounting and other records of its business and maintained adequate systems of control of its business and records (and those arrangements were not to be considered adequate unless they were such as to enable the business to be prudently managed);

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(ii) if the company failed to conduct its business with due regard to the interests of policyholders and potential policyholders;

(iii) if the company failed to satisfy any obligation under the ICA 1982; or

(iv) if the company failed to supervise the activities of any subsidiary undertaking with due care and diligence and without detriment to the company's business.

30. These statutory provisions (as amended from time to time) were in place until the replacement of this statutory regime on 1 December 2001.

<u>Maladministration and the purpose of the Ombudsman's investigation</u>

31. The purpose of our investigation is:

> *To determine whether individuals were caused an injustice through maladministration in the period prior to December 2001 on the part of the public bodies responsible for the prudential regulation of the Equitable Life Assurance Society and/or the Government Actuary's Department; and to recommend appropriate redress for any injustice so caused.*

32. No definition of maladministration was provided in the Parliamentary Commissioner Act 1967, from which the Ombudsman derives her powers. Indeed, successive Ombudsmen have resisted attempts to define rigidly the concept, as they believed that this might lead to an overly restrictive view of the types of complaint that they might consider.

33. However, in the Second Reading debate on the Bill on 18 October 1966, Richard Crossman, the then Leader of the House of Commons, said that an attempt to list the characteristics that might constitute maladministration would include *bias, neglect, inattention, delay, incompetence, inaptitude, perversity, turpitude, arbitrariness and so on.*

34. A former Ombudsman also added to this list in what he said was more 'modern' language in his Annual Report to Parliament for the year 1993. The additional characteristics he listed were: rudeness; unwillingness to treat a complainant as a person with rights; refusal to answer reasonable

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questions; neglecting to inform a complainant on request of his or her rights or entitlements; knowingly giving advice which was misleading or inadequate; ignoring valid advice or overruling considerations which would produce an uncomfortable result for the overruler; offering no redress or manifestly disproportionate redress; showing bias whether because of colour, sex, or any other grounds; omission to notify those who thereby lost a right of appeal; refusal to inform adequately of any right of appeal; faulty procedures; failure by management to monitor compliance with adequate procedures; cavalier disregard of guidance which was intended to be followed in the interest of the equitable treatment of those who used a service; partiality; and failure to mitigate the effects of rigid adherence to the letter of the law where that produced manifestly inequitable treatment.

35. In R v Local Commissioner *ex parte* Bradford Metropolitan City Council [1979] QB 289, Eveleigh LJ referred with approval to the definition of maladministration in the then current Shorter Oxford English Dictionary as being *faulty administration* or *inefficient or improper management of affairs*. Other relevant judicial determinations have relied on or otherwise quoted the 'Crossman catalogue'.

36. In addition to the characteristics outlined in the preceding paragraphs, therefore, maladministration may occur when the following are demonstrated: a failure to follow a public body's own policies and procedures; a failure to comply with recognised good practice; an omission to keep adequate records; a failure to investigate when given information that should lead to investigative action; a lack of corporate action or proper liaison when such was due; and a failure to give proper consideration to available courses of action. This list is not exhaustive.

37. What is to be regarded as maladministration is for the Ombudsman to determine provided only that her decision is one that is within the range of meaning that this term can bear in its statutory context. Section 12(3) of the 1967 Act makes it plain, however, that nothing in the 1967 Act authorises the Ombudsman to question the merits of a decision taken without maladministration by a government department or other authority in the exercise of a discretion vested in that department or authority. Nor is the Ombudsman empowered to investigate the actions of bodies in her jurisdiction if those actions were taken not in the

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exercise of the administrative functions of those bodies but in the exercise of their judicial or legislative functions.

38. Within this context, most of the complaints set out in the statement of complaint relate to actions (or omissions to act) by the regulator and/or GAD in respect of matters which relate to the exercise of administrative functions. Some complaints, however, appear at first sight to relate to ministerial policy decisions. While policy decisions are for Ministers to make, the way that such decisions are taken - for example, whether they were taken without regard to relevant considerations or whether they were taken with regard to irrelevant considerations - is capable of constituting maladministration. However, as explained above, it is not for the Ombudsman to question the merits of such decisions if they were taken without maladministration.

What might reasonably have been expected of the prudential regulator?

39. In order to determine whether the prudential regulator and/or GAD were guilty of maladministration in the performance by them of regulatory actions in respect of Equitable Life, the Ombudsman must first reach an understanding, based on the evidence available to her, of what the regulators did or did not do. She must then make an objective assessment of these actions (or omissions to act) based on the standard of regulation that reasonably could be expected from the regulators at the relevant time in the light of the then prevailing legislation, guidance and accepted good practice. Her assessment is not therefore informed by hindsight or by her opinion of what should have been the regulatory regime in place at the relevant time.

40. It should also be recognised that, while the regulator had a duty to consider their powers of intervention, they had discretion over whether and how to exercise those powers.

41. In considering the actions of the regulators and/or GAD, the Ombudsman's objective assessment will have two strands:

- the first will focus on whether the prudential regulator and/or GAD acted - or omitted to act - in a way that was inconsistent with the statutory regime that the prudential regulator was responsible

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for operating with advice and assistance from GAD and which is summarised in earlier sections of this paper; and

- the second will focus on whether, in the exercise of the discretion afforded to them within that regime, the prudential regulator and/or GAD acted within the bounds of reasonable behaviour or otherwise in accordance with a standard that could be expected of anyone exercising the ordinary skill and care of a competent person charged with the discharge of such regulatory functions - or with giving advice in relation to the discharge of such regulatory functions.

In assessing the regulator's actions, the Ombudsman will also have regard to the information that was made available to them and to the information that, in the light of the then prevailing regulatory regime, it would be reasonable to expect the regulator to have sought and to have obtained.

<u>A framework for determining whether maladministration occurred</u>

42. It is proposed that the Ombudsman will, in this context, ask the following questions:

a. Did the prudential regulator and/or GAD assess appropriately Equitable Life's annual regulatory returns, in the light of the then prevailing legislation, guidance and accepted good practice? In particular, on each occasion:

- were the assessments timely and comprehensive?
- did the regulator and/or GAD seek and obtain from Equitable Life (or from any other relevant source) any clarification or additional information that was needed to appropriately consider the returns?
- did the regulator and/or GAD consider appropriately whether Equitable Life was complying with the then regulatory regime?
- in the light of the information the regulator and/or GAD had, and their assessment of this information, did the regulator and/or GAD consider appropriately

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what action (by way of seeking further information, exercising any of their powers of statutory intervention or otherwise), if any, should be taken?

- did the regulator and/or GAD then pursue appropriately any action they deemed necessary?

b. Did the regulator and/or GAD consider appropriately whether the information they possessed from sources other than the regulatory returns indicated anything of significance to the prudential regulation of Equitable Life and did the regulator and/or GAD consider appropriately whether and how to seek and to obtain anything further that was needed to ascertain and analyse the implications of such information? In particular:

- did the regulator and/or GAD assess appropriately the additional information in their possession and/or any further information that they sought and obtained, or consider whether they should have sought or have obtained further information, in the light of the then prevailing legislation, guidance and accepted good practice?
- did the regulator and/or GAD consider appropriately what action (by way of statutory intervention or otherwise), if any, should be taken in the light of this information?
- did the .regulator and/or GAD then pursue appropriately any action they deemed necessary?

c. In relation to each head of complaint set out in the terms of reference for the investigation, did the regulator and/or GAD act:

- in a way that was consistent with the statutory regulatory regime and with then prevailing guidance and accepted good practice?
- otherwise with the skill and care that could reasonably be expected from such a regulator and/or such a professional adviser in all the circumstances?

Response by the Treasury to standard of regulation discussion paper (July and November 2005)

GOVERNMENT RESPONSE TO THE OMBUDSMAN'S DISCUSSION PAPER ARTICULATING AN APPROPRIATE STANDARD OF PRUDENTIAL REGULATION

Paragraphs 37 and 38

Principles
We agree with the three fundamental principles identified in paragraph 37, i.e. that the Ombudsman may only scrutinise *administrativ*e actions; that the Ombudsman may not question the merits of a discretionary decision taken without maladministration; and that what is to be regarded as maladministration is (subject to the ultimate scrutiny of the court) for the Ombudsman to decide. 'Traditionally', maladministration has focussed upon the *manner* in which decisions are reached and the *manner* in which they are or are not implemented – an interpretation that has been consistently adopted by the courts.

In a very complicated investigation like the present, there are potentially in issue a variety of administrative acts that were performed over a considerable period of time – spanning some 30 years in fact. We are not sure, looking at the Discussion Paper, whether it is the Ombudsman's intention to apply the tests for maladministration to individual instances, or whether she will apply them in the context of an overall assessment of the standard of regulation. This is important because individual instances of maladministration, if found, may have had little bearing on the overall standard of regulation to which ELAS was subject and so, in a broader sense, were not maladministrative.

Perhaps the real issue is injustice – in circumstances like this case, not all instances of maladministration would, even remotely, have caused injustice. In our view it makes sense, in the circumstances of this particular investigation, if maladministration were only addressed in the context of a demonstrable causative link with an identifiable injustice suffered. Where this is lacking, our view is that any finding of maladministration would serve no purpose, because the regime under scrutiny has now been replaced – and there has already been a comprehensive Inquiry conducted by Lord Penrose which looked at the lessons to be learnt.

Scrutiny of Ministerial Policy Decisions
Paragraph 38 mentions that ministerial policy decisions will be subject to scrutiny. This assumes, of course, that the Ombudsman views these decisions as 'administrative functions'. Naturally, as this paragraph recognises, many of the regulator's and GAD's actions at issue in this investigation were administrative in nature. However, we think that the line can be much more difficult to draw in the case of ministerial policy decisions. In practice, there is often a chain of interrelated decisions at different levels, each linked to the other; for example, decisions by civil servants in line with policy decisions of ministers, who in turn act consistently with high level policy determined by the government of the day on the basis of its electoral mandate and the will of Parliament. Logically each of these is a separate decision, and those lower down the hierarchy are determined by and have to be understood in the light of those above it. The higher up the chain, the less administrative in nature the decisions are. The then government's policy of *"freedom with disclosure"*, and the resourcing policy formulated in parallel, is a good illustration of this.

The question is how far up the chain the Ombudsman, in her discretion, chooses to go.

Response by the Treasury to standard of regulation discussion paper (July and November 2005)

A comparison of the Ombudsman's process and judicial review may be a useful means of illustrating the difficulties involved. Indeed this is a particularly appropriate comparison because the language of paragraph 38 suggests a similar scrutiny process to that which the courts would adopt in judicial review.

As already noted, the orthodox meaning of maladministration focuses on the manner in which a decision is taken or executed. As such, it has something in common with the test of procedural fairness applied by the court in exercise of its discretion in judicial review. But there is a very significant difference. Where the court quashes a decision on the grounds of procedural unfairness, it will then remit the matter to the decision maker for reconsideration. The court cannot dictate to the decision maker what decision he or she should make. As such, having considered the matter again, and having followed a fair procedure, the decision maker may quite lawfully *come to exactly the same conclusion as before*. The Ombudsman, on the other hand, does not have the power to quash a decision and refer it back, not least because her investigations are of necessity conducted some time after the relevant events have occurred; and therefore there is no way of knowing whether, absent the maladministration, the decision maker would nevertheless have reached exactly the same policy decision. The higher level the decision, and/or the more policy based it is, and/or the older it is, the more insuperable these difficulties become because there will be an ever-increasing chain of related decisions. The courts do not encounter this problem because of the 3-month time limit to bring a claim in judicial review imposed for this very reason by Parliament to avoid undermining certainty in public administration.

We accept, of course, that there is no absolute legal bar upon the Ombudsman from finding that a policy decision was defective and therefore maladministrative, even in the case of decisions made many years ago. The more significant question is whether it is appropriate for her to do so in practice. In particular, what would she do having made such a finding? It is of course open to her to make a recommendation to pay compensation in any case. However, such a recommendation in the situation contemplated would of necessity be premised upon a conclusion as to what the outcome would have been had the defect been absent. Unless it is quite obvious what the outcome would have been, this must involve some sort of assessment of the merits of the original decision – which is territory in which the Ombudsman cannot go. We suggest that the correct approach is that when decisions are looked at – whenever and by whomever they were made – no maladministration should be found unless it is *obvious* that, had the defect not occurred, a different conclusion *would* have been reached, *and* what that conclusion would have been. Without this, no sensible quantum could be determined in respect of any recommendation to pay compensation. And, if no quantifiable recommendation can be made, there is no practical purpose in making a finding of maladministration.

In relation to the JR-like test that is proposed in paragraph 38, we would also wish to urge caution in treating the traditional grounds of judicial review as grounds for a finding of maladministration. There can't be a simple read-across. For example, a rationality test[1] involves an assessment of the merits of the decision, and the Ombudsman cannot determine what the correct interpretation of the law ought to have been. Even in the example of

[1] In other words, was the decision within the range of responses reasonably open to the decision maker?

whether relevant or irrelevant considerations were taken into account, there cannot be blanket read-across. Discretionary decisions sometimes involve giving different weight to a range of very complex factors. In practice, decision makers acting in good faith have got it wrong and have been judicially reviewed; yet it seems contrary to a common sense understanding of the concept to suggest that on all these occasions there was maladministration. We note the helpful emphasis in paragraph 38, perhaps in recognition of these points, that process flaws are *capable* of constituting maladministration.

Paragraphs 39, 41 and 42

Paragraph 39 recognises that the actions of the regulator and/or GAD cannot be viewed with hindsight or in the light of the Ombudsman's opinion of what the regulatory regime ought to have been at the relevant time. We agree with this.

In relation to the references in paragraphs 39 and 42 to the actions of the prudential regulator/GAD being measured in the light of "the then prevailing legislation, guidance and accepted good practice": we completely agree that the Ombudsman must assess the actions of the prudential regulator and/or GAD in the light of the then prevailing regulatory regime. By "regulatory regime" we refer to the then prevailing legislation and government policy adopted pursuant to it, as embodied in the guidance and accepted best practice that went with them. We feel that "regulatory regime", cross-referenced as necessary to the detailed description of it that will be published, is a better descriptor of what the prudential regulator/GAD ought to be measured against, because "guidance and accepted good practice" does not clearly convey the central role that government policy played in the regime[2]

We are not clear as to what is proposed by the second strand of the Ombudsman's assessment referred to in paragraph 41 (and which similarly appears in paragraph 42(c)). It appears to be an application, in the context of the Ombudsman's jurisdiction over maladministration, of legal concepts of a duty of care and its breach – in effect, negligence. We would urge caution against borrowing from the law of negligence, with the considerable complications that this will entail.

Firstly, is it the Ombudsman's intention to focus on negligence as to *manner*, or negligence as to *outcome*? If the former, we do not think that this adds anything to the first strand of the Ombudsman's assessment, and wonder, therefore, whether the second strand is necessary. If the latter, this would represent a move from the traditional test with its focus on *manner* to a broader substantive inquiry focused upon the result of the decision. This would be problematic. In the case of policy or discretionary decisions in particular, this approach would risk crossing the line drawn at assessing the merits of such decisions. For example, a discretionary decision correctly taken in line with a properly formulated policy may simply be an inadequate response and negligent for that reason. How would such a finding not represent an assessment of the merits of the decision?

Secondly, reliance on concepts borrowed from the law of negligence, like 'duty of care', risks the Ombudsman becoming mired in the same legal complexities that vex the courts. In particular, before imposing a negligence standard on the prudential regulator, the Ombudsman would need to consider the following issues: (i) what would bethe practical consequences of imposing a duty of care on prudential regulators? (ii) what standards

[2] It tends to assume that government policy *was* the guidance and accepted good practice, when in fact guidance and accepted good practice would have been developed *pursuant to or in the light of* government policy.

should be applied when trying to assess whether or not any such duty has been breached? (iii) what tests of causation or remoteness should be applied to any loss said to have been suffered by the investing public? For present purposes, we would simply like to observe that each of these questions has, in the past, given rise to considerable legal debate, which we think cannot be ignored by the Ombudsman before utilising a "negligence" test to determine whether or not there has been maladministration.

(i) Consequences

There are three broad concerns:

Firstly, we assume that the Ombudsman intends to apply the duty of care test to all discretionary decisions, including ministerial policy decisions. If this is so, this would cut across the tendency of the courts (in England and Wales at least) against applying a test of negligence in these circumstances. The courts have drawn a distinction between policy or discretionary decisions, which involve the assessment of different choices of courses of action, and operational decisions, which involve the carrying out or implementation of policy or discretionary decisions[3]. The line of course is difficult to draw, but the principle is that the more policy orientated a decision may be, the less inclined are the courts to impose a duty of care.

Secondly, regarding the position with regulators in particular, on a number of recent occasions the courts (the Privy Council and the House of Lords) have for policy reasons refused to impose a duty of care on prudential regulators in favour of the investing public.[4] The Courts have consistently taken the view that, where prudential regulators are concerned, a number of different factors arise which militate strongly against the imposition of a duty of care. These include the following:

i. There is a serious risk that imposing such liability would result in over-cautious or otherwise risk-averse regulation. This dead hand would not be in the interests of the wider economy, which lie in sectoral innovation, enterprise and thus growth.

ii. In acting, or not acting, regulators are required to consider and balance a range of different matters including the allocation of scarce resources; they have a wide discretion and the issues involved are not readily justiciable.

iii. The imposition of a duty of care on the regulator would involve making it liable for the defaults of a regulated entity. As a matter of principle, a person should not be made liable for the wrongdoings of another unless it can exercise a high degree of

[3] See, for example, *Barrett v Enfield London Borough Council* [2001] 2 AC 550, where Lord Hutton said: "...I consider that where a plaintiff claims damages for personal injuries which he alleges have been caused by decisions negligently taken in the exercise of a statutory discretion, and provided that the decisions do not involve issues of policy which the courts are ill-equipped to adjudicate upon, it is preferable for the courts to decide the validity of the plaintiff's claim by applying directly the common law concept of negligence than by applying as a preliminary test the public law concept of *Wednesbury* unreasonableness (see *Associated Provincial Picture Houses Ltd v Wednesbury Corpn* [1948] 1 KB 223) to determine if the decision fell outside the ambit of the statutory discretion. I further consider that in each case the court's resolution of the question whether the decision or decisions taken by the defendant in exercise of the statutory discretion are unsuitable for judicial determination will require, as Lord Keith stated in the *Takaro* case [1988] AC 473, 501, a careful analysis and weighing of the relevant circumstances."

[4] See in particular *Yuen Kun Yeu v AG for HK* [1988] AC 175; *Davis v Radcliffe* [1990] 2 All ER 536; and *Three Rivers District Council v Governor and Company of Bank of England* [2003] 2 AC 1.

control over the latter. A regulator does not have day to day control over the management of the regulated entity; its role is much more limited.

iv. It is not reasonable for the customers, or potential customers, of a regulated body to expect the regulator to guarantee its soundness. No system of regulation can guarantee that outcome – and all investment carries with it risk.

v. Regulation is conducted in the wider public interest, not for particular groups of investors, either within a particular sector or within a particular company. Different members of the public may have differing and potentially conflicting interests that a regulator is obliged to balance (for example an expectation that regulation would not be too interventionist, so that the costs to industry and therefore the public are kept to a minimum; or, in the present context, the differing PREs of differing classes of policyholder within ELAS).

vi. The potential width of the class of individuals to whom a duty of care would be owed gives rise to a risk of "floodgate" claims, if a prudential regulator is held to owe a duty of care to the investing public.

All of these policy considerations would apply with equal force to preclude a recommendation being made by the Ombudsman for compensation to be paid by a prudential regulator on the grounds of a finding of negligence based upon a breach of a duty of care.

Thirdly, the Ombudsman may be aware of the recent policy initiatives by the government to streamline the regulatory burden on the business sector. The recent Hampton Review recommended that regulators should take a risk-based approach across all of their enforcement activities. In the Chancellor's Budget report the Government accepted the Review's recommendations and undertook to bring forward legislation to implement them. An approach by the Ombudsman which, we believe, potentially could give rise to the prospect of over-cautious or risk-averse regulation would cut right across these policy developments.

(ii) Standard

Aside from assessing whether a duty of care should be imposed, how will the Ombudsman assess whether or not it has been breached? Will she, for example, apply the test in law for judging breach in a professional context – i.e. against what the generality of professional opinion would be (the *Bolam* test)[5]? In other words, will she look to see what other regulators or professional advisers would have done in similar circumstances with the knowledge (and constraints) the regulator actually had at the prevailing time? Or will she consider what skill and care a hypothetical regulator ought to have had and then what a regulator with that skill and care would have done in similar circumstances with the knowledge (and constraints) the regulator actually had (or ought to have had) at the prevailing time? Or will she apply a test more analogous to the test applied by the Courts in a judicial review

[5] See the direction to the jury of McNair J in *Bolam v Friern Hospital Management Committee* [1957] 1 WLR 586 – 587. The test is "...not the test of the man on top of the Clapham omnibus, because he has not got this special skill. The test is the standard of the ordinary skilled man exercising and professing to have that special skill. A man need not possess the highest expert skill at the risk of being found negligent. It is well established law that it is sufficient if he exercise the ordinary skill of an ordinary competent man exercising that particular art..."

context: and consider, when assessing an alleged breach of any duty, whether the regulator conducted itself in a way that no reasonable regulator, in similar circumstances and with the knowledge (and constraints) of the regulator, would have done?

(iii) Causation

Certain questions arise to which we wish to draw the Ombudsman's attention: How will the ombudsman deal with questions of causation and remoteness? In particular, would a mere "but for" test be applied to determine the issues of causation? Or would the Ombudsman consider, as is done in the case of auditors' professional negligence cases, whether the negligence was the effective cause of the investors' loss, as opposed to simply giving rise to the opportunity for the investors to suffer that loss at the hands of fraudulent or incompetent management (and for which the auditor should not be held liable)?[6] What losses break the chain of causation and/or are too remote (for example the fall in the stock market; the outcome of the *Hyman* litigation; the fact that the ELAS sale fell through)?

Conclusion on negligence

Although we recognise that it is a matter for the Ombudsman to decide whether to do so, we wonder whether it would be wise or practical for her to adopt the language of negligence and to try to adapt it as part of the concept of "maladministration". In our view there are real and substantial difficulties with this approach. It risks the Ombudsman's process becoming burdened with the considerable legal baggage that goes with it; and it cuts across the wider public interest that judicial and government policy has sought to address.

We therefore suggest the following wording for paragraph 41:

> *In considering the actions and decisions of the regulators and/or GAD, the Ombudsman's objective assessment will focus on whether the prudential regulator acted – or in omitting to act, behaved – outside the bounds of, or inconsistently with, the regulatory regime that the prudential regulator was responsible for operating with advice and assistance from GAD.*

...

[6] See *Galoo v Bright Grahame Murray* [1994] 1 WLR 1360.

ANNEX A

EXCERPTS FROM: COMMENTS ON THE "FRAMEWORK FOR DETERMINING WHETHER MALADMINISTRATION OCCURRED"

Paragraphs 42 (a) and (b)
We agree that the starting point in the Ombudsman's factual inquiry should be the regulator's assessment of Equitable Life's annual returns. This was, of course, the starting point by which the regulator determined whether life insurance companies were complying with the statutory solvency requirements, supplemented by appropriate questioning of this information, and appraisal of the replies, during the scrutiny process.

...

... [W]e think that it would make sense in this particular investigation if maladministration were only addressed in the context of a demonstrable causative link with an identifiable injustice suffered. We remain of the view that where this is lacking, any finding of maladministration would serve no purpose, because the regime under scrutiny has now been replaced, and because there has already been a comprehensive inquiry conducted by Lord Penrose which looked at lessons to be learnt.

... [M]aladministration has 'traditionally' focused upon the *manner* in which decisions are reached and the *manner* in which they are or are not implemented – an interpretation that has been consistently adopted by the courts. Our view is that this principle ought to be central in any assessment of the "appropriateness" of the regulator/GAD's behaviour. The assessment of whether any behaviour was "appropriate" should not involve questions of whether what was done was "reasonable" or "rational" (see below).

We also wish to comment on your proposal to assess whether behaviour was "appropriate" in the light of "accepted good practice". Unlike the position with legislation and guidance, it is not clear what administrative standards the regulator/GAD are to be measured against if the benchmark is "good practice". This is a flexible concept which could encompass a range of standards from acceptable to best practice. We do not accept that a failure to follow "accepted good practice" would be maladministration. By definition, good practice is of a higher standard than (for example) acceptable practice.

Paragraph 42(c)
We suggest that the primary question for the Ombudsman to consider in her analysis of the facts is whether the prudential regulator acted – or in omitting to act, behaved – outside the bounds of, or inconsistently with, the regulatory regime that it was responsible for operating with advice and assistance from GAD.

This is in part reflected in the first bullet point of paragraph 42(c), but the second bullet point seems to indicate a separate objective test going beyond the requirements of the regulatory regime itself, in particular a duty of care test (hence the comments in our draft response in relation to negligence). In the light of your assurances, we are assuming that the second bullet point will be deleted.

Taking all the above points together, could not paragraph 42(c) be expressed as follows:

Did the regulator and/or GAD, with maladministration, fail to act in accordance with the statutory regulatory regime and the policies adopted in implementing that regime?

Where this involved a discretionary decision or the exercise of judgment, did the process by which the decision was reached or the judgment determined, or its implementation involve maladministration?

In relation to (b), our view is that the question before the Ombudsman ought to relate solely to process, or *manner*. As we mention above, we don't agree that it can involve any assessment of "reasonableness" or "rationality", which would represent in our view an assessment of the merits of the decision. Section 12(3) of the 1967 Act states that "nothing in this Act authorises or requires the Commissioner to question the merits of a decision taken without maladministration...in the exercise of a discretion vested in that department or authority". In our view "decision taken without maladministration" refers to the how the decision was made, not its outcome, which is what an assessment of its reasonableness would refer to.

This view is consistent with the *Bradford* judgment quoted in the discussion paper, where Lord Denning, in considering the meaning of "maladministration", said, *"It would be a long and interesting list, clearly open-ended, covering the manner in which a decision is reached or discretion is exercised: but excluding the merits of the decision itself or of the discretion itself. It follows that a 'discretionary decision, properly exercised, which the complainant dislikes but cannot fault the manner in which it was taken, is excluded'."*

You have of course given us assurances that it is not the Ombudsman's intention to assess the merits of discretionary decisions, for which we are grateful.

ANNEX B

FREEDOM WITH PUBLICITY

We have been requested to provide a 'positive' statement of what the Government believe could have been expected – by individual policyholders and by regulated entities such as Equitable – from those operating the regulatory regime as guided by the policy of freedom with publicity.

Background
The governments of the day had two primary objectives in life insurance regulation: commercial freedom and innovation on the one hand and policyholder protection on the other.
The doctrine of freedom with publicity was seen as providing an appropriate balance between these two competing objectives.

By the time the Insurance Companies Act 1973 was enacted, the doctrine of "freedom with publicity" had been government policy in regulating the insurance sector for almost a century. Its form had of course evolved considerably over this time, but the essence of the doctrine remained the same: provided that life insurance companies complied with certain requirements, they were free to pursue their business as chosen without government interference[1].

In limiting interference in the affairs of insurance companies the doctrine sought to facilitate effective competition, promote growth and expansion in the industry and to reduce the administrative cost of regulation upon the regulated sector. In other words, in applying the doctrine the prudential regulator was pursuing the government's publicly stated objective of an efficient, competitive and innovative market[2].

Freedom with publicity was not so much a " 'benchmark' against which the regulators should or could be judged" as a guiding principle which generated certain expectations in the regulated sector and in the investing public. Provided certain conditions were fulfilled it was fundamentally a policy of "not doing things", as opposed to "doing things", although that does not mean that there weren't positive obligations.

What the industry could expect under Freedom with Publicity
The primary expectation of any government is that it will exercise its discretionary powers consistently and in accordance with its stated policies.

When it came to the prudential regulation of the insurance sector, whilst the industry was of course obliged to comply with the statutory controls placed upon it, there was a clear expectation that the prudential regulator would not otherwise seek to interfere in the affairs of a company.

[1] In an address before the House of Lords on 8 February 1973 the Parliamentary Under Secretary of State, Department of Trade and Industry, said, *"The form and extent of supervision designed to reduce the risk of insurance failures has changed through the years, but a modified form of the caveat emptor doctrine has been the guiding principle throughout. This has usually been referred to as "freedom with publicity", meaning that the insurer normally has more or less complete freedom to run his business as he thinks fit, but must make available certain prescribed information to help the policy holder take a view as to his likely ability to pay up if and when the occasion for indemnity arises."*

[2] On 21 May 1973 the Minister for Trade and Consumer Affairs, in an address to the House of Lords, said, *"The aim in legislation in these matters is to strike a proper balance between, on the one hand, allowing the industry so much freedom that it can be exploited by rogues and, on the other hand, creating for the industry such shackles that it cannot give an efficient, competitive and forward-looking service to consumers here and abroad."*

Provided that they were complying with statutory requirements, authorised insurance companies could legitimately expect to have the freedom to design their own products, set their own premiums and conditions of contract with customers, to determine their own investment and bonus distribution strategy, and to pursue their chosen business models[3].

The obligation upon the prudential regulator was to regulate consistently with these expectations. The approach adopted in practice was characterised as regulating with a "light touch"[4].

"Publicity" as a pre-requisite for "Freedom"
The "price" of the freedom that insurance companies could expect was that they were required to make certain aspects of their affairs public and to comply with certain other safeguards built into the regulatory system[5].

In this the doctrine sought to fulfil the government's other objective of protecting policyholders by enabling them, with input from market analysts, journalists, and brokers, to make informed investment choices. If this was to be effectively achieved, **it naturally entailed an obligation upon the prudential regulator (within the extent of its remit) to ensure that the "publicity" element of the doctrine was properly discharged by the regulated sector.** However the doctrine of freedom with publicity had informed the very design of the prudential regulatory framework to achieve this. Primary and secondary legislation prescribed in detail the nature and form of disclosure required; and this was supplemented by additional guidance. Section 65 of the Insurance Companies Act 1982 obliged the prudential regulator to deposit with the registrar of companies copies of the returns made by insurance companies.

The investing public's expectations
Although not the primary "recipient" of the exercise of executive power pursuant to the doctrine of freedom with publicity, members of the public had expectations deriving from the doctrine's design to best balance their interests as consumers. The public would have had expectations in relation to both the behaviour of the companies they invested in and the prudential regulator's exercise of its statutory powers.

In relation to the companies themselves, the public had an expectation that they would provide honest and proper disclosure to the prudential regulator in accordance with their statutory obligations. In turn their expectation of the prudential regulator was that it would monitor life insurance companies' compliance with regulatory requirements, in particular statutory solvency on the basis of the information disclosed in the regulatory returns.

There was an expectation of the prudential regulator that it would not regulate in a way so as to damage consumers' interests by distorting the market, reducing the amount of choice available or by making insurance products more expensive through failure to minimise the cost-burden of

[3] During the passage of the Insurance Companies Bill through Parliament in 1981, the Under-Secretary of State for Trade said, *"In general, there has been no Government control of premiums or other conditions of contract between insurers and policyholders; there has not been Government direction of the investment of insurance companies; there has been a wish to see the insurance industry expand the range and volume of its business in the United Kingdom and in other countries..."*
[4] As the PCA noted in paragraph 35 of her first report, *"The style adopted by the prudential regulators was variously described by them to my staff at interview as "passive", 'light touch' and 'like negative vetting'...".*
[5] See again paragraph 140 of the PCA's first report.

Response by the Treasury to standard of regulation discussion paper (July and November 2005)

regulation[6]. Powers of intervention were broad and draconian and the intention was that the regulator would be able to use influence and persuasion under threat of their use[7]. **Consumers could legitimately expect that the regulator would not use its powers lightly or capriciously.**

Having highlighted what consumers could expect under the doctrine of freedom with publicity, it is equally relevant and important to highlight what they could not expect.

Firstly, there were limits to the extent to which the prudential regulator could be expected to fulfil the role of policeman or detective in addition to its monitoring role. The investing public did not have an expectation that the prudential regulator would second-guess or challenge the management of a company, or its Appointed Actuary, unless there was clear evidence[8] that it was acting in a way that was contrary to regulatory requirements.

The actuarial practices adopted by a company were a matter for the professional judgment of its Appointed Actuary, acting within the limits permitted by the regulations and guidance issued by the actuarial profession, and there was a range of possible actuarial approaches satisfying this criterion. The Appointed Actuary was professionally bound to provide full and accurate disclosure in the returns and to certify compliance with the regulations, and, consistent with the concept of freedom with publicity, the regulator and GAD could reasonably be expected to rely on the information provided by the company when monitoring compliance with the regulations.

Secondly, there was no expectation that the regulator would prevent all company failures or underwrite their losses when failures occurred. Clear public statements were made to the contrary[9] and this would not have been consistent with an expectation not to distort the market. Where things did go wrong, the government had enacted the Policyholders Protection Act in 1975 to provide some safeguards for the consumer.

[6] As the Ombudsman recognised in paragraph 35 of her first report, "*The philosophy of the regime, in contrast to those that had applied in some of the other financial sector regulatory regimes, such as banking, which concentrated on product and tariff control, was to allow consumers to benefit from competition between insurers through downward pressure on prices and greater choice of products*".

[7] As the PCA found at paragraph 24 of her first report, "*I do not dissent from [the] view that the prudential regulator could only intervene formally if a company breached the statutory requirements and that, otherwise, their role was to identify problems and issues, and through informal pressure, encourage the company to take the necessary action to get back to a sound financial base*".

[8] From the Returns or from replies to questions put to the company by the regulator/GAD

[9] The Under-Secretary of State for Trade, on 2 February 1981, said to Parliament, "*There have been cases in the past where failures of insurance companies have done policyholders and interested third parties great harm, and, indeed done the industry no good. Although no system of supervision can avoid completely the risks of difficulty or failure of an insurance company, Government responsibility for a systematic approach is to be found not just in the United Kingdom, but throughout the countries of the developed world and in many others.*".

Conclusion

The doctrine of freedom with publicity entailed both positive and negative obligations upon the prudential regulator. It was fundamentally a policy of restraint (provided that certain conditions were met) in pursuance of positive market related objectives.

The doctrine of freedom with publicity informed the design and operational implementation of the statutory framework. In other words, a description of the positive obligations under the doctrine of freedom with publicity involves a description of the statutory requirements themselves as they from time to time existed, having been designed to implement the doctrine as it was then interpreted.

When it came to the exercise of discretion, the prudential regulator was obliged to act consistently with the expectations that the doctrine created in terms of its stated objectives. In practice the approach adopted was described as regulating with a "light touch".

Section 3

Information regarding complainants and direct contacts

Results of survey of complainants and direct contacts

Introduction

In August 2006, we conducted a survey of everyone who had registered an interest with the investigation in order to establish up-to-date information about them, their relationship with Equitable Life, and the financial and other effects on them of the circumstances which led them to contact us.

The questionnaire process

A total of 1,873 questionnaires were sent to those people for which we had up-to-date postal or email addresses. 1,213 questionnaires were completed and returned to us. This represented a 64.8% response rate. However, 24 of those responses were deemed to be new contacts, in that those people had not previously had contact with us prior to the questionnaire being sent out. As the primary purpose of the questionnaire was to collect enhanced information on existing complainants and direct contacts, those 24 responses have been excluded from the following reports. Therefore, the number of questionnaires on which the following information is based is 1,189.

Information about respondents

The questionnaire asked respondents to provide us with up-to-date personal information about themselves. The information they provided was as follows:

Chart 1: Gender

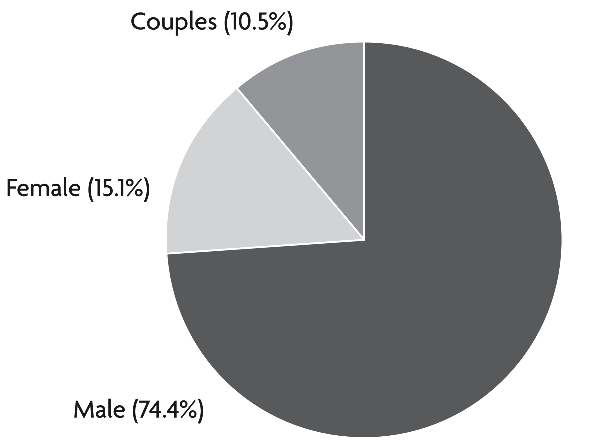


Chart 2: Retirement status

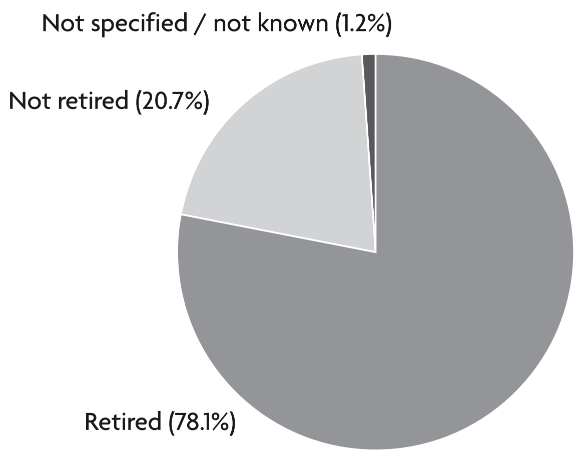
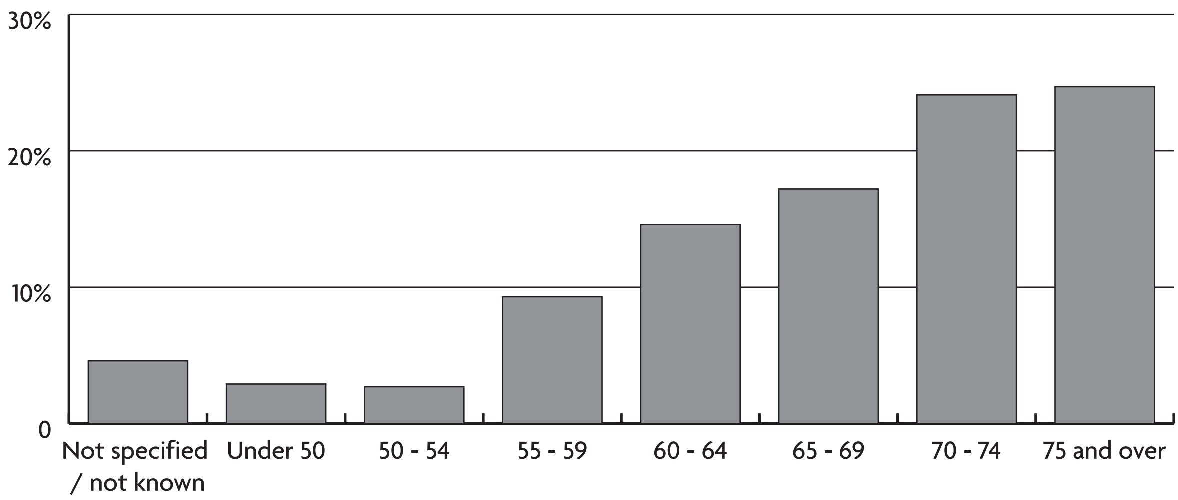
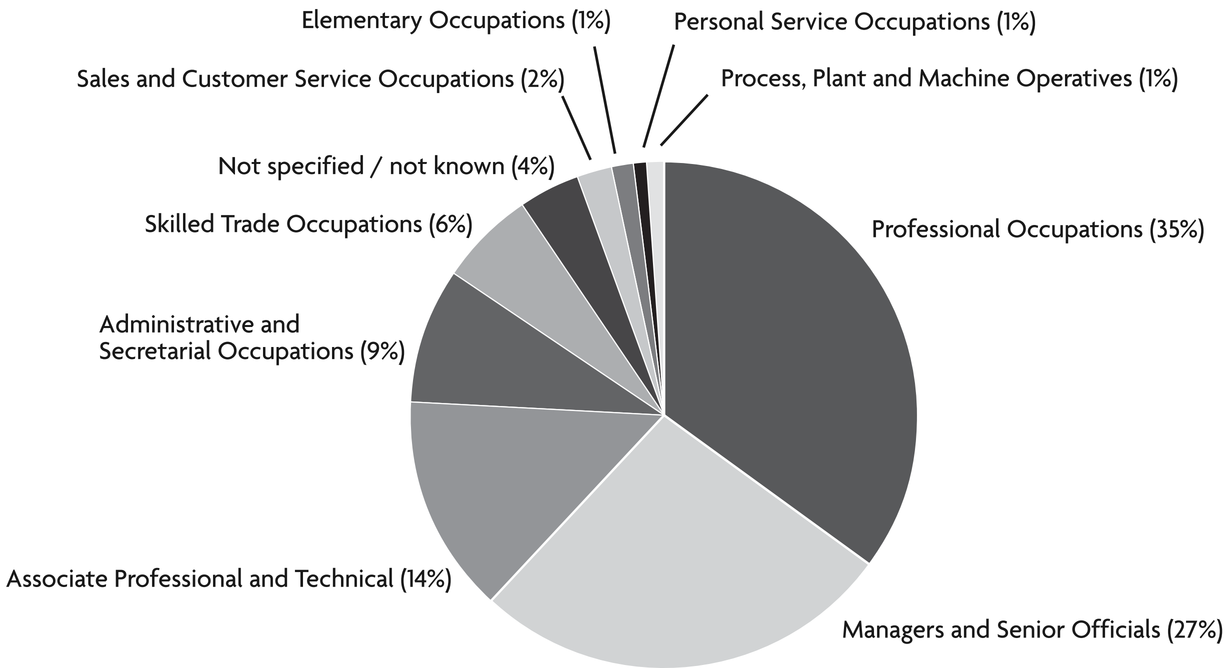


Chart 3: Age range



Results of survey of complainants and direct contacts

Chart 4: Occupation type



(Note: occupations were classified according to categories used in the 2001 Census. Those categories are explained on the website of the Office for National Statistics, at http://www.statistics.gov.uk/methods_quality/ns_sec/soc2000.asp .)

Information about contact with my Office

Throughout the investigation, a range of people contacted us concerning Equitable Life. The questionnaire sought to clarify how many people believed that their complaint had been referred by an MP, and how many had contacted us directly. We also sought to establish during what time period respondents thought that they had first made such direct contact.

In the 'First contact' question, 47.7% of complaints (567 people) indicated that their complaint had not been referred by a MP and a further 1.1% of complainants (13 people) were not sure if their complaint had been so referred. Those 580 respondents said that they thought that they had first contacted the office directly.

In a number of cases, the respondent's belief proved to be incorrect. We have verified each complaint or direct contact and the true position is set out on Chart 16.

Chart 5: Referred complaints?

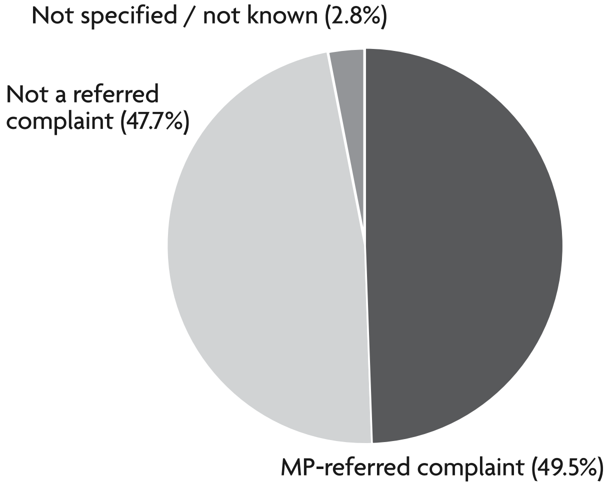
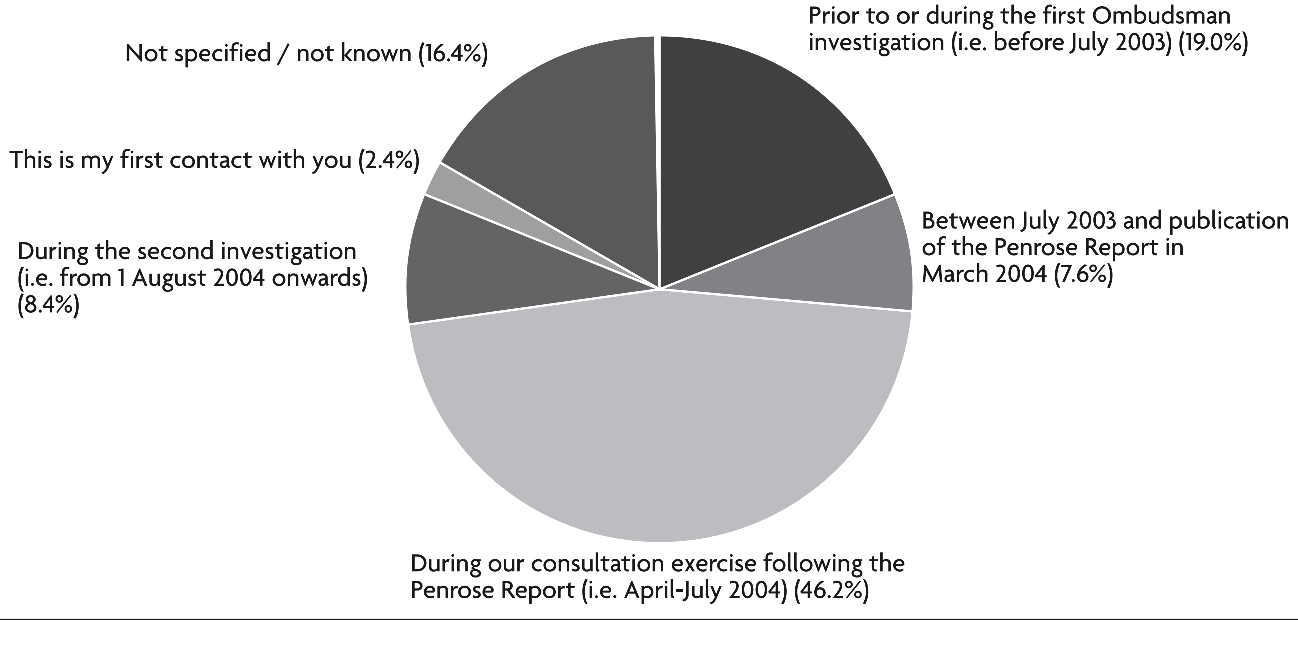


Chart 6: First contact with my Office?



Information about relationship with Equitable Life

The questionnaire sought to obtain information about the types of savings or investments that respondents had made with Equitable Life and also some other information about their relationship with the Society.

The 1,189 questionnaire responses contained information regarding 2,989 policies.

Number of policies
Respondents were asked to specify how many policies they had with Equitable Life. The responses are shown in Chart 7.

With-profits policy?
Respondents were asked to indicate whether their policy/policies were with-profits policies. The responses provided the information depicted in Chart 8.

Guaranteed annuity rate (GAR) status
Respondents were asked to indicate whether their policy/policies contained guaranteed annuity rates. The responses provided the information depicted in Chart 9.

Guaranteed investment return (GIR) status
Respondents were asked to indicate whether their policy/policies contained guaranteed investment return. The responses provided the information in Chart 10.

Was the policy a current investment with the Society?
For each policy identified by respondents, we sought to understand which of those policies were current investments with the Society. The reponses are shown in Chart 12.

Receiving benefits
Where people responded that they were currently receiving benefits (40.6%), respondents categorised those benefits in the ways depicted in Chart 13.

Taking benefits
Where people advised that their policy was no longer with the Society (43.7%), respondents said that they had taken their benefits in ways shown in Chart 14.

Exit charges?
Respondents with such non-current policies (43.7%) identified whether or not they had incurred exit charges. They gave us the information shown in Chart 11.

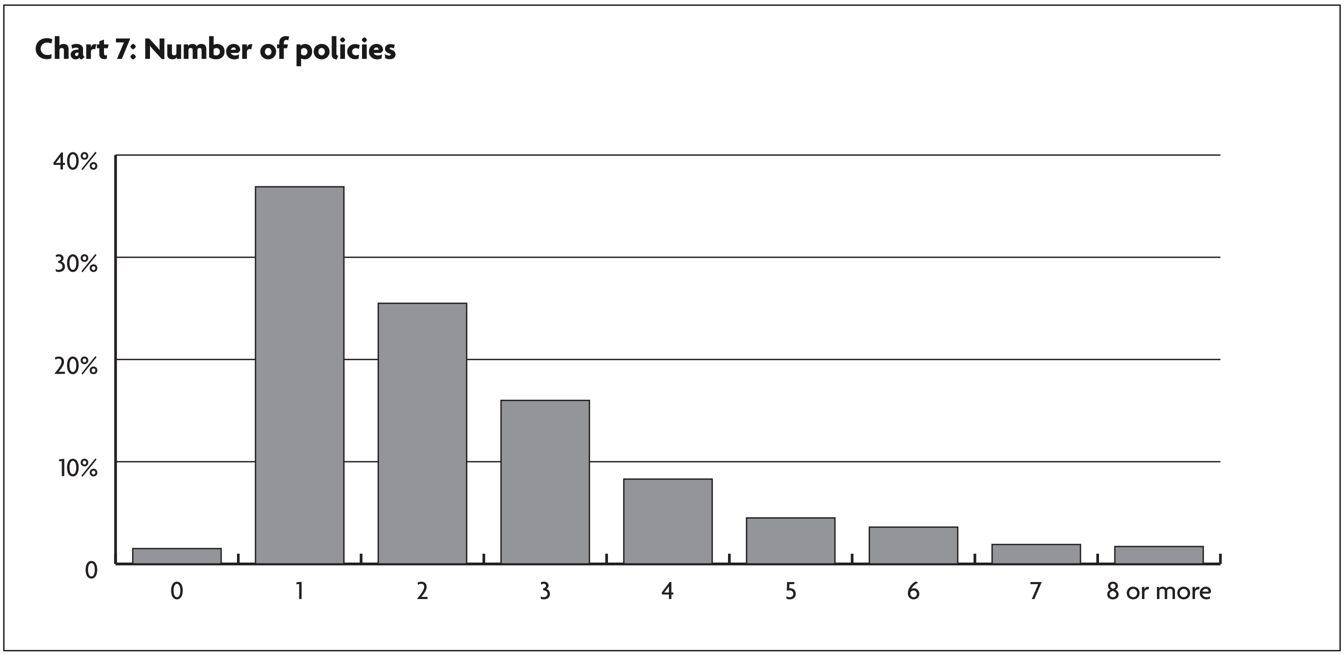
Operation type
Respondents were asked from which Equitable operation they had bought their policy/policies. We were told that:

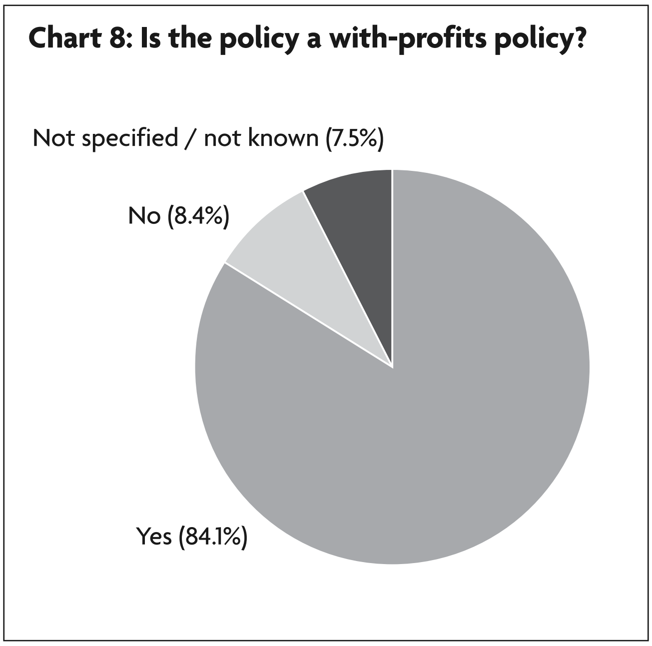
- 97.2% of respondents had dealt with the Society's United Kingdom operation
- 0.8% of respondents had dealt exclusively or in part with one of the Society's overseas operations
- 2% of respondents did not answer or did not know.

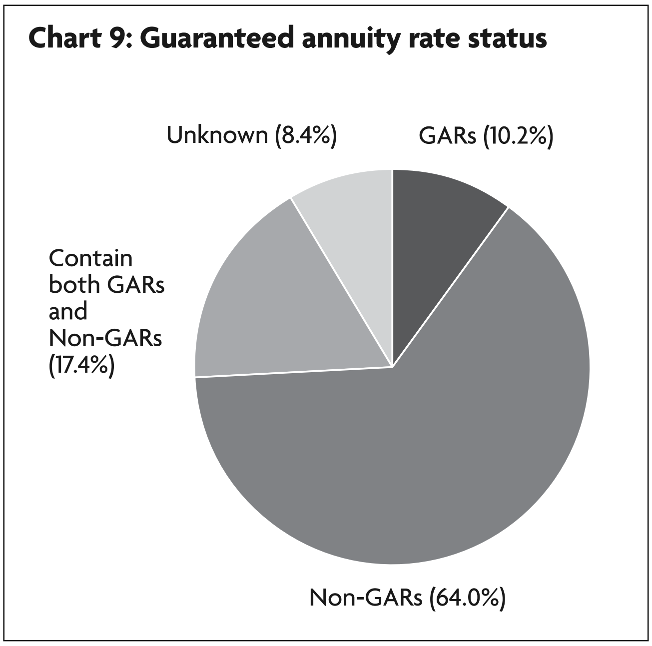
The overseas responses came from people who said that they had dealt with:

- Guernsey & the United Kingdom (4 people)
- Guernsey (2 people)
- Ireland (2 people)
- Kuwait & the United Kingdom (1 person).

Results of survey of complainants and direct contacts







Results of survey of complainants and direct contacts

Chart 10: Guaranteed investment return status

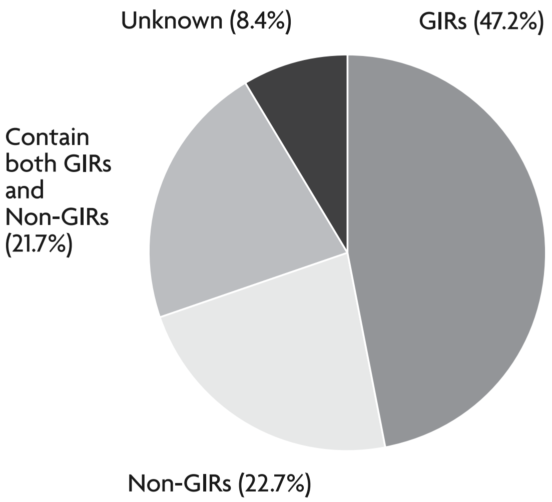


Chart 11: Exit charges?

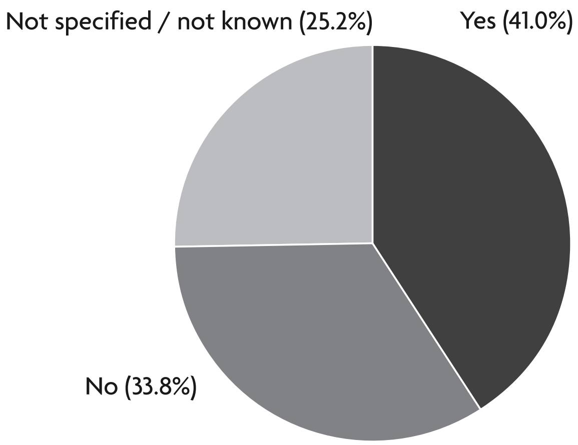
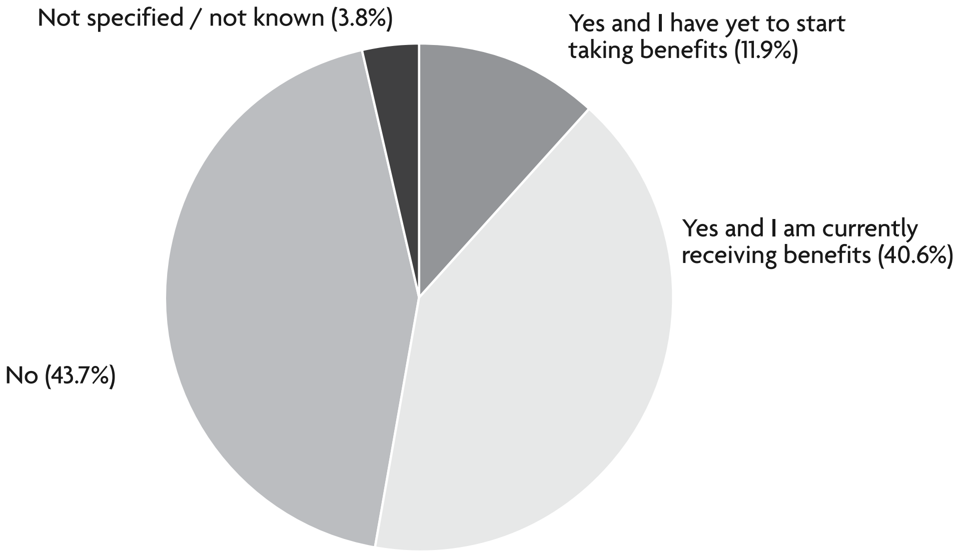


Chart 12: Is the policy a current investment with the Society?



Results of survey of complainants and direct contacts

Chart 13: Receiving benefits

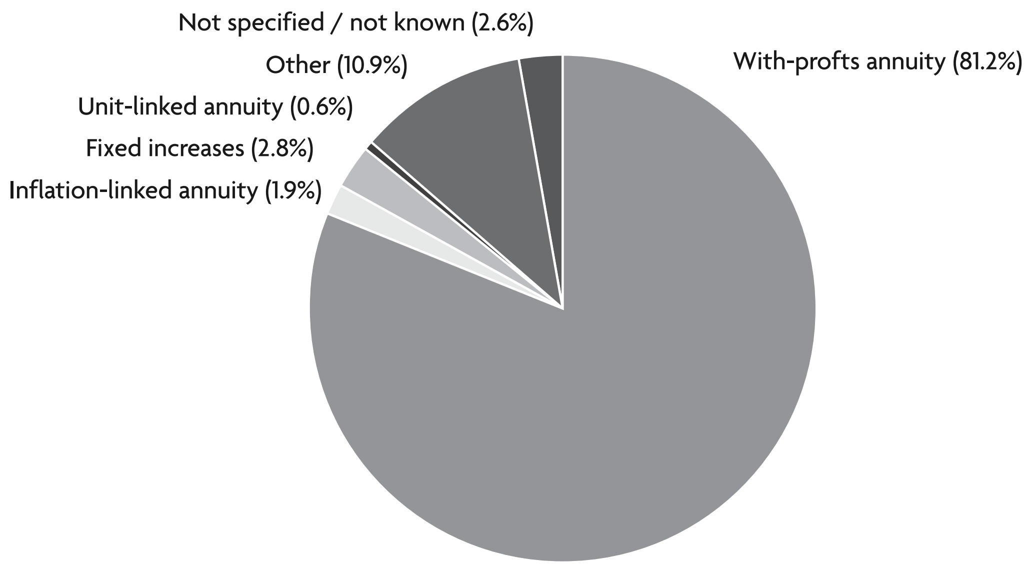
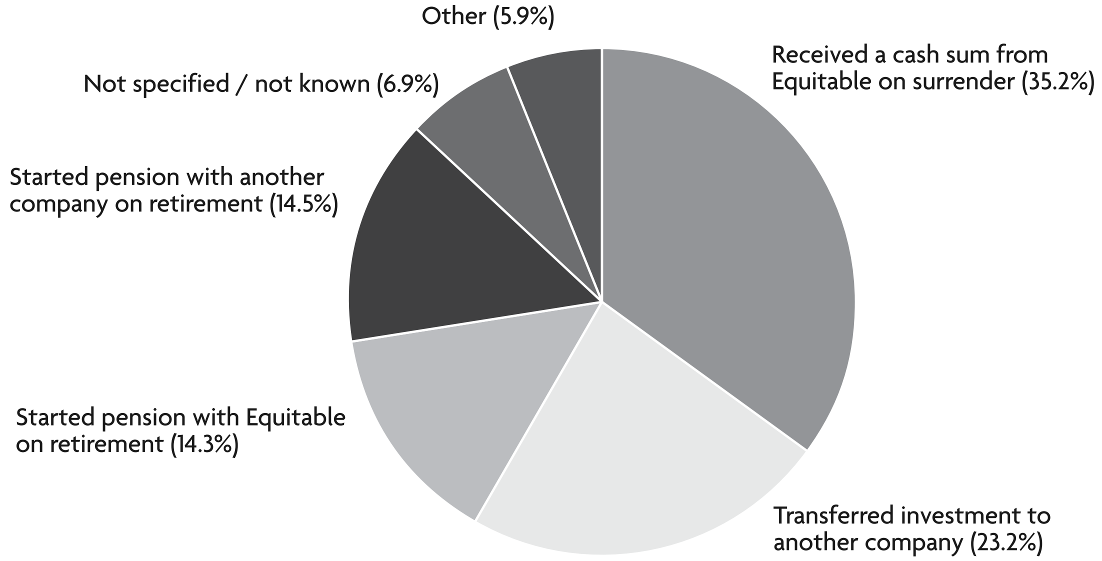


Chart 14: Taking benefits



Information about how respondents had been affected

We sought to understand more about the effects of the Equitable affair on respondents.

Highest and lowest financial losses claimed

The highest claimed losses were:

- *£750,000*
- *I estimate taking into account benefits received and continuing inflation £1,000,000 is the minimum sum required to compensate me and my wife for our anticipated future loss.*

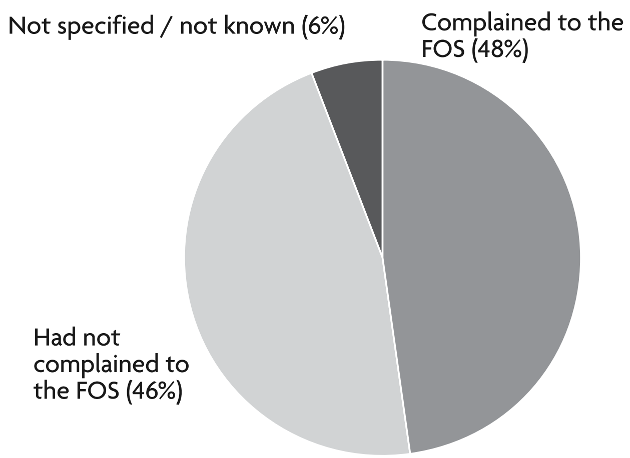
The smallest claimed losses were:

- *£11 p.w.*
- *Paid in £800 received £631.47 loss = £168.53. This loss takes no account of the lump sum and monthly payments made from 03/09/1999. Surrender losing growth or interest for 2+ years.*
- *£236 and up to 12 years' growth in a raging bull market.*

The Financial Ombudsman Service (FOS)

We asked respondents to indicate whether they had also complained to the Financial Ombudsman Service. They gave us the information shown in the chart below.

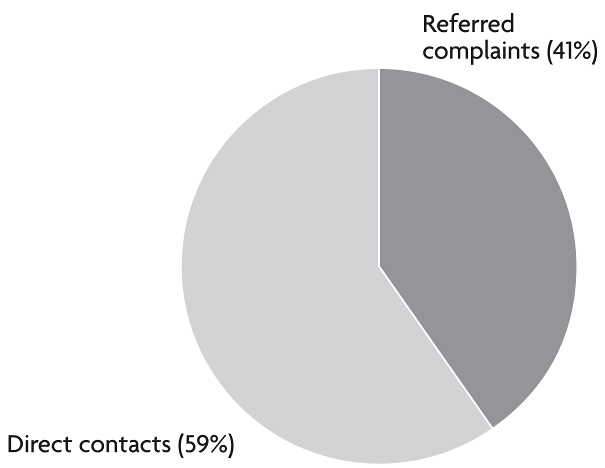
Chart 15: FOS complaints?



Information about those with referred complaints

Of the 1,189 responses, 481 were returned from those who had had complaints referred by their MP. 708 were returned from those who had contacted us directly. Their responses are shown in Chart 16.

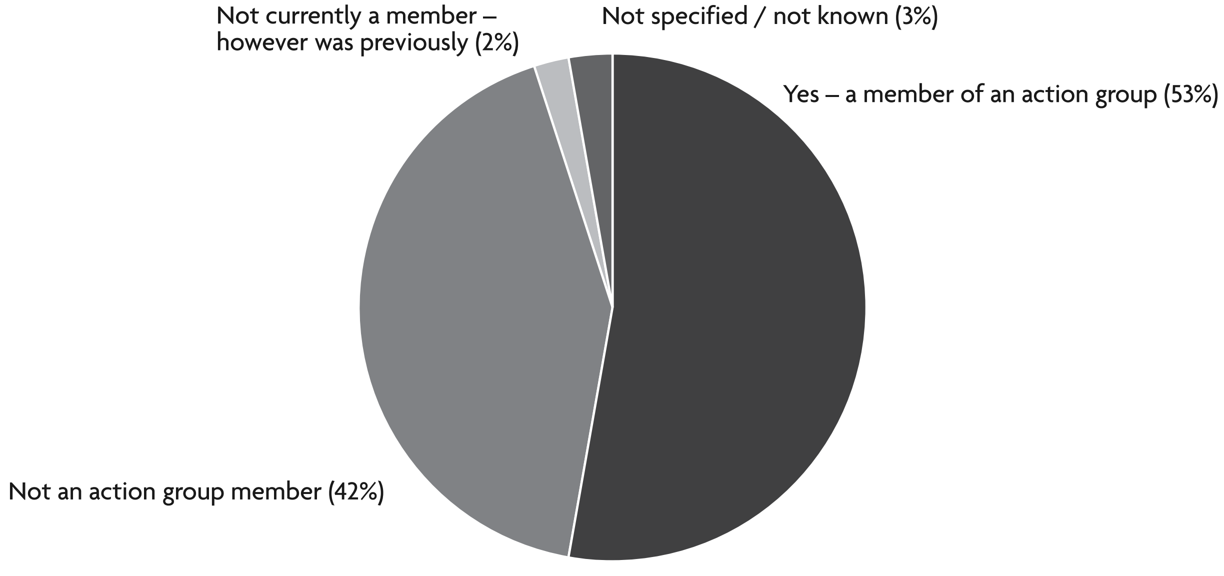
Chart 16: Referred complaints?



Action group

When those with referred complaints were asked if they were members of an action group, they replied as depicted in the chart below.

Chart 17: Action group?

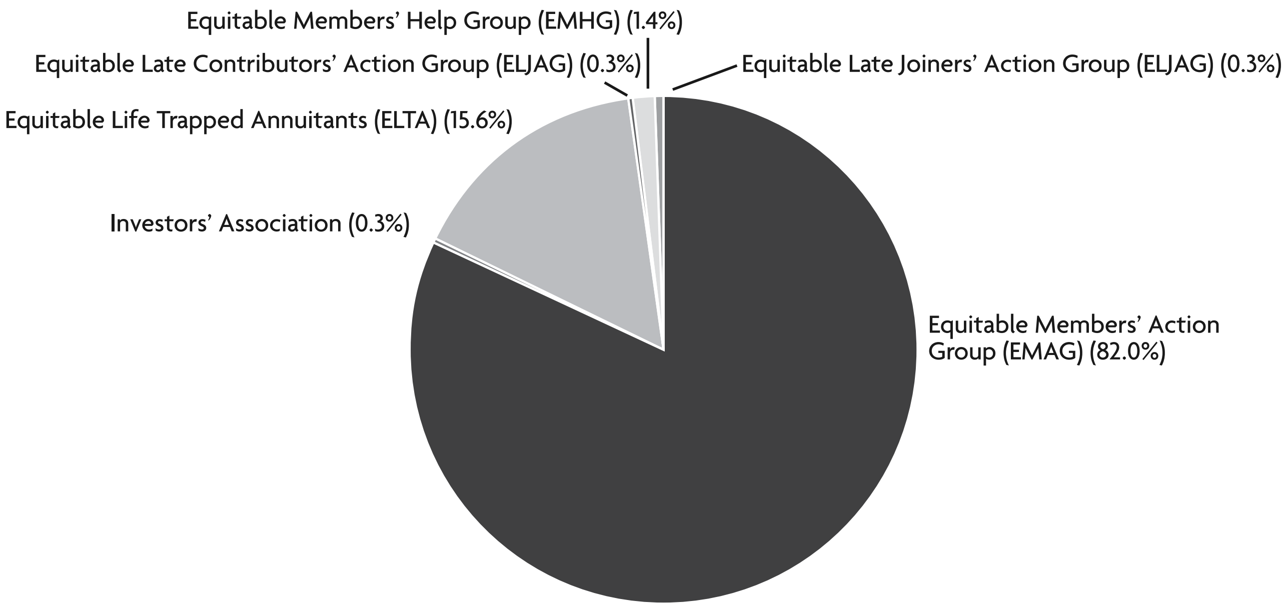


Results of survey of complainants and direct contacts

Action group membership type
When those 53% of referred complaints who, in Chart 17, specified that they were action group members were asked to identify which action group(s) they were members of, they replied:

(Note: some respondents told us that they were members of more than one action group.)

Chart 18: Action group membership type



Deceased complainants

Information held by us shows that 12 complainants are now deceased, and that their complaint is no longer being actively pursued.

A further 19 complainants are now deceased, but their complaints continue to be pursued by others on their behalf.

Section 4

Documents setting out responses to the report

Responses from individual regulators/actuaries

Scrutinising Actuary E

Memorandum of Scrutinising Actuary E to the Parliamentary Commissioner for Administration

1. I am a retired actuary. In the latter part of my career I was a member of the Government Actuary's Department ("GAD"), and from 1996 to 2000 I was closely involved in the supervision of the affairs of the Equitable Life Assurance Society ("Equitable"). In that connection I was interviewed by representatives of the Penrose Inquiry into Equitable, and I made a lengthy statement for that Inquiry. I refer to that statement (which I presume is available to the Parliamentary Commissioner for Administration – "PCA") and I shall not repeat its contents in this Memorandum. I do however wish to draw to the attention of the PCA, and expand a little upon, certain observations that I made towards the end of that statement ... headed – "The Law Lords Verdict".

2. I remain of the view that the arguments and themes that I presented in that passage are worthy of proper consideration, and I am of the opinion that these points have not received the full consideration that they deserve. In presenting these arguments and themes I should emphasise that these are my own personal views, and are not presented on behalf of the GAD or any other Government Department.

3. I recognise that it is no part of the PCA's brief to revisit the judgment of the Law Lords, but in my view it has to be acknowledged that it was the unexpected financial impact of their judgment that brought about the demise of Equitable. Even with full knowledge of the events which have happened since the demise of Equitable and the matters which have been investigated, I remain convinced that had the judgment of Lord Justice Scott been supported on appeal, Equitable would still now be open for business and serving its members fairly.

4. I also realise that the underlying pension contracts issued by Equitable, that were the basis of the Court Hearing, were not happily drafted, but I am confident that the bonus policy being applied to them by the Board of Equitable, acting on the advice of their Appointed Actuary, was fair and equitable. That policy was in line with insurance legislation and actuarial and regulatory guidance, and to the best of my knowledge was properly operated under the terms of the Articles of Equitable. These Articles naturally supported the idea that bonuses should be allocated by the Board on the advice of Equitable's Actuary in the light of the surplus shown as emerging. The bonus policy ultimately insisted upon by the Law Lords took no account of the emerging surplus, but involved the payment of enhanced benefits to one major group of policyholders (i.e. those with GARs) in excess of their "asset shares", to the inevitable detriment of the Reasonable Expectations of all the other participating members of Equitable. Following this judgment, no other business could fairly be written and closure necessarily followed.

5. In order better to illustrate the dramatic financial impact of this bonus judgment, I offer the following simplified example:–

   A policyholder may have contributed, say, £60,000 to his pension contract. In the 1990s his notional accumulated fund (his asset share) might have risen in value to £100,000, at a time

Responses from individual regulators/actuaries

Scrutinising Actuary E

when long Gilt yields were in the region of 7%. This yield might be found adequate to support the prospective lifetime payment of an annuity to the policyholder at the minimum rate guaranteed in the contract. At this point Equitable might have notified the member that his guaranteed fund had accumulated to £80,000, but that there was also an accrued non-guaranteed terminal bonus of a further £20,000.

Without further contributions, the stock-market moved up sharply to a level where the notional asset share of the policyholder had grown to £140,000 – but long Gilt yields were now only 5%. At this point Equitable told the policyholder that his non-guaranteed terminal bonus had risen to £60,000, but that it would be reduced if he elected to take advantage of the GAR.

In practice, a fixed annuity for life as offered by the GAR is not considered to be very attractive unless health is poor, so most policyholders would happily elect to take the enhanced lump sum benefit of £140,000 and buy either an index-linked or a with-profit annuity with the proceeds.

6. A situation similar to this example prevailed for several years during the 1990s. Operating a two-tier bonus policy in this way was consistent with all industry practice at this time.

7. The judgment of the Law Lords that effectively required Equitable to pay a life annuity at the minimum guaranteed rate based on the enhanced lump sum benefit of £140,000, actually required Equitable to find about £196,000 to secure a yield of 7% on £140,000. (An income of 7% of £140,000 is £9,800, and, with gilt yields now only 5%, to obtain this income required the investment of the much larger figure.) Thus, an additional £56,000 had to be found, inevitably by taking it away from the "asset shares" of other policyholders.

8. The Penrose team ignored the fact that this judgment had dramatically changed the financial situation of Equitable - in a way that was unpredicted and unpredictable. The worst court judgment that I had anticipated was that Equitable had failed to explain adequately its bonus policy to members in the past. Management might then be admonished and some compensation might have needed to be paid to certain policyholders. The existing bonus policy would be sustained, but better explained. In the event, the changed bonus policy actually insisted upon by the Law Lords was inequitable and financially unsupportable.

9. By ignoring this fundamental factor behind the financial distress of the Society, and by constructing instead an explanation based upon alleged inadequate reserving and over-bonusing by Equitable and its Actuaries in the 1990s, the Penrose team in my view grossly misrepresented the true position.

10. It seems to me that the PCA is now in danger of repeating this flawed process, with detailed research into the supervision process conducted by GAD during the 1990's. Having seen the evidence collected by the PCA, I do not consider that any significant shortcomings are disclosed, and certainly none which affected in any way the ultimate outcome of events.

Responses from individual regulators/actuaries

Scrutinising Actuary E

11. As with the Penrose team, the persons carrying out the current investigation demonstrate little appreciation or understanding of the nature of a with-profit life assurance operation. Since a with-profit fund should be virtually immune from potential insolvency, the reserving process involves essentially a judgment about timing the emergence and distribution of surplus. The Valuation Regulations were largely drawn up by the team at GAD and I believe that their operation was handled by a very professional group. It was not the job of GAD or the supervising authority to manage companies under their care, but we always did our utmost to encourage good practice.

12. I do not consider that it would have been open to us or reasonable for us at any time to have insisted that additional reserves be established to meet what turned out to be required by the ultimate Law Lords' Judgment. The actual tight balancing act being sustained by the Actuaries at Equitable was fully understood by GAD and the regulator, Equitable's policyholders and the market as a whole. Equitable was always extremely open about, and indeed proud of, its desire not to carry forward a large estate to the detriment of payouts under maturing contracts. I firmly believe that, prior to the final judgment of the Law Lords, all informed observers would have thought it improper and inequitable to establish reserves for such a remote and unlikely contingency.

13. The change in industry practice which has followed from Penrose, to require the holding of stronger reserves by with-profit life funds, has had the inevitable effect of virtually killing off participating life assurance business. The previously existing careful balancing act has been replaced by new reserving requirements, that are in my view unnecessary and unrealistic. These reserves, with the additional minimum solvency margin also required, result in it being very difficult for a with-profit fund to invest in lower yielding equities or property - so that very limited sources now exist for future surplus to emerge from growing asset values.

14. I stress again that these are my personal views, though I know that they are shared by others.

Further Note by Scrutinising Actuary E

I consider it necessary to expose the judgment of the Law Lords' as financially illiterate and partial, and to speak out in defence of the sound and effective appointed actuary system historically adopted in the UK to control the operation of Life Assurance Funds.

With profit funds in the UK were able to invest effectively to achieve maximum long term investment returns precisely because the contracts contained minimum guarantees regarding the benefits being promised. The Law Lords chose to overlook this long established and accepted position, (as embodied in the Articles of the Society - that all bonus additions are at the discretion of the Board acting on the advice of the Actuary), and effectively revised the terms of these contracts by reading into them wider guarantees than had been previously understood and recognised. The contracts certainly never included any premium loadings to cover promises to the extent that the Law Lords deemed were included in the GAR policies.

Responses from those representing complainants

Equitable Members Action Group (EMAG)

Excerpts from EMAG's response to the report

EXECUTIVE SUMMARY

Equitable Life
Equitable Life Assurance Society is the world's oldest life assurance company and was famous for not paying commission, low operating costs and (it claimed) fair distribution of profits. The Government Actuary recommended it for public servants including health workers and judges.

However, it made no provision for the guarantees against low interest rates contained in all policies issued before 1986 (the guaranteed annuity rate or GAR) and it declared bonuses out of all proportion to profits and assets, so far out, that the Institute of Actuaries has (in 2007) expelled its Appointed Actuary for it.

Over the 1990s its with-profit fund expanded six fold to £27,000m involving more than one and a half million people.

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

In July 2001 the new board of directors slashed policy values by 16% (about £4,000 million) and proceeded to affect a compromise scheme to deal with the GAR problem. More cuts followed. However Equitable Life's problems were too deep-seated. The Society is now being both run down and broken up.

Treasury Cover-up
EMAG has no doubt whatever that Equitable Life policyholders have been the subject of a cover up and delaying action by the Treasury/FSA. It was not until July 2004 that the matter was finally taken up by the Parliamentary Ombudsman with power to rule on maladministration and to recommend redress. The Treasury/FSA delaying tactics continued. They will claim that they have co-operated fully, but observers can draw their own conclusions from the seven years that have elapsed from the time that Equitable Life Members' policy values were slashed to the publication of the PO's Report.

Policyholders
Nine tenths of policyholders were saving for their retirement or had retired. As a result of the Treasury/FSA cover-up and delaying action, most of those who suffered the big policy value cuts are now in their sixties and many in their seventies and eighties, many are infirm and some have died. The 500,000 direct savers had an average investment of £46,000 in Equitable Life, the million people whose retirement investment was via group schemes had an average of only £4,000.

Responses from those representing complainants

EMAG

The principal complaint

'That the public bodies responsible for the prudential regulation of insurance companies (successively the Department of Trade and Industry, Her Majesty's Treasury and the Financial Services Authority…) and the Government Actuary's Department (GAD) failed for considerably longer than a decade properly to exercise their regulatory functions in respect of the Equitable Life Assurance Society and were therefore guilty of maladministration.'

Losses & Compensation

EMAG calculates losses incurred by policyholders investing after 1990 at £3.2bn if they would have remained with Equitable or £4.6bn if they would have invested elsewhere.

Elderly policyholders, having suffered 'outrageous' treatment at the hands of the Treasury, deserve a redress package that is rapid in payment, simple to administer, is not administered by either the Treasury, the FSA or any of their offshoots or by Equitable Life and does not require a complicated claims system. EMAG has explained how such a package could be constructed. Its estimate of the Compensation 'Pot' including interest to date is £4.5bn.

As EMAG's Actuary has pointed out, an FSA-style compensation scheme, such as applied to various forms of mis-selling, could take another eight years. In eight years most Equitable Life policyholders will be beyond caring. They need and deserve, having suffered 'outrageous' treatment at the hands of the Treasury and the regulators, a redress package that:

1. Is rapid in payment.

2. Is simple to administer.

3 Is not administered by either the Treasury, or the FSA or any of their offshoots or by Equitable Life.

4. Does not require an extensive and complicated claims system.

Fat Cats

Nine tenths of policyholders were saving for their retirement or had retired. The 500,000 direct savers had an average investment of £46,000 in Equitable Life, the million people whose retirement investment was via group schemes had an average of only £4,000. The story that Equitable Life was a place where 'fat cats' risked their money to get above average returns is not supported by the facts.

Responses from those representing complainants

EMAG

REDRESS

The With Profit Fund

We estimate that the With Profit fund at 31 December 2000 comprised:

With Profit Fund at 31 Dec 2000	Regulatory Returns £m	Estimated Total Value £m	% of Fund
Pension Investment Policies			
GAR Pensions	5,030	7,085	25.9%
Non GAR Group Pensions	3,341	4,074	14.9%
Non-GAR Individual & Personal Pensions	5,730	6,988	25.5%
	14,101	18,147	66.2%
Pensions in Payment Policies			
Drawdown Policies	1,860	2,268	8.3%
With Profit Annuities	3,222	3,929	14.3%
			88.8%
Life & Investment Policies	2,524	3,057	11.2%
	21,707	**27,401**	**100%**

It will be observed that two thirds of the fund was represented by the Society's mainstream Pension Policies and after adding Drawdown and WP annuities, almost 90% of the fund was represented by some form of pension policy.

Responses from those representing complainants

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Below is our estimate of the make up of the fund, by premium year.

Investment	Remaining Premium £m	Contractual Value £m	Terminal Bonus £m	Total Value £m
Pre 1990	N/A	1,682	2,959	4,641
1991	470	864	290	1,154
1992	656	1,112	344	1,456
1993	868	1,357	376	1,733
1994	1,016	1,472	353	1,825
1995	1,406	1,896	406	2,302
1996	1,913	2,402	453	2,855
1997	2,437	2,861	413	3,274
1998	2,649	2,944	256	3,200
1999	2,581	2,734	85	2,819
2000	2,109	2,144	-2	2,142
	16,105	**21,468**	**5,933**	**27,401**

Although the above figures are derived from the Regulatory Returns and Accounts the division of total value and the allocation between premium years has been estimated by EMAG's accountants. Actual figures should be available from the Society and we recommend that the PO obtains them.

Approach to Redress

It will be appreciated from the above that there are issues upon which it would be unreasonable to expect policyholders to prove their individual case, e.g. whether they were influenced by the returns and whether, if they had known Equitable Life's true financial position, they would have removed their investment or invested elsewhere.

It would also be unreasonable to inflict the sort of compensation scheme traditionally applied by the FSA to mis-selling, which could take another 8 years, to policyholders who are now in their 60s, 70s and 80s and who have already suffered 'outrageous' treatment at the hands of the Treasury and the regulators.

The approach EMAG suggests to the PO is as follows:

1. Take the areas where she has found maladministration leading to injustice and make a broad brush estimate of the total loss arising to policyholders at 16 July 2001.

Responses from those representing complainants

EMAG

2. Add an estimate of the 'removal costs' in respect of those that have subsequently moved their funds elsewhere. This would include Market Value Adjustments, other penalties and re-investment charges.

3. Apply a series of appropriate discounts for things like the proportion who were not influenced by published data and those who would not have invested elsewhere and apply those percentages to the total to arrive at a compensation sub-total as at that date.

4. Add something for outrage and interest to the resulting sum to arrive at a current compensation 'pot', which the Treasury should pay immediately to an appropriate independent scheme administrator.

5. Distribute that compensation 'pot' upon a policy by policy basis in accordance with a sliding scale based upon values immediately before the big cut of the 16 July 2001.

The benefit of this approach is that once the compensation pot is agreed and transferred to the scheme administrators, calculation could be handled mechanically from the information held upon Equitable Life's computers, now in the possession of Halifax Financial Services. The downside is a lack of sophistication to deal with all possibilities.

EMAG sees it as vital for the fair treatment of Equitable Life policy holders as a whole that compensation can be calculated, apportioned and distributed without undue delay, even if it involves the acceptance of some rough edges to the calculations.

The Amounts
The table below illustrates the principle of calculating the 'pot'.

Responses from those representing complainants

EMAG

	Financial Loss Staying with Equitable		**Opportunity Loss** Not moving to a competitor	
	£m	£m	£m	£m
The loss incurred through staying with Equitable was crystallised with the 16% policy value cut on 16 July 2001 on the then fund of about £24bn		3,846		
Part could not be recovered by the Society as relating to Contractual Values		(570)		
Part related to excessive bonuses voted in the early 1990s but still reflected in continuing policy values		(1,100)		
		2,176		
A rough estimate of the loss in investment value to 2001 of not moving to a competitor might be				3,600
Removal Costs				
Loss of 16% policy value cut from contractual values	400			
Re-investment costs on about £15bn at say 4%	650			
		1,050		1,050
Losses Incurred by policyholders		3,226		4,650
Discounts				
For those not being influenced in any way by the Returns, Accounts, Newspaper reports etc	5%	(161)		
For those who would not have invested in / moved to another provider, even if they had known Equitable Life's true state			30%	(1,395)
				3,255
For the difficulty in proving that the alternative provider would have done better			10%	(326)
		3,065		2,929
Most Losses relate to Lost Opportunities – take an intermediate figure (say)		3,000		
Discount for the fact that [redacted] and the Directors were primarily responsible. However the regulators allowed a problem with a small company to escalate six-fold over a decade, then adopted cover-up and delay.	10%	(300)		
		2,700		
		500		
Outrage – at say £500 for individual policyholders and £250 for group scheme members.		3,200		
Interest		1,300		
Compensation 'Pot'		**4,500**		

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The estimate of loss in investment value of £3,600m is derived from an examination of the published results of competitor companies by EMAG's accountants. A similar estimate produced by/for the FSA in 2001 produced an estimate of £5,000m. EMAG has found estimates based upon FSA internal information to be unsatisfactory, since they are always alleged to be 'confidential' and therefore cannot be independently scrutinised. The percentage discount in respect of the responsibility of [redacted] and the Directors is based upon EMAG's Counsel's opinion.

Special Cases

In view of the PO's strong findings on the Financial Re-insurance Contract, there are good grounds for adding back some of the discounts in respect of monies invested after 1 May 1999 (about £3,500m) and assuming a higher rate of interest.

With Profit annuitants have been particularly badly hit. They are not able to move their investments to other providers and have been stuck with Equitable Life until 2007. Their underlying funds were cut in July 2001 in the same way as other policyholders. This resulted in pension cuts in subsequent years. Also during those years the Equitable Life fund was invested in fixed interest stocks, which could not support the assumed growth rates. Finally they missed out on the Stock Market rise from 2003-2007 and have been transferred to the Prudential, which has Stock Market exposure, just in time for markets to fall. A special addition will be needed to reflect these matters.

Pivotal Date

The obvious date up to which to calculate compensation is 16 July 2001 when policy values were cut by about £4 billion. This was the action taken by the new board of directors to restore the balance between assets and policy values. It is the most convenient point at which to identify those who lost and to quantify by how much. The records of the policy values themselves, the terminal bonus element and the amount by which they were cut should be readily available from Halifax.

Lost Opportunities

It is imperative that whatever formula is used to assess losses from not moving to alternative providers should be based on public information, not from FSA confidential sources. EMAG members have suffered at the hands of the FOS and the FSA in producing computations of loss which cannot be checked.

Regulatory Contribution

EMAG is advised that in cases of maladministration it is traditional for those found guilty to meet the whole cost of the loss, even though others were partly responsible. However, in a case such as that of Equitable Life where the amounts are very substantial indeed and where the primary responsibility for the Society's demise rested with its actuaries, notably [redacted] and its directors, the matter of whether it is reasonable for the public purse to bear the whole cost does need to be considered.

Lord Penrose demonstrated that in the early 1990s the directors voted bonuses substantially out of proportion to the Society's profits and assets. This was done in order to maintain the Society's marketing advantage. The responsibility for this must lie primarily with [redacted] and the directors. It must, however, be pointed out that at this stage the Society was relatively small in size and with total funds of about £5 billion.

The financial weakness that excess bonuses created made it difficult for the Society to show the necessary degree of financial strength on its regulatory returns and accounts. The PO has found that the regulators were mal-administrative in failing to identify the devices used to conceal that weakness from public knowledge. This failure was not just an isolated incident, but as the PO's report shows, continued for the subsequent nine years.

The initial regulatory failure was taken by [redacted] as a green light to carry on expanding the Society's with profit business based upon imprudent bonuses and a fictitious marketing track record. The regulators carried on failing to deal properly with the Society's Returns for the following nine years, during which time its size expanded six fold from £5 billion to £30 billion. During this time it drew in 500,000 individual and one million group investors, mostly people saving for their retirement.

The regulators cannot reasonably claim that they didn't know what was going on. Both Lord Penrose and the PO demonstrate that they were well aware that bonuses were too high and the Society had insufficient assets to support them. They had opportunity after opportunity to take a stronger line but failed to do so. In EMAG's view, the Treasury, the FSA and GAD's approval of the worthless financial reinsurance contract as an asset valued at £800 - £1,000 million amounted to connivance with Equitable Life to cover up its appalling financial state.

In EMAG's view, supported by Counsel, the thousands of millions of pounds involved, the time over which the fault was allowed to continue, their connivance with the cover up and subsequent delaying action require that the regulators should bear a heavy percentage of the blame and the cost.

Interest

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

Computation of Compensation

a) Pension Investment Policies (two thirds of the WP Fund)

   The most accurate approach would be to apply a compensation factor to each premium paid since 1990. This however depends upon the availability of premium payment data. If this is not available or would involve undue delay, then the terminal bonus content of any policy provides a reasonable indication of the 'vintage' of policies generally and should be used.

Responses from those representing complainants

EMAG

It is a feature of Equitable Life's bonus methodology that the policies with the largest terminal bonus content did best from the over-bonusing and those with the smallest suffered worst from the policy value cut. It would be possible to work out a sliding scale of compensation to counteract these effects. This could then be applied directly to each policy based on its value in July 2001 and its terminal bonus content.

b) Pensions in Payment Policies (about 23% of the WP Fund)

These were single premium policies made by policyholders upon their retirement, in order to provide a pension for life (or in the case of Drawdown) to age 75. The vast majority were taken out after 1990 and did not benefit from the over-bonusing. Compensation would be based upon the amount of that premium and the date of payment.

c) Investment Policies (most of the rest)

Compensation would be based upon the policy value before the big cut and the terminal bonus content, in a similar fashion to Pension Investment Policies

Distribution

The above would enable compensation to be apportioned and distributed primarily from the information available on Halifax's computers and without the need for anyone to make a particular claim and without policyholder input.

The main features of distribution should be:

a) The money and the administration should be in the hands of a suitable body, independent of the Treasury the FSA and Equitable Life.

b) The data required for apportionment between policies should be contained on Halifax's computers.

c) No claim or other input should be required of policyholders

d) The formula should be a simple arithmetic one, open to inspection.

Responses from those representing complainants

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As regards payment, we suggest the following:

1) Continuing With Profit Annuities

   That part of the compensation representing lost income since 2001 should be paid to policyholders direct. The balance should be passed to Prudential for addition to the appropriate fund and policies.

2) Continuing Policies Generally

   The share of the compensation pot should be passed to Equitable Life for addition to the appropriate fund and policies.

3) Pension Policies transferred to other Providers

   The policyholder should have the option of having the relevant compensation share transferred to his new provider or paid to him as cash.

4) Encashed Policies, Deceased Investors

   The relevant compensation share should be paid to the policyholder or his estate as cash.

5) Group Schemes

   These should be dealt with on a group basis. Distribution to individual members should left to the respective trustees.

Recipients and Tax

Where compensation is paid into an ongoing pension fund there should be no question of tax being deducted or of any policy holder being able to claim tax relief in respect of the payment. Eventually the policy holder will benefit in the form of a higher pension and HMRC will of course assess tax thereon in the normal way.

As regards payments in cash to individuals or their beneficiaries, we recommend that some notional tax be deducted on an average basis and that the resulting compensation be made tax free.

The Treasury should ensure that any necessary changes to the tax laws are put in place to enable this to happen. Elderly and much wronged Equitable Life policyholders should not be burdened with future battles with the tax man.

Responses from those representing complainants

EMAG

Conclusion

EMAG is pleased to approve the PO's Report generally and to acknowledge her courage and integrity and her team's industry and dedication.

EMAG believes that in view of the delays that have already occurred and the age of the complainants, any scheme for Redress needs to be open, simple and capable of rapid implementation from existing readily available information. Its proposals are designed to achieve this objective. It will be pleased to provide further details if required.

Responses from those representing complainants

Equitable Life Trapped Annuitants – summary

Summary of submission by Equitable Life Trapped Annuitants

1) The With-Profits annuity was a particularly complex financial product, poorly understood by the vast majority, if not all, the annuitants who purchased it, and predicated on the belief that the Equitable Life Assurance Society was a blue chip, properly regulated institution of sound financial standing. Annuitants would not have purchased the product had they believed otherwise.

2) Three core issues differentiate With-Profits Annuitants being:-

   a. Their inability to surrender the policy or transfer it to another provider;

   b. The importance of the purchase in the context of providing a safe and reliable income, when the individual's abilities to find replacement income were increasingly remote; and

   c. The fundamental role of the increasing terminal bonus that was required to maintain their retirement income.

3) The With-Profits Annuity was deeply flawed and arguably could never have delivered what it promised. Annuitants were invited to "take a risk" in the market, but it was a risk that could not have paid any more than any other annuity type and, in addition, exposed the annuitant to an ever increasing amount of the total annuity that was "not guaranteed", and that could be, and was, removed. In effect, the risk was not "the market", but the financial status of "the Society". This made the WPA a quite unsuitable product for the consumer trying to create a life time's income.

4) It was the responsibility of the Official Regulator to ensure that the products on the market were in fact capable of delivering what they were offering, since annuitants are reliant on the regulator to carry out the sort of tests that lie beyond the competence of the general public.

5) The Ombudsman's findings that the information on financial standing was incomplete, that liabilities were understated and that the solvency position was not appropriately verified leading to a misleading picture of the financial health of Equitable, mean that the clear injustice sustained by With-Profits policyholders was the purchase of a product, which, **without this maladministration**, they would not have purchased.

6) The purpose of compulsory annuity purchase is to require individuals to secure a safe and reliable income for retirement when, crucially, they will be unable to supplement their income from alternative sources. Since this is a key statutory requirement, that an individual MUST buy an annuity, it follows that the regulating authorities have an ***absolute*** obligation to ensure that the products offered on the market can meet that statutory objective. Any failure to do so must inevitably result in a justified claim for maladministration.

7) The ever increasing gap between the "guaranteed" annuity and the total annuity was not covered by reserves, nor was it accrued for in the accounts and could therefore only be met by an ever increasing sales effort so that new

Responses from those representing complainants

Equitable Life Trapped Annuitants – summary

investments were required to meet the obligations of the old, creating in effect a pyramid scheme.

8) The inter-generational transfer that Equitable sought to avoid, where excess investment returns in the past subsidised current policyholders, was replaced save that now future policyholders subsidize the current. This is an inevitable consequence of the Society's flawed financial and business model.

9) It is clear that 50,000 With-Profits Annuitants have suffered significant financial loss as a direct result of the maladministration found. As a result, any redress should be to provide direct financial compensation to them for their losses. Clearly, payment into the fund will not assist them as their policies have been transferred to the Prudential and as explained above, there is no prospect of their policies recovering sufficiently to avoid loss despite that transfer.

10) With-Profits Annuitants are a unique group with unique and more complicated elements to any calculation. The preference should be for individual calculations against their individual alternative transactions. In the absence of that, a standardised scheme should be capable of formulation.

Responses from those representing complainants

Equitable Late Contributors Action Group

Dear Ms Abraham

It has sometimes been suggested (notably by Ruth Kelly MP on 17 June 2004, following publication of the Penrose report) that Equitable policyholders have not suffered undue hardship as a result of the reduction in their funds caused by Equitable. It has been suggested that they have other pensions, are wealthy, have other sources of income and so on.

Extract from Hansard 17 Jun 2004: Column 906 Ruth Kelly: However, people who invested in Equitable Life did so of their own free choice. Investors in Equitable Life tend to have supplementary pension provision, and many members have large pension pots, though others have smaller pots. It is largely their expectations that have been disappointed.

Notwithstanding that the average policy holding was probably somewhere in the region of just £18,000 per person and that the 1.5 million policyholders included people from all stations in society - civil servants, teachers, nurses and other people with modest amounts invested in AVCs (Additional Voluntary Contributions), I sought to find some examples of how the cuts are affecting real people. (I understand that for members of group schemes the average policy size was even lower at just £4,000 per head).

With the assistance of EMAG I sent an inquiry to a random selection of their members in April 2008 to ask whether they had suffered as a result of the cuts to their Equitable Life pensions and policies.

Sadly, I also received many from people who still blame themselves for their “stupidity” and feel ashamed to admit in public that they ever put money into Equitable Life. Additionally there were those who by my reckoning have suffered greatly, but stoically refuse to see themselves as victims.

I have compiled a small selection (with the names removed) which helps remind us about the human cost of the Equitable Life scandal.

Yours sincerely

Paul Weir
Equitable Late Contributors Action Group

Responses from those representing complainants

Equitable Late Contributors Action Group

Letter A
I am 83 with a Wife of 77. She has suffered with Breast Cancer & I am on Kidney Dialysis at home!

My Equitable Life Annuities are now £12,000pa; they were £25,000pa!

Fortunately, we are both very positive people, but we have had to give up the idea of a holiday in September.

Hope these comments are helpful.

Regards.

Name removed

Letter B
Our problems started from the time my husband and I took our pensions at the same time. (My husband) had transferred his occupational pension to them when he no longer had a company pension to pay into. I paid my pension with Pru and we both topped up payments each year to the maximum we could pay.

Pru were impossible in that the could never add my additional payments to my regular ones in their annual statement I. became so fed up with them that I paid the extra each year into a small pension with Equitable.

Our Rep (name redacted) convinced me to transfer all my funds to Equitable which regrettably I did. Then just before we signed on the dotted line I asked him about problems with Equitable which I had read in the Telegraph about a possible Court case. He assured us that Equitable had sufficient funds put by whatever the outcome. When all the problems came up I tried to claim mis-selling but that was declined. We have always been in a low income bracket and therefore knew we would not receive a good pension so we also gave up the idea of holidays abroad and similar luxuries so that we could save so that we would be able to supplement our pension to do the things we always wanted when we retired But because of the reduced pension (My husband) has had to continue to work and at almost 74 he is working as a driver taking people to airports and the trips can be anything from leaving home at 4am or arriving home at midnight.

My husband has always distanced himself from financial matters and left me to do all the facts and figures and as a result thanks to the Disappearing pensions and all the worries and stress my health has suffered. The first problem I picked up was when I was going through figures about the pension reductions on (my husband's) pension involving protected rights and I realised the deductions on the state pension for the contracted out period of employment was far greater than we were receiving from Equitable as protected rights. I had months of correspondence with the D.SS and Equitable and had to go back through all (my husband's) P60s for years to check that, at the DSS request there had not been an error on their part. Still I could get nowhere with Equitable and in addition was the problem of the reducing pension. By this time I was very unwell and suffering many infections not sleeping, tearful and irritable so had to resort to sedatives tranquillizers and antidepressants over the ensuing years and all this is on my medical records as stress caused by Equitable In fact I am still suffering the sleep problems and get stressed so

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easily I am not the person I Was before the Equitable saga. To return to the protected rights problem it was only by writing to [Equitable's Chairman] that I got the answer that they had not included the protected rights (my husband) had paid with them, only the part from earlier Employment. I insisted that this was corrected as at least that small part of (my husband's) minimal pension was hopefully safe and they finally corrected it going back to when the pension was first paid. They had the audacity to ask for the small amount back they had overpaid which they admitted was their error. However when I complained about all the costs of letters and phone calls they did relent.

Each year as the new pension statements become due I find myself waking in the middle of the night worrying about it and with facts and figures going round in my head. The current worry is what will happen this year with our annuities being with Pru.

Now thanks to Gordon Brown we have another worry. (My husband) is only paid minimum wage but that added to his state and Equitable pension means he looses the over 65 tax allowance and now with the 10% allowance removal he is going to be even worse off. Because we have saved we can get no help from the State.

We have felt it is especially important for us to save as due to a brain tumour as a child my daughter became registered blind and is totally kept alive on drugs. She is working as a music teacher but we do not know what the future holds for her. She has already had a further brain tumour due to radiotherapy 30plus years ago and is also at risk of contracting CJD thanks to the NHS blunder with infected growth hormone so naturally we hope that should she have further problems and have to give up work there will be help with money from us

Kind regards,

Thank you for your efforts.

Name removed

Letter C
I will be brief as to the effect on me.

1. I had at the time of Equitable failure £243,000 in the pension pot and had until that time put in £25,000 PER YEAR AS A CATCH UP.

2. On the demise of Equitable due to charges by Equitable and the service provider I transferred to together with the requirement to withdraw 25% to keep in line with the tax at that time my holding went down to 47.3% of the original.

3. As a result of the situation I cannot afford to retire, I am 67 years - 68 in November. I also have Prostate cancer, and cannot afford to stop work given that with a state pension of £4,500- £5,000 per year I would have to go cap in hand to the state for credits.

4. My original intention was to save enough to retire on £24,000 per year at the rate I was saving. However that stopped due to Equitable as any faith in private pension providers

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evaporated with Equitable Life. Should you require any clarification of my statement I will be only to happy to provide. The wife calls I am off, oh yes cheap rail tickets.

Kindest regards.

Name removed

Letter D
I find it difficult to claim that I have suffered hardship as a result of the Equitable situation. I have just had to manage on a decreasing income since I retired in 1998 on a "with profits annuity" that was planned to increase in line with inflation. I am fortunate in that I have some other income including DSS pension with SERPS and some other investments; my wife has substantial investments, not connected to Equitable and I have to rely on her rather more than I might have liked.

The figures below are monthly pensions received from Equitable before tax. As you see, they decrease rather than increase in line with inflation as expected.

- 1999 £2,062.95
- 2000 £2,143.46
- 2001 £2,266.34
- 2002 £2,243.68
- 2003 £2,230.73
- 2004 £1,772.04
- 2005 £1,676.22
- 2006 £1,659.27
- 2007 £1,640.19
- 2008 £1,640.83

Hi. My name is (name removed). My late husband lost approx £16,000 through Equitable. When he was alive, he worked hard, putting away savings for his retirement, he died at 56, knowing that what was left which would come to me, was a pittance, instead of a comfortable pension for me after he was gone.

On his early death, I was “awarded” £44 a month for life! I am 60 now, so given that I might see another 10 years health permitting, not much for all his hard work of saving for old age. How do you survive on a state pension and the miserly “offering” from Equitable?

This government has a lot to answer for! Not least turning their backs on the likes of my late husband who tried to do his “bit”. We are told to/encouraged to take out private pensions to take the strain off the state as well are all living longer – what’s the bloody point?

If corporations like Equitable can get away with ripping us all off our hard earned cash and getting away with it, all power to the people of this country who don’t bother.

“Disgusted”

Name removed.

Responses from those representing complainants

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Letter E
Although I have never suffered true hardship I did lose about £120k of pension value and suffer 5 years of zero growth. I was also trapped in the with-profits fund by dint of the GN11 changes (another stealth tax dear Gordon managed to pass).

I have suffered extreme stress levels which haven't helped my health and I have to say I made my wife and family suffer too. All of my future planning was severely damaged. Some of the replies from ELAS would make a vicar swear.

I have spent thousands of pounds and hundreds of hours trying to take a case against ELAS via my own claims, via the Bristol/Bath solicitors (forgotten their name but they have been a leading light in the claims) via several IFAs and actuaries and via the Pensions Ombudsman. I still have all of this documented in several lever arch folders.

The end result was the FOS ordered ELAS to pay me a £500 cheque for stress!! Still the FOS did state in writing that the pension valuations I received from ELAS were not real and in truth it was never my money so I couldn't claim it back!!!! – a very interesting argument.

I know there are hundreds of more deserving cases than mine (particularly retired people who must be compensated first - although I am 57 myself).

Please note I wrote to all relevant MEPs prior to the European debate.

To all at EMAG who have done so much over these years my usual thanks and keep up the good work.

Name removed

Letter F
Further to my email this morning re Equitable Life difficulties. A very brief summary of my story is as follows, if it interests you and you want more please contact me again. I am prepared to follow your lead on this situation.

1. 1997 "persuaded" by an Equitable Life rep to transfer all bar one of my policies to a managed fund (drawdown).

2. 2003 I was badly advised by an IFA, as a result my pension fund was frozen in a non-interest bearing account by Equitable.

3. There followed debate between Equitable, the FOS and myself, following a complaint made to the FOS in 2003. This has not yet been finalised.

4. At first the FOS found nothing wrong with my case then Equitable agreed I had been mis-sold the managed policy. Since then we have been arguing about what the correction should be to my fund.

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5. Last November/December I appointed an actuary to advise on the complicated calculations received from Equitable. He could not understand them and asked for further explanation. We are still waiting for a reply.

6. Along the way my MP has referred the matter to the Government's independent reviewer who advised the FOS to re-visit the complaint, finding that there had been mistakes made by a number of individuals at the FOS including the service review team.

7. It is about 5 years since my complaint was put to the FOS and the matter has not yet been resolved. I am now 65 years old and still without my pension.

I have several binders full of letters, faxes etc, too much to cover here. I hope I can be of help, please let me know.

Name removed

Letter G
Fortunately my investments in Equitable were not life threatening, but the following three policies of mine give some idea of the depths into which some investors pensions have fallen.

Policy 1 paid gross per month in 2001 £76.29 - in 2007 down to £46.59
Policy 2 paid gross per month in 2001 £64.34 - in 2007 down to £34.04
Policy 3 paid gross per month in 2001 £69.45 - in 2007 down to £34.61

Gives some idea of the scale of Pension reductions. I am now getting three small sums from the PRU!

Name removed

Letter H
Yes I have been seriously affected by the Equitable scandal, to the extent that even now at nearly 70 I am still working to try to make up the shortfall of over 25% in my pension. Though I have complained bitterly both to Equitable, the Financial Services Ombudsman and the Parliamentary Ombudsman, to date I have not received any recompense. I had a GAR, but was manoeuvred out of it into a Draw-Down Managed Pension, and also a With Profits Pension which I was fraudulently sold, which has been reduced by a third and is still falling. Yes I have been seriously disadvantaged by the lack of proper financial control of Equitable by the Treasury at the time ie. Gordon Brown. He indeed was the cause of the pension collapse by thieving £5billion a year, and should be made to pay for damage he has caused.

It is offensive that Politicians have awarded themselves generous pensions and expense allowances at the tax payers expense ie. Me and you, and yet the Government chooses to ignore all the facts that have come to light, showing that they were guilty of negligent financial control of Equitable Life leading up to year 2000, the year I was to start drawing my pension.

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I intend to fight on, and support your noble efforts on our behalf.

Regards,

Name removed

Letter I
I funded an Equitable pension during my working life which was intended to increase annually to reflect the growth of their equity fund. For this I forfeited 2% annually.

I started to draw my pension in 1997 and in the first two years, the mean increase after the 2% forfeit was 5.47%. Instead of this, my actual pension was reduced in 2003 by 25.4% and since then, has reduced annually by the 2% forfeit as the equity fund was extinguished by Equitable.

The result of this is that my pension each year is less than expected by an increasing sum, rising from 37% in 2003 to 52% in 2007 and each year the position gets worse.

In the current year I would have expected in excess of £21,000 whereas I will receive less than half viz £10,200.

The Equitable pension was supposed to be the major part of my retirement income. As it has reduced so dramatically, I have had to economise considerably on my outgoings of everyday living, quite apart from holidays which have necessarily been much restricted for myself and my wife. Furthermore I have had to downsize on my house in order to make ends meet.

I suspect that the majority of Equitable pensioners have a similar experience as I have, thanks to the ineptitude of both the Equitable and the FSA regulatory authorities and I trust that some compensation will be forthcoming from the government.

Yours faithfully,

Name removed

Letter J
Both my wife and I have with profit annuities ex Equitable Life now with Prudential. I have two policies and my wife has one. We have seen our pension payments go steadily down to approximately half of the initial payments. We have lost, so far, approximately £14,000 of income each year. We own our home and we do not go hungry but we have nothing like the life we expected and had planned.

We were led to believe by Equitable Life that we could expect our income to go up at least in line with inflation. We had both worked very hard all our lives and had saved all we could for our retirement. We now struggle to keep our home and maintain it as costs constantly rise and our income falls. Our holidays now consist of visiting one or other of our children.

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I drive an old car and have no prospect of replacing it. The enormous rise in the cost of petrol means that we only use the car when absolutely necessary. We have no access to public transport as we live in a village at the bottom of a very steep hill which neither of us are fit enough to climb.

I am divorced and have to pay my ex wife, who became an alcoholic, £12000 per annum. One of Gordon Browns first action as chancellor was to withdraw tax relief on maintenance payments. This Cost me 3 to 4 thousand pounds a year which I could cope with when I was receiving my full annuity but now, of course it is another story. The payment awarded to my ex wife by the Court naturally was based on my anticipated pension. That pension has been cut in half.

We were anticipating a retirement free from financial worries and looked forward to being able to give our children some financial help if necessary and give treats to our nine grandchildren. We now have to live a very quiet life and watch every penny and it is now our children who give us the occasional treat rather than the other way round.

All in all our life bears little or no relationship to what we planned and worked and saved for

Yours sincerely,

Name removed

Letter K
I hope that indeed the findings of the Ombudsman will meet your and my hopes. I also agree that Mr. Brown is highly unlikely to give in without a fight. But I would certainly like to put my story at your disposal.

After 40 years my very tough but quite successful business career came to an end through some medical condition. With the help of my wife I recovered fortunately quite well during 1992 - 2000. We were looking forward to a relaxed and comfortable retirement based on a good pension invested with a highly recommended pension provider Equitable Life as required by Government regulations. We wanted to be able to spend every year as long as possible during the winter some months in warmer climates; we wanted to help our children with financing the university education of our grandchildren; we wanted to partially refurbish and extend our house; and we wanted to have some cushion against the ravages of inflation.

With horror did we hear of the collapse of Equitable in summer 2001. Suddenly our certainties were gone and we had to adjust our retired life to a substantially reduced pension. Out went our plan for some month in the sun; out went our plan to refurbish our kitchen and add a second bathroom to our house; out went our hope to have a buffer against inflation. However we did not want our grandchildren to suffer and continued to help in full. Today we have to grin and bear it and make the best out what is left of our pension. However we are worried that in time inflation will see to it that we may not be able to cover our needs - a cover that we expected to have based on the original with-profit investment with Equitable. My wife and I feel cheated by a Government that forced us to take out an annuity without making sure that it was in the position to supervise and regulate the pension industry.

I also advised my daughter to invest her savings and company pension contribution with Equitable. A large amount of this money has been lost and the consequences on her future pension will be tough. All this caused by an incompetent Government boasting about pension security without doing anything to supervise and regulate reliably the pension industry.

Name removed

Letter L
I originally had my main pension which was a GAR but switched to WP in 1998 when about to retire without realising the full implications. However about a year or so later I was given the choice to rectify the situation by Equitable Life and return to GAR. Understandably I jumped at chance. I do still have a small WP annuity which used to pay about £100 per month and has now dropped to just over £50 pm. This has now been transferred to the Pru. I find it rather surprising that those annuitants that have suffered so terribly because of this situation are reluctant to come forward. Although my loss is small compared to many annuitants. I still support EMAG as a matter of principle and will continue to do so. If I can be of any help at any time please do not hesitate to contact me.

With warmest regards,

Name removed

Letter M
My father had an Equitable Pension which served him well, so when, as impecunious self-employed architects with four children, we at last had some money to put into a pension The Equitable was our immediate choice. Later, my husband took out another pension from them, and then I was able to take out another, always reciprocal. Now my husband has died and I am 79 and all we depended on has been vastly reduced. I still work to give myself a decent standard of life, but I cannot expect to be able to do this much longer.

I think that the Lord's decision to give precedence to the GAR pensions was unjust, because we relied on the statement that once a bonus was awarded it would be permanent. As a result, our small pensions have been dramatically reduced.

Please keep fighting.

Yours sincerely,

Name removed

Responses from those representing complainants

Equitable Late Contributors Action Group

Letter N
On my retirement in 1994 my capital with Equitable Life was £40,000 which presumably they invested to give me a pension of £306 a month. (now £176 with the Pru).

When the crash came I lost £140 per month which although small by some standards would have given me a chance to travel on holiday about twice a year, my savings were only about £6,000 at the time.

My question to my MP was when I ran a small consultancy for testing welding operatives, which I started on my retirement to boost my pension and savings I had to have Insurance for Professional Indemnity and Public Liability. Why did they not have the same? - after all they were professionals in the investing of money etc.

Thanks for your efforts,

Name removed

Letter O
I'd be happy to help but I suspect my story isn't of a sort to wring the Ombudsman's withers. My pension has been substantially reduced (by £1,000/month, tax-paid) but I am still able to do what I want - having modest needs and other resources to satisfy them. The people who have suffered are my children, for whom this money is/was earmarked. My gripe (and why I started this letter) has more to do with the misrepresentation of EL's fund management policies. Had I been honestly told, I'd have taken different decisions.

Regards,

Name removed

Letter P
The following is a very brief account of my suffering at the hands of the Equitable. I do realise that there will be many others who have suffered more, but here is my story for what it is worth.

I was senior partner in a small legal firm, so self-employed, and retired from work at the end of 1996 having built up a reasonably substantial pension fund spread among several companies. On retirement I was persuaded by the Equitable representative to transfer all the money into the Equitable as at that stage it was the only company offering a drawdown policy, which I found very attractive. The previous generation of partners in my firm had had to convert their pension funds into annuities on retirement and had subsequently been badly hit by the rampant inflation of the 1970s and I was keen to avoid a similar fate.

During the first few years of retirement I was able to live quite comfortably on the income from my drawdown policy, though I was visited by a representative of the Equitable, I think some time in 2000, who tried to persuade me to convert the policy into an annuity. At this time the legal action in which the Equitable was involved was in the news and I asked his opinion of it. He told me that the company was confident of success in the action but in any case the funds in my drawdown policy were "ring-fenced" so that they were safe even if the Equitable lost the case.

When they did lose the case in late 2000, I enquired about transferring my drawdown policy to another company but was told that that was not possible - the only choice was to convert it into an annuity. By the time this rule was relaxed in early 2001, the Equitable had slashed the value of all its policies, including mine, by 25%, the effect of which was that it was now not producing sufficient income for my needs and if I supplemented my income by drawing on the capital, the fund would almost certainly be exhausted well before my death.

I therefore had no alternative but to use the fund to buy an annuity, which I duly did with the Norwich Union. I am therefore now in precisely the situation which I wanted to avoid, getting a fixed income from the annuity which is extremely vulnerable to inflation.

Before the reduction in value my drawdown policy was worth £254,178; this was reduced to £216,051 by the Equitable. I was drawing £1,500 per month from the policy up to then and it was still increasing in value; my annuity with the Norwich produces only £1,121 per month after tax. This covers most normal living expenses though I am not sure how long this will continue to be the case; any one-off expenses, including holidays, are paid for out of capital which of course will not last for ever. I am now aged 72 and my wife is 70.

I did apply to the Equitable for some relief under the scheme which they were running, particularly in view of their representative's words to me in 2000, but as I had no documentary proof of what was said and indeed had destroyed all the correspondence which took place at the time of my retirement, my claim was rejected.

Yours sincerely,

Name removed

Letter Q
I think you should also include people who have a very clear view of how much Equitable have stolen from their investors. I can provide you all of the detailed information you might wish as an example of how investors of 10 or more years standing were conned out of their pension fund entitlement (earned from the early 1990's) including the period starting in the mid 1990s when the Government regulators were in control.

1. Pension fund estimated value: £116k in July 2001
2. Request for conversion of this fund to an Annuity dated 09 July 2001 ignored by Equitable Life management.
3. Actual Received: £86k for Annuity in 2002
4. Lost Funds: £30k in bonuses + interest

I have not signed acceptance of any Equitable Life management activities and wrote to Senior Equitable finance Director, Thomson in September 2002 to indicate that I was prepared to take legal action to resolve the issues.

Responses from those representing complainants

Equitable Late Contributors Action Group

Kind regards,

Name removed

Letter R
For the last 8 years before retirement I "salary sacrificed " all of my annual sales bonuses and the company paid them into my pension fund with ELAS so as to build up my pension as I had agreed with ELAS the capital sum required at retirement to produce the pension my wife required to live on. During this period we did without overseas holidays and many other capital items for the home so as to maintain the annual amount entering the fund.

<u>My Policy No.1 With-Profits pension policy</u> was in September 2002 paying about one-third percent of the total annuity as FINAL BONUS. In September 2005 the final bonus was dropped altogether and the total annuity payable dropped by approx. **£500 per annum**

<u>My Policy No. 2 With-profits pension policy</u> in September 2002 the final bonus payable was 25% of the total gross annuity. By September 2004 the final bonus was discontinued so the annual pension dropped by some **£4000 per annum.**

My total loss 2004 - 2008 is approximately £19,000 when you take into account that in the year 2003 the final bonus was greatly reduced on both policies.

Many of the dreams we had have no longer been affordable and my wife and I wanted to take ocean cruises to ports where I visited in the navy in WW11. Many important changes like changing my car was no longer possible and with such a huge reduction in the overall annual pension many of our retirement hopes were dashed. I have and still am subject to anxiety and fearful we shall not be able to pay bills with increased living costs in our retirement with such an enormous reduction in our ELAS pension. We find it such a worry with living expenses all round escalating at present.

Our private pension with ELAS is the only one we have ever had and as they were such an old established company I trusted them completely. How wrong I was in hindsight.

My wife and I are both in our early 80's now and we feel bitter about the whole debacle particularly as the ELAS sales and financial advisers persuaded me to go into the with-profits policies and they stated they were sound and financially beneficial.

Yours truly,

Name removed

Section 5

Primary documents – the statutory and administrative context

Service level agreements

1984 – between the Department of Trade and Industry (the DTI) and GAD

Arrangement made between Insurance Division and the Government Actuary's Department for the examination of insurance companies returns.

PRELIMINARY

1 This statement sets out the respective roles of the Insurance Division of the Department of Trade and Industry (I Division) and of the Government Actuary's Department (GAD) in respect of the examination of annual and quarterly returns received from insurance companies authorised to carry on long term business under the Insurance Companies Act 1982 (the Act). The statement deals in detail with the arrangements for and in support of the examination and matters directly relating thereto. The underlying approach is that formal action on behalf of the Secretary of State should always be taken by I Division but enquiries to companies (but not to auditors nor, in the first instance, to appointed actuaries) may be made direct by GAD.

2 Within the above framework, GAD is given the major share of the responsibility for the examination of returns relating to long term business and for pursuing technical questions arising directly therefrom with insurance companies. Upon completion of the detailed examination of each return, GAD will provide I Division with a report on solvency and on any other significant matters which have emerged as a result of the examination. GAD will report further when any outstanding matters have been clarified with the company or, where appropriate, its appointed actuary. For priority 4 companies (see paragraph 30) when a full detailed scrutiny of the returns is unlikely to be carried out, a brief report will be made to I Division after the initial examination of the return has been completed.

3. References in this statement to companies are to companies which carry on only long term business and to composite companies in respect of their long term business.

ACTIVITIES TO BE CARRIED OUT BY INSURANCE DIVISION

Applications for Authorisation	4	I Division will provide GAD with a copy of any new authorisation issued in respect of long term business.
Company Profiles	5	I Division will ~~be~~ provide GAD with an up to date copy of the profile (computer Format A) for each company.
Directions, Requirements, Concessions and Undertakings	6	I Division will be responsible for issuing directions and notices of requirements, for granting concessionary orders and for obtaining voluntary undertakings from companies. The views of GAD will be sought as appropriate.
	7	I Division will provide GAD with a copy of any direction, notice of requirements or concessionary order issued to any company on authorisation or subsequently or of any voluntary undertaking given by any company.
Business Plans and Policy documents etc	8	I Division will provide GAD with a copy of any business plan, policy document or reinsurance contract received from a company in support of an application for authorisation or subsequently, and of

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Service level agreements

1984 – between the DTI and GAD

any correspondence or other document which is relevant to an examination of a company's return in respect of its long term business.

<u>Change of ownership or control etc</u>

9 I Division will be responsible for considering any changes or proposed changes in a company's controller, managing director etc which have to be notified to the Department.

10 I Division will scrutinise the Company's annual reports and accounts to shareholders and check that the necessary notifications and approvals have been made.

<u>Appointed actuary</u>

11 GAD will be advised of all appointments notified under section 19 of the Act.

<u>Change of financial year of a company</u>

12 I Division will be responsible for approving any change of financial year of a company but will consult GAD before any change is approved. I Division will notify GAD when any change is approved.

<u>Extension of time for submitting of annual returns</u>

13 I Division will advise GAD when any extension is granted.

<u>Distribution of Annual Returns</u>

14 I Division will be responsible for distributing annual returns received from companies. GAD will be sent a copy of each such return (including documents relating to the general business of a composite company) together with a copy of the shareholders' accounts and of any report issued to the company's policyholders or shareholders.

<u>Initial action on the annual returns by I Division</u>

15 Upon receipt of a company's annual return, I Division will carry out an initial check that the main documents, including the directors', actuary's and auditors' certificates, are present.

16 I Division will arrange for the relevant forms to be submitted for computer processing and will examine all messages shown on the validation and compliance reports. Any significant errors or omissions will be notified to GAD.

17 I Division will ask GAD whether, as a result of their initial examination of the returns (see paragraphs 26 to 29), they have identified any serious omissions or other matters which need to be taken up urgently with the company.

18 I Division will pursue immediately with the company any errors, omissions or matters of serious concern identified as a result of the initial examination of the returns carried out by I Division or by GAD.

19 GAD will be provided with a copy of Formats B to K (ie including general business formats in respect of composite companies) produced by the computer.

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Service level agreements

1984 – between the DTI and GAD

20 I Division will check information on each company's profile (computer Format A) with the returns and wi the annual report to shareholders to make sure that the profile is up to date.

Quarterly returns

21 I Division will send GAD copies of all quarterly returns and supporting documents (such as lapse triangles) relevant to a company's long term business.

Other matters

22 I Division will notify GAD if they consider that a company should be given a higher priority rating tha that suggested by GAD (see paragraph 31).

23 I Division will notify GAD of any other matters which arise and which appear relevant to the examination of a company's return in respect of its long term business.

ACTIVITIES TO BE CARRIED OUT BY GAD

Initial action on the annual returns by GAD

24 GAD will advise I Division if the annual return of a company has not been received by GAD within six weeks of the due date (allowing for any extension granted to the company).

25 As soon as possible after the receipt of the annual return of a company from I Division, GAD will carry out an initial scrutiny of the return with a view to advising I Division of any serious solvency or compliance problems in respect of the company's long term business and to determine an order of priority for GAD's main examination of the returns. This will be carried out in accordance with the following paragraphs.

26 GAD will advise I Division immediately if the return suggests that a company has failed to meet the long term business solvency margin requirements or is otherwise in financial difficulty.

27 GAD will examine the directors', actuary's and auditors' certificates to ensure that they have been properly completed in accordance with the regulations in respect of long term business. GAD will advise I Division immediately of any serious cases of non-compliance, which will require amended certificates to be submitted. GAD will draw attention at the same time to any significant qualifications in any of the certificates.

28 GAD will make an initial examination of those parts of the return relating to long term business which are not subject to computerisation (Form 43-51 of Schedule 3 and Schedules 4 and 5) and check that they appear to have been properly completed. GAD will advise I Division immediately if it appears that any significant information has not been provided or that

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there are significant errors in the information which will require revised or additional information to be submitted by the company.

29 GAD will make an initial examination of Form 58 (Valuation result and distribution of surplus) to determine whether it suggests that there has been a breach of Section 30 of the Act (allocation of surplus to with-profits policyholders). GAD will advise I Division immediately if any such breach appears to have occurred.

Classification of companies by priority

30 As a result of their initial scrutiny of the annual returns, including consideration of the actuary's valuation basis, GAD will give each company a priority rating for the purpose of carrying out the main examination of the returns. There will be four categories of priority rating determined in accordance with criteria set out at Annex A.

31 At the end of each quarter, GAD will provide I Division with a list of current and previous priority ratings for all companies taking into account any special cases notified to them by I Division (see paragraph 22).

Detailed examination of the annual returns by GAD

32 Except in the case of Priority 4 companies in those years when a detailed examination is not to be carried out (see paragraph 39) GAD will:

i carry out on behalf of I Division detailed examinations of the returns submitted by insurance companies in respect of their long term business, and

ii report to I Division any significant matters which emerge as the result of detailed examinations of those returns and, subsequently, from any correspondence or discussions with companies or the actuaries.

33 The primary objectives of each examination will be

i to form a view about the solvency position of the company in respect of its long term business and to determine whether, at the date of the return, the company had and whether, in the foreseeable future, it seems likely to continue to have the margin of solvency required in respect of that business,

ii to determine whether the return in respect of long term business appears to comply with relevant statutory requirements (whether arising from legislation, directions, notices of requirements or conditions contained in concessionary orders) or with undertakings given by the company, and

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iii to determine as far as possible from the return whether the company appears to have complied with other statutory requirements (however arising) or with other undertakings given relating to its long term business.

34 GAD may raise with the company or, with the latter's agreement, its appointed actuary any points on the return and relating to long term business which GAD consider require clarification. If I Division has already contacted the company following the initial examination of the company's return (see paragraph 18), GAD will agree with I Division which Department should correspond with the company on further questions arising. GAD will recommend to I Division any action which GAD consider should be taken in respect of any matters arising on the return. GAD will not initiate any such action nor, in their discussions with a company or its appointed actuary, will they commit I Division to any particular decision.

35 If any points arise on the return which require explanation from a company's auditors, GAD will not approach the auditors direct but will refer the matter to I Division.

<u>Correspondence and Meetings</u>

36 Any correspondence between GAD and an insurance company or its advisers and notes of any meetings held with them will be copied at the time to I Division.

<u>Report to be made by GAD to I Division following the main examination of the annual returns</u>

37 Upon completion of their detailed examination of the annual return of an insurance company GAD will send I Division a report on any significant matters which have emerged as a result of the examination drawing attention to matters of importance being raised with the company. When such matters have been clarified or when GAD feel that some form of formal action is required GAD will further advise I Division.

38 Each report shall include the following information as appropriate:

i A general description of any identifiable major developments or changes during the period covered by the report and relating to the company's long term business. This should include any significant changes in the philosophy or business approach of the company, possibly resulting from a change in ownership or control or in the attitude of the company's shareholders; any significant change in the volume, type or mix of the long term business written by the company; and any internal or external factors which may have had a special effect on the company.

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ii A general commentary on the present and prospective financial position of the company. GAD will draw attention to any major weaknesses in the basis of valuation adopted by the appointed actuary in his (Schedule 4) Valuation Report and to any significant changes (including changes in reinsurance arrangements) in the company's financial affairs since the time of GAD's previous report.

iii If the company provides quarterly returns, attention shall be drawn to any significant differences between the figures in the annual return and those in the corresponding quarterly return and to any significant developments since the date of the last annual return which have been revealed by quarterly returns.

iv If the company has provided a business plan, attention should be drawn to any significant deviations from the plan.

v Details of any breaches or possible breaches f statutory requirements (however arising) (including sections 28 to 31 of the Act) or of undertakings given by the company revealed as a result of the examination of the company's return.

vi Details of any significant errors or omissions in the return (including the directors', actuary's and auditors' certificates) or of any other significant instances of non-compliance noted during the course of the examination. If the company has already rectified the position (as the result, for example, of action taken under paragraph 18) this shall be stated in the report. In other cases, the report shall explain whether or not GAD is drawing the company's attention to the defects.

vii Details of any qualifications contained in any certificate given by the directors, actuary or auditors. If amended certificates have already been provided by the company (following, for example, action taken under paragraph 18) this shall be stated in the report. In other cases, the report shall state whether GAD is raising the matter with the company.

viii An indication if the lapse experience of the company appears to be high for the type of business and whether information available in the return suggests that it may be deteriorating.

x Reference to any correspondence in respect of the examination between GAD and the company or

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its actuary. A copy should be appended to the report if it has not already been provided to I Division (see paragraph 36).

<u>Dispensing with a detailed examination of the annual returns</u>

39 In the case of Priority 4 companies a detailed examination of the annual returns will be carried out at least once in every three years. Before allocating priority 4 to a company, a sufficiently thorough initial scrutiny will be carried out to ensure that there is no evidence in the return of any impending financial problems. This will involve an examination of the following matters in addition to those considered during the normal initial scrutiny of the return: adequacy of valuation basis; possibility of any adverse trends; adequacy of information provided where net premium valuation has not been used; any obvious problems of compliance. GAD will indicate on the list of priority ratings (see paragraph 31) those Priority 4 companies for which annual returns have been received by GAD and which are due to be given a detailed examination.

<u>Quarterly returns</u>

40 GAD will examine all quarterly returns and supporting documents which they receive from I Division.

41 GAD will check that the company appears to have complied with any requirements imposed on it under the Act, including any requirements imposed under Section 40 (trusteeship requirements) or Section 41 (premium limitations). GAD will report immediately to I Division if there appears to have been a breach of any such requirement.

42 GAD will report to I Division any other significant matters noted as a result of their examination of the quarterly returns. GAD will report in particular any significant changes in the volume or type of business being written; any marked deterioration in a company's financial performance; or any major variations from any current business plan submitted by the company.

<u>Progress on the examination of annual returns</u>

43 GAD will provide I Division with a monthly report of progress made in the examination of the annual returns, as regards completion of initial checks, detailed examinations and final reports on outstanding issues. A separate report shall be made to each of the supervisory sections of I Division in respect of the companies supervised by that section. The report shall be in the format set out at Annex B.

<u>Commencement and Review</u>

44 The arrangement will come into effect on 1 July 1984 and will apply to all annual and quarterly returns of companies received by I Division after that date.

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45 The arrangement will be reviewed in early 1986 .

[redacted]

Insurance Division
Department of Trade and Industry
).) . 1984

[redacted]

Government Actuary

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PRIORITY RATINGS TO BE ADOPTED BY GAD

ANNEX A

PRIORITY	CRITERIA	EXAMINATION PROGRAMME
1 Urgent	i) Company has failed to maintain its required solvency margin (RSM); or	Detailed examination to be carried out within days of receipt of the company's return by GAD
	ii) apparent weaknesses in the valuation basis suggest that the RSM might not be covered.	
2 High Priority	i) Company has maintained its RSM but its declared solvency margin is less than 125% of RSM and there is no reason to suppose that significant hidden margins exist; or	Detailed examination to be carried out as soon as possible. Even less urgent companies in this category would normally all be examined within four months of the due date for submission of the returns to I Division.
	ii) Company appears to have failed to comply with the regulations in material respects.	
3 Medium Priority	i) Company has a declared solvency margin of between 125% and 200% of RSM or lesser declared cover but with significant hidden margins; or	Detailed examination normally to be carried out within ten months of the due date for submission of the returns to I Division.
	ii) Company has higher solvency margin cover but doubts exist over certain aspects of the returns.	
4 Low Priority	i) Company appears to have a solvency margin of at least 200% of RSM having regard to the likely level of hidden margins and has no obvious problems of compliance; or	Detailed examination to be carried out at least once in every three years (see paragraph 39). Detailed examinations will be carried out within twelve months of the due date for submission of the returns to I Division.
	ii) Business of company is inherently low risk and solvency margin appears adequately covered.	

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ANNEX B

MONTHLY PROGRESS REPORT FOR 198

Relating to ....*

*All Companies /I1/I2/ Name of Principal or of HEO to be inserted as applicable

SECTION A - RETURNS RECEIVED IN MONTH

Priority allotted	No of companies
1	
2	
3	
4	
Initial scrutiny not complete	
Total	

SECTION B - NUMBER OF RETURNS WHERE INITIAL SCRUTINY COMPLETED BUT DETAILED EXAMINATION OUTSTANDING

(i) Companies with year end 31 December

Priority	No outstanding at beginning of month	Priority allotted during month	Detailed examination completed during month	No outstanding at end of month
1				
2				
3				
4			*	
Total				

* This includes ... companies given a thorough initial scrutiny with a view to no further detailed scrutiny being carried out on these returns.

(ii) Companies with year end other than 31 December

Priority	No outstanding at beginning of month	Priority allotted during month	Detailed examination completed during month	No outstanding at end of month
1				
2				
3				
4			*	
Total				

* This includes ... companies given a thorough initial scrutiny with a view to no further detailed scrutiny being carried out on these returns.

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SECTION C – NUMBER OF RETURNS WHERE DETAILED EXAMINATION COMPLETED BUT FINAL REPORT TO DTI OUTSTANDING

(i) Companies with year end 31 December

Priority	No outstanding at beginning of month	Detailed examination completed during month	Final report to DTI during month	No outstanding at end of month
1				
2				
3				
4				
Total				

(ii) Companies with year end other than 31 December

Priority	No outstanding at beginning of month	Detailed examination completed during month	Final report to DTI during month	No outstanding at end of month
1				
2				
3				
4				
Total				

SECTION D – STATE OF PROGRESS AT END OF MONTH BY DATE OF RETURNS

Returns with accounting date in quarter

	1/'83	2/'83	3/'83	4/'83	1/'84	2/'84	3/'84
Initial scrutiny not complete							
Initial scrutiny carried out but not detailed examination							
Detailed examination carried out but awaiting final report to DTI							
Final report completed							
Total							

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Service level agreements

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Agreement between Insurance Division (I Division) and the Government Actuary's Department (GAD) setting out the level of service to be provided by the GAD in respect of the supervision of companies authorised, or seeking authorisation, under the Insurance Companies Act 1982 to carry on long term business.

INTRODUCTION

This agreement sets out the level of service to be provided by the Government Actuary's Department (GAD) to Insurance Division of the DTI (I Division) in respect of the supervision of all companies authorised, or seeking authorisation, under the Insurance Companies Act 1982 ("the Act") to carry on long term business. This agreement covers the long term business of composite companies as well as companies which transact only long term business.

MAIN PRINCIPLES

1. I Division's primary role, as set out in its mission statement, is to regulate the insurance industry effectively (within its duties and powers set out in the Act) so that policyholders can have confidence in the ability of UK insurers to meet their liabilities and fulfil policyholders' reasonable expectations. In fulfilling these aims I Division has sole responsibility for all executive decisions taken in the exercise of the Secretary of State's powers under the Act.

2. One of GAD's primary functions is to advise I Division in the fulfilment of these aims. In carrying out this role, GAD recognises that its function is advisory and that it has no responsibility for the exercise of the Secretary of State's powers under the Act.

3. In order to enable I Division and GAD to carry out their primary roles, a close working relationship between the two is necessary, in which both sides keep each other fully informed. I Division will copy to the GAD all relevant correspondence received from companies. ("Relevant correspondence" for this purpose does not include letters of complaint from policyholders, unless there are actuarial issues involved, and notifications of management changes.) I Division will also notify the GAD of all changes of control affecting the company, including changes of Managing Director and Appointed Actuary. Unless special circumstances arise, GAD will accompany I Division on all visits to companies, and be given the opportunity to attend all meetings held by I Division with companies. GAD may hold meetings with companies on actuarial issues at GAD. The GAD will notify I Division of, and offer the Division the opportunity to attend, all such meetings.

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Payment by DTI for services provided by the GAD

4. The level of fees to be paid by I Division to the GAD for the provision of services under this agreement will be subject to a separate agreement between the two parties negotiated annually.

DETAILED ACTIVITIES

5. The following sets out the detailed services provided by the GAD to the DTI. It is not an exhaustive list. In particular, as section B and C make clear, GAD will stand ready to comment and advise where appropriate on all issues when asked to do so by the DTI.

A. **Examination (or scrutiny) of annual returns**

A1. The returns submitted to I Division under Section 22 of the Act are the principal tool enabling the Secretary of State to form a view on an insurance company's present and future solvency. GAD have the main role in the detailed scrutiny of these returns, and in providing advice to I Division on what action needs to be taken in following up points arising from the scrutiny.

A2. The following paragraphs are written on the basis that most company year ends are 31 December. However, when the year end of any company is different from 31 December, the same principles will apply.

The scrutiny programme

A3. The scrutiny programme (the order in which the returns are examined in detail by the GAD) for each year is to be agreed between I Division and GAD by **mid September** on the following basis. Where it is known that a company will be visited during the course of the scrutiny year in question GAD will make every effort to carry out the scrutiny and report to I Division before the visit. I Division and the GAD will also agree before the start of each scrutiny cycle whether there are any special topical issues affecting the life assurance industry in the next twelve months which need to be addressed during the course of the scrutinies.

Initial action by I Division

A4. The **role of I Division** initially is to ensure that the GAD receives the DTI returns and shareholders' accounts needed to complete its part of the process. In particular, I Division will aim to provide GAD with appropriate copies within four working days of receipt. I Division will also notify GAD, by end

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June and end December each year of the company visits to be carried out in the next twelve months.

A5. I Division will notify GAD when an extension has been granted to a life office under the terms of Section 22(1) of the Act.

A6. Chasing of late returns is the responsibility of the I Division supervisor who will answer any queries on when a return is expected.

Initial Action by GAD

A7. The role of the GAD in the initial process is to provide I Division with a clear overview of the scrutiny programme by mid September. The main elements of the initial process will be:

a. GAD will report to DTI immediately if the initial scrutiny of any company raises serious concern. The main examples of where serious concerns arise are when:

i. a company has failed to meet its solvency margin, or is in financial difficulties;

ii. a company has failed to provide the necessary directors', actuary's and auditors' certificates, or any of the certificates is significantly qualified;

iii. significant data errors or omissions exist;

iv. a breach of section 30 (allocation of surplus to with profit policyholders) appears to have taken place;

v. a company appears not to be complying with its Notice of Requirements, or with undertakings it has given to the DTI.

vi. there appear to be any other clear breaches of the Act and regulations.

b. GAD will send to DTI by the end of August a report covering all initial scrutinies which will consist of:

i. a priority rating for each company, based on GAD's views of its financial strength;

ii. an indication of solvency cover for each company.

iii. a target date for full scrutiny of each company's returns.

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1995 – between the DTI and GAD

c. I Division and GAD will use their best endeavours to agree the scrutiny programme, both as regards time - tabling and allocation of priority rating **by mid September.** However, GAD does not need to wait for the scrutiny programme to be agreed before starting its detailed scrutinies of what it perceives to be the most urgent cases. Generally speaking, these will be the priority 1 cases.

Progressing the scrutiny programme

A8. The role of GAD in the detailed scrutiny process is to provide I Division, in the form of a report, with a means of identifying those companies which:

a. are not complying with statutory requirements;

b. are failing to meet the statutory requirements, or are in danger of failing to meet them in the near future;

c. appear not to be meeting policyholders' reasonable expectations.

A9. In addition the scrutiny report will contain:

- a basis for action in relation to individual companies if any of the fundamental requirements above are not being met, or if trends in the returns point to problems with these in the near future;
- a basis for informed longer term discussion with individual companies on problems which may arise in future if current trends in key performance indicators continue;
- key indicators include:

a. cover for the solvency margin and trends in free asset ratios

b. actuarial issues, e.g change in strength of valuation basis, matching.

c. type of new business being written, by volume and mix

d. trends in expense ratios

e. trends in lapse rates

f. assets; worrying exposures, investment strategy, impact on bonus strategy

g. significant developments during year

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A10. **Detailed scrutiny reports for all companies will follow the format set out in Annex A** unless a different format is agreed between GAD and I Division for individual cases.

A11. Detailed scrutiny reports will be provided to DTI in accordance with the scrutiny programme. Broadly, the aim will be to provide detailed reports for all companies with priority ratings 1 to 3 by the end of March the following year. Within that period, priority 1 and 2 cases will be given priority.

A12. Detailed scrutiny reports on priority 4 cases will be submitted by the end of May.

A13. Priority 5 cases will not be given a full scrutiny in the year in question but will receive a fuller initial scrutiny.

A14. It may be necessary to amend the programme of detailed scrutinies, as both the priority ratings and the target date for a full scrutiny may be subject to some fine tuning e.g. due to the level of the Stock Market at the balance sheet date. I Division and GAD will agree revised target dates where it is necessary to make amendments to the programme.

Action arising from the detailed scrutiny

A15. Points arising from the detailed scrutiny of the returns which require clarification will normally be taken up with the company, or with its Actuary, by GAD. However, GAD will always consider whether the point to be taken up is more appropriate for I Division and will recommend accordingly. Where GAD has written to the company, it will be for GAD to chase the reply. This should be done within six weeks of the letter issuing. Points arising from the company reply should be dealt with within 2 weeks.

A17. If GAD considers that I Division might need to exercise the Secretary of State's powers, or take any course of action, it will make appropriate recommendations. **GAD will not, however, initiate any such action nor commit I Division to any particular decision or course of action.**

Monitoring the progress of the scrutiny programme

A18. GAD will circulate to I Division at the end of each month a report of the progress of the scrutiny programme.

B. Authorisation of new life offices

B1. The purpose of the authorisation procedure is to form a judgement on whether, on the basis of the application submitted and on the initial starting

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capital, the company will remain solvent until its fourth year of operation, and will be managed and controlled by fit and proper persons. GAD's main role in this process is to evaluate the financial projections and related matters, and provide advice to I Division as to whether, in their view, the solvency requirements will be met.

B2. In the initial stages, GAD will attend the meetings with companies who are considering making an application for authorisation. They will also attend any subsequent meetings as the authorisation progresses.

B3. When the written applications are submitted to I Division by the company, GAD will comment on the draft (of which there may be several over time) and final versions. GAD's main role will be to advise I Division on the proposals as they affect the solvency and financial viability of the company. In the case of companies transacting only long term business GAD will have the main responsibility for commenting on the Scheme of operations, projections, type of investments representing the insurance funds, reinsurance treaties and actuarial certificates (typically paras 10 - 20 and 23 of part 1 of schedule I of the Insurance Companies Regulations 1994). However, they will not be restricted to these matters if they consider that other parts of the application require comment or give rise to concern. In the case of "health composites" which may now be authorised following the implementation of the 3rd EC Directives, I Division will decide whether GAD input is appropriate in respect of the general business Classes 1 and 2.

B4. GAD may also deal direct with the applicant or its advisers in order to clarify any unclear point in the application.

B5. In order to enable I Division to meet its own targets, GAD will provide I Division with comments on the first draft application within four working weeks of receipt. On each subsequent draft of the application, GAD will provide comments within a time - frame agreed between it and I Division.

C. Other supervisory matters

C1. Aside from the scrutiny of returns and authorisation processes, GAD will also provide advice on all areas which impact on a life office's solvency. It is not possible in a document of this nature to anticipate all of the instances in future where GAD's advice will be sought. However, as outlined in paragraph 3 above, to enable GAD to carry out its duties effectively, all documents received by I Division from the life office will be copied to GAD. I Division will request advice from the GAD when there are issues which might affect, for example, the financial security of a life office, policyholders' reasonable expectations, or where the issues raised are actuarial or professional. However, GAD are always free to comment on any document if it believes that there are

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issues that should be brought to I Division's attention. These other areas of responsibility include:

C2. **Transfers of portfolio** - These are transfers of engagements (assets and liabilities) from one company to another under the terms of Schedule 2C of the Act. The main issues to be considered are whether the transfer will adversely affect the security of policyholders or their reasonable expectations. GAD will:

- attend the meeting with the Independent Actuary, and be given the opportunity to attend any meetings held by I Division with the company;

- provide advice on the draft Scheme documents to enable I Division to form a view on the proposals and to comment to the company within the time scales set by the court procedure, and in good time to influence events if necessary

C3. **Requests by companies for concessions under Section 68** - GAD will endeavour to respond to I Division within two weeks of receipt in GAD of such requests in 90% of these cases.

C4. **Other miscellaneous correspondence** - e.g. requests for interpretation of legislation - GAD will endeavour to respond to I Division within two weeks of receipt in GAD of such requests in 90% of these cases.

C5. **Quarterly returns** - GAD will aim to comment on quarterly returns within three weeks of their receipt in the GAD. When there are no substantive issues to raise, the report will be in the form of a "nil return".

C6. **Company visits** - as mentioned above GAD will normally accompany I Division on all company visits according to the agreed visits programme.

C7. **Other issues** - GAD will provide I Division with other services from time to time as agreed. Such other services to include representation at meetings, for example with the Institute and Faculty of Actuaries, European Union etc., and input to policy development as appropriate.

[redacted]
Head, Insurance Division
27 March 1995

[redacted]
Government Actuary
29 March 1995

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1995 – between the DTI and GAD
Annex A

ANNEX A.

SCRUTINY STRATEGY WORKING PARTY

PROFORMA SCRUTINY REPORT,

WITH NOTES ON CONTENT

XYZ LIFE ASSURANCE COMPANY plc

RETURNS AS AT 31 DECEMBER 1993

DETAILED SCRUTINY REPORT

The following pages list the 'standard' section and subsection headings. Notes of likely items to be covered are given in italics. It is suggested that the Sections should remain unchanged from one company report to another, to facilitate finding the desired part of any report, even if an occasional 'not applicable' entry is called for. Subsections should remain in the order shown where possible, but may be amended or omitted more freely.

1 SUMMARY

1.1 Key Features *Key features arising from the scrutiny should be presented, perhaps in the form of 'bullet points'. A possible approach is to extract one item from most Sections of the report. An example list of topics is shown below, but it should not be adhered to rigidly.*

In addition to the specific key points arising from the scrutiny, we should express a view as to the soundness of the company in the short and longer term. Reference to the cover for the solvency margin (8.4 below) should be made, as this is a key DTI supervisory responsibility. The priority rating of the company should be clearly stated. Where there is any doubt as to whether the valuation basis used is in accordance with the Regulations (8.1 below), this should be also be clearly stated.

- *Size and type of office (e.g. medium-sized with profits mutual), and primary source of business (e.g. IFAs).*
- *Ownership issues.*
- *Our view as to its soundness.*
- *Most important types of business, and recent new business trends.*
- *Expense control.*
- *Recent trends in financial results, especially if adverse.*
- *Asset allocation for with profits business, and changes therein.*
- *Approach to valuation, and a general view as to its strength.*
- *Supportability of bonuses, and recent trends in bonus declarations.*
- *Likely impact of the SIB compensation requirements for mis-selling of personal pensions.*

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Annex A

1.2 Action Points *The list of Action Points should include items of as many of the following types as apply:*

(a) *Points needing immediate action by DTI;*

(b) *Points raised by GAD with the actuary in a letter (which should be enclosed);*

(c) *Points to be recorded for raising at a suitable opportunity, e.g. the next company visit.*

2 BACKGROUND

This should be a 'potted history' of the company, covering such things as its size and ownership, and the type(s) of business it writes. Comments on the corporate structure, and particularly of any insurance subsidiaries, should be made. A brief note of the senior management, and particularly the chief executive and the Appointed Actuary, should be given, with information on their experience, recent changes, etc. Any Section 68 Orders in force should be recorded.

The background should also cover significant developments during the year, e.g. acquisitions, disposals, S49 transfers, changes of ownership, and also such things as new types of business or distribution channels, new admin./computer systems, and LAUTRO/PIA regulatory problems, as recorded in the Chairman's statement, for example.

Reference should be made to any recent company visit, including a brief description of its outcome. If there are any issues outstanding with the company they should be mentioned.

[It is intended that the 'Background' section should be in essay form rather than as bullet points; it will form an important part of any briefing note on the company. However, most of it should be self-standing, and may well therefore be carried forward from year to year largely unaltered.]

BUSINESS DEVELOPMENTS DURING THE YEAR

3 NEW BUSINESS

3.1 New products *Any significant new products introduced during the year should be described.*

3.2 Source(s) of new business *The proportion coming from IFAs, direct sales forces, tied agents etc. (and if relevant the amount from overseas), and any significant changes during the year. [If not available from internal information such as the Report & Accounts, this may be obtained from surveys such as that in Planned Savings.]*

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Annex A

3.3 Recent history:

Regular premiums

Class	1989 £000s	1990 £000s	1991 £000s	1992 £000s	1993 £000s
Total					
Year on year percentage increase					

Single premiums

Class	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m
Total					
Year on year percentage increase					

New Business Index (Regular premiums plus 10% of single premiums)

New Business Index (£m)					
Year on year percentage increase					

Note that the classes to be shown in the new business tables must be selected individually to be appropriate to the company concerned. Some examples of likely categories are shown in the list below. One or more rows for overseas business should be shown if appropriate, and if such business is of sufficient significance it should be split by major territories too. There will normally be a row called 'Other' so that the totals reflect the Form 44 totals. Figures should be shown gross of reinsurance but a footnote may be added if, for example, some classes are (almost) wholly reinsured.

Life with profits
Life non profit
Unit linked life
Immediate Annuities
Pensions with profits
Pensions non profit
Unit linked pensions
Group pensions
Critical illness
Permanent Health

For large companies all the above figures, and the expense figures below, may be shown in £millions if this is more appropriate.

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Service level agreements

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4 EXPENSES

4.1 Recent history of expenses:

Expense	1989 £000s	1990 £000s	1991 £000s	1992 £000s	1993 £000s
Initial commission					
Acquisition expenses					
Renewal commission					
Renewal expenses					
Total expenses					
Year on year percentage increase					

Expense ratios: Acquisition					
Renewal					

Expenses should be shown gross of reinsurance. The expense ratios are:

Acquisition (IC + AE) / New Business Index

Renewal (RC + RE) / Regular premium income in force [from Form 41, col. 1, lines 2 + 4 + 6 + 7 + 8]

The definitions of these ratios should be explicitly stated in the text of the report.

4.2 Commentary — *To include comment on the trends in the expense ratios.*

4.3 Exceptional items — *Refer to any exceptional items of expenditure, e.g. fines and compensation payments. Also comment on any references in the Report & Accounts to DP or sales distribution developments.*

5 CLAIMS AND WITHDRAWALS

5.1 Claims experience — *Include reference to Gross Death Claims as a percentage of Gross Sums Assured. Comment, if relevant, on ratio of PHI claims to PHI premiums received.*

5.2 Persistency experience — *As reported to PIA (when we can obtain this information). Also, make reference to any features identified from Form 43, e.g. large increases in maturities or surrenders.*

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1995 – between the DTI and GAD
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SITUATION AT THE YEAR END

6 NON-LINKED ASSETS

6.1 Mix of assets at year end — *Use With-profit Guide information to identify asset mix and performance of WP Fund. Include comment on any significant changes in mix, redirection of investment of new moneys, or use of derivatives.*

6.2 Investment performance

7 UNIT-LINKED FUNDS

7.1 New funds introduced

7.2 Investment performance — *Of the most important funds only (e.g. the managed fund).*

7.3 Fund Management Charges to policyholders — *With particular reference to any changes.*

8 VALUATION & SOLVENCY

8.1 Strengths and/or weaknesses — *An explicit statement as to whether the basis is, or might not be, in accordance with the Regulations must be made. Include a general statement about the relative strength or weakness of the basis overall compared with that used by other similar companies. Add comment to highlight the types of risk to which the company is particularly vulnerable.*

8.2 Changes since previous year

8.3 Summary of results for main classes

[The entries shown in the next two tables are examples only - see note below.]

Liabilities for non-linked business:

Class	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m
Life with profits					
Pensions with profits					
Non profit					
Annuities in payment					
Permanent Health					
Additional reserves					
Less reinsurance					
Total non-linked liability (Form 55)					

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1995 – between the DTI and GAD
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Liabilities for linked business:

Class	1989 £m	1990 £m	1991 £m	1992 £m	1993 £m
Life regular premium					
Pensions regular premium					
Life single premium					
Pensions single premium					
Additional reserves					
Less reinsurance					
Total linked liability (Form 56)					

Note that, as with the new business tables, the entries for classes should be adjusted to suit the particular company. If Unitised With Profits business is significant it should be shown separately from conventional with profits. Where there are additional reserves (e.g. mismatching or contingency) then these should be identified in the tables or in a note thereto.

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1995 – between the DTI and GAD
Annex A

Valuation summary

		1989 £m	1990 £m	1991 £m	1992 £m	1993 £m
1	Non-linked liability (as above)					
2	Linked liability (as above)					
3	Reversionary bonus					
4	Total mathematical reserves (1+2+3)					
5	Additional reserves					
6	Other liabilities					
7	Total long-term liabilities (4+5+6)					
8	Long term assets					
9	Shareholders' assets allocated to RMM					
10	Assets available to meet RMM (8+9-7)					
11	Implicit items					
12	Total amount available (10+11)					
13	Required Minimum Margin					
14	Cover (12÷13)					
15	Assets available in excess of RMM as % of LT assets ((10-13)÷8)					

8.4 Cover for the solvency margin *Comment on recent trends, and any implicit items.*

9 FINANCIAL RESULTS

9.1 Surplus emerging

9.2 Transfer to (or from) P&L Account

9.3 Dividend declared

10 BONUSES

10.1 Cost of bonuses declared

10.2 Key rates of bonus

10.3 Changes to bonus rates

Perhaps including a table giving a five-year history of the most important bonus rates only.

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Service level agreements

1995 – between the DTI and GAD
Annex A

10.4 Distribution policy — *Draw attention to the split between reversionary and terminal bonuses, and also (where relevant) between policyholders and shareholders. Make particular reference to any changes of practice, and any PRE implications.*

11 REINSURANCE

11.1 Overview of treaties

11.2 Changes during the year

11.3 'Financing reinsurance'

OTHER ISSUES

12 COMPLIANCE

12.1 DTI compliance problems

12.2 PIA and other compliance problems

13 MISCELLANEOUS

Possible topics for inclusion here might include press comment about the company, changes in senior staff or directors, etc.

APPENDIX

In certain circumstances, it may not be appropriate to complete a full detailed scrutiny report for each member of a group of companies, although it is usually sensible to consider all the member companies of a group at the same time. Where a full report is not called for, the subsidiary company may be dealt with in an abbreviated report forming an appendix to the parent company report. Examples of where this might be appropriate include pensions management subsidiaries, captive reinsurers and closed fund subsidiaries.

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Service level agreements

1996 – detailed scrutiny programme for the 1995 returns

The priorities for DTI for the 1995 scrutinies are to be

Priority	Description	**Other Indicators** *(note: these indicators are subordinate to the description, and are merely to give some broad assistance. They are no substitute for judgement, both where a higher or lower priority may be justified)*	Target
1	As at present, the allocation of priority 1 will denote a company which either is not demonstrating that it holds the required minimum margin or else where there are significant problems which lead GAD to believe that it does not meet the requirements under proper bases.		Within two weeks
2	This priority denotes those companies where there are significant and substantial concerns.	1. The cover for the RMM is less than 1.25x 2. There is evidence of material non-compliance with the valuation regulations	Within four months
3	This priority denotes companies where there are sufficient concerns to warrant early attention, or there are other reasons to require scrutiny early in the cycle.	1. The cover for the RMM is less than 1.5x 2. There is evidence of a non-trivial, but not material non-compliance with the valuation regulations 3. The company was in priority 1 or 2 for the previous year 4. A company visit is scheduled for October to January (or equivalent for non-December companies) 5. The company had commenced trading, but was authorised for less than eighteen months at the valuation date	Within six months
4	Companies which warrant a scrutiny for any reason, but would otherwise not fall within a category to ensure this.	1. The cover for the RMM is less than 2x 2. The company was in priority 3 in the previous year 3. There is evidence of non-compliance with less important regulations 4. The company did not receive a scrutiny in either of the previous two years 5. A company visit is scheduled for February to September (or equivalent for non-December companies)	Within nine months
5	Companies which do not qualify for priority 4 after the initial scrutiny, but for which decisions will be taken later in the year.	Scrutiny within the last two years	No target date initially
6	Companies which, at the review, are determined to be omitted from the scrutiny process.		None

Service level agreements

1998 – between the Treasury and GAD

Agreement between Insurance Directorate (I Directorate) of Her Majesty's Treasury (HMT) and the Government Actuary's Department (GAD) setting out the level of service to be provided by the GAD in respect of the supervision of companies authorised, or seeking authorisation, under the Insurance Companies Act 1982 to carry on long term business.

INTRODUCTION

This agreement sets out the level of service to be provided by the Government Actuary's Department (GAD) to Insurance Directorate (I Directorate) of HMT in respect of the supervision of all companies authorised, or seeking authorisation, under the Insurance Companies Act 1982 ("the Act") to carry on long term business. This agreement covers the long term business of composite companies as well as companies which transact only long term business.

MAIN PRINCIPLES

1. I Directorate's primary role, as set out in its mission statement, is to regulate the insurance industry effectively (within its duties and powers set out in the Act) so that policyholders can have confidence in the ability of UK insurers to meet their liabilities and fulfil policyholders' reasonable expectations. In fulfilling these aims I Directorate has sole responsibility for all executive decisions taken in the exercise of the Secretary of State's powers under the Act.

2. One of GAD's primary functions is to advise I Directorate in the fulfilment of these aims. In carrying out this role, GAD recognises that its function is advisory and that it has no responsibility for the exercise of the Secretary of State's powers under the Act.

3. In order to enable I Directorate and GAD to carry out their primary roles, a close working relationship between the two is necessary, in which both sides keep each other fully informed. I Directorate will copy to the GAD all relevant correspondence received from companies. ("Relevant correspondence" for this purpose does not include letters of complaint from policyholders, unless there are actuarial issues involved, and notifications of management changes.) I Directorate will also notify the GAD of all changes of control affecting the company, including changes of Managing Director and Appointed Actuary. Unless special circumstances arise, GAD will accompany I Directorate on all visits to companies, and be given the opportunity to attend all meetings held by I Directorate with companies. GAD may hold meetings with companies on actuarial issues at GAD. The GAD will notify I Directorate of, and offer the Directorate the opportunity to attend, all such meetings.

Payment by HMT for services provided by the GAD

4. The level of fees to be paid by I Directorate to the GAD for the provision of services under this agreement will be subject to a separate agreement between the two parties negotiated annually.

DETAILED ACTIVITIES

5. The following sets out the detailed services provided by the GAD to I Directorate. It is not an exhaustive list. In particular, as section B and C make clear, GAD will stand ready to comment and advise where appropriate on all issues when asked to do so by I Directorate.

A. Examination (or scrutiny) of annual returns

A1. The returns submitted to I Directorate under Section 22 of the Act are the principal tool enabling HMT to form a view on an insurance company's present and future solvency. GAD have the main role in the detailed scrutiny of these returns, and in providing advice to I Directorate on what action needs to be taken in following up points arising from the scrutiny.

A2. The following paragraphs are written on the basis that most company year ends are 31 December. However, when the year end of any company is different from 31 December, the same principles will apply.

The scrutiny programme

A3. The scrutiny programme (the order in which the returns are examined in detail by the GAD) for each year is to be agreed between I Directorate and GAD by **mid September** on the following basis. Where it is known that a company will be visited during the course of the scrutiny year in question GAD will make every effort to carry out the scrutiny and report to I Directorate before the visit. I Directorate and the GAD will also agree before the start of each scrutiny cycle whether there are any special topical issues affecting the life assurance industry in the next twelve months which need to be addressed during the course of the scrutinies.

<u>Initial action by I Directorate</u>

A4. The **role of I Directorate** initially is to ensure that the GAD receives the insurance annual returns and shareholders' accounts needed to complete its part of the process. In particular, I Directorate will aim to provide GAD with appropriate copies within four working days of receipt. I Directorate will also notify GAD, by end June and end December each year of the company visits to be carried out in the next twelve months.

Service level agreements

1998 – between the Treasury and GAD

A5. I Directorate will notify GAD when an extension has been granted to a life office under the terms of Section 22(1) of the Act.

A6. Chasing of late returns is the responsibility of the I Directorate supervisor who will answer any queries on when a return is expected.

Initial Action by GAD

A7. The **role of the GAD** in the initial process is to provide I Directorate with a clear overview of the scrutiny programme by mid September. The **main elements of the initial process** will be:

a. GAD will report to HMT immediately if the initial scrutiny of any company raises **serious concern**. The main examples of where serious concerns arise are when:

i. a company has failed to meet its solvency margin, or is in financial difficulties;

ii. a company has failed to provide the necessary directors', actuary's and auditors' certificates, or any of the certificates is significantly qualified;

iii. significant data errors or omissions exist;

iv. a breach of section 30 (allocation of surplus to with profit policyholders) appears to have taken place;

v. a company appears not to be complying with its Notice of Requirements, or with undertakings it has given to the HMT.

vi. there appear to be any other clear breaches of the Act and regulations.

b. GAD will send to HMT **by the end of August** a report covering all initial scrutinies which will consist of:

i. a priority rating for each company, based on GAD's views of its financial strength and taking account of the indicators set out in Annex A.

ii. an indication of solvency cover for each company.

iii. a target date for full scrutiny of each company's returns.

c. I Directorate and GAD will use their best endeavours to agree the scrutiny programme, both as regards time - tabling and allocation of priority rating **by**

mid September. However, GAD does not need to wait for the scrutiny programme to be agreed before starting its detailed scrutinies of what it perceives to be the most urgent cases. Generally speaking, these will be the priority 1 cases.

Progressing the scrutiny programme

A8. The role of GAD in the detailed scrutiny process is to provide I Directorate, in the form of a report, with a means of identifying those companies which:

a. are not complying with statutory requirements;

b. are failing to meet the statutory requirements, or are in danger of failing to meet them in the near future;

c. appear not to be meeting policyholders' reasonable expectations.

A9. In addition the scrutiny report will contain:

- a basis for action in relation to individual companies if any of the fundamental requirements above are not being met, or if trends in the returns point to problems with these in the near future;
- a basis for informed longer term discussion with individual companies on problems which may arise in future if current trends in key performance indicators continue;
- key indicators include:

a. cover for the solvency margin and trends in free asset ratios

b. actuarial issues, e.g. change in strength of valuation basis, matching.

c. type of new business being written, by volume and mix

d. trends in expense ratios

e. trends in lapse rates

f. assets; worrying exposures, investment strategy, impact on bonus strategy

g. significant developments during year

A10. **Detailed scrutiny reports for all companies will follow the format set out in Annex B** but modified for companies that are less important subsidiaries within an insurance group or where a different format is agreed between GAD and I Directorate for individual cases.

A11. Detailed scrutiny reports will be provided to HMT in accordance with the scrutiny programme. Broadly for companies with December year-ends, (and therefore with returns to be submitted to HMT by end-June), the aim will be to provide detailed reports for all companies with priority ratings 1 to 3 by the end of December in the year they are received. Within that period, priority 1 and 2 cases will be given priority, and will be completed by the end of October.

A12. Detailed scrutiny reports on priority 4 cases will be submitted by the end of March the following year.

A13. GAD will endeavour to complete a scrutiny by the end of May for the remaining Priority 5 cases.

A14. Companies with year ends other than December will have detailed reports provided within a comparable timescale, according to the priority awarded to them (as indicated in Annex A).

A15. It may be necessary to amend the programme of detailed scrutinies, as both the priority ratings and the target date for a full scrutiny may be subject to some fine tuning e.g. due to some restructuring of an insurance company being planned. I Directorate and GAD will agree revised target dates where it is necessary to make amendments to the programme.

Action arising from the detailed scrutiny

A16. Points arising from the detailed scrutiny of the returns which require clarification will normally be taken up with the company, or with its Actuary, by GAD. However, GAD will always consider whether the point to be taken up is more appropriate for I Directorate and will recommend accordingly. Where GAD has written to the company, it will be for GAD to chase the reply. This should be done within six weeks of the letter issuing. Points arising from the company reply should be dealt with within 2 weeks.

A17. If GAD considers that I Directorate might need to exercise HMT's powers of intervention, or take any course of action, it will make appropriate recommendations. **GAD will not, however, initiate any such action nor commit I Directorate to any particular decision or course of action.**

A18. GAD actuaries will be available on request to discuss with supervisors any issues concerning individual companies, or arising out of their detailed scrutiny.

Monitoring the progress of the scrutiny programme

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1998 – between the Treasury and GAD

A19. GAD will circulate to I Directorate at the end of each month a report of the progress of the scrutiny programme.

B. Authorisation of new life offices

B1. The purpose of the authorisation procedure is to form a judgement on whether, on the basis of the application submitted and on the initial starting capital, the company will remain solvent until its fourth year of operation, and will be managed and controlled by fit and proper persons. GAD's main role in this process is to evaluate the financial projections and related matters, and provide advice to I Directorate as to whether, in their view, the solvency requirements will be met.

B2. In the initial stages, GAD will attend the meetings with companies who are considering making an application for authorisation. They will also attend any subsequent meetings as the authorisation progresses.

B3. When the written applications are submitted to I Directorate by the company, GAD will comment on the draft (of which there may be several over time) and final versions. GAD's main role will be to advise I Directorate on the proposals as they affect the solvency and financial viability of the company. In the case of companies transacting only long term business GAD will have the main responsibility for commenting on the Scheme of operations, projections, type of investments representing the insurance funds, reinsurance treaties and actuarial certificates (typically paras 10 - 20 and 23 of part 1 of schedule I of the Insurance Companies Regulations 1994). However, they will not be restricted to these matters if they consider that other parts of the application require comment or give rise to concern. In the case of "health composites" which may now be authorised following the implementation of the 3rd EC Directives, I Directorate will decide whether GAD input is appropriate in respect of the general business Classes 1 and 2.

B4. GAD may also deal direct with the applicant or its advisers in order to clarify any unclear point in the application.

B5. In order to enable I Directorate to meet its own targets, GAD will provide I Directorate with comments on the first draft application within four working weeks of receipt. On each subsequent draft of the application, GAD will provide comments within a time-frame agreed between it and I Directorate.

C. Other supervisory matters

C1. I Directorate will notify GAD of any changes of appointed actuary that have been advised to them. GAD will liaise with I Directorate over any action that is needed where there is any concern about the reasons for the change of appointed actuary. All new appointed actuaries (who have not previously held

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such a position) will be interviewed by the Government Actuary and a note of this meeting will be forwarded to I Directorate.

C2. Aside from the scrutiny of returns and authorisation processes, GAD will also provide advice on all areas which impact on a life office's solvency or the reasonable expectations of policyholders. It is not possible in a document of this nature to anticipate all of the instances in future where GAD's advice will be sought. However, as outlined in paragraph 3 above, to enable GAD to carry out its duties effectively, all documents received by I Directorate from the life office will be copied to GAD. I Directorate will request advice from the GAD when there are issues which might affect, for example, the financial security of a life office, policyholders' reasonable expectations, or where the issues raised are actuarial or professional. However, GAD are always free to comment on any document if it believes that there are issues that should be brought to I Directorate's attention. These other areas of responsibility include:

C3. **Transfers of portfolio** - These are transfers of engagements (assets and liabilities) from one company to another under the terms of Schedule 2C of the Act. The main issues to be considered are whether the transfer will adversely affect the security of policyholders or their reasonable expectations. GAD will:

- attend the meeting with the Independent Actuary, and be given the opportunity to attend any meetings held by I Directorate with the company;

- provide advice on the draft Scheme documents to enable I Directorate to form a view on the proposals and to comment to the company within the time scales set by the court procedure, and in good time to influence events if necessary

C4. **Requests by companies for concessions under Section 68** - GAD will endeavour to respond to I Directorate within two weeks of receipt in GAD of such requests in 90% of these cases.

C5. **Other miscellaneous correspondence** - e.g. requests for interpretation of legislation - GAD will endeavour to respond to I Directorate within two weeks of receipt in GAD of such requests in 90% of these cases.

C6. **Quarterly returns** - GAD will aim to comment on quarterly returns within three weeks of their receipt in the GAD. When there are no substantive issues to raise, the report will be in the form of a "nil return".

C7. **Company visits** - as mentioned above GAD will normally accompany I Directorate on all company visits according to the agreed visits programme.

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C8. **Training seminars** – GAD will provide appropriate training on specified insurance issues for supervisors as requested.

C9. **Other issues** - GAD will provide I Directorate with other services from time to time as agreed. Such other services to include representation at meetings, for example with the Institute and Faculty of Actuaries, European Union etc., and input to policy development as appropriate.

[redacted]
Director, Insurance Directorate
29 October 1998

[redacted]
Government Actuary
6 November 1998

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1998 – between the Treasury and GAD
Annex A

Annex A - Allocation of Priorities for Detailed Scrutiny of Life Insurers

Priority	Description	Other indicators (note: these indicators are subordinate to the description, and are merely to give some broad assistance. They are no substitute for judgement, both where a higher or lower priority may be justified)	Target
1	As at present, the allocation of priority 1 will denote a company which either is not demonstrating that it holds the required minimum margin or else where there are significant problems which lead GAD to believe that it does not meet the requirements under proper bases.		Within two weeks
2	This priority denotes those companies that there are significant and substantial concerns.	1. The cover for the RMM is less than 1.25x 2. There is evidence of material non-compliance with the valuation regulations	Within four months
3	This priority denotes companies where there are sufficient concerns to warrant early attention, or there are other reasons to require scrutiny early in the cycle.	1. The cover for the RMM is less than 1.5x 2. There is evidence of a non-trivial, but not material non-compliance with the valuation regulations 3. The company was in priority 1 or 2 for the previous year 4. A company visit is scheduled for September to January (or equivalent for non-December companies) 5. The company had commenced trading, but was authorised for less than eighteen months at the valuation date.	Within six months
4	Companies which warrant a full scrutiny for any reason, but would otherwise not fall within a category to ensure this.	1. The cover for the RMM is less than 2 x 2. The company was in priority 3 in the previous year 3. There is evidence of non-compliance with less important regulations 4. The company did not receive a full scrutiny in either of the previous two years 5. A company visit is scheduled for February to August (or equivalent for non-December companies).	Within nine months
5	Companies which do not qualify for priority 4 or higher after the initial scrutiny	Cover for the RMM is more than 2 x, and scrutiny within the last two years	Within eleven months

Service level agreements

1998 – between the Treasury and GAD
Annex B

XYZ LIFE ASSURANCE COMPANY
RETURNS AS AT 31 DECEMBER 1997
DETAILED SCRUTINY REPORT
GAD PRIORITY RATING:

To: **[HMT Supervisor], Her Majesty's Treasury**
From: **[GAD Actuary], Government Actuary's Department**

This report conforms fully with the professional requirements of the Institute and Faculty of Actuaries, details of which are set out in section [16] of this report.

[The following pages list the 'standard' section and subsection headings. Edit the items in square brackets in the opening sentence above and in the final section (Professional Requirements), but otherwise these must be left unchanged. Notes of likely items to be covered in other sections are given in italics. It is suggested that these sections should remain unchanged from one company report to another, to facilitate finding the desired part of any report, even if an occasional 'not applicable' entry is called for. Subsections should remain in the order shown where possible, but may be amended or omitted more freely. It is essential that the whole of sections 1 and 2 fit onto just page 1 of the report.]

1. KEY FEATURES

Type of company:	*(mutual/proprietary, UK/overseas owned, etc)*	
Type of business:	*(with-profit, credit life, unit-linked, etc)*	
Last visit date:		
Key Financial Statistics:	1995	**1996**
New Business Index:		
Long Term Assets:		
Assets Available:		
RMM		

[The key statistics table must be completed for all companies, and its format and position in the report left unaltered. HMT have requested this specifically. If company has any implicit items and/or subordinated loans, then these will be shown in an extra line in the table.]

2. ACTION POINTS

[This should (a) clearly identify any points needing immediate action by HMT; (b) give a very brief summary of the most important points raised by GAD with the company and/or Appointed Actuary in a letter (stating that this letter can

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1998 – between the Treasury and GAD
Annex B

be found in the Appendix); (c) identify any points to be recorded for raising at a suitable opportunity, e.g. the next company visit. It is essential that all points requiring action by HMT are highlighted clearly in this section of the report, and an indication given as to their relative importance/priority.

***When there are no points for immediate action, this fact should be highlighted in boldface**.]*

3. EXECUTIVE SUMMARY

[This section should be kept <u>fairly concise but still draw out all salient features on a company</u>. It should express a view as to the soundness of the company in the short and longer term, comment on its general competitive position and likely long term viability, and indicate whether it presents any particular difficulties for HMT. Where there is any doubt as to whether the valuation basis used is in accordance with the regulations (section 10 below), this should be clearly stated. Summaries on companies with no concerns will be more concise than those on rogue ones. The features drawn out in this part of the report should link to the action points.

Topics from which these might be drawn include:

- *significant changes in types of business written*
- *recent trends in new business and/or sources of business*
- *ownership issues (e.g. changes of control)*
- *recent trends in expenses*
- *recent trends in financial results, especially if adverse*
- *likely impact of compensation for pensions mis-selling*
- *reinsurance treaties or other financing.]*

4. BACKGROUND

[This should be a 'potted history' of the company, covering such things as its size and ownership, and the type(s) of business it writes. Comments should be made on the corporate structure, and particularly any insurance subsidiaries, all past Sch 2C transfers, and any history of significant HMT or PIA regulatory problems. A brief note of the senior management, and particularly the Chief Executive and the Appointed Actuary, should be given, with information on their experience, recent changes, etc. Any section 68 orders in force should be recorded.

This section should also cover any <u>significant</u> developments during the year, e.g. acquisitions, disposals, Sch 2C transfers in that year, changes of ownership, and also such things as new types of business or distribution channels, new admin/computer systems and PIA regulatory problems, as recorded in the Chairman's statement, for example.

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Reference should be made to any recent company visit, including a brief description of its outcome. If there are any issues outstanding with the company they, should be mentioned.

It is intended that this section should be in essay form; it will form an important part of any briefing note on the company. Most of it should be self-standing, and may well therefore be carried forward from year to year largely unaltered, but items which are no longer of interest should be deleted. It would be helpful in this regard if items which are of short term interest are separately identified from those of more enduring interest.

Particular care should be taken to ensure that this section is historically sound and as complete as possible.]

BUSINESS DEVELOPMENTS DURING THE YEAR

5. NEW BUSINESS

5.1 New and altered products
[Any significant new products introduced during the year should be described. Reference should also be made in this subsection to any significant changes in existing product terms, such as increases in policy charges.]

5.2 Source(s) of new business
[Give the proportion of new business coming from IFAs, direct sales forces, tied agents etc. and, where relevant, from the UK and overseas. If not available from internal documents such as the Report & Accounts, this information should be obtained from surveys such as those in Money Management and Planned Savings. Highlight any significant recent trends or other changes in sales direction, presenting the data in a table where possible.]

5.3 Recent history:

New regular premiums

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life and general annuity: - accumulating with-profit					
- other with-profit					
- non-profit					
- property-linked					
- index-linked					
Pensions:					

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- accumulating with-profit					
- other with-profit					
- non-profit					
- property-linked					
- index-linked					
Permanent health					
Overseas (all classes)					
Other					
Total					
Year on year % increase					

Source: Form 47, column 6

New single premiums

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life and general annuity: - accumulating with-profit					
- other with-profit					
- non-profit					
- property-linked					
- index-linked					
Pensions: - accumulating with-profit					
- other with-profit					
- non-profit					
- property-linked					
- index-linked					
Permanent health					
Overseas (all classes)					
Other					
Total					
Year on year % increase					

Source: Form 47, Column 3

New Business Index (regular premiums plus 10% of single premiums)

New Business Index (£000s)					
Year on year % increase					
ABI comparisons (UK business): - Life	*4%*	*1%*	*(11)%*	*(9%)*	***22%***
- Pensions	*9%*	*(5%)*	*(11%)*	*(11%)*	***16%***
- Overall	*6%*	*(2%)*	*(11%)*	*(10%)*	***20%***

Source: ABI Insurance Statistics Yearbook 1996

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[Note that the classes to be shown in the new business tables should be selected individually to be appropriate to the company concerned. One or more rows for overseas business should be shown if appropriate, and if such business is of sufficient significance, it should be split by major territories too. Where the 'Other' rows contain only rounding entries, absorb these appropriately but ensure that the totals reflect the Form 47 totals.

Figures should be shown gross of reinsurance but a footnote may be added if, for example, some classes are (almost) wholly reinsured. Directly written business and reinsurance accepted should be separately identified, where both are material. For large companies, all the above figures, and the expense figures below, may be shown in £m if this is more appropriate.

For companies writing new industrial business, separate tables should be produced for OB and IB, with separate NBI figures being shown for these two classes, clearly labelled.

5.4 Commentary
Comment on any atypical features and on recent new business trends. Retain the ABI comparatives in the NBI table in subsection 5.3 above, but comment additionally in this subsection on the company's relative new business performance compared with its peer group of companies (chosen appropriately), using data from the annual report or elsewhere.

Make specific reference to any material discontinuities or distortions in the figures caused by changes in the way in which recurrent single premium contracts are reported, or due to the inclusion of increases to premiums on existing contracts in new business figures from 1996.]

6. CHANGES IN BUSINESS IN FORCE

6.1 Recent history of regular premiums received

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life and general annuity					
Pensions					
Permanent health					
Other contracts					
Total gross regular premiums					
Less reinsurance premiums					
Total net regular premiums					
Year on year % increase					

Source: Form 41

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6.2 Claims experience

Recent history of claim amounts

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life assurance deaths					
Life assurance maturities					
Annuity payments					
Surrenders					
Pension lump sums					
Pension annuity payments					
Pension surrenders					
PHI lump sums					
PHI regular payments					
Other lump sums					
Other regular payments					

Source: Form 42

[Immaterial lines should be deleted/combined as appropriate.]

6.3 Persistency experience

Latest PIA persistency statistics (represented as % of policies written in year no longer in force at end of term)

	Endowments					
Business Year:	1993	1994	1995	1993	1994	1993
Persistency Term:	1yr	1yr	1yr	2yr	2yr	3yr
Regular Premium:						
Company Reps						
Industry ave company reps	*8.2*	*8.1*	*7.7*	*13.9*	*13.2*	*19.0*
IFAs						
Industry ave IFAs	*5.8*	*5.5*	*4.7*	*9.6*	*8.4*	*12.5*
Direct Adverts.						
Industry ave direct adverts.	*5.8*	*6.0*	*4.9*	*10.4*	*10.4*	*14.5*
Single Premium:						
Company Reps						
Industry ave company reps	*1.2*	*1.4*	*1.6*	*4.6*	*3.6*	*6.8*

	Other Life					
Business Year:	1993	1994	1995	1993	1994	1993
Persistency Term:	1yr	1yr	1yr	2yr	2yr	3yr
Regular Premium:						
Company Reps						
Industry ave company reps	*14.9*	*13.8*	*12.2*	*25.5*	*23.7*	*34.0*

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IFAs						
Industry ave IFAs	*8.0*	*7.1*	*6.7*	*13.8*	*13.5*	*20.5*
Direct Adverts.						
Industry ave direct adverts.	*10.5*	*11.7*	*11.5*	*14.8*	*16.8*	*17.4*
Single Premium:						
Company Reps						
Industry ave company reps	*3.2*	*3.4*	*1.9*	*9.4*	*7.3*	*14.7*
IFAs						
Industry ave IFAs	*2.7*	*2.6*	*1.5*	*6.6*	*6.9*	*11.4*

	Pensions					
Business Year:	1993	1994	1995	1993	1994	1993
Persistency Term:	1yr	1yr	1yr	2yr	2yr	3yr
Regular Premium:						
Company Reps						
Industry ave company reps	*14.5*	*14.8*	*13.5*	*25.4*	*25.1*	*33.7*
IFAs						
Industry ave IFAs	*7.6*	*7.9*	*8.6*	*15.2*	*16.4*	*11.6*
Single Premium:						
Company Reps						
Industry ave company reps	*0.5*	*0.8*	*1.1*	*1.0*	*1.5*	*1.7*
IFAs						
Industry ave IFAs	*1.1*	*1.3*	*1.7*	*2.3*	*2.8*	*3.5*

Source: PIA: Third Survey of the Persistency of Life and Pensions Policies (Nov 1997)
Note: Data not available for SP via direct adverts (all classes) and SP via IFAs (endowments).

[Delete inappropriate or unusable sections and add appropriate commentary.]

Recent history of combined surrender, lapse & paid-up conversion rates

Class	1992	1993	1994	1995	1996
Life non-linked					
Life linked					
Pensions non-linked					
Pensions linked					

Note: The combined surrender, lapse and paid-up conversion rates are:
Form 46, UK business, annual premiums, lines (24+25+26) / [½*lines (11+39+24+25+26)]

[Make reference to any features identified from these figures, e.g. large increases in surrenders. Where it is felt necessary, draw attention to the differences between these two sets of persistency rates, in particular that the PIA statistics are based on policy not accounting year and are to some extent

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out of date, and that the Form 46 figures relate to the company's total portfolio.]

7. EXPENSES

7.1 Recent history of expenses:

Expense	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Initial commission					
Acquisition expenses					
Renewal commission					
Maintenance expenses					
Other management expenses					
Total expenses					
Year on year % increase					

Source: Form 41

Expense ratios:	1992	1993	1994	1995	**1996**
Acquisition					
[Sector] average acquisition					
Renewal					
[Sector] average renewal					
Renewal as % of total fund					
[Sector] average renewal as % of total fund					

Notes: 1. The expense ratios are:
Acquisition: (IC+AE+OME)/New Business Index
Renewal: (RC+ME)/Gross earned regular premiums [F41.29.1]
Renewal as % of total fund: (RC+ME)/Average total fund [½*(F40.49 + F14.51.1 + F40.59 + F 14.51.2)]

2. The trend in the acquisition expense ratio is subject to distortion from the reclassification of recurrent single premiums as regular premiums from 1996, and also from the inclusion of other management expenses in this ratio.

[Expenses should be shown gross of reinsurance, but a footnote may be added if these are substantially reinsured. Only the version of the renewal expense ratio most appropriate to the company should be retained, the other and its accompanying note being deleted.

For making comparisons, choose the sector appropriate to the company, and enter its name in the tables, extracting the data from the annual report.

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Where there is industrial business, separate tables of expenses should be created for OB and IB, and the above table of expense ratios substituted with the following table:

Expense ratios:	*1992*	*1993*	*1994*	*1995*	***1996***
OB acquisition					
[Sector] average OB acquisition					
OB renewal					
[Sector] average OB renewal					
IB combined					
Industry average IB combined					

Notes: 1. The expense ratios are:

OB Acquisition: OB(IC+AE+OME)/OB New Business Index
OB Renewal: OB(RC+ME)/OB Gross earned regular premiums [OB F41.29.1]
IB combined: IB(Total expenses)/IB Gross earned total premiums [IB (F41.19.1 + F41.29. 1)]

2. The acquisition expense ratio is subject to distortion from the reclassification of recurrent single premiums as regular premiums from 1996, and also from the inclusion of other management expenses in this ratio.

Separate tables and appropriately modified expense ratios should also be created where there is any other major and continuing subdivision of the fund — such as between with-profit and non-profit business.

Mention should be made of discontinuities arising from the 1996 A&S Regulations, expanding in particular on the fact that recurrent single premium business is now treated as regular, with a knock-on effect to the acquisition (and, to a lesser extent renewal) expense ratio, and also that other management expenses, which are treated as wholly acquisition expenses above, may also in fact include some renewal expenses.]

7.2 Commentary
[To include comment on the trends in the expense ratios, and their relative level compared with the relevant sector average, where appropriate.

The service company arrangements disclosed under note 5 on page 96 of the A&S Regulations (note to the returns coded 4008) should be mentioned and, if known, a statement as to whether expense charges from the service company are at cost should be made.

Note any sub-fund divisions where expenses are determined specially, e.g. under a Sch 2C scheme, and comment with cross reference to the controlling document. Comment also where expenses are shared with other companies within the same group.

Comment on where investment expenses are shown — in expenses or as an offset to investment income]

7.3 Exceptional items
[Refer to any exceptional items of expenditure, e.g. fines and compensation payments. Also comment on any references in the Report & Accounts to sales distribution developments and/or computer upgrades to illuminate the progression of expenses and in particular those shown as other management expenses.]

SITUATION AT THE YEAR END

8. NON-LINKED ASSETS

8.1 Make-up of portfolio

Recent history of asset mix

Type of asset	1992 %	1993 %	1994 %	1995 %	**1996 %**
Land					
Approved fixed interest					
Other fixed interest					
Approved variable yield					
Other variable yield					
Equity shares					
Debts sec'd by mortgages					
Other — producing income					
Other — not producing income					

Source: Form 48

[Figures to be shown without % signs, and to the nearest whole number.]

Movement in asset values during the year

Type of asset	1995		**1996**		
	£000s	Yield %	£000s	Yield %	Mkt yld %
Land					
Approved fixed interest					
Other fixed interest					
Approved variable yield					

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Other variable yield					
Equity shares					
Debts sec'd by mortgages					
Other — producing income					
Other — not producing income					
Total					

Source: Form 48

[Yields to be shown without % signs, and to 1 d.p.

Comment on any significant changes in asset mix and redirection of investment of new moneys.

Make reference as to whether Form 49 reveals any significant spread of yields (columns 3 and 6), i.e. if a typical average yield above hides some very low and some high yielders.

Make specific reference to any discontinuities or distortions caused by the change in definition of the assets included in Form 48 from 1996 compared to those included in the old Form 45, in particular that excess linked assets are now included, and that assets matching index-linked liabilities (many of which may be derivatives) are now definitely excluded.

Make reference to any material holdings of inadmissible assets, and any significant reconciliation items to the Companies Act assets as per lines 94 and 95 of Form 13.

Comment on the balance between non-income producing assets above and the non-interest demanding other insurance liabilities, and whether the yield on net assets would be markedly different to the above yield on gross assets due to high other insurance liabilities, including loans. Comment if a separate investment house exists rather than an in-house team, and whether any performance bonus arrangements or penalties apply to our knowledge.

Make reference to any significant debts/loans or contingent liabilities relating to connected companies (see line 100 of Form 13 and note to the returns coded 1404 respectively).

Comment also on any material counterparty exposures disclosed under paragraph 11 of Schedule 1 (note to the returns coded 1306).

For making comparisons, compare with data from Annual Report.]

<u>8.2 Derivatives</u>

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[Include this subsection only for companies with a material exposure to derivatives.

Comment on any significant amendment to the asset distribution shown in section 8.1 from the impact of derivatives (see Regulation 23(1)(d) statement), and whether such usage is long-standing or new. Comment on margining arrangements in force.]

<u>8.3 Investment performance</u>
[Estimate the investment return on the total non-linked assets from Form 40 and the template below. The result of the calculation should be quoted, but the actual table may be hidden in the report <u>after</u> it has been reviewed by the chief actuary (but preferably not deleted), unless desired to be shown.

	£000s	£000s
1. Total investment income (F 40.12)		
2. *less* estimated investment income on assets matching property linked liabilities *		
3. *less* estimated investment income on non-linked assets matching index-linked liabilities ‡		
4. Investment income on Form 48 assets		
5. Increase in non-linked assets brought into account (F 40.13)		
6. *less* increase in non-linked assets matching index-linked liabilities brought into account ‡		
7. Increase in Form 48 assets brought into account		
8. Investment reserve carried forward (F 14.51.1)		
9. Investment reserve brought forward (F 14.51.2)		
10. Increase in investment reserve		
11. Investment return		
12. Opening Form 48 assets		
13. Closing Form 48 assets		
14. Mean fund excluding investment return [=½x(12+13-11)]		
15. Rate of return from investment [=11/14]		%
16. Expected investment return †		

* calculated as F44.12/average F55 internal linked col 7*average F55 total cols (8-9)
‡ estimated figures based on Form 56
† based on overall market performance applied to asset mix shown in section 8.1

Given the problems of subdividing the index-linked assets and the resulting approximations above, it is recognised that the estimated investment return is subject to distortion. Clear health warnings should therefore be included where the volume of index-linked business is significant.

Where there is a separate with-profit sub-fund, the investment return should be calculated for this separately, where possible (i.e. when the split of the total investment reserve is known). Supplementary information on the with-profit sub-fund should be obtained from the with-profit guide, which will be requested for all major with-profit companies as a matter of course at the end of August each year.

Where there is a marked disparity between the crude actual investment return calculated above and that shown in line 16 expected from the mix of assets held and market performance during the reporting period, this should be commented upon. Where there is no such disparity, and the table is being retained, the line 16 figure may be deleted.

Draw attention also to any marked disparity between the crude actual investment return calculated above and that seen for a typical office (again separately for the with-profit fund where possible). Indicate whether this appears to be driven purely from differences in asset mix and comment on its possible implications for the company's long term competitiveness.]

9. ASSETS HELD TO MATCH LINKED LIABILITIES

<u>9.1 Internal linked funds</u>

9.1.1 New and altered funds
[Give details of any new funds introduced during the year, and of any fund mergers or rationalisations, including the terms on which these were made.]

9.1.2 Investment performance
[Comment on the relative investment performance of the most important funds only (e.g. the managed fund) compared both with the performance expected given the stated investment objectives of the funds and overall market performance during the reporting period, and with the performance of funds with similar investment objectives operated by other companies in the industry based on the results of magazine surveys.]

9.1.3 Fund Management Charges to policyholders
[Make reference to any changes in particular.]

9.1.4 Principles of unit pricing
[Give a brief description of the basis on which assets are valued and how this is selected, including the timing of the asset valuation used in respect of unit creations and cancellations in relation to the time at which both the operation is decided upon and effected. If there is any evidence that the procedures adopted may result in incoming, outgoing and continuing policyholders being treated inequitably, a specific statement to this effect should be included.

Where unit trust principles are adopted, this may be stated in lieu of a description. Reference should also be made to the allowance made for CGT (see paragraph 5(5) of Schedule 4). Draw attention to any apparent inconsistencies between this information and the accounting data shown in Form 45.]

9.1.5 Liquidity and gearing
[Include this subsection only where there are any liquidity or gearing issues arising from Forms 43 and 45, adding appropriate commentary.]

9.2 Other assets matching property-linked liabilities
[Include brief details of any directly held assets shown in Form 55, where relevant.]

9.3 Mismatching to property-linked liabilities
[Indicate the degree to which linked assets (be they in internal linked funds or directly held) exceed or fall short of the corresponding property-linked liabilities they are held to match. Emphasise that such surplus or shortfall is included in section 8.1 above.]

9.4 Assets matching index-linked liabilities
[Include brief details of these assets, with particular reference to derivatives, and of the liabilities they are matching. If there is a material mismatch, this fact should be specifically noted. Comment also on counterparty exposure and margining arrangements in force in respect of such derivatives.]

9.5 PRE (issues on linked funds)
[Include reference in this subsection to any possible implications for PRE not covered in earlier subsections, for example arising from internal linked fund mergers/rationalisations, lacklustre investment performance or increases in fund management charges or any other policy fees. Comment also on rebates from unit trusts, and in particular the extent to which policyholders benefit from such rebates.]

10. VALUATION BASIS

[An explicit statement as to whether each element of the basis (interest, mortality, morbidity (if relevant), expenses and any other relevant factors) is, or might not be, in accordance with the Regulations should be made, together with a comment on the company's matching position, under the separate headings set out below. Changes since the previous year should be clearly described within each relevant section. Specific reference should be made both to trends in the basis caused by successive small changes over recent years, and to any apparently arbitrary changes.]

10.1 Overall strength

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[Include here a general statement about the relative strength or weakness of the basis overall compared with that used by other similar companies. Add comment to highlight the types of risk to which the company is particularly vulnerable.]

<u>10.2 Interest</u>
[Comment on the supportability of, and the degree of margin apparent in, the interest rate used for each group of liabilities shown in Form 57. Check that allowance has been made for the change to asset classes brought about by derivatives (Regulation 23(d) statement and paragraph 6(1)(a) of Schedule 4). Comment on whether the with-profit interest rates appear to make adequate provision for PRE. The method by which regard has been given to PRE, and account taken of the custom and practice of the company in the manner and timing of the distribution of profits or the grant of discretionary additions over the duration of the policy should be described briefly.]

<u>10.3 Mortality</u>
[Make specific reference to any concerns over the mortality assumptions used, including in particular the allowance made for future improvements in annuitant mortality. Consider also the reasonableness of any other adjustments made to the assumptions, for example for changes in incidence of disease, medical developments and the State of the commitment, and of the allowance for AIDS.

Provide a commentary on the recent history of the mortality assumptions used for the most important liability classes, perhaps by means of a table if desired.]

<u>10.4 Morbidity</u>
[Include this subsection only for companies for which morbidity is material, making specific is reference to any concerns over the assumptions used.]

<u>10.5 Expenses</u>
[Comment on the amount and adequacy of the aggregate allowance made in the valuation for expenses in the year following the valuation date (paragraph 10(2) of Schedule 4) compared with the level of expenses in connection with maintenance of business shown in Form 41, qualifying these remarks appropriately if there are material other management expenses shown in Form 41 with the possibility that these may in fact more properly be classified as in connection with maintenance of business.

Comment also on the information provided in paragraphs 10(1), (3) and (4) of Schedule 4 on the assumed level of expense inflation and the bases used to allow for such inflation, the reserve for expenses of continuing to transact new business during the 12 months following the valuation date, and the subsequent close-down reserve.

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It is recommended that a 5-year history of the per policy expense assumptions used for the most important linked liability classes is given in a table.]

10.6 Mismatching and Resilience
[Comment on the suitability of the assets hypothecated to each group of liabilities shown in Form 57, and whether these still look reasonable after the change to asset classes brought about by derivatives (see Regulation 23(d) statement). Comment on the size and method of calculation of the Regulation 75(b) resilience reserve, and also on any material mismatching by currency. Highlight any apparent inconsistencies between the information given in the Schedule 4 narrative on either of these two issues and the data on these shown in Form 57. Comment also on the size and method of calculation of any Regulation 75(a) reserve required in respect of cashflow mismatching.]

10.7 Other factors
[Comment on the adequacy of aspects of the valuation basis adopted for linked contracts not already covered in earlier subsections, including in particular the differential between the rate of unit growth, gross of tax and management charges, and expense inflation, and the extent to which account has been taken of any increases in management charges which are allowed under policy terms.

Highlight any concerns over the allowance made for tax, where relevant, including in particular the adjustments made to the gross interest rates in Form 57, and the aggregate provision made for CGT.

Where additional reserves are held, these should normally be described.

Make specific reference where relevant to the provision made for pensions mis-selling, including a comment as to its likely adequacy and whether it has been increased since last year.]

10.8 Options and Guarantees
[Include details only if material, making particular reference to annuity guarantees, including information on reserving and implications.]

11. FINANCIAL RESULTS

11.1 Overview
[Comment on recent trends in the level of cover for the RMM and any implicit items. Where shareholders' assets are allocated to the RMM, comment on the quality and suitability of the assets held for this purpose.

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Reference should be made as to where any mismatching reserves, CGT reserves or pensions mis-selling reserves are located in the returns, and in the tables in sections 11.2 and 11.3 below.

Include comments on subordinated loans, where applicable.

Provide, if possible, a brief history of policyholders' shares shown in section 11.4 below over a long period to enable the 5 years shown to be judged in context.

Include also a general comment on the apparent current and future financial viability of the company.]

11.2 Summary of results for main classes

11.2.1 Liabilities for non-linked business

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life & general annuity: - accumulating with-profit					
- other with-profit					
- non-profit					
Pensions: - accumulating with-profit					
- other with-profit					
- non-profit					
Permanent health					
Additional reserves					
Overseas (all classes)					
Other					
Total non-linked liability					

Source: Forms 51 & 52

11.2.2 Liabilities for linked business

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life & general annuity: - property-linked					
- index-linked					
Pensions: - property-linked					
- index-linked					
Permanent health					
Additional reserves					
Overseas (all classes)					

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Other					
Total linked liability					

Source: Forms 53 & 54

[As with the new business tables, the entries for classes should be adjusted to suit the particular company.]

<u>11.3 Valuation summary</u>

		1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996** **£000s**
1	Non-linked liability					
2	Linked liability					
3	Bonus reserves					
4	Total math. reserves					
5	Additional reserves					
6	Other liabilities					
7	Total LT liabilities					
8	Total LT assets					
9	Excess of LT assets over LT liabilities (8-7)					
10	Shareholders' assets allocated to RMM					
11	Assets available (9+10)					
12	Implicit items					
13	Total amount available					
14	RMM					
15	Cover (13/14)					
16	Free assets ratio ((11-14)/8)					

<u>11.4 Composition and distribution of surplus</u>

£000s	1992	1993	1994	1995	**1996**
Surplus brought forward					
Transfer from P/L account					
Surplus emerging in year					
Total available					
Allocated to policyholders					
Transfer to P/L account					
Surplus carried forward					
% of distributed surplus allocated to policyholders					

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Investment Reserves: *[Include in this memo item the amount of the investment reserves]*
Source: Form 58

[Subdivide for separate sub funds with differing policyholders' shares.]

11.5 Movement in shareholders' assets allocated to RMM

£000s	1992	1993	1994	1995	**1996**
Brought forward					
Transfer from (to) LT fund					
Other net income after tax					
less dividends paid					
Total brought forward plus retained profit/loss					
New capital injected					
Change in inadmissible assets					
Other movements					
Carried forward					

[Delete this subsection for mutuals and (genuine) composites. Where total brought forward plus retained profit/loss equals carried forward, the former and intermediate lines should be deleted. Where the balancing item other net income after tax is material, it should be subdivided as appropriate, identifying in particular dividends received from subsidiary companies.]

12. BONUSES

12.1 Cost of bonuses declared

£000s	1992	1993	1994	1995	**1996**
Bonus payments made in anticipation of a surplus					
Reversionary bonuses					
Other bonuses					
Total					

Source: Form 58

[Subdivide for the separate sub funds shown in section 11.4 above. Note any valuation basis changes or cuts in bonus rates that have driven any significant changes in the table.]

12.2 Recent history of key bonus rates

	1992	1993	1994	1995	**1996**

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Life: - accumulating with-profit					
- other (specify)					
Pension: - accumulating with-profit					
- other (specify)					

Source: Schedule 4, Paragraph 15

[Note any initial guaranteed rates on accumulating with-profit contracts from with-profit bond launches etc. Ensure that any guarantees are included in the bonus rates shown where the company quotes a minimum guaranteed bonus or increases benefits automatically and quotes bonuses on top. Comment should be made where accumulating with-profit bonus rates look difficult to sustain, and in particular where these exceed the tax adjusted yield on gilts.]

<u>12.3 PRE (issues on with-profit business)</u>
[Include details of the principles on which the distribution of profits among policyholders and shareholders (where relevant) is based, the company's aims in relation to the distribution of profits among policyholders, and of the methods used in order to ensure that these aims are achieved. Make particular reference to any changes of practice.

Note how rights are specified, by sub-fund if necessary, by Sch 2C transfer scheme, Articles, etc., as described in paragraph 14(1) of Schedule 4. Cross reference to documents held on file and any commitments given to HMT in addition to published documents.

Draw attention to the split between reversionary and terminal bonuses, including where possible a brief history of the percentage of total payout for key contracts represented by terminal bonus. Highlight any significant trends in this percentage and/or marked differences with the industry average.

Comment on other bonus or quasi bonus series such as deposit administration business.]

<u>12.4 Recent history of maturity payouts</u>

£000s	1992	1993	1994	1995	**1996**
25 yr endowment					
Industry average 25 yr endowment					
10 yr endowment					
Industry average 10 yr endowment					
15 yr pension					

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Industry average 15 yr pension					
10 yr SV on 25 yr endowment					
Industry average 10 yr SV on 25 yr endowment					

Note: Endowments: £50p.m., maturing 1 Feb. in next year
Source: Money Management 4/97
Pensions: £200p.m., maturing 1 Jul. in year
Source: Money Management 10/96

[Comment on the company's relative competitive position, the significance of individual maturity years, etc.

Warnings should be included if the method of calculation is over or under estimating the actual amount of the base asset share.]

13. REASSURANCE AND FINANCING

13.1 Overview of reassurance treaties
[Highlight in particular deals with associated companies, looking at the total risk involved overall and any other implications; significant exposures to individual reinsurers, especially ones not authorised in the UK; and new (for that company) and imaginative uses of reinsurance. The names of significant individual reinsurers should be stated, and any changes in the company's reinsurance arrangements since the previous year should be highlighted. Make reference to any deposit back arrangements in force, and comment on the issue of tax deductibility of interest payments under such arrangements, where relevant.]

13.2 Financing arrangements
[Include details of the nature of, and risks involved for the company in, any financing arrangements, apart from subordinated loans entered into, including in particular the amounts of any undischarged obligations of the company, the conditions for their discharge, and how these have been taken into account in the valuation.]

OTHER ISSUES

14. COMPLIANCE

14.1 HMT compliance problems
[Watch in particular for likely errors in completing Forms 55-57, the assets which have been included in Form 48, the treatment of recurrent single premium contracts, the possible misclassification as non-linked of certain contracts which are now classified as linked, and Section 35A issues.

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Also comment on Form 48/57 comparisons, if problems arise.]

14.2 PIA and other compliance problems

15. MISCELLANEOUS
[Possible topics for inclusion here might include press comment about the company, changes in senior staff or directors, etc. Delete this section if not applicable.]

16. PROFESSIONAL REQUIREMENTS

This report conforms fully with the requirements of the Institute and Faculty of Actuaries as set out in their Memorandum of Professional Conduct and Advice on Professional Conduct.

This report had been prepared under the terms of the Agreement between Insurance Directorate of the Her Majesty's Treasury (HMT) and the Government Actuary's Department (GAD) dated March 1995 ("the service agreement") setting out the level of service to be provided by GAD in respect of the supervision of companies authorised, or seeking authorisation, under the Insurance Companies Act 1982 to carry on long term business.

The purpose of this report is to enable HMT to fulfil its duties under the Third Life Directive and the Insurance Companies Act 1982.

The scope of this report is:

- to advise on the statutory solvency position of the company;
- to identify any issues relevant to the duties of HMT;
- to describe the development of the company over the previous 12 months;
- to provide historical background to the company.

[This report is limited to a minor degree because certain questions need to be put to the company and/or the Appointed Actuary. Under the service agreement, GAD has written to the company directly on these. A copy of our letter is included in Appendix [B] to this report.]

The advice and information contained in this report are solely for the use of HMT in fulfilling its statutory duties and should not be transmitted to third parties, including the company concerned, without the prior consent of GAD.

[GAD Actuary], [FIA/FFA]
Government Actuary's Department
[DD] [Month] 199[Y]

Service level agreements

1998 – between the Treasury and GAD
Annex B

APPENDIX A

[In certain circumstances, it may not be appropriate to complete a full detailed scrutiny report for each member of a group of companies, although it is usually sensible to consider all the member companies of a group at the same time. Where a full report is not called for, the subsidiary company may be dealt with in an abbreviated report forming an appendix to the parent company report. Examples of where this might be appropriate include pensions management subsidiaries, captive reinsurers and small closed fund subsidiaries.]

APPENDIX B

[Include here a copy of the letter (if any) sent to the company and/or Appointed Actuary on the returns.]

Service level agreements

1998 – authorisation for prudential regulation functions to be contracted out to the FSA

AUTHORISATION

1. Pursuant to the provisions of Part II of the Deregulation and Contracting Out Act 1994 ("the Act") and the Contracting Out (Functions in Relation to Insurance) Order 1998 Her Majesty's Treasury ("the Treasury") hereby authorise the functions listed in the Schedule to this authorisation to be exercised in that behalf by the Financial Services Authority ("FSA") or by employees of the FSA subject to, and to the extent provided in, the Act and in the Contract.

2. The authorisation shall be for a period of 2 years from 1 January 1999.

3. This authorisation is subject to the provisions of section 69(5)(b) and (c) of the Act.

4. In this authorisation the reference to "the Contract" means the Agreement for the Provision of Services made between the Treasury and the FSA on 18 December 1998.

Signed by for and on behalf of Her Majesty's Treasury	[signature] Dated 18th day of December 1998

Service level agreements

1998 – authorisation for prudential regulation functions to be contracted out to the FSA

SCHEDULE

PART I

INSURANCE COMPANIES ACT 1982(c.50)

1. Functions conferred by or under any of the provisions of the Insurance Companies Act 1982 as follows.

2. Section 3 (authorisation by Treasury).

3. Section 5 (submission of proposals etc.).

4. Section 6 (combination of long term and general business).

5. Section 7 (United Kingdom applicants).

6. Section 8 (applicants from other member States).

7. Section 9 except subsection (7) (applicants from outside the Community).

8. Section 11 (withdrawal of authorisation in respect of new business).

9. Section 12 (notices of withdrawal under section 11).

10. Section 12A (suspension of authorisation in urgent cases).

11. Section 13 (final withdrawal of authorisation).

12. Section 19(2) (appointment of actuary by company with long term business).

13. Section 21A(1), (2), (3), and (5) (communication by auditor with Treasury) except insofar as it relates to the making of regulations by the Treasury applying to any auditor or class of auditor and specifying circumstances in which matters are to be communicated to the Treasury.

14. Section 22 (deposit of accounts etc. with Treasury).

15. Section 23 (rights of shareholders and policyholders to receive copies of deposited documents).

16. Section 24(1) (deposit of accounts etc. by registered society).

Service level agreements

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17. Section 25(4) and (5) (periodic statements by company with prescribed class of business) except insofar as it relates to prescribing such period within which copies of any statement must be deposited with the Treasury.

18. Section 26 (statements of transactions of prescribed class or description) except insofar as it relates to prescribing the classes or descriptions of agreements or arrangements appearing to the Treasury as likely to be undesirable in the interests of policyholders.

19. Section 29(3) (application of assets of company with long term business).

20. Section 30(3) (allocations to policyholders).

21. Section 32(4) (margins of solvency).

22. Section 33 (1) and (2) (failure to maintain minimum margin).

23. Section 37 (grounds on which powers are exercisable) except insofar as it relates to the functions under sections 43A, 44(2)(b) and (4A) and 44A.

24. Section 38 (requirements about investments).

25. Section 39 (maintenance of assets in the United Kingdom).

26. Section 40 (custody of assets).

27. Section 40A (prohibition on disposal of assets).

28. Section 41 (limitation of premium income).

29. Section 42 (actuarial investigations).

30. Section 43 (acceleration of information required by accounting provisions).

31. Section 44(1), (2)(a), (2A), (2B), (3) and (4) (power to obtain information and require production of documents) except insofar as the exercise of any of those functions would require any individual to produce any documents at such time and place as may be specified.

32. Section 45 (residual power to impose requirements for protection of policyholders).

33. Section 46 (notice of proposed exercise of powers on ground of unfitness of certain persons) except insofar as it relates to the functions under sections 43A, 44(2)(b) and (4A) and 44A.

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34. Section 47(1) and (3) (rescission, variation and publication of requirements) except insofar as it relates to a requirement imposed under sections 43A and 44(2)(b).

35. Section 48(2A) (power of Treasury to bring civil proceedings on behalf of insurance company).

36. Section 52A (issue of certificates by Treasury).

37. Section 52B (effect of transfers authorised in other EEA States).

38. Section 54 (winding up on petition of Treasury).

39. Section 56(6) (continuation of long term business of insurance companies in liquidation).

40. Section 60 (approval of proposed managing director or chief executive of insurance company).

41. Section 61 (approval of person proposing to become controller of insurance company where section 60 does not apply).

42. Section 61A (approval of acquisition of notifiable holding in UK company).

43. Section 62(2) (duty to notify change of director, controller or manager).

44. Section 63 (change of manager etc of company from outside United Kingdom).

45. Section 64(1) (duty to notify change of main agent).

46. Section 65(1) (documents deposited with Treasury).

47. Section 69 (power to alter insurance company's financial year).

48. Section 70(3) (service of notices).

49. Section 75(3) (statutory notice by insurer in relation to long term policy).

50. Section 78(4) (linked long term policies).

51. Section 83 (requirements to be complied with by Lloyd's underwriters).

52. Section 83A (Lloyd's underwriters - insurance Directives) except insofar as it relates to the functions under section 44(2)(b) and (4A).

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53. Section 84 (Lloyd's underwriters - financial resources) except insofar as it relates to such modifications as may be prescribed by the Treasury and to the functions under section 44(2)(b) and (4A).

54. Section 85 (Lloyd's underwriters - transfer of business).

55. Section 86(1) (statement of business by Committee of Lloyd's).

56. Schedule 2A (criteria of sound and prudent management).

57. Schedule 2B (restriction on disclosure of information).

58. Schedule 2C (transfers of insurance business).

59. Schedule 2D (further provisions with respect to controllers of UK companies).

60. Schedule 2F (recognition in the United Kingdom of EC and EFTA companies) except insofar as it relates to the functions under section 44(2)(b) and (4A).

61. Schedule 2G (recognition in other EEA States of UK insurers).

PART II

OTHER ENACTMENTS

Lloyd's Act 1871 (34 Vict.c.xxi)

62. Functions conferred by or under any of the following provisions of the Lloyd's Act 1871:

(a) section 35 (salvage operations as to wreck of Lutine); and
(b) section 39 (agreements for incorporation of other Societies etc).

Policyholders Protection Act 1975 (c.75)

63. Functions conferred by or under any of the following provisions of the Policyholders Protection Act 1975:

(a) section 21(2A) (levies on authorised insurance companies);
(b) section 26 (overseas companies);
(c) section 29 (disclosure of documents and information to insurance advisers appointed by the Treasury);

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(d) Schedule 1 (additional provisions with respect to the Policyholders Protection Board) other than the functions under paragraphs 5 and 6 of that Schedule; and
(e) Schedule 3 (additional provisions with respect to levies on authorised insurance companies).

Financial Services Act 1986 (c.60)

64. Functions mentioned in any of the following provisions of the Transfer of Functions (Financial Services) Order 1992:

(a) paragraph 6, 7, 8(a) and 10 of Schedule 1 (certain functions under the 1986 Act retained by the Secretary of State); and
(b) paragraph 1(a), 2 and 6 of Schedule 2 (functions under the 1986 Act exercisable by the Secretary of State jointly with the Treasury).

Friendly Societies Act 1992 (c.40)

65. Functions conferred by or under paragraph 13(2) of Schedule 15 to the Friendly Societies Act 1992 (power to certify that a person possesses the margin of solvency required by Part II of the 1982 Act).

Policyholders Protection Act 1997 (c.18)

66. Functions conferred under or by virtue of section 6(1) of the Policyholders Protection Act 1997 (schemes of arrangement etc; power of Treasury to intervene).

PART III

SUBORDINATE LEGISLATION

Insurance (Lloyd's) Regulations 1983

67. Functions conferred under or by virtue of any of the following provisions of the insurance (Lloyd's) Regulations 1983:

(a) regulation 3(4) (financial resources);
(b) regulation 5(1A) (statement of business);
(c) paragraph 2 of Schedule 1 (modifications to Schedules 3 and 4 to the Insurance Companies Regulations 1994); and
(d) paragraphs 4(1)(a), 6, 10 and 11 of Schedule 1A (calculation of prescribed surplus).

Insurance Companies Regulations 1994

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68. Functions conferred under any of the following provisions of the Insurance Companies Regulations 1994:

(a) regulation 9 (direction etc by the Treasury);
(b) regulation 12 (disposal of surplus);
(c) regulation 13 (cessation of business etc);
(d) regulation 14 (effect of direction etc);
(e) regulation 80 (insurance statistics: EFTA States and EFTA companies); and
(f) regulation 81 (insurance statistics: other member States).

Financial Institutions (Prudential Supervision) Regulations 1996

69. Functions conferred under regulation 21(2) of the Financial Institutions (Prudential Supervision) Regulations 1996 (duty to notify close links to the Treasury).

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THIS AGREEMENT is made on the 18th day of December 1998

BETWEEN:

(1) **THE FINANCIAL SERVICES AUTHORITY** ("the FSA") registered as a limited company in England and Wales (No. 1920623) whose registered office is situated at 25 The North Colonnade, London, E14 5HS.

(2) **HER MAJESTY'S TREASURY** ("the Treasury") whose office is situated at Parliament Street, London SWIP 3AG.

WHEREAS:

1. The FSA has functions under the Financial Services Act 1986 and the Banking Act 1987 both as amended by the Bank of England Act 1998.

2. The Treasury has functions under the Insurance Companies Act 1982 and other legislation relating to insurance business.

3. The Treasury, in the exercise of powers conferred on them by section 69 of the Deregulation and Contracting Out Act 1994, has made the Contracting Out (Functions in Relation to Insurance) Order 1998 (SI 1998 No. 2842) ("the Order").

4. Any function of the Treasury which is listed in the Schedule to the Order may be exercised by, or by employees of, such persons as may be authorised in that behalf by the Treasury.

5. Pursuant to the Order the Treasury proposes to authorise the FSA and its employees to exercise the functions to be listed in the Schedule to the authorisation a draft of which is annexed hereto ("the authorisation").

6. The authorisation will be for a period of 2 years and is subject to the provisions of section 69(5)(b) and (c) of the Deregulation and Contracting Out Act 1994.

The FSA and HM Treasury **HEREBY AGREE** as follows:

1. **Interpretation**

(1) In this Agreement including its recitals the following definitions apply unless the context requires otherwise:

> "**Effective Date**" means 1 January 1999;

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"**the functions**" means the functions listed in the schedule to the authorisation;

"**parties**" means HM Treasury and the FSA;

"**policyholders**" in Schedule 1 to this Agreement shall where appropriate include potential policyholders;

"**services**" means the services to be provided by the FSA to HM Treasury as set out in clause 2 herein and "**service standards**" means the standards set out in Schedule 1 to this Agreement;

"**the transitional period**" means the period from the Effective Date until such time as the FSA ceases to provide services and facilities to HM Treasury following the coming into effect of the proposed financial services legislation.

(2) The headings in this agreement do not affect its interpretation.

2. **The Services**

2.1 The FSA will from the Effective Date subject to the terms herein exercise the functions and will use best endeavours to ensure that in doing so it meets the relevant service standards set out in Schedule 1 hereto.

2.2 The FSA and the Treasury may from time to time agree in writing to amend or supplement a particular service standard.

2.3 Schedule 1 may be amended at any time in simple form by mutual agreement in writing.

2.4 The FSA will provide the Treasury with a quarterly written report on the exercise of the functions during each preceding period and such other reports as may be from time to time specified in the service standards.

2.5 Without prejudice to any of the above the FSA shall upon being given reasonable notice provide the Treasury with any information relating to the exercise of the functions as the Treasury may reasonably require.

3. **Charges**

3.1 In consideration of the FSA exercising the functions, the Treasury will pay to FSA a service charge in accordance with the following clauses.

3.2 For the period 1 January 1999 to 31 March 1999 the charge shall, subject to clauses 3.5 to 3.8 below amount to £2,960,000 exclusive of VAT if payable.

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3.3 For the financial year 1 April 1999 to 31 March 2000 (and for each further financial year thereafter or any part thereof) the FSA will agree with the Treasury prior to the start of each financial year a forecast of FSA's expenditure in relation to the exercise of the functions. Without prejudice to the generality of the foregoing such forecasts shall include for this purpose heads of expenditure and overheads as follows:

(i) salaries

(ii) other employment costs

(iii) secondments

(iv) accommodation (including rent, rates, water and sewage charges, service charges, utility charges, cleaning, maintenance and insurance)

(v) IT (including telecoms)

(vi) personnel/financial administration

(vii) legal and actuarial services

(viii) depreciation charge on transferred assets.

And the forecast of such expenditure will, subject to clauses 3.4 to 3.8 below, be the amount of the charges to be paid by the Treasury to FSA during the relevant period.

3.4 For the financial year 1 April 1999 to 31 March 2000 (and for each further financial year or any part thereof *thereafter*) the Treasury and FSA will by the end of January in each year review the actual cost of services provided. If the estimate of the actual cost of providing services during the preceding period shows an excess or shortfall from budgeted expenditure as determined under clause 3.3 the FSA shall propose a revised budget for the year which once agreed by the Treasury will form the basis on which the FSA will levy charges for services under the contract for the remainder of the financial year concerned. A revised budget may take into account any issue which the parties agree is material in delivering the cost of services provided under the Service Agreements during the remainder of the year.

3.5 The FSA shall within 3 months following the end of each financial year calculate in accordance with the provisions of clause 3.6 the actual cost incurred during the financial year which is properly attributable to the exercise of the functions. If the actual cost shows an excess over or shortfall from the forecast of expenditure agreed under clauses 3.2, 3.3 and 3.4 the amount of

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such shortfall or excess shall be credited or debited against the charges levied by FSA in the subsequent financial year. In relation to the period from the Effective Date until 31 March 1999 the amount of any shortfall or excess determined under this clause shall be reflected in an adjustment to the charges levied by FSA for the remainder of the financial year 1 April 1999 to 31 March 2000. In relation to the financial year in which the FSA ceases to exercise the functions the amount of any shortfall or excess will result in a balancing payment between the parties. The determination of any shortfall or excess from the budgeted expenditure in accordance with this clause shall not be made until the FSA's auditors have reported on the FSA's statutory accounts for the relevant financial year.

3.6 In determining whether the costs incurred by FSA are properly attributable to the exercise of the functions the following principles shall be applied:

(i) staff costs shall be attributed according to the proportion of the working time of the relevant staff members that has been spent in the exercise of the functions;

(ii) where assets and facilities available to the FSA or goods and services provided to the FSA are used by it in the course of exercising the functions the Treasury shall be charged a due proportion of the costs attributable to such assets, facilities, goods or services (including charges for depreciation in accordance with FSA's published accounting policy) such due proportion being calculated by reference to the usage of the assets, goods or services or by reference to such other factors as may be relevant to the particular asset, facility, goods or service or class thereof as shall be mutually agreed between the parties;

(iii) in default of agreement the matter in dispute shall be referred to an independent firm of auditors agreed by the parties or in default of agreement an independent firm nominated by the President of the Institute of Chartered Accountants in England and Wales. In any such reference the independent firm shall act as an expert and not as an arbitrator and its decision shall be final and binding on both parties.

3.7 FSA shall procure that in respect of the period between the Effective Date and 31 March 1999 and in respect of each subsequent financial year (or part thereof) its auditors issue a report addressed to and in a form approved by the Treasury, stating that in their opinion the costs attributed in accordance with clause 3.5 have been properly attributed in accordance with the principles laid down in clause 3.6. The issue of such a report shall not affect any rights or obligations of the parties under this Agreement.

3.8 If during any financial year the FSA and the Treasury agree to alter the level or standard of the services the parties shall also agree the level of

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budgeted expenditure which will be involved and make such adjustment to the charges to be paid by the Treasury to the FSA in that period as the parties agree to be appropriate.

3.9 The Treasury shall pay the FSA the charges monthly in advance by cleared funds by not later than 2 business days before the FSA's payroll dates which shall for each financial year (or part thereof) be specified in advance by the FSA against the invoices rendered by the FSA, or on the 10th working day following the Treasury's receipt of the invoice if later. There shall be attached to each invoice a schedule containing a breakdown of the amount covered by the invoice in such form as may be reasonably required by the Treasury.

3.10 The FSA will for each financial year (or part thereof) provide the Treasury with information about its activities in relation to the functions so as to enable the Treasury to determine the amount of fees to be levied upon insurance companies and upon the Council of Lloyds under the Insurance Companies Act 1982.

4. **Inspection and Retention of Records**

4.1 The FSA shall procure that at all reasonable times and upon giving reasonable notice all books, records and systems relating to the exercise of the functions by FSA are open to inspection by the Treasury or by its agents and such persons may at their expense take copies of such books and records relating to the exercise of the functions as they may require.

4.2 The FSA shall take all reasonable steps to keep secure and maintain full and accurate records of the services provided under this Agreement, of all expenditure reimbursed by the Treasury and such records shall be kept until 2 years after the final payment of all sums under this Agreement or for such longer period as may be agreed between the parties.

5. **Asset Transfers**

5.1 In return for a consideration of £3,272,769 payable by 31 January 1999 the Treasury agrees to transfer on the Effective Date to the FSA the assets listed in Schedule 2 to this Agreement.

6. **Termination**

6.1 This Agreement will be terminated with immediate effect if the authorisation is revoked.

6.2 This Agreement will be terminable by either party giving to the other 3 months written notice to that effect.

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6.3 This Agreement shall be terminable with immediate effect if the Treasury gives notice in writing to the FSA to that effect upon the occurrence of an act of insolvency in relation to the FSA which for this purpose shall mean:

(i) the FSA making a general assignment for the benefit of, or entering into a reorganisation, arrangement, or composition with creditors, or

(ii) the FSA admitting in writing its inability to pay its debts as they become due, or

(iii) the FSA seeking, consenting to or acquiescing in the appointment of any trustee, administrator, receiver or liquidator or analogous officer of it or any material part of its property, or

(iv) the presentation or filing of a petition in respect of the FSA in any Court or before any agency alleging its bankruptcy, winding up or other insolvency (or any analogous proceeding) or seeking any reorganisation, arrangement, composition, readjustment, administration, receivership, liquidation, dissolution or similar relief under present or future statue law or regulation, such petition not having been stayed or dismissed within 30 days of its filing, or

(v) the appointment of a trustee, administrator, receiver or liquidator or trustee or analogous officer over all or any material part of the FSA's property.

7. **Litigation**

7.1 Subject to clause 7.2, in the event of the FSA being the subject of any legal action by a third party for anything done or omitted to be done in connection with or arising from the exercise or purported exercise of the functions, the Treasury will take all reasonable steps to ensure that such litigation becomes the responsibility of the Treasury without unreasonable cost to the FSA. For the avoidance of doubt this will include any legal action which relates to alleged misfeasance or a breach of European Community law or of the Human Rights Act 1998.

7.2 Clause 7.1 above shall not apply to any claim (in particular in negligence or breach of contract) which is not directly related to the exercise or purported exercise of the functions.

7.3 Clauses 7.1 and 7.2 above are without prejudice to the Treasury's right to seek a contribution from the FSA in respect of any claims for compensation made against the Treasury which are attributable to any negligence, misfeasance or breach of contract or breach of the Human Rights Act 1998 (arising out of the exercise of the functions) on the part of the FSA.

7.4 If the Treasury is or becomes a party to any litigation arising out of the exercise of the functions:

(a) neither the FSA nor its employees or contractors shall make any written or oral admission, denial, statement or other communication to any person making such a claim against it without the prior approval of the Treasury; and

(b) the FSA shall provide such advice and assistance as the Treasury may reasonably request including the provision of evidence, witnesses, documents and information.

7.5 Subject to clause 7.2 above the Treasury shall be responsible for any costs reasonably incurred by the FSA in connection with or for the purposes of any litigation arising out of the exercise of the functions.

7.6 The Treasury may apply to intervene in any private litigation which raises issues of public interest in relation to the functions and the FSA may also apply to intervene in such litigation with the prior consent of the Treasury.

7.7 Nothing in the foregoing shall affect the FSA's responsibility for legal proceedings arising under sections 40A, 48(2A), 54 and Schedules 2C and 2F of the Insurance Companies Act 1982 and the functions mentioned in paragraphs 7, 8(a) and 10 of Schedule 1 to the Transfer of Functions (Financial Services) Order 1992 (SI 1992 No. 1315).

8. **General**

8.1 Except as may be provided by the authorisation nothing in this Agreement shall in any way affect the status, powers and obligations of the FSA under the Financial Services Act 1986.

8.2 This Agreement may not be assigned by either party.

8.3 Any notice to be served on either of the parties to this Agreement by the other will be deemed to be duly served two business days after the day on which it is posted if sent to the registered office of the FSA or to the address of the Treasury shown in this Agreement by pre-paid first class post, or on the date received if given by telex, facsimile or personal delivery to either of the said offices within business hours.

8.4 This Agreement will be governed by and construed in accordance with the law of England and Wales.

AS WITNESS the hands of the duly authorised representatives of the parties the day and year first above written.

Signed by [signature]
for and on behalf of
THE FINANCIAL SERVICES AUTHORITY:
In the presence of:

Signed by [signature]
for and on behalf of
HER MAJESTY'S TREASURY:
In the presence of:

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Schedule 1

SCHEDULE 1

This Schedule sets out the aims and objectives which the FSA is to adopt in respect of the functions which the FSA is authorised to exercise on behalf of the Treasury, and defines the standards and performance measures which the FSA will use it best endeavours to achieve.

SERVICE STANDARD SPECIFICATION

AIMS AND OBJECTIVES

1. In May 1997 the Chancellor of the Exchequer announced the Government's intention to create a unified financial services regulatory body. The draft legislation, published on 30 July 1998, specifies the FSA's objectives:

- maintaining confidence in the UK financial system;
- promoting public understanding of the financial system, including awareness of the benefits and risks associated with different kinds of investment or other financial dealing;
- securing the appropriate degree of protection for consumers, having regard to the differing degrees of risk involved in different kinds of investment or other transaction, the differing degrees of experience and expertise which different consumers may have, and the general principle that consumers should take responsibility for their decisions; and
- reducing the extent to which it is possible for a business to be carried on by a regulated person to be used for a purpose connected with financial crime.

2. The new legislation will require the FSA, in pursuing these objectives, to have regard to:

- the need to use its resources in the most efficient and economic way;
- the responsibilities of those who manage the affairs of authorised persons;
- the principle that a burden or restriction which is placed on a person, or on the carrying on of a regulated activity, should be proportionate to the benefit intended to be conferred in general by that provision;
- the desirability of facilitating innovation in connection with regulated activities;

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- the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom; and

- the principle that competition between authorised persons should not be impeded or distorted unnecessarily.

3. While these objectives are not yet enacted and may be amended during the passage of the legislation they serve to inform the general approach the FSA proposes to take during the period prior to the new legislation coming into force ("N2"). This will include the FSA's approach to carrying out the functions which it will exercise on behalf of the Treasury for insurance supervision.

The FSA's aim will be effectively to regulate the insurance industry so that policyholders can have confidence in the ability of UK insurers to meet their liabilities and fulfil policyholders' reasonable expectations. UK insurance legislation is now significantly affected by EC Directives and there is increasing co-operation between international regulators, within the EC and more widely. The FSA will, in conjunction with the Treasury, play its part in maintaining and improving this international co-operation.

4. The FSA's key supporting objectives shall be:

- to ensure that persons or companies who are not fit and proper or appropriately resourced or otherwise not able to satisfy the criteria for authorisation do not carry on business in the UK;

- to carry out the regulation of insurance companies and Lloyds efficiently and effectively;

- to meet the insurance industry's reasonable requests for prompt and clear responses to their requests for information and advice and to keep the cost and inconvenience of regulation for insurers as low as is commensurate with effective protection of the consumer;

- to co-operate with the Treasury in seeking to deliver efficient operation of the single market, including assistance in EU negotiations to secure that EC law develops to maximise an open and competitive market in the EU.

INSURANCE SUPERVISION WORK PROGRAMME

5. The key areas of work on which resources are to be deployed in 1999 fall into the following categories:

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Schedule 1

- conduct of on-going regulatory, and related, work to specified standards;

- initiatives to support the development of more effective and efficient regulatory procedures;

- preparation for the coming into effect of the new regulatory regime.

Conduct of on-going regulatory, and related, work to current standards

Authorisation, fit and proper checking, perimeter

6. *General responsibilities*

- In response to demand and subject to their achieving adequate standards, the authorisation each year of around 25-30 non-life and life insurance companies and for undertaking in the order of 4,500 fitness and properness checks on controllers, directors and managers, around half of which are on behalf of other regulators. The FSA will operate a rigorous authorisation process to ensure that as far as possible companies or persons who are not financially sound or fit and proper or otherwise not able to satisfy the criteria for authorisation do not operate in the insurance market.

- Following up promptly, in conjunction where appropriate with DTI's Companies Investigation Branch, the 50-60 new cases of alleged illegal insurance business brought to the FSA's attention each year. Where appropriate to achieve a resolution bilaterally with the parties concerned; other cases may result in formal investigation, and some in prosecutions or winding up applications.

7. *Performance Measures*

Functions and *Performance Measures(*)*	Targets
– **Authorisation of insurance companies**	
** First draft of application for authorisation % responded to in 25 working days*	60% (remaining 40% within 3 months)
** Formal applications for authorisation % decided in 3 (general business) or 4 (life business) months as appropriate*	90% (remaining 10% within 6 months)

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– **Prevention of unauthorised carrying on of insurance business and determining questions about the definition of insurance activity**	
** % of unlawful insurance cases actioned within 10 working days*	100%
– **Carrying out fitness checks on controllers, directors and managers of authorised insurance companies and maintaining fit and proper database**	
** Number of notifiable persons listed for fitness checking within 6 working days*	100% of notifications received
** Number of notifiable persons checked within 5 weeks*	100% of notifications received

<u>Supervision</u>

8. <u>*General responsibilities*</u>

- The prudential supervision of around 350 non-life companies, 200 life companies and 40 composite insurance groups. In addition, the FSA will be responsible for the supervision of Lloyd's, Equitas and some 80 companies in the London Market.

- Protecting policyholders against the risk of company failure and, more specifically, to protect them against the risk that UK authorised insurers might be unable to pay valid claims. In the case of life insurance companies this includes the risk that they will be unable to meet policyholders' reasonable expectations. The Treasury and FSA agree that it is neither realistic nor necessarily desirable in a climate which seeks to encourage competition, innovation and consumer choice, to seek to achieve 100% success in avoiding company failure. The FSA will therefore pursue its supervisory objectives by aiming to minimise, but not eliminate, the risk of company failure by identifying early signs of trouble, and taking preventative action.

<u>*Key Tasks*</u>

9. Supervisory resource will be focused on the following key tasks:

- monitoring the financial soundness of insurers to see that they are run in a sound and prudent manner by fit and proper people, based mainly on the scrutiny of financial returns and other information (with the assistance of the Government Actuary's Department particularly in the case of life companies), and site visits;

- monitoring of companies' preparedness for Year 2000 in respect of both the compliance of their own systems, and their assessment of and reserving for potential liabilities, taking further regulatory action as necessary.

Performance Measures

10. The supervisory process is in an ongoing state of development. Some changes have been made to the examination procedure in the past six months and further changes can be expected in the context of the initiatives to support the development of more effective and efficient regulatory procedures described in paragraphs 13 and 14 below. The performance measures set out in Annex A relate to the supervisory process as it is expected to be conducted for the 1998/99 supervisory year. The measures will be kept under review and amended from time to time as agreed between the Treasury and the FSA.

International

11. *General responsibilities*

- To co-operate with the Treasury so that regulation keeps pace with market developments, remains in line with EU obligations, and is effective without imposing an undue burden on the industry. To achieve this the FSA will play an active role in the various international fora where supervisory standards are discussed and developed, in particular:

  - Co-operating with the Treasury, to achieve UK objectives within the EU, in particular in negotiations on proposals for EC legislation.

  - Through the EC Insurance Supervisors' Conference where regular contact will be maintained with other insurance supervisors in the European Economic Area with the view to seeing that the single market in insurance operates efficiently.

  - Through the International Association of Insurance Supervisors (IAIS) which has commenced an ambitious programme to develop international standards of insurance supervision. Discussions are underway on solvency issues, reinsurance supervision, electronic commerce and the internet, investments and accounting standards.

- Through the Joint Forum on Financial Conglomerates which brings together banking, investment and insurance supervisors with the aim of developing regulatory co-operation and suitable methodologies to deal with the new supervisory challenges posed by the increasing number of financial conglomerates and complex groups operating on a global basis.

12. <u>*Performance Measures*</u>

Functions and *Performance Measures(*)*	Targets
– **To play an active role in the various international fora where supervisory standards are discussed and developed.**	
* *Increase UK participation in international work on supervision standards*	On-going
* *Ensure adequate contribution to work of Joint Forum*	On-going

<u>Policy issues and casework</u>

13. This section deals with arrangements to secure co-operation on insurance policy issues and casework. By drawing on FSA expertise, Treasury officials will enhance their understanding of insurance market capabilities and practices; FSA officials will improve their awareness of trends in policy-making.

General policy issues

14. The FSA will provide the Treasury, on request or at its own initiative, with timely advice on, inter alia:

- the development of Government policy initiatives which bear on the insurance industry including mortgage payment protection insurance; unisex annuities; the use of genetic information; disability discrimination and equal opportunities; the application of funds held as part of inherited estates; and the means of calculating damages due in settlement of personal injury claims;
- the proposed content of draft speeches or statements prepared for the Treasury, other ministers and senior officials;
- Parliamentary business, including debates, early day motions and Parliamentary Questions;

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- meetings with other supervisors, whether held in the United Kingdom or overseas, at which policy issues are to be or have been discussed, in particular policyholder protection and insurance intermediary regulation;

- matters relating to the implementation of the Policyholders Protection Act 1997 and the operation of the 1975 Act as amended;

- matters relating to insurance law and financial services and markets regulation where that impacts on insurance - but without prejudice to FSA use of other channels;

- the undertaking of specified tasks of investigation and enforcement;

- any contentious or novel regulatory policy issues which bear on the insurance industry before any statement is made by FSA;

- other relevant subjects, raised either by the Treasury or the FSA.

15. Whilst the FSA will have the day-to-day responsibility for supervising insurance companies, certain of the powers required to carry out this function will remain with the Treasury until the coming into force of the proposed relevant provisions of the Financial Services and Markets Bill.

S 68 Orders

16. The Treasury needs to be satisfied about the appropriateness of such measures before it issues formal approval. Therefore, after the FSA has considered and approved the measure, FSA will provide the Treasury (Financial Services team and Treasury Solicitors) with:

- a draft order;

- advice giving background, recommendation and timing for the Order; and

- a draft letter for the Treasury to send to the insurer to accompany the Order. This should be addressed to a named contact at the insurance company; explain why the Order has been made; and provide a designated FSA contact to whom all enquiries on the matter can be addressed.

17. The Treasury will then consider the Order; clarify any points as necessary with FSA and/or Treasury Solicitors; and if satisfied, make the Order. The

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Treasury will then send the Order to the insurance company; advise FSA of dispatch by telephone; and follow-up this up with a copy of the Order.

18. The Treasury will maintain a separate record of Orders and letters issued and advise FSA at the end of each month of that month's correspondence.

Other Orders

19. Other supervisory Orders bearing on specific companies, and of a kind which after N2 would be within the authority of the FSA but which until N2 cannot be made by FSA, will be taken forward by the Treasury using the same the principles of co-operation, consultation, and good administration which are to apply to s68 Orders. Statutory instruments of more general applicability are dealt with below.

Treasury functions under paragraphs 6(3) to 6(5) and 10 of Schedule 10 to the Financial Services Act.

20. Paragraphs 6(3) to 6(5) of Schedule 10 to the Financial Services Act 1986 make provision for the giving of notice to the Treasury by a designated agency or self regulating organisation and the serving of a notice by the Treasury on the said designated agency or organisation.

21. There is no need for change in the existing arrangements. Where FSA is the designated agency, it shall give the Treasury notice as required in the Act; and the Treasury may in turn serve the FSA with a notice. Where an organisation which is a recognised self-regulating organisation under the Financial Services Act 1986, proposes to exercise in the case of a member of that organisation which is a regulated insurance company as defined in s129 of the Financial Services Act, any powers of the self regulating organisation corresponding to those of Chapter VI of Part 1 of that Act, and the FSA is acting on behalf of such a self regulating organisation, the FSA shall ensure that notice is given to the Treasury as required in the Act, and advise the Treasury to whom in the self regulatory organisation notice by the Treasury may in turn be given.

22. In order that the requirements of paragraph 10 (1) to Schedule 10 of the Financial Services Act may be complied with, where the appropriate authorisation section of the FSA is, under the terms of the Contracting Out Order considering issuing an authorisation under s3 of the Insurance Companies Act 1982 to an applicant who proposes to carry on in the United Kingdom insurance business which is investment business, then that section shall consult all other relevant sections of the FSA on any matters which are relevant to the FSA and relate to the applicant in accordance with paragraph 10(1)(a) and, in accordance with paragraph 10(1)(b), take into account any advice that the authorisation section may receive from other sections of FSA.

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23. In order to meet the requirements of paragraph 10(2) of Schedule 10, the appropriate authorisation section of the FSA may furnish other FSA sections with any information obtained from an applicant for authorisation.

24. If the FSA has reasonable grounds for believing that a regulated insurance company, that is one which is within the definition given in s129 of the Financial Services Act 1986, has failed to comply with obligations imposed upon it by that Act, then the FSA shall forthwith give notice to the Treasury. However, FSA need not give notice in respect of any matter unless it considers that the matter in question, whether considered alone or in conjunction with other matters, is sufficient to justify the withdrawal of the authorisation to carry on investment business. The notice will comply with the requirements of s10(4) of Schedule 10 of the Financial Services Act 1986.

25. The Treasury will decide whether to give a direction or serve a notice in respect of that company under s11 or 12 of the Insurance Companies Act 1982 or s33 of the Financial Services Act 1986. If the Treasury decides that a direction should be given using powers under s11, or a notice served under s12 of the Insurance Companies Act, then the FSA may make such a direction or give such a notice, once it has obtained the agreement in writing of the Treasury.

Fees Order

26. The Treasury will produce the annual statutory instrument which sets fees under the Insurance Companies Act. In addition to providing the financial information required by the Agreement, the FSA will also give advice on the way in which such recovery of costs might be made in the instrument having regard to the size of the business on which fees are charged.

Proposed secondary legislation on insurance matters

27. The FSA will advise the Treasury on how legislation may keep pace with market developments while remaining effective without imposing an undue burden on the insurance industry. Where subordinate legislation is required, the FSA will provide to the Treasury a statement or statements of the policy to be achieved. Similarly, the FSA will support the preparation of legislation needed to implement European Directives through secondary legislation made under the European Communities Act, Insurance Companies Act or both (e.g. implementing Groups Directive).

28. The FSA will assist in deliberations leading up to negotiation of European legislation and will provide information, advice and assistance to the Treasury in order to progress successful negotiations.

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Policyholders Protection Act 1975

29. In addition to the PPA functions contracted to the FSA, the FSA will undertake an annual exercise to ascertain the amount of income earned by authorised insurers in the previous underwriting year which is leviable under the Policyholders Protection Act 1975 and inform the Policyholders Protection Board accordingly.

Correspondence and Casework

30. Casework on insurance matters can cover a wide range of issues. It is not possible to set out arrangements of every case or even every category of case, although correspondence referred by MPs and MEPs will be channelled differently from cases referred directly by the public, as set out below. The list below covers the main categories. It assumes that FSA Public Enquiries will have a role to play in dealing with many enquiries including providing information about access to the Insurance Ombudsman.

31. The following arrangements will apply:

- letters about routine insurance matters which are received by the Treasury, whether sent directly to officials or to Ministers, will be answered in full by the Treasury when they contain an issue relating to the Government's policy on regulating insurance: the objectives of such policy being to secure protection for consumers and clean markets;

- letters from or on behalf of policyholders which focus on refusal to provide cover, terms and conditions, or allege unfair or incompetent complaints-handling will be sent to the FSA Chairman if they are from an MP or MEP, and to FSA Public Enquiries if they are direct from the public;

- letters requiring an explanation of market practice will be answered and sent to the FSA Chairman if they are from an MP or MEP, and to FSA Public Enquiries if they are direct from the public;

- letters sent to the Treasury concerning FSA practice will be answered and sent to the FSA Chairman if they are from an MP or MEP, and to FSA Public Enquiries if they are direct from the public;

- letters calling for changes to the future regulation of Lloyd's will be answered in full by the Treasury if they are from an MP or MEP, and to FSA Public Enquiries if they are direct from the public;

- letters about past Lloyd's regulatory issues and on-going correspondence will be sent to the FSA Chairman if they are from an MP or MEP, and to FSA Public Enquiries if they are direct from the public;

- issues which achieve significant prominence and require a statement of regulatory principle or practice to be made public (e.g. guaranteed annuities) will be handled by the FSA after consultation with the Treasury.

32. These arrangements are without prejudice to other working arrangements which may need to be made either by the Treasury or the FSA.

Initiatives to support the development of more effective and efficient regulatory procedures

33. *Key Tasks*

- The FSA will be committed to developing the means to achieve improved efficiency and effectiveness of its regulatory procedures. The following activities will be undertaken during the course of 1999:

  - review and, where necessary, undertake an interim update of non-life and life insurance supervisory procedures and internal guidance to ensure a consistent and properly documented approach;

  - the preparation of sectoral and market analyses to improve understanding of the context in which insurance companies operate;

  - undertaking specific projects in response to market developments;

  - the enhancement of a risk-based approach to supervision. As part of its work on procedures, the FSA will further develop a risk-based approach to insurance supervision against the FSA's broader canvas of financial regulation with a view to aligning the methodology and categorisation, to the extent possible whilst taking account of the particular complexity of assessing insurance companies, with the practice in relation to other sectors of the financial industry. A particular focus of this work will be the identification of the key elements, and the development of a risk rating system which could be implemented within 2 years of N2, if appropriate;

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- as part of the FSA's wider training and development responsibilities, the implementation of a comprehensive Training and Development Programme to develop the skills and competencies of insurance and friendly society supervisors and specialists.

34. *Performance Measures*

Functions and *Performance Measures (*)*	Targets
– **To achieve improved efficiency and effectiveness of regulatory procedures.**	
** Complete review and interim update of non-life and life insurance supervisory procedures and internal guidance*	April 1999
** Development of a risk rating system*	1 year after N2
** Delivery of Training and Development Programme for insurance and friendly society supervisors etc.*	On-going

Preparation for the coming into effect of the new regulatory regime

35. *Key Areas of Responsibility*

- The oversight and co-ordination of the FSA's insurance regulatory policy.
- Ensuring that FSA's draft principles and other statements of policy upon which the FSA intend to consult reflect the needs of insurance regulation and sufficiently implement Community law obligations arising from the Insurance Directives.
- Securing the development of practical and effective arrangements for the supervision of Lloyd's.
- Integrating the supervisory regimes for insurance companies and friendly societies.
- Providing input on insurance aspects of the Financial Services and Markets Bill to the Treasury Bill Team through the FSA's usual mechanisms.

36. *Performance Measures*

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Functions and *Performance Measures (*)*	Targets
– **To ensure that FSA's draft principles and other statements of policy reflect the needs of insurance regulation**	
* *To ensure FSA handbook properly reflects the needs of the insurance industry and its customers, including the preparation of insurance specific chapters*	By deadlines set out Appendix 3 to the FSA document "Meeting Our Responsibilities"
– **Lloyd's Supervision**	
* *To secure the development of practical and effective arrangements for the supervision of Lloyd's.*	By N2
– **To input to the Treasury Bill Team on Financial Services and Markets Bill through the FSA's usual mechanisms**	
* *To ensure Bill takes proper account of issues specific to the insurance industry and its customers.*	Prior to introduction of the Bill

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ANNEX A: SUPERVISION PERFORMANCE MEASURES

Functions, and *Performance Measures*	Targets
• **Returns receipt and processing**	
– To send returns for keypunching within 1 day of receipt from returns unit (2 days between 28 June & 28 July).	90% (remainder within one further day)
– To make QST extract available on IDIS within 1 day of receipt back from bureau	90% (remainder within one further day)
– To run validation and take up absolute errors with company:	
within 6 weeks of receipt from keypunching	all priority 1
within 9 weeks of receipt from keypunching	all priority 2
within 15 weeks of receipt from keypunching	all priority 3
within 18 weeks of receipt from keypunching	all priority 4
within 23 weeks of receipt from keypunching	all priority 5
– To have fully validated return available on IRIS (i.e. fit to run solvency tests)#	
within 3 months of receipt from keypunching	all priority 1
within 5 months of receipt from keypunching	all priority 2
within 7 months of receipt from keypunching	all priority 3
within 9 months of receipt from keypunching	all priority 4 & 5
[# the total number of fully validated returns available within 9 months of keypunching to be >99% of all returns received]	
• **Supervision of general business and composite insurers**	
– Complete initial scrutiny/planning document:	
* *For companies writing new business, within 2 months of receipt of return (3 months when return received between 15 June and 30 July)*	80% (remainder within one further month)

Service level agreements

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** For companies not writing new business, within 6 months of receipt of return*	100%
– Conduct balance of annual examination process and document action taken against plan in a "completion memorandum":	
** Within 9 months of receipt of return*	75%
** Within 12 months of receipt of return*	100%
– Complete examination of quarterly returns within 4 weeks of receipt	90% (remaining 10% within 8 weeks)
• **Supervision of life companies**	
– To decide on and where necessary commence follow up action within 2 weeks of completion and review of the GAD scrutiny report	90% (remaining 10% within 6 weeks)
– Secure the timely and satisfactory outcomes to on-going and future proposals for life industry restructuring and inherited estates.	100%
• **Supervision of London Market companies**	
– Complete initial scrutiny/planning document within 3 months of receipt of return	80%(remainder within one further month)
– Conduct balance of annual examination# process:	
** Within 9 months of receipt of return*	75%
** Within 12 months of receipt of return*	100%
[# work involved in change of control constitutes full examination of company]	
• **Supervision of all companies**	

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– Carry out visit programme to improve understanding and risk assessment of companies supervised	60 p.a. (general/composite) 30 p.a. (life) 50 p.a. (London Market)
– Process changes in companies' business requiring specific action under legislation to statutory time limits. These vary, but main ones include:	
* *change of control (3 months)*	100%
* *EU branch applications (3 months)*	100%
* *EU service applications (1 month)*	100%
• **Monitoring of companies' preparedness for Year 2000 in respect of both the compliance of their own systems, and their assessment of and reserving for potential liabilities**	
– Conduct review with all companies identified as high priority	By April 1999

DTI's policy guidance notes (1991)

General Introduction

DTI Insurance Division

Policy Guidance Notes

The Guidelines

General Introduction

1. The Department should operate, and be seen to operate, a firm but fair regulatory regime in respect of UK authorised insurance companies. The "message" to the Industry and to the public should be that the Department is watching very carefully and is likely to err on the side of caution rather than to adopt a relaxed attitude, particularly toward companies in difficulties.

2. The Insurance Division Guidelines, now being issued under cover of a new series of Policy Guidance Notes (PGNs) and forming this Manual, help to ensure that these aims inform our approach to supervision. Where appropriate, each Guideline will contain paragraphs covering "Best Practice". They will help individual supervisors to adopt a firm but fair, and effective, regulatory approach toward their own portfolio of companies. Adherence to the Guidelines by all supervisory staff in the Division will also help to achieve a consistent regulatory regime for all insurance companies in the UK.

3. In 1990, at our request, [redacted] carried out the "DTI Insurance Division Business Review and Information Systems Strategy Study". On the subject of guidelines, [redacted] Management Summary, which was distributed to all staff in the Division at the time it was published, suggested:

"drawing up guidelines to help staff in areas of supervision where significant judgemental decisions are required"

4. Their two recommendations on the subject were:

"We recommend that guidelines are drawn up to help staff in areas of supervision where important and publicly visible decisions are required, in particular, the issue and withdrawal of concessions and requirements, decisions on the admissibility of certain types of assets, etc.

We recommend that such guidelines are introduced because of the perceived need for greater consistency in decisions made which may affect individual companies' operations."

5. The new Guidelines are the tangible result of the acceptance of these recommendations. It is intended that they will, in due course, cover most procedures involved in the supervision of UK authorised insurance companies. They are not limited to just those of the type specifically referred to by [redacted] However, they stop short of providing instruction and guidance on the examination of returns, which is provided in other ways.

[redacted]
Head of Insurance Division
September 1991

Issued September 1991 General Introduction

DTI's policy guidance notes (1991)

Guideline 1.4: obtaining advice from GAD on long term business

Guideline 1.4

Obtaining advice from GAD on long term business

Synopsis
1. Guidance on when and how to obtain advice on long term business from the Government Actuary's Department (GAD).

The Legislation
2. Although there is no statutory obligation for Insurance Division to consult GAD, the conduct of relations between the Division and GAD, and their respective roles, are set out in a "Concordat" signed between the Head of Insurance Division and the Government Actuary in 1984. A copy of the concordat is attached as Annex A to this guideline. There have been no amendments to it. Until there are any changes, both parties are bound by its terms.

Exercise of the Secretary of State's Functions
3. As made plain in the concordat, formal action on behalf of the Secretary of State should always be taken by Insurance Division (but enquiries to companies - but not to auditors nor, in the first instance, to external appointed actuaries - may be made direct by GAD).

Insurance Division Objectives
4. In the first instance, to ensure a sound working relationship with the GAD, to the mutual benefit of both parties, in:

(a) the examination of the solvency position and ongoing financial strength of life assurance companies;

(b) consideration of applications for the authorisation of new life insurance companies;

(c) assessment of proposals for company structures including in particular Section 49 transfers (see Guideline 12.1);

(d) participation in the regular visits to insurance companies in order to understand better the structure, dynamics and future prospects of each company; and

(e) resolution of other miscellaneous questions relating to the finances of long-term insurers, and the interests and reasonable expectations of policyholders.

Best Practice
5. To adhere as closely as possible to the concordat and to pay particular attention to the terms of paragraphs 4 to 23 thereto which set out the activities to be carried out by Insurance Division. It will be necessary from time to time to review procedures to ensure that they enable the proper operation of the concordat. As with any framework agreement, there will be occasions when it is necessary to depart from the terms of the concordat. However, GAD should always be consulted and their agreement sought to any departure.

Implications for our Understanding of a Company's Position
6. The proper operation of the concordat by both Insurance Division and the GAD is essential to our understanding of the company's position.

Standard Draft Letters
7. Not applicable in the context of this Guideline.

Conditions to be Attached
8. Not applicable in the context of this Guideline.

Legal Advice
9. Not directly relevant to this guideline, but it should be borne in mind that any advice provided by the GAD which has legal implications should be referred to Solicitor's Office for advice. (See Guideline 1.5). This applies particularly to advice given by GAD on the application of the insurance companies legislation which may need an additional input from Solicitor's office.

EC Aspects
10. Not applicable in the context of this Guideline.

Issued July 1992 Guideline 1.4

DTI's policy guidance notes (1991)

Guideline 1.4: obtaining advice from GAD on long term business

On the Record Statements
11. Not applicable in the context of this Guideline.

The Precedent Register
12. Advice from the GAD which is considered to have a general effect or which may guide future cases should be copied to the register.

Compliance Costs for Companies
13. Not applicable in the context of this Guideline.

Insurance Annual Report
14. Not applicable in the context of this Guideline.

Policy responsibility
15. Policy responsibility for the concordat and its operation rests at Grade 5 level in I2 and at Chief Actuary level in the GAD. However, should any amendments to the concordat become necessary it is envisaged that they will form part of a formal agreement signed by the Head of Division and the Government Actuary.

Issued July 1992 **Guideline 1.4**

DTI's policy guidance notes (1991)

Guideline 2.2: Carrying on Insurance Business in the UK

Guideline 2.2

Carrying on Insurance Business in the UK

Synopsis

1. Some general guidance on interpreting what constitutes the carrying on of insurance business in the UK.

The legislation

2. Section 2 of the Insurance Companies Act 1982 ("the Act") provides that, with certain exceptions, no person shall carry on any insurance business in the United Kingdom unless authorised to do so under Section 3 or 4. However, under Part IIIA of the Act, an insurance company authorised in another EC member state can provide direct business in the UK without breach of section 3 or 4 if it has first furnished to the Secretary of State the particulars specified in Section 81B of the Act.

3. It is an offence under Section 14 of the Act to carry on business in contravention of Part I and, under Section 81J, to provide insurance in the United Kingdom in contravention of Section 81B.

Exercise of Secretary of State's functions

4. Where a company appears to be carrying on insurance business without authorisation, the operation may require formal investigation. An investigation will normally be done under section 447 of the Companies Act. Investigations Division will decide whether or not to investigate upon our notification of the case to them. On occasions, and particularly if the operation is being conducted by an unincorporated body, an investigation may be requested under section 44 of the Insurance Companies Act. An Insurance Division officer of at least Grade 5 level should take the decision to request any such investigation under s44, ICA 1982 and will sign the ensuing authorisation of the officers appointed to conduct it.

Insurance Division objective

5. The protection of policyholders and potential policyholders is paramount. Where a body has written unauthorised insurance business, our aim is to stop the unlawfulness. This may be achieved by (i) the operation being properly underwritten by a company which can legitimately write the business, (ii) the body voluntarily ceasing the operation and making arrangements to safeguard the interests of those whom it has insured, or (iii) the Department winding up the body.

Best practice

6. There are two elements to take into account when considering whether insurance business is being carried on in the UK:

i. whether the activity is insurance business;

ii. where the business is being carried on.

Both questions are often difficult to answer and the answers can be determined authoritatively only by the courts. However, it is necessary for Insurance Division to form a view in order to decide whether further action should be taken.

7. Because of this, the notes below are intended as no more than an indicator as to whether or not you should take advice.

DTI's policy guidance notes (1991)

Guideline 2.2: Carrying on Insurance Business in the UK

You should consult I1A who will either take over responsibility for your query or provide you with paragraphs to include in your own response.

Whether an activity is insurance business

8. Elements usually present in a contract of insurance are:

a **consideration** (monetary or otherwise) is paid,in return for which there is

a **requirement to provide** money or its equivalent by means of a service

on a **non-discretionary** basis

on the **happening** in the future of an event

the likelihood or timing of which is **uncertain** at the moment of contracting and

the provider **cannot influence** the likely timing or occurrence of the event and

the other party has an **interest** in the event.

9. The following points may be relevant:

i) the provider's degree of control over the occurrence event. Product of the insured guarantees and service and repair contracts may well not be insurance contracts if they are guaranteeing the provider's own product;

ii) is there a necessary causal connection between the providers of other business and the providers of the insurance. If so, then it may not be insurance business. The mere fact that the insurance is only a small part of the total business of the provider will not, of itself, stop the business being insurance business;

iii) whether a professed power of discretion in the provision of benefit is in fact illusory. If it is, authorisation is probably needed.

What constitutes the carrying on of insurance business in the United Kingdom?

10. The Department is likely to take the view that authorisation is required where the insurer, or its agent to whom it has devolved effective decision-making power, will

- have a place of business in the UK which is more than temporary **and**

- decide in the UK to accept risks **and/or**

- decide in the UK to pay claims where those liabilities were entered into in the UK.

Reference offshore of the final decision or its ratification is not enough to escape from the authorisation requirement.

11. The Department would probably take the view that authorisation is not required if **only one** of the following takes place in the UK, **without any other UK - based involvement of either the insurer or its agent:**

- An insurer advertises its existence and kind of business.

- The transmission of premiums to outside the UK.

12. A plethora of related insurance activities has not been mentioned, deliberately. In addition to the actual conclusion of contracts or payment of claims, any other activities in the UK relating to the effecting or carrying out of contracts of insurance need to be considered as a whole and a judgement reached as to whether in combination they amount to effecting and/or carrying out contracts to any substantial extent. It

Isssued August 1993 Guideline 2.2

DTI's policy guidance notes (1991)

Guideline 2.2: Carrying on Insurance Business in the UK

is not possible simply to disregard activities of any given kind.

Implications for our understanding of a company's position

13. A company which is carrying on any type of insurance business without having formal authorisation is not supervised and is putting its "policyholders" at risk.

Standard drafts

14. An example is attached (at Annex A) of the standard text incorporated into letters to individuals or companies which the Department has reason to believe may be carrying on unauthorised insurance business. However, each case needs to be considered individually to determine whether the sending of a letter, or alternative action, is appropriate in the particular circumstances; and, if a letter is sent, whether all or only some of the standard paragraphs should be included.

Conditions to be attached

15. Not applicable.

Legal advice

16. To reach a view in cases where there is doubt about a company carrying on insurance business, particularly when we remain unconvinced about the arguments that may have been put to us, the advice of Solicitors should normally be obtained.

GAD

17. In some cases it might be appropriate or desirable to consult GAD. I1A could offer advice as to whether GAD should be approached.

EC aspects

18. Special consideration applies to the provision of insurance services in the UK. Section 81(A)(5) of the ICA 1982 provides that an EC insurer will not be regarded, for the purposes inter alia of Section 2, as carrying on insurance business in the UK by reason only of the fact that it provides insurance in the UK. Under Part IIIA of the Act, an insurance company authorised in another EC member state can provide direct business in the UK without breach of Section 3 or 4 if it has first furnished to the Secretary of State the particulars specified in Section 81B of the Act. Where the insurer has its head office outside the community, the advice set out in paragraphs 10 and 11 above would apply.

On the record statements

19. As to whether insurance business is being carried on in the UK, there have been three Court judgements which have had far-reaching implications for the insurance industry and the Department:-

Bedford Insurance Co Ltd v Instituto de Ressaguros do Brasil [1984](1 Lloyd's Rep 210; decided 10 November 1983)

B A Stewart & Others v Oriental Fire & Marine Insurance Co Ltd [1984] (2 Lloyd's Rep 109; decided 18 April 1984)

Phoenix General Insurance Co of Greece v Administratia Asiguraliror de Stat [1985] (2 Lloyd's Rep 599; decided 9 October 1986)

Ackman & Others and Scher & Others v The Policyholders' Protection Board and Others and the Secretary of State (not fully reported and subject to appeal).

20. These decisions created considerable doubt for the Department and the insurance industry over the basis for distinguishing between circumstances

DTI's policy guidance notes (1991)

Guideline 2.2: Carrying on Insurance Business in the UK

which required, and those which did not require, authorisation to carry on insurance business in the United Kingdom. So far as the Department is concerned, the main significance lies in the Ackman & Others judgment given by Leggatt, J that the test of whether authorisation is required is whether the relevant operations (not simply those on which the Department had focused hitherto) occur here to any substantial extent. The decision is relevant both to the way offshore insurers conduct their business and to the activities of different kinds of intermediaries, agents and providers of specialist services.

Precedent register

21. When legal advice has been obtained or decisions taken which may have relevance for consideration of future cases, then the papers should be copied to I1B for inclusion on the Precedent Register.

Compliance cost for companies

22. There are obviously cost implications for companies in satisfying the authorisation requirements and being liable for the appropriate supervisory fee but these are statutory and are clearly legitimate.

Insurance annual report

23. The Report contains a list of all companies authorised to carry on insurance business in the UK, which includes the particular classes for which each has been authorised. Supervisors must maintain accurate records on their companies from which the information in the Report is compiled.

Policy responsibility

24. Divisional policy on this issue rests with I1A.

Isssued August 1993 Guideline 2.2

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Guideline 2.5: Withdrawals of Authorisation

Guideline 2.5

Withdrawals of Authorisation

Synopsis

1. Guidance on the withdrawal of authorisation, whether in respect of only new business or for carrying on any insurance business.

The Legislation

2. Sections 11-13 of the Insurance Companies Act 1982 relate to the withdrawal of authorisation. **S11** withdrawals prevent companies from accepting **new** business, while **S13** withdrawals mean that companies are no longer authorised under the Act and may not carry on **any** insurance business, or business relating to a particular class.

3. In the majority of cases, the withdrawal of authorisation pursuant to S11 will be at the company's own request, or with their agreement. However, there are circumstances where the Secretary of State may under the provisions of S11 direct that a company shall cease to be authorised to effect contracts of insurance. The grounds on which the SoS may take such action are:

(1) that it appears to the SoS that the company has failed to satisfy an obligation to which it is subject by virtue of the Act or the Financial Services Act 1986 or the rules of any self-regulating organisation of which it is a member;

(2) that it appears to the Secretary of State that the company has failed to satisfy an obligation to which it is subject by the law of another member State giving effect to the general insurance Directives;

(3) that there exists a ground on which he would be prohibited (by S7, S8 or S9 of the Act) from issuing an authorisation to the company; or

(4) that the company has ceased to be authorised in a Member State where it has its head office, or where under S9(2) it has made a deposit.

4. Before issuing a direction under S11, **other than at the request of the company concerned**, the SoS must serve a written notice stating that he is considering giving a direction and the ground on which he is considering it and that the company may within one month make written representations to the Secretary of State and, if it so requests, make oral representations to an officer of the Department appointed for this purpose. Similarly, before giving a direction on the ground that any director, controller, manager or main agent of the company is not a fit and proper person to hold the position, a written notice must be served on the person whose fitness is in question.

5. It should be noted that a direction under S11 does not prevent a company from effecting a contract of insurance in pursuance of a term of a subsisting contract. So, if under the terms of a contract, the company subject to the direction is obliged to renew, the company is permitted to do this as well as continue to pay claims on its contracts.

6. With the exception of a direction given in respect of a company which has its head office, or has made a deposit, in another member State, a direction under S11 cannot be revoked or varied. However, further authorisation can be granted, in which case the direction will cease to have effect.

7. S13 relates to final withdrawal of authorisation. Where an insurance company ceases to carry on in the UK any insurance business, or business of any class, the SoS may direct that it shall cease to be authorised. It is not necessary to have taken action under S11 before instituting procedures for final withdrawal under S13. On the other hand, consideration of the use of S13 powers does not preclude the prior use of S11. Directions issued under both S11 and S13 can of course be in respect of particular, and not necessarily all, classes for which a company may have been authorised.

Exercise of Secretary of State's Functions

8. No decisions about withdrawal of a company's authorisation should be taken at a level below Grade 7. If a company disputes the grounds for withdrawal under S13 the matter should be referred to the appropriate Grade 5. Similarly, if withdrawal of

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authorisation is on any of the grounds referred to in S11(2), the prior approval of the Grade 5 must be sought. S11 procedures are actioned by the supervisory section; S13 withdrawals are formally handled by I1A, at the instigation of the appropriate supervisor who should state that there are no outstanding liabilities and make available all relevant supporting documentation.

Insurance Division Objectives

9. Not to allow authorisations to remain unused for an indefinite period. This restriction on unused authorisations is imposed so that companies cannot suddenly reactivate lines of business which may have remained dormant for some years without providing prior notification and justification to DTI. It also prevents a market developing in shell insurance companies. By withdrawing a company's authorisation in respect of new business (under S11) if we have serious concerns about their solvency position, we would be able to limit the risk to potential policyholders.

Best Practice

10. As part of the process of examining annual returns, supervisors must check that the insurance company is carrying on all classes of business for which it is authorised. If an insurance company which carries on direct insurance business does not show in its returns a class of business for which it is authorised and the matter is not covered by a concession, or otherwise explained, the supervisor should write to the company to ask the reason and enquire about their intentions. Our general policy is that if a company has an authorisation for any class of business which it is not using then it should be persuaded to relinquish that authorisation. That line should be conveyed to the company at the time we send our enquiry letter.

11. S13(2) allows the SoS to direct that a company shall cease to be authorised to carry on business of any class if they have not at any time carried on business in that class, and at least 12 months have elapsed since the issue of the authorisation (NB authorisation cannot be withdrawn under S13 for pre-1966 companies which have never written business of the particular class). Before an authorisation is withdrawn it is the Department's practice to notify the company concerned that we are intending to withdraw the authorisation and to give them an opportunity to object if they so wish. This is a sensible approach because without some investigation, we cannot be sure that business is not currently being carried on, or that it is not about to be carried on in the near future. The intention is to get the company's agreement to withdrawal if this is at all possible. It may be that a company has legitimate reasons why a particular authorisation has remained unused but if not made known these reasons should be probed.

12. For instance, it is possible that in some cases where no business is reported in a particular class such risks may in fact be written as ancillary risks to business falling within other classes. In such circumstances it is acceptable that the authorisation for an unused class should be retained.

13. For companies operating entirely as reinsurers, it is likely that they are incurring liabilities by way of retrocession which relate to all authorisation classes of general insurance business, possibly without even being aware of it, through, for example, involvement in non-proportional account treaties. For this reason, it has been divisional policy for reinsurance companies in this position to be authorised for all classes of general insurance business in order to avoid the possibility that they are carrying on insurance business unlawfully.

14. The basis for our policy of withdrawing unused authorisations is that it is necessary to restrict companies so that their authorisation relates to business which they actually carry out, not only so that those consulting records can be sure whether a company is authorised and is carrying out that particular class of business but, more importantly, because our financial over-view of the company must take into account the business which they are writing. An unused authorisation could mean that a company would be able, through reactivation, to greatly increase its business during a year without us knowing about it for 12 months or more.

15. In the event that a company which is not carrying on business in a particular class opposes withdrawal of authorisation for

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reasons which are not considered valid then the Grade 7 should be consulted about follow-up action, with a view to deciding, with appropriate referral to the Grade 5, whether we should ask the company for a proper long term plan for the activities covered by the authorisation or, if we are satisfied that there are no outstanding liabilities, proceed to institute withdrawal procedures under the provisions of S13(1). We should bear in mind that there are no simple procedures for reinstating authorisations which have been revoked. If a company wishes to recommence business in a class for which its authorisation has previously been withdrawn, then it is required to apply to be re-authorised in **all** of the classes of business it currently writes and intends to write.

16. The majority of cases for withdrawal of authorisation are non-contentious and will be by agreement with the company. They are likely to be either when a company has ceased to carry on business in a particular class, to follow a S51 transfer of business, or perhaps in the case of a UK branch, where liabilities have been run off and business is now being written through a UK subsidiary.

17. Where a company decides to cease writing business entirely or only in a particular class, it is more than likely that for some time after, claims will be made in respect of previous contracts accepted. It would be appropriate, therefore, to seek to withdraw authorisations for such classes under S11. The Department takes the view that insurance business is carried on even if the only activity is the settlement of claims by the company which originally wrote the business. Consequently, while a company is running off liabilities the final authorisation cannot be withdrawn. A run off can take years to complete and in the later years outstanding liabilities may be minimal. But if a company still has outstanding claims, or possible outstanding claims, however small, then it still has contracts of insurance to carry out and a S13 withdrawal of authorisation cannot be effected.

18. This really means that unless a company can state categorically that it has no outstanding liabilities, then a transfer of business under S51 of the Act will normally have to take place before an authorisation can be finally withdrawn. (There has been one case where the transfer of insurance obligations was undertaken by means of novation but this was exceptional; as most insurance companies have thousands of policyholders novation is not a practical option so a S51 transfer is the more normal route.) However, in reaching a decision as to whether a company has outstanding liabilities, the directors, in consultation with their professional advisers, can properly consider whether the possibility of further claims arising is so minimal as to be properly disregarded in reaching this decision. If the possibility of a further claim is fanciful then this should not necessarily inhibit the withdrawal of authorisation.

19. When an insurance company transfers business to another company under the provisions of S51 of the Act, the Department's policy is to use S13 to withdraw authorisation as soon as the transfer is complete, unless the company is to be sold immediately after transfer of the business and the purchaser intends to start business within the relevant class within 3 months.

20. There may be circumstances where an insurance company has authorisations for various classes of business, eg by virtue of S4 of the Act, but has never carried out any business in those classes. In such cases, withdrawal of authorisations could only be achieved under S11 since it would, by definition, be in respect of new business. Where an authorised company has never actually carried on any insurance business there is no question of them having ceased to carry on that business. It must be noted, however, that withdrawal of authorisation under S11 can only be at the request of the company unless one or more of the grounds set out in S11(2) exist.

21. The Department publishes information relating to the use of the SoS's powers under S11 and S13. When withdrawal of authorisation occurs under S11, it is the responsibility of the supervisor to take all necessary action, which includes notifying Information Division and requesting them to arrange for a notice to be published in the London, Edinburgh and Belfast Gazettes. The minute to Information Division must be

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copied to I1A, as well as to I4, so that records may be noted (see Annex C). In the case of withdrawal of authorisation under S13, the supervisor will initiate the action but must instruct I1A to undertake the formal withdrawal procedures, which will include notifying Companies House and the Inland Revenue (as well as GAD and Land Registry for long term business, and the Motor Insurers Bureau, if appropriate). I1A also issues a standard monthly press notice publicising withdrawals of authorisation.

Implications for our Understanding of a Company's Position

22. A company which, through lack of action on our part, has been allowed to retain its authorisations for classes which have remained unused, perhaps for some years, would be able to recommence writing business in those classes without having to obtain DTI approval. This may result in an expansion of business which could have a significant and adverse impact on their overall solvency position and this would not be detected until the examination of their next returns which may be more than a year after they have recommenced that business.

Standard Drafts

23. Standard drafts (for adaption as appropriate) are attached of (1) the formal Direction of withdrawal of authorisation under S11, (2) a covering letter to the company, (3) a minute to Information Division, and (4) a typical notice for publication are attached at Annexes A to D.

Conditions to be Attached

24. None applicable.

Legal Advice

25. Legal opinion has been sought from time to time in respect of individual cases and some of that advice has been taken into account in compiling this guideline. Sols have said that in general terms there is little scope for flexibility in interpreting S13 of the Act and we should be cautious about adopting a pragmatic approach in deciding at what stage a company has ceased carrying on insurance business. The advice of solicitors should be taken in cases where there is a doubt whether the company has ceased to carry on business.

26. The case of Ackman and Others v The Policyholders Protection Board and Others provides some authority for the proposition that payment of claims under a policy of insurance effected in the United Kingdom will always constitute the carrying on of insurance business in the United Kingdom wherever the claims are paid. If this is so, then a company running off its business must retain its authorisation and continue to be supervised even if its business is run off overseas. The judicial comments were obiter and, at the time of writing this guideline, the judgement was under appeal. If reliance is placed on this judgement, then reference should first be made to Sols.

GAD

27. GAD should be involved in decisions about withdrawals of authorisation in respect of long term business or cases concerning life companies.

EC Aspects

28. There are no particular EC aspects in the context of this guideline.

On The Record Statements

29. None.

The Precedent Register

30. Supervisors who may be involved in cases in which unusual features are raised or where legal advice may have been provided which is likely to be of wider interest, should consider copying relevant documents to I1B for inclusion in the Precedent Register.

Compliance Costs for Companies

31. There are no compliance cost considerations directly arising from this guideline.

Insurance Annual Report

32. To enable publication of details of the exercise of the Secretary of State's powers, a central record of the number of occasions on which the powers contained in S11 and S13 have been used is maintained by I1A. This is checked for accuracy with supervisors before publication and hence all HEO supervisors should maintain their own separate records.

Policy Responsibility

33. Divisional policy on S13 withdrawals rests with I1A.

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Guideline 4.2: Change of Control

Guideline 4.2

Change of Control

Synopsis

1. Guidance to I Division staff on the procedures to be followed in respect of an application for the Secretary of State's consent to a proposed change of control of an insurance company.

The legislation

2. The legislative framework for changes of control is set out in Sections 60 to 62 of the Insurance Companies Act 1982 ("the Act"). Section 60 deals with Managing Directors and Chief Executives of insurance companies. Section 61 deals with other controllers. Controller is defined in Section 7(4) of the Act and guidance on interpretation of Section 7(4) is given in Guideline 4.1. Both Section 60 and 61 require notification of proposed new controllers to be given to the Secretary of State together with their prescribed particulars.

3. The prescribed particulars are set out in Schedule 6 to the Insurance Companies Regulations 1981 ("the 1981 Regulations"). For a proposed Managing Director or Chief Executive of an insurance companies the particulars are prescribed in Form A. For any other individual who proposes to become a controller Form B applies and for a body corporate proposing to become a controller Form C applies.

4. Both Section 60 and 61 provide that before a person or company can become a controller the Secretary of State must either indicate in writing that he has no objection to the proposal or a period of three months must elapse from the date of notification without the Secretary of State having served on the company a written notice of objection to the appointment.

5. If the Secretary of State, having enquired into the fitness of the person or body corporate proposed as controller, decides that he wants to object to the proposal, he has first to serve a written notice of intent to object on the person or body corporate concerned. If the appointment proposed is that of a managing director or chief executive of an insurance company a notice of intent to object has to be served both on the proposed controller and on the company proposing to appoint him/her. It should be noted that while the Secretary of State is not obliged to give particulars of the grounds on which he is considering objecting, in practice such grounds have to be disclosed to allow representations to be made.

6. The proposed controller (and the company if the proposal is to appoint a managing director or chief executive) then have one month in which he/they may make written and/or oral representations to the Secretary of State on the matters raised in the notice of intent. The Secretary of State then has to consider the representations and take a final decision on the matter and, if he is so minded serve a formal notice of objection within a period of three months from the date on which the original notice and prescribed particulars were served on the Secretary of State.

7. In the event that the proposed change of control goes ahead (not all proposed changes of control to which consent is given or to which no objection is made actually happen) Section 62 requires the insurance company to be notified in writing within 7 days of that fact and of the matters prescribed in Form D of Schedule 6 to the 1981 Regulations. The insurance company is then required to notify the Secretary of State within 14 days.

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8. Section 71(3)(a) and (b) make it an offence to fail to comply respectively with the obligations imposed by Sections 60 and 61. However Section 71(5) provides a defence if the person subject to those duties is able to prove that he did not know that he had become or ceased to be a controller.

Exercise of Secretary of State's functions

9. The day to day work on change of control applications is appropriate to the HEO grade but indications of non-objection to a proposed change of control should always be cleared in advance with the supervisory Grade 7. The Secretary of State's power to object (including intent to object) should not be exercised at a level below G5 and, depending on the contentiousness of the case, reference to Ministers may be appropriate.

Insurance Division objective

10. To prevent persons or companies that appear to the Secretary of State not to be "fit and proper" to be controllers of insurance companies from assuming such positions.

Best Practice

Timing

11. All applications for change of control consent must be dealt with as quickly as possible. Sections 60 and 61 allow the Secretary of State three months only in which to object, during which period:

(a) the fitness of the person or company concerned has to be investigated by I1A and those findings considered;

(b) a preliminary notice of intent to object has to be drafted and served on the proposed controller;

(c) a month has to be allowed for the making of written and the hearing of oral representations by the proposed controller, and

(d) consideration of those representations and drafting and service of a formal notice of objection.

12. The three month period starts to run the day that a properly completed form is received by us. In effect there are only six weeks from the date the application is received to investigate and decide to issue a notice of intent to object. The fitness checks will take about half that time (more if an individual is resident overseas or if a company is registered overseas).

Confidentiality

13. Proposed corporate changes of control are frequently market sensitive in that the prior knowledge that we have of acquisition plans could be used by the unscrupulous unlawfully to obtain an unfair advantage and distort the normal workings of the market. Although the insurance company that is to be the subject of the acquisition may sometimes be aware of what is planned this is often not the case. It is therefore essential that proposed changes of control are kept confidential (with the exception of notification to the Office of Fair Trading - see paragraph 17) even from the insurance company which is the subject of the application. This requirement extends beyond the giving of consent to the moment when we are informed that the change of control has actually taken place.

14. The only occasions on which the insurance company will definitely be aware of a proposed change of control are when it is itself proposing to appoint a new managing director or chief executive

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or where the change of control is purely a technical one resulting from a corporate restructuring initiated by the insurance company or group itself.

Acknowledgement

15. All changes of control that involve a body corporate proposing to become a controller of a UK authorised insurance company (and therefore the submission of one or more Forms C) must be acknowledged by the supervisor of the target company by standard letter. This is at Annex A and alerts the originator of the application to the need to contact the Office of Fair Trading ("OFT") if the transaction gives rise to a qualifying merger situation under the Fair Trading legislation or the European Commission if the merger is one which would come within the jurisdiction of that body.

Notification to OFT

16. The Fair Trading Act 1973 requires the Director General of Fair Trading to consider whether a proposed acquisition constitutes a merger for the purposes of that Act and if so, whether he should recommend the Secretary of State to refer the proposed merger to the Monopolies and Mergers Commission for investigation and report. The powers of the European Commission are set out in the European Community Merger Control Regulations 1989 (SI 4069/1989).

17. It is therefore the practice to send to the OFT's Mergers Secretariat a copy of the acknowledgement letter referred to in paragraph 15 above together with a covering letter indicating who is the appropriate contact point in Insurance Division. A draft covering letter is at Annex B. The contact point should normally be the HEO responsible for supervising the target insurance company.

Checking the application

18. This task is the responsibility of the supervisor. Changes of control frequently involve the submission of a number of forms. Each form represents a separate application for consent. Each form submitted should be checked carefully for completeness. If any of the prescribed particulars have not been provided the application represented by the form is defective and is deemed not to have been submitted. It should be remembered that the forms are multi-purpose and need to be specifically tailored to the situation in hand.

19. It is also necessary to check that all forms that should be submitted have been submitted. Acquiring companies and their legal advisors do not always interpret Section 7(4) correctly and it may be necessary to call for more or different forms to be submitted. If one of a batch of forms is missing or defective the clock starts to run for the forms that are present and correct but not for any that are defective or missing.

20. Deficiencies should be rectified and missing forms supplied as quickly as possible. Processing of forms that are present and correct should not be held up and if possible processing of forms that are deficient should be started. I1A should be consulted as to whether this is possible. If it is an individual and his/her full name, address and date and place of birth are given then fitness enquiries can be started.

The fitness enquiries

21. These are carried out for supervisors by I1A. That section should therefore be sent a photocopy of all correctly completed forms as quickly as possible (and of any defective forms where sufficient information exists for fitness

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checking to be started). The original copies should be retained by the supervisor and placed on the notifiable persons file relating to the target insurance company with a suitable indication of the date that the three month period ends.

22. The checks on fitness carried out by I1A consist, inter alia, of consulting the Stock Exchange and checking records of bankruptcy, adverse court judgments, company investigations etc. They are initiated once a week when a list of persons and companies to be checked is prepared. The list is dispatched on Fridays. To ensure that the individuals or companies you are considering are included on the current week's list I1A need to be given their copies of the forms as early as possible during the week.

23. In addition I1A will be prepared, in cases where there appears to be good reason to do so, to check out the criminal record of an individual with the Criminal Records Office at New Scotland Yard. It should be noted that we have an exemption from the Rehabilitation of Offenders Act 1974 which provides that convictions that might otherwise not be required to be disclosed have to be disclosed on the Forms. A note to this effect is in Form A and Form B beneath item 7.

24. If any individual is or has recently been resident overseas I1A's checks will include an enquiry to the nearest UK diplomatic representative (ie Embassy or Consulate) (known as the "Post"). Companies incorporated overseas will also be checked out with the nearest Post in the same way.

25. Standard checks on companies and other bodies corporate proposed as controllers are somewhat different. They are designed to indicate whether the accounts of the proposed controller show a satisfactory financial position, bearing in mind the porposed acquisition, and nothing more than that. I1A will consult the supervisory Grade 7 Accountant responsible for supervising the target insurance company. If the supervisory Grade 7 is not an accountant or if the accountant is a secondee from a firm that audits the proposed controllers accounts then I1A will arrange to consult another Grade 7 accountant.

26. In addition I1A will also check their records and those of Investigations Division to see whether anything adverse is known about any of the directors of the proposed corporate controller as that might render the proposed corporate controller unfit.

27. I1A carries out the fitness checks using their own company files specifically dedicated to this task and the results of their investigations are reported back to Supervisors on those files.

28. It should be noted that if the fitness of an individual or a company has been checked with no adverse finding within the previous 12 months they will be deemed to be still fit and proper unless any information suggesting or indicating the contrary has since been brought to the attention of I1A.

29. Supervisors should consider whether the normal fitness checks are sufficient or whether some other check or investigation is desirable. An example where this would be necessary is that of an overseas insurance company that is proposing to become a controller of a UK incorporated insurance company. I1A should be asked to ask the Post to consult the insurance supervisor in the country where the overseas insurance company is incorporated or carries on business. A similar procedure should be followed in

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respect of any individuals who hold or who have in the recent past held senior positions in overseas insurance companies.

Considering fitness

30. Consideration of the fitness of an individual or company to be a controller of an insurance company is fraught with difficulty. The purpose of our fitness powers is to protect policyholders and potential policyholders from the dishonest, the insolvent, the inexperienced and the incompetent. They should not be used to make wider moral judgements. For example incest may be morally repugnant but a conviction for it does not in itself make a person unfit. However failure to disclose such a conviction is prima facie evidence of dishonesty. Whether or not a person or a company is unfit is frequently a matter of subjective judgement but there are certain ground rules that should always be followed.

31. The fitness of the individual or company must always be considered in the light of the position that they are proposing to take up. For example an individual may well be perfectly fit and proper to act as a notifiable manager of an insurance company but may not necessarily be fit and proper to act as the company's managing director of chief executive. A misdemeanour that might disqualify a proposed controller might not necessarily disqualify a manager. Where the proposed controller is a body corporate the results of our internal checks on adverse information held about its directors must also be taken into account. An unfit person holding a position as director of a proposed corporate controller can render the proposed corporate controller unfit.

32. Proposed controllers who will be controllers by virtue of the fact that they are proposed as managing director of chief executive of an insurance company must have the relevant experience. By this we mean five years experience gained over the last 10 years at a similar level or the next step down in a UK authorised insurance company that has carried on similar business. Nationality or ethnic origin is irrelevant in this regard. Location is however relevant. It would be wrong for us to approve or let go by default a proposed appointment of a managing director of chief executive of an insurance company where the individual concerned is not resident in the UK. Effective management of a UK insurance companies cannot be carried out by remote control by an absentee. If that is the only reason for wishing to object to the proposed appointment, the circumstances should be first explained to the originator of the application and its withdrawal invited.

33. If there is any doubt as to a person's or a company's fitness to be a controller the case should always be put up to senior officers for a second opinion. In the event that fitness action is to be considered Solicitors should always be consulted for their views as to whether or not, if it came to a judicial review, the Court would be likely to take the view that a finding of unfitness was reasonable. It is the usual practice to ask at the same time that Solicitors draft a Notice of Intent to Object if they are of the opinion that objection is sustainable.

Giving approval

34. It is not a legal requirement that approval (in the form of an indication that the Secretary of State does not intend to object) be given before a change of control can take place. It can take place without our approval provided that three months have elapsed since the date the notification was received by us and the Secretary of State has not subsequently indicated that he is objects to the proposed change. It is however Divisional

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policy, where no fitness issues arise from our enquiries, always to issue such a letter. Failure is issue a letter of non-objection is construed by the industry as indicating that the Department is less than completely happy about a proposed change of control. There may be the occasional case in which it would be appropriate neither to indicate non-objection nor to object. This is likely to be where there is suspicion of unfitness but useable evidence that would enable a charge of unfitness to be sustained cannot be obtained or cannot be obtained within the time limit set by the Act. However these are few and far between and should be agreed at G5 level.

35. In cases where no adverse information has been uncovered during fitness enquiries letters of non-objection may be issued by the HEO supervisor of the target company. These must be formal letters and a standard draft is at Annex C.

Notification of change of control

36. Indicating that the Department does not object to a proposed change of control does not in any way commit the proposed acquirer actually to make the acquisition. However it is imperative that we are advised if a change of control has actually taken place. Section 62 of the Act therefore requires all persons or companies who have become controllers of an insurance company to notify us of that fact. Similarly persons or companies who have ceased to be controllers of an authorised insurance company are required by Section 62 to notify us of that fact also.

37. Form D of Annex 6 to the Insurance Companies Regulations 1981 is prescribed for this purpose. All persons or companies that have become controllers of an insurance company are required by Section 62 to notify the insurance company within 7 days. The insurance company in turn is required to notify us within 14 days. Therefore notification of a change of control should be received by us within 3 weeks of the event. However this is a duty that controllers, both past and present, their advisors and the insurance companies themselves frequently forget about. If Forms D are not received within two months of the date of the letter of non-objection the originator of the change of control application should be asked what the position is. Sometimes regular checks on the position are necessary for longer before it is resolved one way or another.

38. It is an offence under Section 71(1)(a) for an individual to fail to notify the company of a change of control in accordance with Section 62 and under Section 71(3)(a) it is an offence for the copany to fail to notify the Secretary of State in accordance with Section 62. However Section 71(5) provides a defence if the person under the obligation to notify is able to prove that he did not know that there had been a change of control.

Implications of change of control

39. Once the Forms D have been received the change of control is complete. This does not mean that supervisors can then put the file away. The implications for supervisors of a change of control need to be considered. These are set out in Guideline 4.5.

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Guideline 4.4: Notices of Objection and Representations

Guideline 4.4

Notices of Objection and Representations

Synopsis
1 Guidance on serving notices of objection on persons holding or proposed for notifiable positions (eg managing director, chief executive, controller) in an insurance company and on considering any representations which might be made to the Department.

The Legislation
2 The Insurance Companies Act 1982 gives the Secretary of State the following responsibilities in respect of persons whom he considers are not fit and proper to hold given positions in an insurance company.

(a) Authorisation

3 Under sections 7,8 and 9 the Secretary of State shall not issue an authorisation under section 3 if it appears to him that any director, controller, manager or main agent (for EC companies any relevant executive and in the case of any other overseas company the general and individual representative) is not a fit and proper person to hold his position.

(b) Withdrawal

4 Under section 11, the Secretary of State may direct that an authorised insurance company shall cease to be authorised to effect contracts of insurance, **inter alia** where he would be prohibited by sections 7,8 or 9 from issuing an authorisation.

(c) Changes of director, controller or manager etc

5 Section 60 prohibits an insurance company from appointing a new managing director or chief executive if, within three months of being notified of the proposed appointment, the Secretary of State serves on the company a written notice of objection on the ground that it appears to him that the person proposed to be appointed is not a fit and proper person for the position in question. (Section 63 modifies this provision so that in respect of companies whose head office is outside the UK it applies only to the principal UK executive.)

6 In addition, Section 61 prohibits a person from becoming a controller (otherwise than by virtue of Section 60) of an insurance company if, within three months of being notified of the proposed change, the Secretary of State serves on the person concerned a written notice of objection on the ground that it appears to him that the person is not a fit and proper person to be a controller of the company. (Section 63 disapplies this section in relation to direct insurers with their head office in another EC country.)

(d) Intervention powers

7 Under section 37(1)(2), the Secretary of State's intervention powers under sections 38 and 41 to 45 are exercisable **inter alia** on the ground that he would be prohibited by section 7,8 or 9 from issuing an authorisation with respect to the company were it applied for. Nor, where any adverse information on a person comes to light, is the Secretary of State precluded from taking action because he may have expressly or implicitly accepted the person as being fit and proper at some previous time eg by authorising a company or by approving a change of control involving the person concerned. (However, should we wish in such a case to consider taking action against the company, eg to withdraw its authorisation, the need for administrative consistency should be taken into account.)

8 Action may be taken, as appropriate, whenever it appears to the Secretary of State that a person is not fit and proper; it is not dependent on a change of a notifiable officer or on the submission of the Forms A-D prescribed by Schedule 6 to the Insurance Companies Regulations.

Serving Notices of Objection

(a) Authorisation

9 The Act contains no provision for the service of notices and making of representations in respect of fitness issues arising from applications for authorisation. In practice, however, the Department normally informs the applicant and the person concerned and, on an extra-statutory basis,

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affords them the same opportunities for making oral and written representations, as those required by section 12.

(b) Withdrawal of authorisation

10 Section 12 lays down the procedure to be followed in all cases in which the Secretary of State envisages issuing a direction under Section 11. When this arises from fitness considerations, the procedure varies according to the person involved. In the case of a person who is not a controller or principal UK executive written notice must be served on that person stating that issue of a direction to the company is under consideration, the ground for its issue, and particulars of that ground. One month is allowed for written and oral representations. If the intention is reaffirmed having considered any representations, a similar notice is served on the company, which in turn may make representations. Where the person whose fitness is in question is a controller or principal UK executive, notices may be issued simultaneously to the individual and the company.

(c) Changes of director, controller or manager etc

11 When it is intended to object to the appointment of a proposed managing director or chief executive under section 60, the Secretary of State serves preliminary written notice of intended objection on both the person concerned and on the company. In the case of a person seeking to become a controller (section 61), the Secretary of State is required to serve the preliminary notice only on the person concerned (the insurance company might not be aware of the proposal). The recipient(s) may then, within one month from the date of service of the preliminary notice, make written representations to the Secretary of State and, if they request, oral representations to a DTI officer appointed for the purpose by the Secretary of State. Where representations are made, the Secretary of State is obliged to take them into consideration before deciding whether to serve the notice of objection. The Secretary of State is not obliged to give particulars of the ground on which he is considering objecting under sections 60 and 61. However, in practice, he will normally disclose the ground in such cases so far as he reasonably can to enable the person or company to respond to the Secretary of State's concerns.

(d) Intervention powers

12 Where the unfitness is intended to be dealt with by any of the intervention powers in sections 38 and 41-45, the procedure in section 46 must be followed. If the person in question is not a controller, a two stage procedure corresponding to that described in paragraph 10 above applies. If the person in question is a controller, notice is served on the company only, and the company may make representations, written and oral, within one month. Notices served under section 46 are required to state the ground for action and the powers intended to be used.

Exercise of Secretary of State's Functions

13 A decision to serve a notice or preliminary notice of objection may not be taken at a level below Grade 5. It may be appropriate to involve the head of Division or even the Minister, depending on the nature of the particular case. Recommendations about the level of approval to obtain should be made by the Grade 7 in a submission to the Grade 5. In all cases, the views of Solicitors should be sought prior to service of a preliminary notice of objection.

Insurance Division Objective

14 To ensure that persons holding key positions in insurance companies are to the best of our knowledge competent, suitably experienced and trustworthy, and in cases where we are aware of information which casts doubts on their fitness for the particular post, we should be prepared to serve notice of objection.

Best Practice

15 An integral and important part of the regulation and supervision of insurance companies in the UK is the consideration of whether persons appear not to be fit and proper to hold certain positions in those companies. The fitness provisions of the ICA 1982 reflect the desirability of high standards and competence and integrity among persons running insurance companies.

16 The acceptability of an individual may need close consideration because of what is disclosed in their notification, or because of

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what is found during I1A's routine enquiries (outlined in another chapter of this section of the Guidance notes), or because of what is known separately to the Department. In deciding a person's fitness, it is legitimate for the Department to have regard for any views which may have been formed at any time in its dealings with the person concerned.

17 Financial unfitness - where the Department has any doubts about the ability of a proposed new controller, it will be necessary to enter into an early dialogue and, if necessary, serve a notice of objection in the normal time scale. Indications that a proposed new controller is financially unfit are that, for example, the acquisition of the target company is being funded by an unacceptably high level of borrowings which will put pressure on the insurance company to yield up dividends. Acquisitions by private individuals and new companies which cannot submit accounts for three previous years must always be looked at with great care. Advice on financial fitness should always be sought, from GAD in the case of life companies.

18 The term "fit and proper" is not defined in the legislation; and it is not possible and probably not desirable to give an exhaustive list of the kinds of conduct which could lead to a finding of unfitness against an individual. However, the information required by the Insurance Companies Regulations provides some pointers to the relevant issues. These are principally the honesty, integrity, knowledge and experience of an individual. By way of illustration, the following considerations may be relevant to decisions on fitness cases:

1 **Non-disclosure** – this alone may not necessarily be sufficient reason for formal action, but there can be dishonest concealment which would make the individual unsuitable for many positions. Where our enquiries reveal an omission from a notification (e.g. of a conviction or bankruptcy) the supervisory section should always ask the individual whether its information is correct, and for comment on the omission and the circumstances of the matter. Such enquiries should be made discreetly and usually to the home address of the person concerned (an example is provided at paragraph 4 of Annex B). It may be appropriate subsequently to require the individual, irrespective of the embarrassment it may cause, to inform the company of the matter omitted, followed by the sending to the Department of an accurately completed form or of a letter from a person of suitable standing in the company confirming awareness of the matter in question.

2 **Offences** – the significance of any offence known to the Department should be considered on its merits, taking full account of all available information concerning the surrounding circumstances. Relevant considerations would be: the nature of the offence (those involving dishonesty would probably be regarded more seriously than a speeding conviction), the period of time since the offence (the more recent, the more seriously it may be regarded), and the age at the time of the offence (some allowance for youthful folly might be appropriate).

3 **Bankruptcies** – we should take account of the surrounding circumstances, particularly the nature of the individual's role and degree of culpability.

4 **Experience** – in considering proposed appointments of chief executives and managing directors it is reasonable to expect such people to have had 5 years experience in the preceding 10 years at a similar level or the next step down in a UK-authorised insurance company that has carried on similar business. With regard to the experience of a new director, it has usually been considered sufficient if at least one third of the directors have been directors of a UK-authorised insurance company for at least 5 of the previous 10 years. The absence of professional qualifications has not been regarded a bar to the holding of senior positions in authorised insurance companies.

5 **Other considerations** – examples would be (a) age of directors (the age and composition of the board as a whole should be considered); (b) irresponsible behaviour (e.g. investing the assets of an insurance company in unsuitable speculative directions, or delegating the management of the company to an agent whose fitness and properness is itself in

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doubt); (c) character weakness (such as failure to resist a dominating management recognised as being engaged in doubtful or worse practices.

19 It is important to bear in mind that the fitness of a person must always be considered in the light of the particular position that he holds or is proposing to take up. An individual who may well be perfectly fit and proper to act as a notifiable manager of an insurance company may not necessarily be fit and proper to act as the company's managing director or chief executive.

20 The time scale for taking action in the case of changes of director, controller or manager is an extremely tight one. Sections 60 and 61 of the ICA 1982 enable the Secretary of State after completing the statutory procedures to object to, and thus prevent, the proposed appointments. A 3 month period is allowed for the Secretary of State to serve on the company a formal notice of objection to the proposed appointment. But within this period, I1A's enquiries must be completed and 5 weeks must be pencilled in for the making and consideration of representations. In order to invoke the statutory process, therefore, a preliminary written notice indicating that the Secretary of State is considering objecting to the person concerned must in practical terms be served within **6 weeks** of his particulars being received in the Department. The provisions of the Act relating to the refusal or withdrawal of authorisation and the exercise of intervention powers contain no corresponding time limits. However, where the Secretary of State may wish to exercise these powers on fitness grounds on the basis of notifications under, for example, section 62 or section 64, our policy is to try to operate within a similar time scale.

21 Once a decision has been taken, at the appropriate level (see paragraph 13), to serve a preliminary notice of objection the advice of Solicitors should be sought on the precise drafting of the statutory notice and the accompanying letter(s). They should already have been involved in evaluating the case. It is also important that I1A are advised of the action being taken by the supervisory section, including notification of the eventual outcome of the case. A covering letter is then sent to the individual concerned (and if necessary to the company - see paragraphs 9-12) enclosing the preliminary written notice of objection to the company. As indicated above, it is Department policy normally to disclose the particulars of the ground on which the Secretary of State is considering the service of a notice of objection, even though we are not obliged in all cases to do so.

22 The letter and notice bring to the attention of the individual (and if appropriate the company) that they may submit written, and make oral, representations within one month from the date of service of the preliminary notice. If receipt of the letter(s) is not acknowledged or an indication is not given fairly quickly that representations will be made, we should send a reminder letter or enquire by telephone. However, it should be noted that -

(a) under sections 12(7) and 70(3) of the Act a notice served on any person by the Secretary of State under section 12(1) or (2), 46, 60 or 61 may be served by post and a letter containing the notice shall be deemed to be properly addressed if it is addressed to that person at his last known residence or last known place of business in the United Kingdom; and

(b) by virtue of section 7 of the Interpretation Act 1978, in the case of service by post service is deemed to be effected by properly addressing, pre-paying and posting the letter and, unless the contrary is proved, to have been effected at the time at which the letter would be delivered in the ordinary course of post.

Receipt of any written representations should be formally acknowledged.

23 If oral representations are requested, satisfactory arrangements about time and place should be made expeditiously with the person concerned. Some practical advice about arrangements for the oral representations is provided at Annex A. There is advantage in the officials involved having had an opportunity to consider the written representations before any oral representations are heard, so they should be requested in advance of the hearing. The interval between the receipt of written, and hearing of oral, representations will usually be very short.

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24 The officer appointed to hear any oral representations should be a Grade 5 or above. The appointment should be made in writing by an officer of higher rank (see Annex C) . Normally the officer appointed will be the head of Branch responsible for supervising the company involved. It is important that the person concerned should have no reason to think that the appointed officer has any pre-conceived views on the matters at issue. It may not be appropriate, therefore, for the head of Branch concerned to hear oral representations if he/she has been closely involved in discussions with the person concerned relating to the subject which gave rise to the fitness issue.

25 The appointed officer will be accompanied at the oral representations by a representative from Solicitors Division. Other members of staff may be present, but the number should be kept to a minimum. Arrangements should be made for a verbatim record of the hearing. This will subsequently be copied to the person concerned to confirm the accuracy of the record.

26 Once the representations (written and, if requested, oral) are complete the appointed officer will arrange for a submission to be prepared recommending what further action, if any, should be taken. It is likely that the submission will be referred to Ministers and it should be cleared in draft with Solicitors. It should set out the statutory and company background, summarise the grounds on which the Department doubts the person's fitness and the representations to the contrary, and give an evaluation of the representations. If no representations have been made, it can be taken that the grounds for the action are uncontested and this should be reflected in the submission.

27 The Secretary of State must be seen to have acted fairly, particularly by taking into account the representations made by the person/insurance company concerned. A particular difficulty in the operation of the legislation is that the Department appears as both prosecutor and judge. This makes it vulnerable to the criticism that it has acted unfairly. Particular care is necessary to avoid this criticism. Statutory action should only be recommended when, in the light of all the circumstances, it appears that the person concerned is not a fit and proper person to hold the appointment in question and action is desirable for the purpose of protecting the policyholders or prospective policyholders.

28 If our decision is that, after considering the representations made, we still find the person concerned to be not fit and proper to hold the particular position, we can refuse authorisation, withdraw the company's authorisation, serve a notice of objection or issue a notice of requirements, as the case may be.

29 Should we, on the other hand, decide not to object on grounds of fitness we should confirm in writing to the person(s) concerned that in the light of the representations made, we have no objection to the (proposed) appointment.

30 It may well be the case that following service of the preliminary written notice, the individual decides to resign from the company. In that event, further action is unnecessary; the grounds for the exercise of the powers cease to exist if the office holder ceases to hold his position.

31 There is always the possibility of taking action otherwise than under the Act, eg by reporting a professional to his disciplinary body or reporting evidence of crime to the police, or taking some lesser action in less serious cases or where there is a doubt about the culpability of the individual concerned, eg a warning letter or a letter indicating to a company that the Secretary of State would be content to see the person concerned appointed to a different position.

32 In cases where a person has been found not fit and proper (and in some cases where a finding has not been made, eg because the person concerned resigned or the evidence was not clear) it may be desirable in any event to notify other regulators (including overseas regulators).

Implications for our Understanding of a Company's Position

33 The Department ought to be able to have reasonable confidence in the competence, integrity and experience of those in positions of authority in insurance companies. If we consider we have valid reasons to question that a person is fit and proper to hold certain notifiable posts, we should be prepared to

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take action as outlined in this Guideline. Failure to carry out vigilant checks and to act in cases where we have reason to doubt a person's fitness could allow less than scrupulous people to remain in charge of the affairs of a company with the possibility that through either incompetent, negligent, reckless or even fraudulent dealings they could affect the viability of the company and put policyholders at risk.

Standard Drafts
34 Some specimen notices and letters are attached at Annex B which should be adapted carefully as appropriate, taking account of legal advice obtained. A draft minute arranging for authorisation of the appointed officer for the hearing is at Annex C.

Conditions to be Attached
35 None applicable.

Legal Advice
36 This Guideline is based on procedures which have been agreed with Solicitors. In any event, it will be necessary to consult Solicitors during the course of evaluating all cases where fitness action is being considered.

GAD
37 It is for Insurance Division to decide whether to initiate fitness action, but in cases involving companies conducting long-term business the advice of GAD should be sought.

EC Aspects
38 Not applicable at present (although the provisions for EC companies referred to in paragraphs 3 and 6 take account of the responsibilities of home State supervisors). However, the Third Insurance Directives contain, in addition to the "single passport" rules, provisions about the suitability of directors, managers and controllers which may require amendments to be made to the Act, notably to enable the Secretary of State to act directly against unfit controllers.

On the Record Statements
39 The Parliamentary Commissioner for Administration has commented on the handling of fitness cases:

> "It is not improper for (the Department) to have regard for any views which may have been formed at any time in their dealings with (that) person, but when actually making a case for action under the very broad and far reaching powers which Parliament has conferred on them, they should be scrupulous in their dealing with the individual or individuals concerned to make sure that they are being fairly treated, that they understand the case that is being made against them and that they have an opportunity to answer the case. Finally, on putting the issue for decision to Ministers **the Department should be scrupulous in seeing that the case for the (absent person) is fully and fairly deployed."**

[Parliamentary Papers : House of Commons : Session 1976-77, Volume XXXVIII, page 49]

The Precedent Register
40 A separate database on fit and proper cases is maintained by [redacted] in I1B. It is important in order to keep the database up to date that supervisors supply [redacted] with relevant information in the required format (see Annex to Guideline 1.2) for all cases where fitness action is started. Supervisors may also find it useful to consult the database for precedents when considering taking fitness action.

Compliance Costs for Companies
41 There will be some cost implications for individuals and companies in preparing information in defence of fitness cases but this should not inhibit us from taking action in the interests of policyholders where we have reasonable grounds for doing so.

Insurance Annual Report
42 Relevant in so far as the number of times intervention powers under sections 38-45 have been used must be recorded in the Report, and of these sections 38 and 41-45 can be triggered by fitness considerations following action under section 46. If there have been instances where this has occurred, the HEO supervisor must keep note for eventual publication in the Report.

Policy Responsibility
43 Divisional policy on this issue has not been specifically allocated (but note that I1A has responsibility for carrying out "routine" fitness checks, as opposed to a subjective evaluation).

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Guideline 5.4: Correction of Inaccuracies and Supply of Deficiencies

Guideline 5.4

Correction of Inaccuracies and Supply of Deficiencies

Synopsis

1. Guidance on action to be taken if it appears that any document forming part of a company's annual return is inaccurate or incomplete in any respect.

The Legislation

2. Section 22(5) ICA 1982 requires the Secretary of State to "consider the documents deposited" under both s22(1) and s22(2), ie the annual return and statement of connected intermediaries. It also requires the Secretary of State, "if any such document appears to him to be inaccurate or incomplete in any respect", to "communicate with the company with a view to the correction of any such inaccuracies and the supply of deficiencies".

Exercise of Secretary of State's Functions

3. Letters to a company, on behalf of the Secretary of State, requiring the correction of inaccuracies and the supply of deficiencies, should be signed at a level not below EO.

Insurance Division Objective

4. To secure the correction of material errors and the supply of deficiencies in annual returns, or in statements of connected intermediaries, in order that neither the Department nor the public, including shareholders and actual or potential policyholders, form a view of the company based on inaccurate or incomplete information.

Best Practice

5. Supervisors should have few reservations about formally requesting companies to correct inaccuracies and/or to supply deficiencies.

6. Errors in and omissions from a company's annual return may be discovered at any stage during the examination process. They may be discovered on first receipt of a return by supervisors, by the Central Reception and Progressing Unit ("CRPU"), by the Validation and Compliance Unit ("VCU") or subsequently by supervisors or by GAD.

7. In the case of I1 companies, the CRPU will draw the supervisor's attention to any errors or omissions identified by the Unit in the course of its work. Also in respect of I1 companies, the VCU will, in most cases, take up with the company concerned, using section 22(5) powers, material absolute errors identified in computer-generated validation and compliance reports on any return. At present, these Units do not process returns from companies supervised by I2. Therefore, supervisors in I2A and I2B must themselves execute all the checks which fall to I Division staff.

8. Insurance Division staff are responsible for checking in detail the returns of a general business company and for checking those parts of a return of a composite company which relate to its general business. A more limited examination of returns, or parts of returns, relating to long term business is carried out in the Division (see paragraph 22 below).

9. Supervisors should make a note of any errors or omissions which emerge during the examination process, and which have not been the subject of follow up action by the VCU, with a view to writing to the company as soon as the examination is complete. The timing of such a letter must be left to individual judgement but the aim must be to write sooner rather than later, whilst endeavouring to ensure that no further errors or omissions are likely to be discovered. However, depending on the significance of any error or deficiency, there may be occasions when it will be necessary to seek

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corrections or the supply of deficiencies before further examination continues; in extreme cases it may be that resubmission of the whole return should be sought.

10. A draft "section 22(5) letter" is at Annex A (see also paragraphs 11 and 16 below). This may need to be amended slightly to suit particular cases but it is essential that most of the draft remains in any revised version.

11. There may be occasions when it is not entirely clear whether there is an inaccuracy in a return although one may be suspected. Whilst it only has to "appear" to the Secretary of State that there is an inaccuracy or a deficiency it may be necessary to query the point with the company before concluding there is definitely an error. In such cases the draft at Annex B should be used.

12. When five copies of the amended material are received they should be checked. If they are not in an acceptable form the company should be requested to resubmit them. In particular, supervisors should check that any corrected or new material which is part of the return subject to audit has been endorsed by the auditor. Supervisors should also ensure that the form of the document is such that members of the public examining the return will be able to understand it (see paragraph 5 of the draft letter at Annex A). If necessary, marginal notes should be added in order to identify to which parts of the original return the corrections refer. Copies will be distributed by the CRPU in the case of I1 companies, and should be distributed by supervisors in other cases, on the same basis as the original return.

Despatch of Documents Received to Companies House

13. A copy of the new or revised material must be sent to Companies House under cover of a minute suggesting, if necessary, how the original return should be marked in order to show that particular parts have been amended or replaced. Suggestions for marking original returns must be kept to a minimum. Companies House cannot remove documents from the original return on public record nor can new or replacement parts of the return be inserted at the appropriate place in the original return; they will be filed in "date of receipt" order.

14. If any inaccuracies or deficiencies in returns for any earlier year are identified, which were not at the time taken up with the company, attention should be drawn to them during the process of examining and reporting on the current year's return. There may be practical considerations which suggest that past uncorrected inaccuracies or deficiencies should not be taken up, but supervisors should be aware of the legal advice at paragraph 20 below.

Implications for our Understanding of a Company's Position

15. Clearly, any return may be misleading if it contains material inaccuracies or is deficient. It is important that any inaccuracies or deficiencies be rectified as soon as possible. The materiality of an inaccuracy depends, inter alia, on the extent to which it affects the validity of the conclusions which may be drawn about the company.

Standard Drafts

16. The draft letter at Annex A should be used when it is clear that there are inaccuracies and/or deficiencies, subject to any adaptation necessary in particular cases (see also paragraph 10 above), whereas the draft at Annex B should be used if it is not entirely free from doubt that there is an inaccuracy in a particular case (see paragraph 11 above).

Legal Advice

17. Section 22(5) imposes on the Secretary of State a duty to "police" the documents rather than merely to act as a depository for them. This contrasts, for example, with documents deposited by a company with the Registrar of Companies under the Companies Act.

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18. Notwithstanding the use in s22(5) of the expression "inaccurate or incomplete in any respect", this can be interpreted in a common sense way to mean "in any material respect". Materiality must, however, be judged not only from the point of view of the supervisor acting on behalf of the Secretary of State but also from the point of view of a shareholder or policyholder who either applies to the company for a copy (section 23 ICA 1982) or inspects the copy on the public record at Companies House (section 65 ICA 1982). Therefore, the Department must communicate with the company to secure the correction of inaccuracies and/or the supply of deficiencies. This must be the case, even though the supervisor, because of his skill and experience, may be able to see through the inaccuracy or deficiency and ascertain the true meaning if there is any risk that a policyholder or shareholder will not be able to do so.

19. There is no legal obligation to take up every trivial error in an annual return, provided we are satisfied that it is indeed trivial and does not hide serious compensating errors. If there is a material inaccuracy or deficiency this must be taken up with the company. All errors in items which are used in solvency tests should be regarded as material unless, or until, the supervisor is satisfied that either they will not affect the results of the solvency test in the current or future years, or effective supervision is possible without the test.

20. Should there be material inaccuracies or deficiencies in a company's returns for earlier years, which were not at the time taken up with the company with a view to them being rectified, we would be in breach of the duty under s22(5). However, an action by a shareholder or policyholder is unlikely to succeed in the absence of damage.

21. The requirement to deposit with the return, in accordance with s22(6), a copy of any report to shareholders or policyholders is not covered by s22(5).

GAD

22. Whilst Insurance Division staff carry out a limited examination of the returns of a long term business company, and of the long term business part of a composite company's return, the detailed examination of long term business returns will be carried out by GAD in accordance with the Concordat which sets out the arrangements made between Insurance Division and GAD (see Appendix 9 of the Examination Manual and Guideline 1.4).

23. Any significant errors or omissions discovered in Insurance Division in relation to long term business must be notified to GAD. Following their initial scrutiny of a return, GAD will advise Insurance Division if it appears that any significant information has not been provided, or if there are significant errors in the information, in order that supervisors may take action under s22(5). If, on detailed examination, GAD identifies further inaccuracies or deficiencies they will agree with Insurance Division who should correspond with the company.

24. A copy of any amended or new material received by Insurance Division in response to a s22(5) request must be sent to GAD if it relates to long term business or to a general business return already sent to GAD. Similarly, GAD will copy to Insurance Division any such material received by them.

EC Aspects

25. None.

On the Record Statements

26. None.

The Precedent Register

27. Provided this Guideline is adhered to, there is unlikely to be a need to take account of any specific precedents, nor is there likely to be a need to copy anything for inclusion in the Register, but do not rule out the possibility in either case.

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Compliance Costs for Companies

28. The need for a company to submit revised or additional material in accordance with section 22(5) is bound to increase its compliance costs. However, an insurance company has an obligation to deposit accurate and complete returns and statements which are required by legislation. Nevertheless, we should only take s22(5) action in respect of material inaccuracies and deficiencies (see paragraph 18 above) and should not abuse our powers in order to "score points" against a company.

Insurance Annual Report

29. To enable publication of details of the exercise of the Secretary of States powers, a record must be kept of the number of occasions on which the power in s22(5) is exercised. Therefore, a central record must be kept in each HEO supervisory unit of each occasion the power is exercised by that unit and a separate record must be kept by the VCU of the occasions on which they exercise the power.

30. For the purpose of recording, and in fact, each approach to a company is a separate exercise of the s22(5) power. This means that where it is necessary to approach a company more than once about the same return, but about different inaccuracies and/or deficiencies, each approach should be recorded as a separate exercise of the s22(5) power. However, if it is necessary to write more than once about the same issue(s), eg to send a reminder or to seek clarification of an earlier response, the subsequent letters should be regarded as part of the original exercise of the s22(5) power and should not be separately counted.

Policy Responsibility

31. Divisional Policy on this issue has not been allocated, but Branch 1 policy issues on s22(5) rest with I1B1 ([redacted]).

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DRAFT SECTION 22(5) LETTER **ANNEX A**

I have considered the return deposited by the above named company under the Insurance Companies Act 1982 in respect of the financial year ended +............ It appears that it suffers from the inaccuracies and/or deficiencies listed in the Annex to this letter.

2. I am writing, therefore, to ask you, in accordance with Section 22(5) of the Act, to correct the inaccuracies and/or to make good the deficiencies by submitting five copies of amended or new forms as necessary.

3. Amended or extra forms deposited in response to this letter must be signed in accordance with Section 22(3) of the Act. Moreover, it will be necessary for the documents to be endorsed by the auditors and signed by them in accordance with Section 22(4) of the Act. You will, therefore, wish to ask the auditors to report on the amended material either by issuing a completely new report under Regulation 27 of The Insurance Companies (Accounts and Statements) Regulations 1983, or a report on the amended material only. If the auditors prefer the former option, their report should, of course, make the position quite clear and include a nullification of their earlier report. If they prefer the latter option, they should include a reference to their earlier report so that the latest one can be read in conjunction with it.

4. I would remind you that the documents constituting the company's response to this letter -

a. will be deposited with the Registrar of Companies pursuant to Section 65(1)(a) of the Act, and,

b. should be supplied to any shareholder or policy holder pursuant to Section 23(1)(b) of the Act.

5. It follows that such documents should be self explanatory at least to the extent of -

a. bearing the name of the company,

b. indicating the fact that they form part of the company's return under the Act,

c. indicating the financial year to which they relate,

d. indicating they are amending/additional documents furnished pursuant to Section 22(5) of the Act, and,

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e. where appropriate, identifying the original documents which are being replaced.

6. Please comply with this letter urgently so that your reply is received by [date 3 weeks after date of letter.]

7. Should you have any queries regarding this letter or the enclosed Annex, please contact the undersigned at the address shown at the head of this letter. *[Any other queries on regulatory matters should continue to be referred to your company's usual contact within Insurance Division].

*[8. Finally, I should make clear that examination of the returns to which this letter relates is not yet complete and the Department may find it necessary to raise other points at a later stage.]

Yours [ ]

Name [ ]
Room [ ]
Insurance Division
Branch [ ]

* Include if appropriate
\+ Insert date

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Guideline 5.4: Correction of Inaccuracies and Supply of Deficiencies – Annex B

DRAFT.SEC

ANNEX B

DRAFT SECTION 22(5) LETTER (WHERE THERE IS DOUBT)

I have considered the return deposited by the above named company under the Insurance Companies Act 1982 in respect of the financial year ended + ...

2. Whilst it is not entirely free from doubt, it appears that the return may suffer from the inaccuracies and/or deficiencies listed in the Annex to this letter. If you agree, I ask you, in accordance with Section 22(5) of the Act, to correct the inaccuracies and/or make good the deficiencies by submitting five copies of amended or new forms as necessary should you not agree I would appreciate a letter of explanation from you.

3. Amended or extra forms deposited in response to this letter must be signed in accordance with Section 22(3) of the Act. Moreover, it will be necessary for the documents to be endorsed by the auditors and signed by them in accordance with Section 22(4) of the Act. You will, therefore, wish to ask the auditors to report on the amended material either by issuing a completely new report under Regulation 27 of The Insurance Companies (Accounts and Statements) Regulations 1983, or a report on the amended material only. If the auditors prefer the former option, their report should, of course, make the position quite clear and include a nullification of their earlier report. If they prefer the latter option, they should include a reference to their earlier report so that the latest one can be read in conjunction with it.

4. Any documents constituting the company's response to this letter in cases where it is accepted that there are inaccuracies and/or discrepancies -

a. will be deposited with the Registrar of Companies pursuant to Section 65(1)(a) of the Act, and,

b. should be supplied to any shareholder or policy holder pursuant to Section 23(1)(b) of the Act.

5. It follows that such documents should be self explanatory at least to the extent of -

a. bearing the name of the company,

b. indicating the fact that they form part of the company's return under the Act,

c. indicating the financial year to which they relate,

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d. indicating they are amending/additional documents furnished pursuant to Section 22(5) of the Act, and,

e. where appropriate, identifying the original documents which are being replaced.

6. Please comply with this letter urgently so that your reply is received by [date 3 weeks after date of letter.]

7. Should you have any queries regarding this letter or the enclosed Annex, please contact the undersigned at the address shown at the head of this letter. *[Any other queries on regulatory matters should continue to be referred to your company's usual contact within Insurance Division].

*[8. Finally, I should make clear that examination of the returns to which this letter relates is not yet complete and the Department may find it necessary to raise other points at a later stage.]

Yours [ ]

Name [ ]
Room [ ]
Insurance Division
Branch [ ]

* Include if appropriate
\+ Insert date

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Guideline 6.2: Valuation of Long-term Liabilities

Guideline 6.2

Valuation of Long-term Liabilities

Synopsis

1. Guidance, in very broad terms, on the valuation of long-term liabilities.

The legislation

2. Section 19 of the 1982 Act requires every company carrying on long-term business to appoint an actuary, within one month of commencing business in respect of a new company and as soon as possible after termination of the previous appointment in respect of an existing company; and to notify the Secretary of State of the appointment, within fourteen days. This post is known as that of the "Appointed Actuary", and is one of the key features of our supervision of life assurance companies.

3. Section 18(1) of the 1982 Act requires the Appointed Actuary to carry out an actuarial valuation of the long-term liabilities of the company every twelve months. When the annual valuation has been carried out, and at other times - that is, when the company has carried out a valuation with a view to making a distribution to its shareholders, or when the results of such valuation are to be made public - an abstract of the actuary's report of his valuation must be made available in the prescribed form.

4. Section 18(3) requires a more detailed statement of a company's long-term business once every five years at the same time as the annual valuation of liabilities for that year is being carried out.

5. The prescribed form for the abstract of the actuary's report is required by Regulation 24 of the Insurance Companies (Accounts and Statements) Regulations 1983 ("the 1983 Regulations") which in turn requires the abstract to follow the form set out in Schedule 4 to the 1983 Regulations -together with Schedule 5 in the case of a five yearly statement required by Section 18(3) of the 1982 Act.

6. Very broadly speaking, the valuation of long-term liabilities involves placing a present day value on the future liabilities of a long-term business company. Under the terms of the 1982 Act, the Appointed Actuary is responsible for this. In carrying out his duties the Appointed Actuary must follow the broad requirements set out in Part VI (Regulations 50 - 64) of the Insurance Companies Regulations 1981 ("the 1981 Regulations"). This part of the 1981 Regulations is couched in very broad terms requiring the Appointed Actuary, inter alia, to determine the long term liabilities "on actuarial principles and to make proper provision for all liabilities "on actuarial principles and to make proper provision for all liabilities on prudent assumptions" [Regulation 54], "to take into account the nature and term of the assets representing the long term fund and to include appropriate provision against the effects of possible future changes in the value of assets" [Regulation 55], and to make provision for meeting the expenses likely to be incurred in future. A brief, but more detailed summary of the principles that have to be observed in the calculation of the technical provisions held for life insurance business by authorised UK companies in their statutory returns has been prepared by the Government Actuary's Department and is at Annex 1.

7. In other words, the regulations do not prescribe precise ways of valuing long term liabilities. The actual amounts to be placed on a company's long term business, therefore, is for the judgement of the Appointed Actuary in the light of his professional knowledge and skills, subject to the criteria set out in the 1981 Regulations and further guided by the professional guidance notes issued by the Institute and Faculty of Actuaries (Guidance Notes GN 1 and GN 8). Copies of these professional guidance notes are attached at Annex 2.

8. In separate letters issued by the Government Actuary to Appointed Actuaries guidance has been given as to the benchmarks against which their individual provisions against AIDS and Resilience will be examined. The former was originally in a letter dated 14 November 1988, which was subsequently updated on 7 December 1989.

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The latter was originally set out in a letter dated 13 November 1985, but has recently been updated in the communication dated 31 July 1992, to which reference is made in paragraph 20 of Annex 1.

9. When he has completed his valuation of long term liabilities the Appointed Actuary must certify, under Regulation 26 of the 1983 Regulations and as specified in Schedule 6 to those Regulations, that proper records have been kept by the company adequate for the purposes of the valuation, that the mathematical reserves shown in the returns (Form 14) constitute proper provision for the long term liabilities, and that the liabilities have been assessed in accordance with Part VI of the 1981 Regulations. He is also required to confirm in his certificate the amount of the required minimum margin applicable to the company's long-term business at the end of the year, as calculated in Form 60.

Exercise of Secretary of State's Functions
10. Advice on the valuation of long-term liabilities must be obtained from GAD by the relevant HEO supervisor. Formal action on behalf of the Secretary of State should always be taken by Insurance Division (based on GAD's advice).

Insurance Division Objective
11. To be satisfied that the valuation of long-term liabilities is in accordance with the 1981 Regulations and is correctly reported in Schedule 4 (together with Schedule 5 where appropriate) of the 1983 regulations. In addition, to be satisfied that the required minimum margin of solvency is covered at all times and that it appears likely that the company will be able to continue to maintain adequate cover for its solvency margin in the future. Advice on this is provided by GAD under the "concordat". However, if GAD advise that the valuation does not meet the provisions of Part VI, action to require the company to take corrective action will ultimately rest with the Department.

Best practice
12. The GAD will advise on best practice, and all matters connected with the determination of long term liabilities must be referred to them.

Implications for our understanding of a company's position
13. The appropriate valuation of a company's long term liabilities is essential to our understanding of its financial position.

Standard Drafts
14. Not applicable in the context of this Guideline.

Conditions to be attached
15. Not applicable.

Legal Advice
16. Although legal advice may be sought on certain aspects, eg enforcement in rare cases where the valuation has been wrongly carried out, the judgement on whether the company is complying with their terms of the Regulations is normally a matter for the GAD.

The Government Actuary's Department
17. GAD's role in advising on the valuation of long term liabilities is paramount.

EC Aspects
18. The 3rd Life Framework Directive sets out broad principles for the determination of long term liabilities. When the Directive is implemented, this Guidance will require to be amended.

On the Record Statements
19. None.

The Precedent Register
20. Not applicable.

Compliance Costs for Companies
21. Clearly there are compliance costs for companies in carrying out actuarial valuations of long-term liabilities but this is a legislative requirement under the terms of the ICA 1982.

Insurance Annual Report
22. Not applicable in the context of this Guideline.

Policy Responsibility
23. With I2, in conjunction with the advice received from the GAD.

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Guideline 6.2: Valuation of Long-term Liabilities – Annex 1

ANNEX 1

Life Insurance Technical Provisions

1. This note has been prepared as a brief summary of the principles that have to be observed in the calculation of the technical provisions held for life insurance business by UK authorised companies in their statutory returns. These provisions must be assessed by a suitably qualified actuary as prescribed by regulations.

2. Although Part VI of the Insurance Companies Regulations 1981 (attached) governs the valuation of the liabilities of insurance undertakings, these regulations are buttressed by Guidance Notes issued by the two actuarial professions in the UK, which are mandatory on the actuary. A departure from those guidance notes can lead to disciplinary action against the actuary, including dismissal from his profession. (The Guidance Notes GN1 and GN8 are also attached).

3. The overriding requirement of the legislation in regard to the determination of the mathematical reserves is that they should be made on actuarial principles making proper provision for all liabilities on prudent assumptions in regard to the relevant factors (ie mortality rates, technical interest rates, expenses, options, morbidity, etc). Please see Regulation 54.

4. There are also certain minimum reserving standards set out in the regulations for most relevant factors. Please see Regulations 55 to 64. However, the fundamental and overriding actuarial principle that requires a prudent assessment of the technical provisions applies to every significant category of business and may impose a higher level of technical provisions on a company than the minimum requirements may imply.

5. It is convenient to analyse separately the following major types of business for which different considerations under the valuation rules are

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required.

1) Class I (non-linked) business and Class IV business with regular premiums.

2) Class I (non-linked) non-profit business with single premiums

3) Class III (linked) business.

1) Non-linked regular premium business

6. The statutory valuation regulations prescribe that a net premium method of valuation shall be adopted for almost all regular premium business in Class I or Class IV. (The exceptions are broadly where the premiums paid in future increase the benefits under a contract by an equivalent amount.) Please see Regulation 57.

7. This means that the actuary will calculate a net premium on the same mortality rates and technical interest rates as adopted for the valuation of each contract. The value of each contract is then taken to be the present value of future benefits less the present value of future net premiums.

Mortality and Disability Bases

8. The mortality and disability rates used for valuation purposes are usually determined on the basis of appropriate mortality and disability tables (eg for assured lives or annuitants, where different considerations apply) based on investigations of the insured lives' experience collected from a large number of UK life offices in recent years, with regard also to the relevant experience of the office writing the business. Some offices are large enough to derive appropriate mortality or disability rates from their own experience, but whether offices are large or small, margins are built into the basis used for reserving purposes. Please see Regulation 60.

9. Actuarial principles require that mortality rates must be adjusted to allow for future improvement of mortality for annuitants and pensioners. For assured lives insured for death or disability benefits, allowance must also be made for the future AIDS risks at a projected level assessed on a

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prudent basis. The Government Actuary has written to appointed actuaries on behalf of the Department of Trade and Industry to indicate the Working Rule which would be applied when analysing the valuations of life insurance companies.

Technical interest rates

10. In the UK, regulations require companies to value their assets largely on a market value basis, and when considering the value of a company's liabilities, the technical interest rate must be assessed with regard to the current yield (in a market value context) on the assets which the company possesses that are deemed to cover each category of business (and, to the extent appropriate, to the yield which it is expected can be earned on sums to be invested in the future). Please see Regulation 59(1).

11. The current yield on the existing assets is taken to be the redemption yield for fixed interest securities (ie including allowance for any amortisation or appreciation of the capital payable on redemption) but otherwise is taken as the running yield eg on equities and properties. Therefore, no allowance can be taken for possible future dividend growth on equities or rental growth on property, or potential increases in the values of those assets, which have represented the major component of their overall investment return in the past. Please see Regulation 59(3) to 59(6). This current yield on existing assets must then be reduced by a 7½% general contingency margin and an appropriate deduction for taxation on future investment income. Please see Regulation 59(2).

12. For regular premium business, there will of course be future premiums and interest income on existing assets to be invested in later years and the rate of return that may be earned on these future investments is uncertain. The statutory regulations, therefore, set a restriction on the maximum rate of future investment return that may be anticipated for investments to be made more than 3 years after the valuation date.

13. After due consideration of the rates of investment return that have been available on UK investments in the past including fixed interest securities and short term deposits, it was decided to set a limit of 7.2% per annum (gross) for this purpose. (In the UK, the yield on Government securities

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has never been below 7.2% for over 20 years). Please see Regulation 59(7).

14. Thus, where sums are to be invested in future, the technical interest rate which can be used for a particular contract will be a weighted blend of the yield on existing assets and the yield which the actuary considers can be earned on future sums invested from three years hence, with the latter limited to 7.2% gross. However, there is a further restriction on the maximum technical interest rate which can be used, and this is the current yield on the existing assets less the 7½% contingency margin and the appropriate deduction for future taxation in investment income. Thus, if current yields, as defined, are lower than 7.2%, no account can be taken of the higher figure in the blended yield when determining the technical interest rate to be used. Please see Regulation 59(8).

15. The restriction on the maximum technical interest rate referred to in para 14 has an important effect on the valuation of with-profits business sold in the UK. Premiums for with-profit business can be significantly higher than their non-profit equivalents, and so insurance companies can invest the premiums with long term considerations of the investment return in mind, with the objective of covering the guaranteed benefits at the maturity date specified in the policy or on earlier death, and also seeking to generate a level of surplus which provides competitive levels of bonuses to with-profit policyholders.

16. Equities, and property investment, have outperformed fixed interest investments significantly in the UK over the recent past, and so insurance companies have matched large proportions of their with-profit business with such investment. However, as only the running yields can be used (see para 11 above) on these investments, this severely restricts the technical rate of interest which can be used. (At the time of writing the yield on the Financial Times Actuaries All Share index is about 5.2%, so if a company were to invest only in equities to match its with-profits business, the maximum technical interest rate which it could use for that business would be about 4.75% for its pensions (gross) business and 3.5% for its life (net) business. In practice, nearly all companies have a mixture of gilts, equities and properties to cover their with-profit business).

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17. Additionally, for with-profit policies (which might account for some 80-90% of the regular premium Class I policies, other than pure term assurances in many offices), the actuary is required to satisfy himself as to the pace of the emergence of surplus, (see GN8 para 2.1.3) and in this he would also take into account the nature of the expected bonus distributions, ie the extent to which the company should declare reversionary or terminal bonuses. This would generally mean valuing the with-profit policies at a relatively lower (ie stronger) technical rate of interest than without-profit policies. (The increase in companies' investment in equities and properties has led to an increasing proportion of a policyholders' final maturity proceeds arising from terminal bonus which is only declared as a final addition to the policy to reflect, broadly, current market conditions at the time).

18. Finally, in regard to technical interest rates, it is appropriate to return to the question of the overriding need for prudence in Regulation 54. In the context of the overseas business of a UK authorised life company, where the policy benefits are specified in the foreign currency, and the liabilities are matched by assets of that country and denominated in that currency, the actuary and the UK supervisor would need to consider afresh the suitability of the 7.2% maximum yield for future investment. This maximum has been set in the context of investment conditions in the UK, and is inappropriate for those countries with lower investment returns. (For countries where investment returns have been higher than in the UK in the past, and where they can be expected to continue higher in the future, the 7.2% maximum yield might be too conservative and need to be reconsidered.)

<u>Mismatching reserves</u>

19. As a further fundamental statutory requirement, the actuary must also take into account the nature and term of the assets and include appropriate provision in his mathematical reserves against the effects of possible future changes in the value of the assets on their adequacy to meet the liabilities. For matching purposes it is very important to consider not only matching by term, but also whether the types of assets

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held (eg equities rather than fixed interest) and their currency are appropriate for the liabilities of the company. Please see Regulation 55.

20. Furthermore, in 1985, the Government Actuary circulated a letter to all appointed actuaries on mismatching and resilience testing indicating the standards, or Working Rule, which he would be applying to the latter in considering the suitability of actuaries' statutory valuations when advising the Department of Trade and Industry on the solvency position of each insurance company. Later, in May 1986, the actuarial profession issued a Temporary Practice Note which supported the Working Rule, which requires consideration to be given to a rise or fall of 25% in the value of equities (and property) and a change of 3% in the yield on fixed interest securities. The Temporary Practice Note has been consolidated into a revised GN8 and whilst the benchmark remains, the onus is now placed on the Appointed Actuary to use his professional judgement in the particular circumstances of his own office and the economic conditions prevailing at the time when the valuation is effected. The Government Actuary issued a letter to Appointed Actuaries in this connection dated 31 July 1992.

21. These additional mismatching reserves reflect the effect of a greater resilience to change in the value of the liabilities compared to the value of the assets when recalculating the net premium valuation reserves in the alternative investment conditions tested against (caused largely because the net premium itself changes when interest rates vary) and has led to increasing pressure from UK insurance companies who feel that the combination of Regulation 59 and Regulation 55 has led to a seriously overstrong reserving basis overall. The actuarial profession is currently researching this point.

<u>Zillmerisation</u>

22. Zillmerisation is a technique (named after a Dr. Zillmer) whereby an addition is made to the valuation net premium in order to represent the initial expenses of writing the policy. Essentially this has the effect of

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spreading (or deferring) acquisition costs over a longer period which might extend to the expected lifetime of each policy.

23. The reserves may be zillmerised to take into account the recovery of the balance of initial expenses from future premiums payable by the policyholder. The value of the zillmer must not be greater than 3½% of the relevant capital sum (normally the sum assured on death) or the total acquisition costs for which allowance is made in the premiums if this is lower. There is also a restriction that the zillmerised net premium must be no greater than the actual premium payable by the policyholder. Please see Regulation 58.

<u>Expenses</u>

24. Under the net premium method of valuation, allowance for future policy maintenance expenses comes mainly from the margin between the actual gross premiums receivable and the assumed valuation net premium. The actuary is required to investigate whether this margin is likely to be adequate to cover the expenses likely to be incurred in fulfilling the existing contracts including the effect of inflation on those expenses. For this purpose, he must have regard to the company's actual expenses in the previous 12 months, and examine the position should the office cease to write new business from the valuation date. As para 3.5 of GN8 states, the transition from a going concern to a closed fund basis can be costly (it may need to include redundancy payments and well as expense overruns while the company closes branch offices etc.) and an additional expense reserve may then be required to supplement the margins in future premiums and any other margins available for expenses. Please see Regulation 61.

<u>Surrenders, options etc.</u>

25. No allowance may be made for future voluntary cessations of policies except where there is an option for policyholders to take some guaranteed cash surrender value or paid-up policy terms. In the case of such options and all other possible options that may be selected by policyholders, provision must be made against any increase in liability that would result

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from policyholders' exercising options under their contracts.

26. In particular, the technical provision must never be less than zero and must be adequate to cover any guaranteed cash payment that could be secured by the policyholder within the next 12 months.

27. In this context, it should be noted that most UK Class I with-profits life insurance policies do not include any guaranteed payment terms on early surrender of the policy. (Policyholders are given illustration at the point of sale of projections of surrender values for their contract type at specified durations, but these do not constitute a guarantee.) The lack of guaranteed surrender values reflects the investment practice of insurance companies for with-profit contracts, as described in para 16. Clearly, if guaranteed surrender values were given, companies would need to invest proportionately more of their assets in deposits and short-term fixed interest securities, at the expense of the long term investment return. Please see Regulations 62 to 64.

2) <u>Non-linked non-profit single premium business</u>

28. For non-profit single premium contracts, a net premium method of valuation is inappropriate as no further premiums are payable. The technical provision is then assessed as the present value of future benefits including allowance for the expenses of fulfilling the contract and any options that may be exercisable by policyholders.

29. The considerations in relation to mortality rates are similar to those for regular premium contracts. For annuities and pensions in payment, an allowance for future improvement in mortality is particularly important.

30. Technical interest rates are assessed in relation to the current yield obtainable from the assets covering each category of business less a 7½% contingency margin. Where some reinvestment of future income may be required (due, perhaps, to the term of assets being shorter than the term of liabilities), the maximum rate of return that may be assumed is 7.2% per annum gross for investment made more than 3 years after the valuation date.

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31. A mismatching test is also applied on this business. In particular, there is a resilience test to ensure that adequate provision is made to cover any shortfall that might occur in the amount of assets available relative to liabilities following a 25% rise or fall in the value of equities or a 3% change in the yield on fixed interest securities. Of course, if the nature and term of the assets are properly matched to the liabilities, then little additional provision would be required for this purpose.

32. Where fully appropriate assets are held to cover single premium liabilities, then the technical rate of interest may be quite close to the current yield on these assets. For example, if the redemption yield on the assets is 12% per annum, then a technical interest rate of almost 12(1 - 0.075) = 11.1% may be adopted, provided that the assets are fully matched to the liabilities. Otherwise , a rather lower technical rate of interest would be required to cover any potential losses arising from mismatching, or from holding investments that include an element of risk that the income from, or the capital value of, the asset may not be received as they fall due. See Regulation 59(6).

33. Deferment of acquisition costs on single premium business would be inappropriate. The required provisions for future maintenance expenses expected to be incurred in fulfilling the contracts and also for options exercisable by policyholders need to be considered in a similar manner to regular premiums business.

3) <u>Class III Linked contracts</u>

34. Under linked contracts issued by life insurance companies, the benefits payable are directly linked to the value of certain assets held by the insurance company including interest income derived therefrom, or to some specified external unit trust or an index of stocks. In each case, it is important for the insurance company to minimise its own investment risk by holding the appropriate assets to which policyholder benefits are linked.

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35. Therefore, the main risk borne by the insurer are those of covering future mortality costs and the expenses associated with fulfilling these contracts, along with any potential liability arising from the exercise of particular options to policyholders or investment performance guarantees that may be included in the contract.

36. As, essentially, all the interest income derived from the assets held by the company to meet these liabilities is applied to increase the policy benefits, and any change in the value of assets is directly reflected in the value of liabilities, there is no particular merit in adopting a net premium method of valuation.

37. Consequently, the technical provisions are calculated as being equal to the unit liability (ie the amount that would normally be paid on encashment of the policy) plus a non-unit reserve often referred to as a 'sterling reserve' assessed as being equal to the present value of future administrative expenses and mortality costs less the margins available to the office from future premiums and fund management charges. The sterling reserve is calculated on discounted cash flow principles on methods and procedures which are well-established in the UK actuarial profession through discussion and papers presented to the professional bodies.

38. The fund management charges are calculated as a proportion (typically 3/4 to 1½ per annum) of the value of assets held in respect of linked contracts. They are intended to cover some of the future expenses of fulfilling these contracts and part of the mortality costs, and broadly represent a hedge against inflation of expenses.

39. There are no detailed regulations at present about the assumptions that should be made in assessing the technical provisions for linked contracts, although an appropriate set of regulations has recently been drafted. Nevertheless, there are now well established actuarial principles governing the valuation of linked contracts, and a general consensus about the parameters to be used in the calculations.

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40. In particular, prudent assumptions must be made about the increase in the value of assets relative to the rate of inflation on future expenses; also consideration must be given to the relative sizes of individual contracts as a large proportion of the expenses incurred will be independent of the size of policy although the margins available for expenses are related to the premiums paid or payable.

Government Actuary's Department

1 October 1992

Issued November 1992 Guideline 6.2

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Guideline 8.1: Intervention Powers, General

Guideline 8.1

Intervention Powers, General

Synopsis

1. A summary of the Secretary of State's powers to intervene in the affairs of insurance companies together with details of the grounds on which these powers may be exercised.

The Legislation

2. The powers of the Secretary of State to intervene in the affairs of insurance companies are contained in Sections 38 to 45 ICA 1982. These are considered in detail in the succeeding parts of this chapter but they may be summarised as follows:

S. 38 - power to require a company to refrain from making, or to realise, specified investments.

S. 39 - power to require a company to maintain assets in the United Kingdom.

S. 40 - power to require assets to be placed in trust.

S. 41 - power to limit a company's premium income.

S. 42 - power to order an actuarial investigation (for a company which carries on long term business).

S. 43 - power to require early provision of accounting information.

S. 44 - power to obtain information and require production of documents.

S. 45 - residual power to impose requirements for the protection of policyholders.

3. The powers are exercisable in respect of companies to which Part 11 of the Act applies, for which see S. 15 ICA 1982. It includes anyone carrying on insurance business in the UK, whether authorised or not, and whether an incorporated body or not. The grounds are set out in S. 37(2) and (3) ICA 1982. A summary of these is as follows:

S. 37(2) - the desirability of protecting policyholders or potential policyholders against the risk that the company will be unable to meet its liabilities or meet the reasonable expectation of long term policyholders.

- failure of the company (or in certain circumstances its parent or a subordinate) to satisfy an obligation under the insurance legislation or an obligation under the law of a Member State giving effect to the general insurance Directives (i.e. the EC Directives making provision in respect of non-life insurance - see S. 96A(1) ICA 1982).

- the provision of misleading or inaccurate information for the purposes of the insurance legislation.

- failure to make adequate reinsurance arrangements.

- the existence of a ground which would prohibit the Secretary of State from authorising the company.

- that there has been a substantial departure from a proposal or forecast submitted by the company in accordance with S. 5 ICA 1982.

- that the company has ceased to be authorised to effect contracts of insurance in a Member State where it has its head office or has made a deposit in accordance with S. 9(2) ICA 1982.

S. 37(3) - the Secretary of State has given and not revoked a direction under S. 11 ICA 1982.

- the company has failed to satisfy an obligation under S. 33, 34 or 35 ICA 1982.

- an account or statement has been submitted which specifies the amount of any liabilities of the company determined otherwise than in accordance with valuation regulations or generally accepted accounting concepts.

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Guideline 8.1: Intervention Powers, General

4. The powers conferred by Sections 38 and 41 to 45 are exercisable on the grounds set out in S. 37(2); the powers conferred by Sections 39 and 40, on the grounds set out in S. 37(3).

5. The powers conferred by S. 44(2) - (4) are also exercisable on the ground that the Secretary of State considers the exercise desirable in the general interest of persons who are or may become policyholders of insurance companies.

6. The powers conferred by Sections 38, 41, 42, 44(1) and 45 are, in addition, by virtue of S. 37(5) ICA 1982 exercisable in relation to an insurance company in respect of which the Secretary of State has issued an authorisation, or in relation to an insurance company of which a person has become a controller within S. 7(4) ICA 1982, if the power is exercised before the expiration of 5 years from the date on which the authorisation was issued, or that person became a controller. Requirements imposed in reliance of S. 37(5) only remain in force for a period of 10 years from the event which gave rise to their imposition.

7. The powers conferred by S. 45 ICA 1982 cannot be exercised unless the Secretary of State considers the purpose of protecting policyholders cannot be appropriately achieved by the exercise of the other powers of intervention, or by the exercise of these powers alone.

8. Before exercising any of the powers on the ground that the Secretary of State would be prohibited from issuing an authorisation because of the unfitness of any person for the position held by him (not being a controller) a preliminary notice must be serviced on that person, and the recipient must be given an opportunity of making representations (S. 46 ICA 1982 refers).

9. S. 47(1) of the ICA 1982 empowers the Secretary of State to rescind or vary a requirement imposed under Sections 38-45. S. 47(2) provides that no requirement imposed on either of the S. 37(5) grounds can be varied after the expiration of a period of five years following the date of the authorisation or the date of the change of control, as the case may be. Sections 47(3)(4) and (5) set out the procedures to be followed if a requirement imposed under S. 40 is rescinded or varied.

10. The Secretary of State has separate powers to withdraw a company's authorisation (S.11/12) and to object to a change of controller (S. 60-62). For specific guidance in such situations you should refer to Guidelines 2.5 and 4.4 respectively.

Exercise of Secretary of State's Functions

11. Requirements imposed under Sections 38 to 45 ICA 1982 should not be signed at a level below Grade 7.

Insurance Division Objective

12. To ensure that the Secretary of State's powers of intervention are exercised whenever it is necessary for the protection of policyholders, without companies being subject to unnecessary restrictions.

Best Practice

13. Requirements are imposed on a company because some aspect of its affairs is causing concern or, more routinely, because the company is newly authorised, re-authorised or there has been a change of controller. It should always be borne in mind that requirements are restrictive and may be costly for a company to comply with, and for the Department to supervise. Although they should not be imposed unnecessarily, requirements should always be imposed in proper cases, and Ministers are content for officers to apply such powers robustly.

14. Companies are at their most vulnerable during their early years, and for that reason it is the Department's practice to use the imposition of requirements to strengthen its control during this period. The decision on the precise requirements to be imposed is taken by Branch 1A (or 2A in the case of life business) after consultation with the company, who will be provided with a draft of the notice for comment.

15. When deciding what requirements are necessary regard can be had to the standard requirements. However, these requirements should not all be imposed as a matter of course. The aim should be that broadly similar

Issued October 1992 — Guideline 8.1

DTI's policy guidance notes (1991)

Guideline 8.1: Intervention Powers, General

4. The powers conferred by Sections 38 and 41 to 45 are exercisable on the grounds set out in S. 37(2); the powers conferred by Sections 39 and 40, on the grounds set out in S. 37(3).

5. The powers conferred by S. 44(2) - (4) are also exercisable on the ground that the Secretary of State considers the exercise desirable in the general interest of persons who are or may become policyholders of insurance companies.

6. The powers conferred by Sections 38, 41, 42, 44(1) and 45 are, in addition, by virtue of S. 37(5) ICA 1982 exercisable in relation to an insurance company in respect of which the Secretary of State has issued an authorisation, or in relation to an insurance company of which a person has become a controller within S. 7(4) ICA 1982, if the power is exercised before the expiration of 5 years from the date on which the authorisation was issued, or that person became a controller. Requirements imposed in reliance of S. 37(5) only remain in force for a period of 10 years from the event which gave rise to their imposition.

7. The powers conferred by S. 45 ICA 1982 cannot be exercised unless the Secretary of State considers the purpose of protecting policyholders cannot be appropriately achieved by the exercise of the other powers of intervention, or by the exercise of these powers alone.

8. Before exercising any of the powers on the ground that the Secretary of State would be prohibited from issuing an authorisation because of the unfitness of any person for the position held by him (not being a controller) a preliminary notice must be serviced on that person, and the recipient must be given an opportunity of making representations (S. 46 ICA 1982 refers).

9. S. 47(1) of the ICA 1982 empowers the Secretary of State to rescind or vary a requirement imposed under Sections 38-45. S. 47(2) provides that no requirement imposed on either of the S. 37(5) grounds can be varied after the expiration of a period of five years following the date of the authorisation or the date of the change of control, as the case may be. Sections 47(3)(4) and (5) set out the procedures to be followed if a requirement imposed under S. 40 is rescinded or varied.

10. The Secretary of State has separate powers to withdraw a company's authorisation (S.11/12) and to object to a change of controller (S. 60-62). For specific guidance in such situations you should refer to Guidelines 2.5 and 4.4 respectively.

Exercise of Secretary of State's Functions

11. Requirements imposed under Sections 38 to 45 ICA 1982 should not be signed at a level below Grade 7.

Insurance Division Objective

12. To ensure that the Secretary of State's powers of intervention are exercised whenever it is necessary for the protection of policyholders, without companies being subject to unnecessary restrictions.

Best Practice

13. Requirements are imposed on a company because some aspect of its affairs is causing concern or, more routinely, because the company is newly authorised, re-authorised or there has been a change of controller. It should always be borne in mind that requirements are restrictive and may be costly for a company to comply with, and for the Department to supervise. Although they should not be imposed unnecessarily, requirements should always be imposed in proper cases, and Ministers are content for officers to apply such powers robustly.

14. Companies are at their most vulnerable during their early years, and for that reason it is the Department's practice to use the imposition of requirements to strengthen its control during this period. The decision on the precise requirements to be imposed is taken by Branch 1A (or 2A in the case of life business) after consultation with the company, who will be provided with a draft of the notice for comment.

15. When deciding what requirements are necessary regard can be had to the standard requirements. However, these requirements should not all be imposed as a matter of course. The aim should be that broadly similar

Issued October 1992 **Guideline 8.1**

DTI's policy guidance notes (1991)

Guideline 8.1: Intervention Powers, General

requirements should be imposed in broadly similar circumstances, but if it is believed that certain requirements can be dispensed with without detriment to the interests of policyholders, they should not be imposed. Conversely, in certain circumstances, additional non-standard requirements should be imposed.

16. Particular occasion for a departure from the standard form may arise with new subsidiaries of established companies, especially life companies, where tax and other considerations may influence corporate structure. More generally a corporate restructuring may lead to non-standard requirements, when for example a demutualisation by means of the establishment of a new company and a S. 49 transfer can often be treated for practical purposes as a continuation of the previous company, rather than as a new authorisation, which is the legal reality.

17. The decision to impose requirements on the change of controller is, in the first instance, a matter for the supervisor. It is usual to impose some requirements but their nature will depend on the circumstances of the company concerned, the standing of the new controller and his plans for the development of the company's business and the dangers which could result from the change of control. The company should be given the opportunity of commenting on the notice of requirements in draft.

18. The imposition of requirements other than on authorisation or change of control is a delicate matter; the failure to impose requirements at the appropriate time can result in policyholders suffering an avoidable detriment; the imposition of unnecessary or inappropriate requirements can exacerbate a company's difficulties.

19. If a company is giving cause for concern, whether because of failure to satisfy an obligation or otherwise then the matter would be reported to the Grade 7 supervisor as a matter of course. It should then be established whether there are grounds for imposing requirements, whether it is necessary and desirable to impose requirements and which requirements should be imposed.

20. Consideration should be given to whether the company should be approached before the requirements are imposed. There will be circumstances when the urgency of the situation will preclude prior negotiation with the company.

21. A more comprehensive note about our Powers of Intervention has been prepared for training purposes by [redacted] (I1B). Copies of that note can be made available on request.

Standard Drafts

22. Standard drafts are included in the appropriate sections of this chapter.

Legal Advice

23. Much of the guidance in this Guideline is based on the advice of Sols. B1. However, if requirements are being imposed other than in pursuance of S. 37(5) ICA 1982, the requirements should be cleared with Sols. B1 before being served on the company.

24. Not all the powers to impose requirements are exercisable on the same grounds. It is, therefore, vitally important to check that proper grounds exist before a requirement is imposed.

25. Great care should be taken before purporting to exercise the power contained in S. 45 ICA 1982. These powers cannot be exercised if the purpose of protecting the policyholder can be achieved by the exercise of the powers contained in Sections 38 to 44 ICA 1982.

26. Because of possible legal difficulties, Sols B1 should be consulted particularly if it is intended to use S. 45 to impose a "stop order" on a company.

GAD

27. GAD should be consulted on areas where it is known they have expertise or where their advice has been found useful in the past. GAD should always be consulted when it is proposed to serve requirements on companies carrying on long term business, and on general business companies with which it has recently been involved.

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DTI's policy guidance notes (1991)

Guideline 8.1: Intervention Powers, General

EC Aspects

28. The restriction contained in S. 37(3) ICA 1982 relating to the power to interfere with the company's disposal of its assets was required to bring the ICA 1982 in line with the EEC directives.

29. The grounds on which the Secretary of State may take action were extended to include a failure by the company to satisfy an obligation under the law of another Member State giving effect to the general insurance Directives as part of the implementation of the second Non-Life Directive. They will be further extended to cover corresponding obligations arising from the EC life insurance Directives as part of the implementation of the second Life Directive. Further changes in the area covered by the Guideline will be necessary when the third Directives are brought into force.

On the Record Statements

30. None.

The Precedent Register

31. In cases where unusual requirements have been imposed, eg dividend control or financial guarantee companies needing to report rating agency status, details should be notified to the precedent register for future reference.

Insurance Annual Report

32. The number of times the Secretary of State exercised his powers of intervention must be recorded in the Insurance Annual Report. In addition, in respect of a company in liquidation, or in financial difficulties, the Secretary of State must lay before Parliament a statement with respect to the exercise of his powers in relation to that company. s. 28 Policyholders Protection Act 1975.

Policy Responsibility

33. Divisional Policy on this issue has been allocated to I1B.

Issued October 1992 — Guideline 8.1

DTI’s policy guidance notes (1991)

Guideline 8.2: Notice of Requirements

Guideline 8.2

Notice of Requirements

Synopsis
1. Matters relevant to Notices of Requirements generally.

The Legislation
2. Ss. 38 to 45 ICA 1982 provide that the Secretary of State may require a company to take certain action or refrain from certain action. The grounds on which he may issue such requirements are contained in s. 37 ICA 1982 and guidance on this is found in Guideline 8.1. Guidance on the specific requirements set out in Ss. 38 to 45 may be found in Guidelines 8.3 to 8.9.

3. If appropriate grounds exist, the powers of intervention are exercisable in relation to any insurance company to which Part II of the ICA 1982 applies. S. 15 ICA 1982 provides that Part II applies to all insurance companies, whether established within or outside the United Kingdom, which carry on insurance business within the United Kingdom. The section then provides that it does not apply to friendly societies, trade unions and employers’ associations where the business is limited to the provision of provident benefits and strike benefits for their members, members of Lloyd’s complying with S. 83 ICA 1982 and persons whose only insurance business is general business class 14, 15, 16, 17 or 18 carried on in the course of banking business.

4. S. 15(6) ICA 1982 provides that Part II does not apply to an insurance company whose insurance business is restricted to general business consisting in the effecting and carrying out of contracts of such descriptions as may be prescribed, being contracts under which the benefits provided by the insurer are exclusively benefits in kind. Regulation 23 Insurance Companies Regulations 1981 prescribes certain contracts covering vehicle breakdown assistance for the purposes of this section.

5. An insurance company is defined by S. 96(1) ICA 1982 as “~~arson~~ person or body of persons (whether incorporated or not) carrying on insurance business.” There is no definition of insurance business although S. 95 ICA 1982 deals with certain borderline cases which it makes clear are within the meaning of the term.

6. S. 47(1) ICA 1982 provides that the Secretary of State may rescind a requirement imposed if it appears to him that it is no longer necessary for the requirement to remain in force and he may from time to time vary any such requirement. If a requirement is imposed by virtue of S. 37(5) ICA 1982 it cannot be varied after the expiration of 5 years except in a manner which relaxes the requirement.

7. Before a Notice of Requirement is served on the grounds that the Secretary of State would be prohibited from issuing an authorisation because of the unfitness of a person for the position held by him, then notice must be given to that person pursuant to S. 46 ICA 1982 that the Secretary of State is considering the exercise of these powers and the person on whom the notice is served must be given an opportunity to make representations.

8. S. 37(7) ICA 1982 provides that when exercising any power under Ss. 38 to 45, the Secretary of State shall state the ground on which he is exercising it or, if he is exercising it by virtue of S. 37(5) that he is so exercising it.

9. By S. 70 ICA 1982, a notice served under this section may be served by post and a letter containing that notice shall be deemed to be properly addressed if it is addressed to that person at his last known residence or last known place of business in the United Kingdom.

10. A failure to comply with a Notice of Requirements is made a criminal offence by virtue of S. 73 ICA 1982. A director, chief executive, manager, secretary or other officer may be guilty of an offence, as well as the company, by virtue of S. 91 ICA 1982.

Exercise of Secretary of State’s Functions
11. A Notice of Requirements should not be signed by a grade below Grade 7. A decision to prosecute for failure to comply with a Notice of Requirements should not be made by a grade below Grade 5.

Issued July 1992 **Guideline 8.2**

DTI's policy guidance notes (1991)

Guideline 8.2: Notice of Requirements

Insurance Division Objective

12. To ensure that the intervention powers of the Secretary of State are used when it is necessary for protecting the interests of policyholders but are not used in such a way as to unnecessarily restrict the operation of an insurance company.

Best Practice

13. In considering whether a Notice of Requirements should be served on an insurance company, regard should be had to the Guidelines contained in Chapter 8.1 dealing with grounds for intervention. Guidance on specific requirements is contained in parts 8.3 to 8.9 and these should be studied before these requirements are imposed.

14. A "top and tail" Notice of Requirements is at Annex A. It should be unnecessary to depart from this format. If for any reason it is thought that this format is inappropriate then Sols B1 should be consulted.

15. The specimen requirements set out in the annexes to parts 8.3 to 8.9 will usually be appropriate. However, when a decision has been made to impose a requirement the officer responsible must be clear in his or her mind as to the precise result it is intended to achieve and must be satisfied that the proposed requirement will, indeed, achieve this result.

16. Although care should be taken in drafting requirements, it should be borne in mind that they are not Statutory Instruments. It is Insurance Division who should be the masters, not the wording of the requirements. If an insurance company purports to interpret a requirement in a way that is not intended, they should be informed that this is not the correct interpretation. If they refuse to accept the Division's interpretation then Sols. B1 should be consulted with a view to the requirement being varied.

17. Whenever possible an insurance company should be informed in advance of requirements it is intended to impose and their comments invited. This may not be possible in cases of urgency and should not be done if this will result in an increased risk to policyholders.

Standard Drafts

18. A standard "top and tail" draft is annexed to this Guideline. Specimen forms of particular requirements are annexed to parts 8.3 to 8.9.

Legal Advice

19. Much of this Guideline is based on legal advice. In considering the imposition of requirements, regard should be had to the legal advice in the other parts of this chapter.

20. A Notice of Requirements should be served on a company at its registered office which is not necessarily its place of business. If service is effected other than at the registered office, confirmation should be obtained that the company has accepted service. If service is effected on the company's solicitors they should be asked to acknowledge service on behalf of their client.

GAD

21. GAD should always be consulted when it is intended to serve a Notice of Requirements on a company carrying on long term business or on a general business company with which they have had recent dealings. More generally it is advisable that GAD be consulted on areas where it is known they have expertise or where, their advice has been found useful in the past.

EC Aspects

22. There are no EC aspects directly related to this Guideline.

On The Record Statements

23. None.

The Precedent Register

24. It is important that officers dealing with a company are aware of any action that has been taken in past cases of a similar nature, and the reasons for such action. To this end, any advice received on particular cases, and the background to any decisions taken, should be copied to I1B for inclusion on The Precedent Register.

Insurance Annual Report

25. To enable publication of details of the exercise of the Secretary of State's powers, a record must be kept of the number of occasions on which the powers exercised in Ss. 38 to 45 ICA 1982 have been used. A pro forma is provided as an annex to this Guideline.

Issued July 1992 **Guideline 8.2**

DTI's policy guidance notes (1991)

Guideline 8.5: Premium Income Limitation

Guideline 8.5

Premium Income Limitation

Synopsis

1. Guidance on the exercise of the Secretary of State's powers to require an insurance company to limit its premium income.

The Legislation

2. Section 41(1)(a) of the ICA 1982 provides that the Secretary of State may require a company to take all such steps as are requisite to secure that the aggregate of the premiums to be received by the company in consideration of the undertaking by it during a specified period of liabilities in the course of carrying on general business or any specified part of such business shall not exceed a specified amount.

3. Section 41(1)(b) provides that the Secretary of State may require a company to take all such steps as are requisite to secure that the aggregate of the premiums to be received by it in a specified period in consideration of the undertaking by the company during that period of liabilities in the course of carrying long term business, or any specified part of that business, shall not exceed a specified amount.

4. Section 41(2) provides that a requirement under Section 41 may apply either to the aggregate premiums to be received or to the aggregate of those premiums after deducting any premiums payable by the company for reinsuring the liabilities in consideration of which the premiums were received.

Exercise of Secretary of State's Functions

5. A decision to impose a requirement limiting a company's premium income must not be made below Grade 7.

Insurance Division Objective

6. To limit the risk of a company becoming insolvent in the future by controlling its rate of expansion.

Best Practice

7. The power to impose a requirement under Section 41 is exercisable on the grounds specified in Section 37 ICA 1982. If it is intended to impose such a requirement, regard should be had to the guidance on grounds for intervention and notice of requirements set out in Guidelines 8.1 and 8.2.

8. A requirement under this section can be imposed on authorisation, or subsequently. A premium income limitation on grant of authorisation will be in accordance with the business plan and it is unnecessary to deal with it further in this guideline.

9. The power to issue a requirement limiting a company's premium income is one of the powers vested in the Secretary of State to enable him to take action where there does not appear to be any doubt that the company is solvent, but there is a risk that it may become insolvent unless corrective action is taken.

10. It is not possible to set out exclusively all the circumstances which can result in the Secretary of State properly reaching a conclusion that it is desirable for protecting policyholders that this power should be used. The whole circumstances of the company must be taken into account. If there is a change of control then consideration should be given to imposing a requirement under this section. The power to impose a requirement in these circumstances is set out in Section 37(5) ICA 1982.

11. It may also be the case that the company has breached the solvency requirements or otherwise failed to satisfy an obligation to which it is subject by virtue of the ICA 1982. In this case, grounds will exist on which the Secretary of State can direct that it shall cease to be authorised to effect contracts of insurance.

12. In exceptional circumstance it may be necessary to make a decision whether it is in the interests of policyholders to cut off completely its source of new income. If this situation arises, the matter should be referred to the appropriate Grade 5.

13. When imposing a requirement the following factors should be borne in mind. First, the limitation in Section 41(1)(b) has been redefined so as to relate only to the premiums receivable during the specified

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Guideline 8.5: Premium Income Limitation

period, not to the premiums receivable during the whole term (which could be 20 years or more) under contracts entered into during the period.

14. There is no obligation to defer the coming into operation of the requirement. Nevertheless, consideration should be given to a possible deferment. A company may need to decide how best to effect the limitation and notify any intermediaries authorised to effect risks on its behalf. In other cases, however, the Department may have to act quickly in order to prevent the company stepping up new business before cutting back.

15. It is possible to impose a requirement in which the maximum permitted premiums receivable are expressed to be net of reinsurance. Obviously, regard must be had to the adequacy of the company's reinsurance arrangements.

16. It is possible to draft a requirement imposing a premium income limitation, not in respect of the whole of the company's business, but in respect of a specified part of the company's business.

Implication for our Understanding of the Company's Position
17. Not strictly relevant in the context of this guideline. The company's position should be understood before imposing the requirement.

Standard Drafts
18. Standard Drafts are attached at Annexes A and B.

Conditions to be Attached
19. Not relevant in the context of this guideline.

Legal Advice
20. A requirement under this section should not be used to achieve results which are properly achieved by the use of other sections of the legislation. In particular, it should not be used as a method of stopping the company writing any new business by reducing its premium income in a specified period to zero.

21. Section 41 has been drafted differently in respect of long term business and general business. In respect of general business the limitation is on the aggregate of premiums to be received in respect of business written during a specified period. For example, there could be a limitation of £X worth of premiums to be received in respect of business written during 1992. It does not matter whether the premiums are received in 1992. The company must take all such steps as are requisite to secure that the amount of premiums they will receive (whenever it may be) in respect of the business written in 1992 does not exceed £X.

GAD
22. The advice of GAD should always be sought when it is intended to impose a requirement under this section on a company carrying on long term business. They should also be consulted in respect of non-life companies with which they have had recent dealings and whenever their expertise is likely to be of assistance.

EC Aspects
23. No specific EC aspects.

On the Record Statements
24. None.

The Precedent Register
25. The Precedent Register can be consulted with respect to requirements imposed under this section on other companies. It should be used in conjunction with the drafts annexed to this guideline.

Insurance Annual Report
26. A record must be maintained of the occasions on which this power has been exercised for inclusion in the annual report.
Policy Responsibility

27. Divisional responsibility for this issue has not been allocated.

Issued October 1992 — Guideline 8.5

DTI's policy guidance notes (1991)

Guideline 8.6: Actuarial Investigations

Guideline 8.6

Actuarial Investigations

Synopsis

1. Guidance on the circumstances in which the Secretary of State may require a company to have an actuarial investigation carried out.

The Legislation

2. Section 42(1) ICA 1982 provides that the Secretary of State may require a company which carries on long term business (a) to cause its appointed actuary to make an investigation into its financial condition in respect of that business, or any specified part of that business, as at a specified date (b) to cause an abstract of the actuary's report to be made and (c) to prepare a statement of its long term business, or of that part thereof, as at the specified date.

3. Section 42(2) ICA 1982 provides that for the purposes of the investigation, the value of any assets and the amount of any liabilities shall be determined in accordance with applicable valuation regulations.

4. Section 42(3) ICA 1982 provides that the form and contents of any abstract or statement shall be the same as for any abstract or statement made under section 18 and the provision of section 18(2) shall apply in the same way as it applies to an investigation to which section 18(1)(b) relates. By section 42(4) ICA 1982, five copies of the abstract or statement must be deposited with the Secretary of State on or before the specified date and one of the copies must be signed by the persons required to sign copies of abstracts or statements made under section 18.

5. For provisions as to "appointed actuary" regard should be had to section 19 ICA 1982. "Long term business" is defined in section 1 ICA 1982.

6. Section 42 relates only to long term business. There is no equivalent provision in respect of general business. If an actuarial investigation is required into a company's general business, the more general powers conferred by sections 44(1) and/or s45(1) may be invoked. Before such a requirement is imposed legal advice must be obtained.

Exercise of Secretary of State's functions

7. A decision to require an actuarial investigation should not be made at below Grade 7 level.

Insurance Division objective

8. To ascertain the financial condition of a company's long term business and the adequacy of a company's general business reserves.

Best practice

Long term business

9. The power to impose a requirement under this section is exercisable on the grounds specified in section 37, ICA 1982. If it is intended to impose such a requirement, regard should be had to the guidance on grounds for intervention and notice of requirements set out in guidelines 8.1 and 8.2.

10. This power was introduced by the Insurance Companies (Amendment) Act 1973 at a time when carrying out an actuarial investigation every year was optional. Although it is now a requirement

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Guideline 8.6: Actuarial Investigations

that actuarial investigations be carried out annually, this power can be used to require an actuarial investigation after a period of less than a year from the investigation, if it is thought desirable.

11. When imposing the requirement, consideration should be given as to whether it is necessary to require the investigation into the whole of the company's long term business or only a specified part of that business. For example, it is permissible to order an investigation into its business in a particular country.

12. It is necessary, in the requirement, to specify the date at which the financial condition is to be ascertained and, also, to specify the date by which the copies of the abstract or statement are to be delivered. The latter date should give the company a reasonable period in which to have the investigation completed but it is possible to vary the requirement under section 47 ICA 1982 so as to give the company an extension if necessary.

13. When an investigation into the whole of the company's long-term business is required at a date other than the standard year-end for that company, GAD will advise what information is required in addition to Schedule 4. Normally this will include, as a minimum, forms 9,10,13,14,15,43,45 and 46, but each case will be separately considered in the light of the special circumstances prevailing.

General business

14. The power to impose a requirement for an actuarial investigation of a company's general business under section 44(1) and/or s45(1) is exercisable on the grounds specified in section 37, ICA 1982. If it is intended to impose such a requirement, regard should be had to the guidance on grounds for intervention and notice of requirements set out in guidelines 8.1 and 8.2.

15. The decision to impose such a requirement will normally be the culmination of considerable discussion with the company on the adequacy of its general business reserves. The genesis of our concern is usually where an examination of the annual return indicates that there are or may be putative underprovisions. However sometimes our concern arises because we are unable to form a view as to the strength of the provisions, e.g. latent claims and where such provisions are material in the context of the company as a whole. The first step is to write to the company, after consultation with GAD or the Division's Actuarial Adviser, saying that our examination of the return indicates that they may be underreserved in one or more classes and asking for their comments. The company's reply may satisfy us, either because the information makes it clear that the basis on which we reached our view of underprovisioning is not an appropriate one for the company's circumstances or because the company has since increased their reserves to a more realistic level.

16. It is more likely however that the company will refute our suggestion that they are inadequately reserved and further correspondence and/or meetings may ensue. GAD should be involved fully at every step in the discussions. If the company are unable to allay our concerns, we should, subject to GAD's advice, consider the imposition of a requirement for an actuarial investigation into the company's general business reserves. GAD should be asked to advise on the terms of reference (i.e. what the investigation should cover) to be appear in the requirement. It is of course necessary to ensure that an adequate ground under section 37 exists, but given the wide ground of s37(2)(a) this is not

DTI's policy guidance notes (1991)

Guideline 8.6: Actuarial Investigations

likely to be problematic. Nevertheless, the advice of Sols B as well as GAD should be obtained before imposing a requirement for an actuarial investigation of general business reserves.

Implication for our understanding of a company's position

17. This power will be used when it is thought desirable to ascertain the financial condition of a company's long term business (or part) in advance of the section 18 investigation, or to ascertain whether a company's general business reserves are adequate. The implications are self-evident.

Standard drafts

18. Standard drafts are annexed to this guideline. It should however be borne in mind that the terms of reference for general business actuarial investigations will need to be tailored to suit the particular circumstances of the company

Conditions to be attached

19. Not relevant in the context of this guideline.

Legal advice

20. This is covered by para 6 above.

GAD

21. The advice of GAD should always be sought when it is proposed to impose an actuarial investigation requirement, whether in respect of long term or general business.

EC aspects

22. There are no specific EC aspects.

On the record statements

23. None

The precedent register

24. Not relevant in the context of this guideline.

Compliance cost for companies

25. A requirement under this section will result in a company incurring considerable costs. It may be possible to lessen the impact by specifying a date which fits in with work already done but this is unlikely to be the prime consideration.

Insurance annual report

26. A record must be maintained of the occasions on which these powers have been exercised for inclusion in the annual report.

Policy responsibility

27. Divisional responsibility has not been allocated.

Issued December 1993 Guideline 8.6

DTI's policy guidance notes (1991)

Guideline 8.7: Acceleration of Annual Returns

Guideline 8.7

Acceleration of Annual Returns

Synopsis

1. Guidance on the power of the Secretary of State to require a company to deposit returns earlier than is specified in the legislation.

The legislation

2. Section 43(1) ICA 1982 provides that the Secretary of State may require that any documents which under section 22 are required to be deposited with him within the period specified in that section, be deposited with him on or before a specified date before the end of that period.

3. The specified date must not be earlier than three months before the end of that period and not earlier than one month after the date on which the requirement is imposed. For example, if a company's financial year is the calendar year, deposit of returns is normally required by 30 June the following year. This can be brought forward to 31 March at the earliest provided the notice of requirement is served by 28 February.

4. Section 43(2) provides that the Secretary of State may require any statement which under section 25 ICA 1982 (Periodic statements by a company with a prescribed class of business) is required to be deposited with him within a prescribed period be deposited with him in or before a specified date before the end of the period.

5. As at the date of this Guideline, no regulations have been made pursuant to section 25 ICA 1982.

Exercise of Secretary of State's Functions

6. A decision to impose a requirement under this section should not be made at below Grade 7 level.

Insurance Division Objective

7. To ensure that the Division has up to date information regarding companies whose financial position may be deteriorating.

Best Practice

8. The power to impose a requirement under this section is exercisable on one or more of the grounds specified in section 37 ICA 1982. If it is intended to impose such a requirement, regard should be had to the guidance on grounds for intervention and notice of requirements set out in Guidelines 8.1 and 8.2.

9. It is essential for supervisory purposes that the Division is aware of a company's financial position. The provisions of the ICA 1982 dealing with accounts and statements mean that the Department is made aware of a company's financial position on an annual basis. If there is any reason to suspect that there has been a deterioration, consideration should be given to imposing a requirement under this section.

10. There are other circumstances in which it would be appropriate to consider requiring accelerated returns, namely tardiness in submitting returns and errors in returns.

11. In the case of tardiness, a section 43(1) requirement will focus the company's mind on the need to put proper systems in place to gather the

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Guideline 8.7: Acceleration of Annual Returns

information, rather than to create records in arrears. Even if the company cannot meet the requirement it is still likely that the returns will be received earlier than would otherwise be the case and it is more likely that they will be received in time to be useful. Accelerated returns also yield an advantage to supervisors, as it will be possible to examine them before the end June flood (assuming the company has a December year end) descends, thus allowing supervisors to concentrate on the company at a time of relatively low examination activity.

12. In the case of errors, again it will encourage the need for proper systems. If the errors are repeated then earlier receipt of the return will in part compensate for the delays caused by the time taken to resolve the errors. In some cases errors will give rise to uncertainty about the position of the company and uncertainty is itself a reason for wanting more information about the company.

13. When considering the exercise of this power, supervisors must be satisfied that a ground exists under section 37 of the ICA 1982 and that the requirement is not being imposed merely to "punish" the company. However, given the fairly wide grounds specified in section 37 this should not in practice present much of a problem. It is invariably the case that a company which is getting into financial difficulty is also more prone to (for example) breach the Act. This power has probably been used too sparingly in the past and supervisors should get into the habit of considering its imposition in respect of companies who are getting into financial difficulties or where their financial health appears uncertain.

Implication for our understanding of the company's position
14. This is self-evident from the above.

Standard drafts
15. A standard draft is annexed to this guideline.

Conditions to be attached
16. Not relevant in the context of this guideline.

Legal advice
17. Covered in para 13 above.

GAD
18. GAD should always be consulted if it is intended to impose a requirement under this section on a company carrying on long term business. They should also be consulted in respect of non-life companies with which they have had recent dealings.

EC Aspects
19. There are no specific EC aspects.

On the record statements
20. None.

The Precedent Register
21. The papers which set out the circumstances leading to the imposition of a s43(1) requirement should be copied to I1B for the Precedent Register.

Compliance cost for companies
22. Although the imposition of a requirement under this section may result in a company incurring further costs, it is unlikely to be a material consideration having regard to the reason for the imposition of the requirement.

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Guideline 8.7: Acceleration of Annual Returns

Insurance annual report

23. A record must be maintained of the occasions on which this power has been exercised, for inclusion in the annual report.

Policy responsibility

24. Divisional responsibility has been allocated to [redacted]

DTI's policy guidance notes (1991)

Guideline 8.8: Obtaining Information

Guideline 8.8

Obtaining Information

Synopsis
1. Guidance on the powers of the Secretary of State to require a company or other body to provide information.

The Legislation
2. Section 44(1) ICA 1982 provides that the Secretary of State may require a company to furnish him, at specified times or intervals, with information about specified matters. This requirement can be extended to requiring the information be verified in such manner as may be specified.

3. Section 44(2) ICA 1982 provides that the Secretary of State may (a) require a company to produce specified documents at a specified time and place or (b) authorise any person to require a company to produce forthwith any documents which that person may specify.

4. Section 44(3) ICA 1982 extends the power to require production of documents from a company to requiring the documents from any person who appears to be in possession of them, subject to rights of lien.

5. By Section 44(4) the power to require production of documents includes the power to take copies and demand explanations of them from any person who is a present or past director, controller or auditor of, or is or was at any time employed by the company in question. Any statement made by a person in pursuance of a requirement under this Section may be used in evidence against him.

6. Section 44A ICA 1982 makes provision for a justice of the peace to issue a search warrant if he is satisfied that there are, on any premises, documents whose production has been required under Section 44(2) to (4) but which have not been produced.

Exercise of Secretary of State's Functions
7. A decision to require information about specified matters under Section 44(1) should not be made a level below grade 7. A decision to require production of specified documents may be made at grade 7 but a decision to authorise a person to require production of documents, to him, should be made at grade 5 level. A decision to apply to a magistrate for a search warrant should be made by a grade 5, but the information will be given by the person authorised to require the production of the documents.

Insurance Division Objective
8. To ensure that the Division is fully informed of a company's financial affairs or other aspects of its activities giving cause for concern.

Best Practice
9. The grounds for exercising powers under this Section are contained in Section 37 ICA 1982 and regard should be had to the guidance contained in Guidelines 8.1 and 8.2 dealing with grounds for intervention and notice of requirements.

10. It should be particularly noted that the powers contained in Section 44(2)-(4) ICA 1982 may be exercised on the grounds that the Secretary of State considers the exercise of the power to be desirable in the general interests of persons who are or may become policyholders of insurance companies to which Part 11 ICA 1982 applies.

11. A distinction should be made between Section 44(1) ICA 1982 and Sections 44(2)-(4). Section 44(1) is a requirement that a company provide information about specified matters. It replaced a power used on authorisation when future insolvency was not foreseen. It can now be used when a constant check is required on certain aspects of a company's affairs.

12. The powers contained in Sections 44(2)-(4) are in the nature of investigatory powers and are based on powers contained in the Companies Acts. These powers are wider than the Insurance Companies Acts powers in that they can be used against an unincorporated body carrying on insurance business. Furthermore, the powers are not limited to authorised insurers and can be used in respect of a company which is carrying on business without authorisation.

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Guideline 8.8: Obtaining Information

13. The power to authorise a person to require production of documents is not limited to officers of the Department. Consideration should be given, in appropriate cases, to granting authorisation to outside experts, particularly GAD.

14. It is likely that use of the investigatory powers will be made in conjunction with Investigations Division and consideration should always be given to appointing an officer from Investigations Division to exercise the authority either alone or with an officer from Insurance Division. In these circumstances, it should be considered whether ICA or Companies Acts powers are the most appropriate.

15. In deciding the composition and the level of the team to undertake the investigation we should take into account the extent of our concern and the potential implications for policyholders. We should also try and ascertain whether there exists validation of those concerns or corroboration of any allegations which may have been made. It may be that in the case of a small scale and relatively simple investigation of a company with limited business exposure (eg a small hospital scheme), it would be appropriate for an individual officer to undertake the inspection, whether from Insurance Division, Investigations Division or GAD. The grade of the officer authorised (by the head of the Branch) to conduct the investigation should be not below SEO, if they are the sole investigator, or HEO if they are clearly in a supporting role.

16. It is probable that the investigation will involve a visit by the appointed officer(s) to the administrative offices of the company concerned. Depending on the nature of the information which has prompted the investigation it may be appropriate for the person or team conducting the investigation to arrive at the premises unannounced, ie without prior warning. In some circumstances, it may be desirable to give the company prior or simultaneous notification of the visit. The head of the Branch should be involved in decisions about the tactics which should be employed. In any case, a copy of the formal authorisation document should be available for inspection, if requested by the company's representatives. The Department does not announce or publicise specific cases of the exercise by the Secretary of State of his powers under S44.

17. The nature of our concerns will determine whom we should interview and which papers we require access to but in examining these, supplementary documents may be identified which seem pertinent to our enquiries and should be produced. The investigating officer(s) may take copies of any documents they require to be produced either at the time of the visit or which they may request subsequently.

18. In exercising an authority, a careful note must be made of all conversations with officers of the company and of any explanations given of documents. It may be necessary to give evidence before a magistrate on the application for a search warrant and, possibly, in subsequent civil or criminal proceedings.

19. Following the inspection, a report will need to be prepared which summarises the results and recommends what action should be taken to alleviate any concerns which still exist. The head of Branch should approve the follow-up action considered necessary.

20. Unauthorised disclosure of information obtained under this Section is a criminal offence. Specific attention is drawn to Part 10 of these Guidelines on disclosure of information.

Implications for Our Understanding of a Company's Position
21. This is self evident.

Standard Drafts
22. Because the wording of the requirement will depend on the precise circumstances of the case, no draft is included with this Guideline. It is recommended that the assistance of Sols B1 is sought with the drafting.

Conditions to be Attached
23. Not relevant in the context of this Guideline.

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Guideline 8.8: Obtaining Information

Legal Advice
24. This Guideline is based on advice from Sols B1. It is recommended that any officer authorised under Section 44(3) should discuss the matter with Sols before exercising the authority. If necessary, advice can be obtained through Sols B1 from Investigation Division lawyers.

GAD
25. The advice of GAD should always be sought when a requirement under this Section is imposed on a company carrying on long term business. They should be consulted in respect of non-life companies with which they have had recent dealings and in all cases where it is thought their expertise will be of assistance.

EC Aspects
26. There are no specific EC aspects.

On the Record Statements
27. None.

The Precedent Register
28. Officers contemplating action under s.44 ICA might find it helpful be able to refer to action taken on past cases of a similar nature. All such case details, or appropriate file(s) and locational references, should therefore be copied to I1B for addition to the Register.

Compliance Cost for Companies
29. Unlikely to be specifically relevant in the context of this Guideline.

Insurance Annual Report
30. A record must be maintained of the occasions on which this power has been exercised for inclusion in the annual report.

Policy Responsibility
31. Divisional responsibility for this issue rests with I1B.

Issued December 1992 **Guideline 8.8**

DTI's policy guidance notes (1991)

Guideline 8.10: Non-Statutory Intervention

Guideline 8.10

Non-Statutory Intervention

Synopsis
1. Guidance on the power of the Secretary of State to intervene in the affairs of companies otherwise than in pursuance of statutory powers.

Legislation
2. The Secretary of State's powers of statutory intervention have been set out in the earlier parts of this chapter. Guidance on other statutory provisions is given in the appropriate sections of this manual.

3. As well as being governed by the insurance legislation, insurance companies are subject to the requirements of the Companies Act. They are companies and subject to the obligations imposed on them by virtue of this status to which is added additional obligations because of the nature of the industry to which they belong.

4. The legislation should not be interpreted as setting out exclusively all actions which the Secretary of State can take in pursuance of his duty to regulate the insurance industry. It presupposes that action will be taken, for the purposes of protecting policyholders, which is covered by the statutory provisions.

Exercise of Secretary of State's Functions
5. The level at which action can be taken in the name of the Secretary of State will, obviously, depend on the proposed course of action. Assistance on this matter can be obtained from Guideline 0.2.

Insurance Division Objective
6. To intervene in a company's affairs in the most appropriate manner for protecting policy holders or potential policy holders.

Best Practice - General
7. In addition to his statutory powers, the Secretary of State enjoys the benefit of the general principle that everything is permitted by law unless it is specifically prohibited. In considering action to be taken, regard must be had not only to whether the action is specifically prohibited by law, but whether there is an implicit prohibition either by UK or EC law.

8. In principle, if there are express statutory powers to deal with a particular situation, then the situation should be dealt with by the exercise of these statutory powers. Although the exercise of the powers is discretionary, there is a duty to give proper consideration to whether the discretion should be exercised.

9. Although it is unlikely that a course of action will arise for failure to exercise a discretionary power, when the failure to exercise the power arose following the weighing up of competing policy considerations, the failure to exercise the powers could well result in criticism of the Division. The following paragraphs should be read in the light of this.

Acceptance of Undertakings
10. There are circumstances where a view can properly be taken that, it is in the best interest of policyholders, not to invoke statutory powers but to try and achieve the same result by accepting an undertaking from the company or its controllers to take, or refrain from taking, a particular course of conduct.

11. For example, it is not unusual to accept an undertaking from a company that it will cease writing new business. The advantage is that the undertaking can take effect forthwith and thus avoid the delay inherent in taking the action set out in Sections 11 and 12 ICA 1982.

12. Although, in legal theory, it may be possible to bring an action for breach of an undertaking, it would be unwise to regard this as a practical proposition. Therefore, it goes without saying, that undertakings should only be accepted when it is believed that they will be honoured. Only in exceptional circumstances should an undertaking by a controller to support a company financially, influence Insurance Division's actions.

13. A breach of an undertaking will not amount to a criminal offence. However, it may give rise to circumstances in which the person who has breached the undertaking could be held not "fit and proper" to hold a notifiable position with the company. It may also be evident that it is expedient in the public interest that a company be wound up.

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14. If it is possible to take an undertaking from the company's solicitors, then this course of action should be followed. As a breach of an undertaking is particularly serious in the case of a solicitor, a solicitor will be extremely unlikely to give an undertaking if the matter is not entirely under his control. An undertaking to "use best endeavours" is a standard and in many cases, acceptable wording.

15. A company should not be led to believe that the Secretary of State has power to demand an undertaking. If an undertaking is accepted, it should be made clear that this is without prejudice to the exercise by the Secretary of State of any of his statutory powers.

Suggesting a Course of Action to a Company

16. There is no legal bar to the Secretary of State suggesting a course of action to a company, or even seeking to persuade the company to take a particular course of action which will alleviate regulatory concerns. Again, it should not be implied to the company that the Secretary of State has power to insist on this course of action.

17. Great care must be taken to ensure that the Department does not find itself acting as a shadow director. A shadow director is a person in accordance with those directions or instructions the directors of the company are accustomed to act. It has been held by the Courts to be arguable that a bank had acted as shadow director when a company was managed in accordance with the bank's instructions as a condition of the bank not appointing an administrative receiver.

18. Although it is unlikely that the Department will be held to be acting as a shadow director, there are two sets of circumstances which require particularly careful handling. First, the "white knight" situation where a company is considering going into liquidation and the Department encourages it to defer this action until a purchaser can be found. The directors should not be led to believe that they can abdicate their responsibility for the affairs of the company in favour of blindly following the Department's lead.

19. More importantly, the situation may arise where the Department is minded to present a petition for the winding-up of the company but holds off whilst the company takes steps to prevent this. The initiative in these circumstances should come from the company and the situation should not be allowed to arise where it could be claimed that the directors were acting on the instructions of the Department as a condition of the Department not presenting a petition.

Interpretation of Legislation

20. Insurance division will often be asked for its opinion as to how a particular piece of legislation should be interpreted. Such queries are likely to arise from both members of the public and firms of solicitors.

21. The interpretation of legislation is a matter for the Courts and not for the Department. It is quite in order for Insurance division to express an opinion as to how a piece of legislation should be interpreted, but this should be subject to the caveat that, at the end of the day, only the Courts can decide matters of interpretation. If the question is raised by a firm of solicitors, it should not be necessary to labour the point and it should be sufficient to precede the opinion with words to the effect "Obviously, only the Courts can decide authoritatively, but the Department's view is ...."

22. If the query is raised by a member of the public it must be made quite clear that the Department is expressing only its own view and that such view is given without responsibility. Although the Department will wish to be as helpful as possible, members of the public should not be led to believe that contacting the Department is a substitute for taking their own legal advice.

23. Notwithstanding the above, Insurance division should not be afraid of expressing a forceful opinion on regulatory matters. If an interpretation is preferred which the division is not prepared to accept, it should be made quite clear that the division will not accept this interpretation and if following it leads, in the division's opinion, to a breach of the legislation such regulatory action as is deemed necessary will be taken.

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Guideline 8.10: Non-Statutory Intervention

Unauthorised Insurers

24. In dealing with cases of unauthorised insurers, it will sometimes be necessary to mount a statutory investigation followed by winding-up proceedings. This is particularly so when the public is seriously at risk. On other occasions the matter can be dealt with without recourse to statutory powers.

25. It is common for activities, which may amount to unauthorised insurance business, to be brought to the Department's attention. Usually, the division will be provided with a copy of the literature distributed by the company. It is necessary for the division to form a view as to whether the activities as set out in the literature constitute insurance business.

26. If there is no doubt that the activities are insurance then the company can be informed that such is the Department's view and an assurance sought that the activities will cease. Action can be taken under statutory powers if the company is defiant.

27. If there is some doubt as to whether the activities amount to insurance, then further explanations can be sought from the company. This should be regarded as a fact finding exercise the object of which is to obtain sufficient information to enable the division to form a view. The usual caveat that, only the Courts can decide the matter authoritatively should not be used in a letter requesting this information. Carrying on insurance business without authorisation is a criminal offence. Whether or not a criminal offence has been committed is always a matter for the Courts and it is no more relevant to point this out in investigating unauthorised insurance business than it is in investigating any other crime.

Reports to Professional Associations

28. Occasionally evidence of unprofessional conduct by accountants, lawyers or actuaries will come to the attention of Insurance division. Subject to any legal restraints on the disclosure of the information, consideration should be given to reporting the matter to the appropriate professional organisation.

Requests for Additional Information

29. Although the ICA 1982 provides for returns to be filed with the Department, and powers under Section 44 ICA 1982 to obtain information and require production of documents, there is no bar on requesting additional information.

Standard Drafts

30. None.

Conditions to be Attached

31. Not applicable in the context of this Guideline.

Legal Advice

32. This Guideline has been prepared by Sols B1.

GAD

33. The advice of GAD should always be sought when it is proposed to take non-statutory action in respect of companies carrying on long term business and in respect of non-life companies with which they have had recent dealings. GAD's experience may also be relevant to interpretation of insurance legislation and deciding whether an activity constitutes insurance; reference to GAD should be considered on these matters. Where DTI concerns relate to matters of a nature on which GAD have advised in the past, reference to GAD should be considered, GAD may be able to advise on what type of intervention might be appropriate or practicable, and whether proposals made to DTI will meet DTI's objective.

EC Aspects

34. None other than that care should be taken so as to avoid the Secretary of State taking action that would be forbidden by EC law.

On the Record Statements

35. None.

Compliance Costs for Companies

36. Not relevant in the context of this Guideline.

Insurance Annual Report

37. Not relevant in the context of this Guideline.

Policy Responsibility

38. Not specifically allocated.

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Guideline 9.1: Section 68 ICA 1982

Guideline 9.1

Section 68 ICA 1982

Synopsis

1. Guidance on the use of the Secretary of State's power under s68 ICA 1982 to modify certain provisions of Part II ICA 1982 in relation to particular companies.

The Legislation

2. S68 ICA 1982 provides that, "on the application or with the consent of an insurance company" to which Part II ICA 1982 applies, he may by order direct that certain provisions "shall not apply to the company or shall apply to it with such modifications as may be specified in the order". The provisions referred to in s68 are:

a. the provisions in sections 16 to 22, 23(1), and 25 to 36 ICA 1982;

b. the provisions of any regulations made for the purpose of any of the above sections; and

c. the provisions of any valuation regulations (regulations 37-49 and 50-64 of the Insurance Companies Regulations 1981).

3. Section 68 orders "may be subject to conditions".

4. Section 68 orders "may be revoked at any time by the Secretary of State", without the consent of the company, and "the Secretary of State may at any time vary" a s68 order "on the application or with the consent of the company".

5. In the Insurance Companies Act 1974 the equivalent provision was in s57. There may still be some concessions made under that section which continue to have effect.

6. In respect of s31 ICA 1982, which applies to companies carrying on long term business, any exclusion or modification to the operation of the section by means of s68 can extend to include any subordinate company of the insurance company in question, as defined by s31(4).

Exercise of Secretary of State's Functions

7. Orders issued on behalf of the Secretary of State should not be signed by an officer below G7 level. It therefore follows that consideration as to whether an order under s68 is appropriate in a particular case, and proposed revocations and variations, must be considered at least at G7 level.

Insurance Division Objective

8. To ensure that UK authorised insurance companies comply with all relevant primary and secondary legislation, whilst recognising that in particular circumstances in relation to particular companies it may be appropriate to modify the legislative requirements referred to in paragraph 2 a-c above.

Best Practice

9. The discretion contained in s68 is exercised by means of a "Section 68 Order" but it should only be exercised when it is absolutely necessary. There should be no routine issue of a particular type of s68 Order just because a company is of a particular type, eg a mutual or is operating a "hospital benefits" scheme. No indication should be given to any company that a particular type of s68 Order, eg one modifying the asset valuation regulations in a particular respect, is available "on request", unless there has first been full consideration within the Division, including reference up to G7 level, and to GAD as necessary.

10. Following full consideration, including scrutiny of the company's returns, there can be circumstances where it may be appropriate to indicate to a company that a s68 Order is likely to be available (see para 15 below). Such cases may include those where there is an exactly parallel case for which a S68 Order has been correctly given and there

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Guideline 9.1: Section 68 ICA 1982

has been no subsequent change of policy, where it has already been agreed that the legislation is to be changed, eg to give effect to an EC obligation, and to count an implicit item if previously established criteria are satisfied.

11. When dealing with a request for a s68 Order from a company, or a company's advisers, or considering the issue of an Order for which a company's consent will be needed, it is important to precisely identify what the Department is attempting to achieve by means of the proposed Order, the implications for our understanding of the company's position and business and for the understanding of that company by others.

12. When considering the issue of a new s68 Order, it is necessary to bear in mind the possible impact on the future computer processing of the company's return. The granting of a concession of a type not previously granted to any other company is likely to be undesirable. To do so may result in the Division's inability to subject the affected return to meaningful computer analysis, thus hindering our supervision of the company.

13. Requests for s68 orders are frequently received by EO or HEO supervisors. They should ensure that the company provides written argument in support of such a request and that the nature of the concession being sought is clearly stated (but see paragraphs 14 and 15 below). Following receipt of a properly argued request, and after any necessary internal consultation and consideration of precedents, it will usually be for the HEO to make a submission to G7 level recommending whether or not a S68 Order should be issued and, if so, to propose the form of the Order and any conditions to which it should be subject.

14. There may, however, be occasions when a company does not know quite what concession they should be seeking and/or does not present its argument very well. In such cases it may be necessary to arrange a meeting with the company. Only then can the precise form of concession, if one is considered appropriate, be considered. Following such a meeting, and possibly in other cases, if the supervisor is quite clear as to the concession required and the reason for it, rather than insisting on a written request with argument from the company, it may be appropriate for the supervisor to send to the company a draft s68 Order, seeking its consent to the form of the concession and confirmation of the particulars.

15. Similarly, it will be appropriate for the supervisor to write to a company, setting out the detail and seeking its consent to the form of the concession, if we have identified the need for a concession and we are taking the initiative (see paragraph 10 above).

16. Although the discretion provided by s68 relates to a wide range of sections within Part II ICA 1982 and related regulations, it is in practice rarely used in respect of many of them. It is, however, commonly used to modify the 1983 Regulations made, inter alia, under s17 and s20 ("annual accounts and balance sheets" and "annual statements" respectively) (but see paragraph 42 below), and therefore the form of annual return to be deposited by a particular company in accordance with s22 will be affected (see Guideline 9.2 covering "Accounting Concessions").

17. S68 is also used to relieve particular companies of the requirement imposed under s32 to maintain a margin of solvency of an amount determined in accordance with the Insurance Companies Regulations 1981 (but see paragraph 40 below in respect of companies to which the EC Directives on direct insurance apply). It is also not uncommon for the asset valuation regulations in the Insurance Companies Regulations 1981 to be modified in a particular respect by means of a s68 Order issued to a particular company (see Guideline 6.1 - Valuation of Assets).

18. In respect of s16, as a matter of law we do not have the power to exercise discretion in relation to companies to which the EC Directives on direct insurance apply (see paragraph 39 below) and, therefore, s68 should not be used to modify s16 for such companies. As a matter of policy, there would need to be exceptional circumstances to use s68 to modify s16 in relation to other companies (see Guideline 14.1).

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Guideline 9.1: Section 68 ICA 1982

19. In respect of s22(1), the s68 discretion should not be used to extend the period which may be allowed for the deposit of an annual return beyond the 3 month period already provided (see Guideline 5.2).

20. When considering the possibility of using s68 to waive all or any part of a section or regulation, it is essential that the entire provision of that section or regulation, and any other related provisions, are considered. This is because it is often the case that only part should be waived or modified, with other provisions continuing to apply, and because the provisions of other sections or regulations may be affected.

21. Some of the sections to which s68 applies have associated regulations. In such cases those regulations form part of the overall provision and it is necessary, when considering the modification of any section, to also consider the regulations made under the primary power in order to avoid logical inconsistencies. There may be provisions in the regulations which should be excluded entirely and others which should continue to stand and have effect. If there is any element of doubt Sols B1 should be consulted.

22. Prior to seeking advice from Sols B1 on any proposed s68 Order, taking account of the guidance in Guideline 1.5, supervisors should consider the following:

a. What objective is the company or Department attempting to achieve?

b. Is it necessary for the Order to have the effect of modifying the secondary legislation as well as the primary section?

c. What modifications to both the primary and secondary legislation are necessary?

d. What conditions should be attached to the Order?

e. Should the Order have effect for a limited period only rather than giving carte blanche for a protracted period?

f. Are there other Orders in force which need to be revoked or varied?

g. What impact will the Order have on the company's future annual returns and on the Division's ability to supervise the company effectively by means of computer analysis and to fully understand its financial position.

23. No concession should be granted informally, ie without a s68 Order. Any such concessions have no legal force.

24. Each s68 Order must be the subject of regular review to ensure that it remains relevant and appropriate and that it is not hindering our ability to supervise effectively. Such a review should take place at least once a year in respect of each company which enjoys a s68 concession following receipt of its annual return.

25. Special attention should be paid to whether all conditions to which an Order was subject have been satisfied and to whether, either because of a breach of any condition or because of a time limit, the concession has ceased to have effect. Where, for whatever reason, a s68 Order has legally ceased to have effect, but the company appears still to be relying upon it, it will normally be appropriate to communicate with the company about it (but see paragraph 26 below), having first sought advice from Sols B1 as necessary.

26. Whilst a s68 Order may be revoked at any time by the Secretary of State, it should be remembered that, by virtue of s68(3), any variation of a s68 Order must be at the company's request or with its consent. Even in cases of a proposed revocation it will frequently be appropriate to give a company advance warning of a revocation in order to provide an opportunity for the company to comment. This also helps to ensure that the Division is seen to be acting fairly and reasonably; a company may need time to arrange its affairs so that it can cope without the concession. However, where a company has breached a condition of an Order, or breached an undertaking given in connection with an Order, it may be unnecessary to give advance warning, provided that action is taken promptly following discovery of the breach.

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Guideline 9.1: Section 68 ICA 1982

27. Reviews will normally be undertaken at EO and/or HEO level as part of the annual returns examination process, rather than as a separate exercise, with recommendations being put to G7s. In respect of reviews in connection with long term business, there must be liaison with GAD.

Implications for our Understanding of a Company's Position

28. The sections of the legislation to which the discretion available under s68 relates are important in respect of our monitoring of all companies and therefore no agreement to waive them should be lightly entered into (see the "Best Practice" guidance in paragraphs 9 - 23 above).

29. A record of all extant concessions for each company must be kept on the standard "top document" on the "Requirements, Concessions and Directions" file. This enables supervisors at all levels to see at a glance, and easily locate, any concessions a company currently enjoys. This does not remove the need for a record of all concessions granted to be recorded on the current computer system "Company Profile".

Standard Drafts

30. A skeleton draft of a Section 68 Order is at Annex A. This is little more than a standard "topping" and "tailing". Each Order needs to be tailored to the particular circumstances and Sols B1 should normally be consulted (see Guideline 1.5, paragraphs 22 and 23). At Annex B is a draft of a Notice revoking a s68 Order.

Conditions to be Attached

31. It is important to consider what conditions should attach to any s68 Order. They may vary from a straightforward limitation on the duration of the effect of the Order, to the extent of any waiver with regard to subsidiary companies in cases where s31 is being modified, or to more complex conditions.

32. In many cases it is necessary to attach to a s68 Order a condition that the company includes in its annual return a statement, for all to see, referring to the fact that the Secretary of State made an Order on a specified date and stating the nature of the Order (see paragraph 3b of the draft at Annex A). Such a condition is clearly appropriate when the effect of a s68 order is to allow a company to submit a modified or abbreviated annual return, or relieves a company not covered by the EC Directives from the need to maintain the statutory solvency margin. It may also be appropriate to attach the condition to s68 Orders which modify the valuation regulations.

33. In order to decide whether a condition such as that mentioned in paragraph 32 above is appropriate, supervisors may test the circumstances against the following questions:

a. Would someone looking at the return in isolation wonder why the company had not submitted a return in the format prescribed by the 1983 Accounts and Statements Regulations, or wonder why it had not complied with the legislation in some other way?: and/or

b. Would the financial position of the company as shown in the company's future annual returns, particularly as regards admissible assets, be significantly different, and possibly cause someone to take a different view of the company, if the s68 concession had not been granted?

If the answer to either question is "yes" the condition, for a statement in the return referring to the 68 Order, should be attached.

Legal Advice

34. The major part of this Guideline is based on legal advice.

35. Although it is possible for a s68 Order to apply in respect of a financial year already ended, provided that the return has not been deposited and the due date has not passed, it should be noted that s68 cannot otherwise be applied with retrospective effect. Consequently, a s68 Order cannot "decriminalise" any event which has already occurred eg the failure by a company to satisfy an obligation which existed under one of the relevant sections of the Act prior to the issue of a s68 Order which had the effect of disapplying that section in respect of that company.

Issued December 1991 Guideline 9.1

DTI's policy guidance notes (1991)

Guideline 9.1: Section 68 ICA 1982

36. Paragraphs 22 and 30 above refer to Guideline 1.5, which deals with the obtaining of advice from Sols B1 and advises that Sols B1 should normally be consulted about the making of an Order under s68. Consultation with Sols B1 should be in relation to a particular section or sections of the ICA 1982 to which s68 can apply, and/or to a regulation or regulations made under one of those sections, and in respect of a particular company.

GAD

37. GAD should be consulted about proposed s68 Orders in respect of all long term business companies and all general business companies with which they have recently been involved, or need to be involved, prior to seeking advice from Sols B1. A copy of GAD's views should then be made available to Sols B1.

38. GAD should be sent a copy of any s68 Order made in respect of a company writing long term business. They should also be provided with a copy of s68 Orders made in general business company cases with which they have recently been involved, and their attention drawn to, or a copy provided of, any existing s68 Orders in cases where their advice is being sought (see Guidelines 1.3 and 1.4).

EC Aspects

39. S16 ICA 1982 implements Articles 8 1.(b) of the First Council Directives on both non-life and life insurance. Therefore, s68 Orders should not be made in respect of s16 (see Guideline 14.1) where the company in question is one to which the Directives apply. To do so would give rise to a breach of Community law.

40. Similarly, the requirements of s32 and 33 ICA 1982, relating to solvency margins, stem from the First Council Directives on both non-life and life insurance. Consequently, s68 should not be used to relieve a company to which the directives apply of the need to maintain a solvency margin or margins determined in accordance with the Insurance Companies Regulation 1981, and nor may a company be relieved of obligations imposed under these sections following a failure to maintain a required margin (see Guidelines 7.1 and 7.2).

41. Composite companies writing both long term and general business are required under the First Council Directive on life insurance to manage separately the two kinds of business. Therefore, the requirements of s28 and 29 ICA 1982 may not be modified in respect of such companies in a way that would result in a breach of the requirements of that Directive.

42. It is a requirement of the First Council Directives on non-life and life insurance that insurance companies with their head office in the UK must "produce an annual account, covering all types of operation, of its financial situation [and] solvency". All undertakings carrying on insurance business in the UK, no matter where their head office is situated, are required to "render periodically the returns, together with statistical documents, which are necessary for the purposes of supervision". Therefore, a s68 Order should not be made which would have the effect of relieving a company from the requirements of the ICA 1982, or regulations under it, to such an extent that these requirements of the Directives would no longer be met.

43. In respect of Forms EC(P), EC(A) and EC(B), for which it may be considered appropriate to make a s68 Order allowing a company a period longer than 6 months to submit them, see Guideline 5.2, paragraphs 20 and 21.

On the Record Statements

44. None.

The Precedent Register

45. By using the Precedent Register examples of previous s68 Orders can be identified.

46. To enable maintenance of the Precedent Register, copies of all "top documents" (see paragraph 29 above) should be sent to I1B1, as should a copy of any s68 Order made after 1 September 1991 together with the professional advice obtained prior to the making of the Order.

Issued December 1991 | Guideline 9.1

DTI's policy guidance notes (1991)

Guideline 9.1: Section 68 ICA 1982

Compliance Costs for Companies

47. The making of an appropriate s68 Order may have positive compliance cost implications for an insurance company. However a request for a s68 Order on compliance cost grounds alone should not be granted if it will significantly inhibit our ability to effectively supervise the company in question.

Insurance Annual Report

48. To enable publication of details of the exercise of the Secretary of State's powers, a record must be kept of the number of occasions on which the powers contained in s68 have been used. A pro-forma for maintaining this information at HEO level in supervisory sections is at Annex C. This will also serve as a record for management purposes.

Policy Responsibility

49. There has been no allocation of Divisional responsibility for s68 issues.

DTI's policy guidance notes (1991)

Guideline 9.1: Section 68 ICA 1982 – Annex A

Guideline 9.1 Annex A

DRAFT TOP AND TAIL OF SECTION 68 ORDER

ORDER BY THE SECRETARY OF STATE FOR TRADE AND INDUSTRY UNDER SECTION 68 OF THE INSURANCE COMPANIES ACT 1982

[insert FULL NAME OF INSURANCE COMPANY]

The Secretary of State for Trade and Industry, in exercise of his powers under section 68 of the Insurance Companies Act 1982 ("the Act") and [* on the application of/with the consent of] [insert full name of insurance company] ("the Company"), being a company to which Part II of the Act applies, by this Order directs as follows:-

1. In this Order:-

(a) "the 1981 Regulations" means the Insurance Companies Regulations 1981;

(b) "the 1983 Regulations" means the Insurance Companies (Accounts and Statements) Regulations 1983;

(c) references to the Act, to the 1981 Regulations, and to the 1983 Regulations are to that Act and to those Regulations as amended at the date of this Order;

(d) any expression used in this Order which is an expression defined in the Act, the 1981 Regulations, or the 1983 Regulations, shall have the meaning assigned to it in the Act or those Regulations;

[*(e) "accounting classes" means the accounting classes as set out in Regulation 3 of the 1983 Regulations;

(f) "insurance business" includes reinsurance business;

(g) "the financial year" means the financial year of the Company;]

[add/delete other definitions as appropriate]

DTI's policy guidance notes (1991)

Guideline 9.1: Section 68 ICA 1982 – Annex A

[* 2.This Order shall first apply to the Company's accounts and statements in respect of the financial year ended [insert company's fye date].]

3. This Order is conditional upon and shall have effect so long as:-

(a) the Company informs the Secretary of State forthwith of any proposed change, and within 21 days of an actual change, in the circumstances of the Company where such proposed change or actual change may reasonably be expected to be material to the maintenance of this Order in force.

[* (b) the documents required by section 17(1) include a Note stating:

"The Secretary of State for Trade and Industry, [* on the application of/with the consent of] the Company, issued to the Company in [month and year] an Order under section 68 of the Insurance Companies Act 1982 [*allowing/directing that] the Company [insert appropriate summary of the effect of the Order].]; and

[insert any further appropriate conditions]

[* 4. The Order dated [insert date] and issued to the Company is revoked.]

Dated this day of 19

[signature]

A N OTHER
For the Secretary of State for Trade and Industry

* Add/delete as necessary

DTI's policy guidance notes (1991)

Guideline 9.2: Accounting Concessions (using Section 68 ICA 1982)

Guideline 9.2

Accounting Concessions (using Section 68 ICA 1982)

Synopsis

1. Guidance on considering, granting and reviewing "accounting concessions" to authorised insurers, whether at the request of the insurer or on our initiative.

The Legislation

2. The Secretary of State may grant accounting concessions by exercising the power contained in s68 ICA 1982. This provides that, "on the application or with the consent of an insurance company" to which Part II ICA 1982 applies, he may by order direct that certain provisions "shall not apply to the company or shall apply to it with such modifications as may be specified in the order". The provisions referred to in s68 are:

a. the provisions in sections 16 to 22, 23(1), and 25 to 36 ICA 1982;

b. the provisions of any regulations made for the purpose of any of the above sections; and

c. the provisions of any valuation regulations.

3. Section 68 orders "may be subject to conditions".

4. Section 68 orders "may be revoked at any time by the Secretary of State", without the consent of the company, and "the Secretary of State may at any time vary" a s68 order "on the application or with the consent of the company".

Exercise of Secretary of State's Functions

5. Orders issued on behalf of the Secretary of State should not be signed by an officer below SEO level. It therefore follows that consideration as to whether an order under s68 is appropriate in a particular case, and proposed revocations and variations, must be considered at least at SEO level.

Insurance Division Objective

6. To ensure that we continue to receive all necessary information to enable our effective supervision of authorised insurers, whilst recognising that in particular circumstances in relation to particular companies it may be appropriate to modify the legislative requirements relating to the provision of accounting information.

Best Practice

7. There should be no routine issue of concessions just because a company is of a particular type, eg a marine mutual, a company in "run-off", etc, and no indication should be given to representatives of any company that a particular type of s68 accounting concession is available "on request". However, in many cases where an accounting concession is considered to be appropriate, it will also be appropriate for the nature of the concession, and the conditions attached to it, including any substitute reporting requirements, to be of a standard type. This will facilitate computer analysis and will enable the monitoring of various companies whose circumstances are similar to be carried out on a standard and comparable basis.

8. Requests for accounting concessions are frequently received by the EO or HEO supervisor. Supervisors should ensure that the company provides written argument in support of such a request and that the nature of the concession being sought is clearly stated (but see paragraphs 9 and 10 below). Following receipt of a properly argued request, and after any necessary internal consultation and consideration of precedents, it will usually be for the HEO to make a submission to SEO/G7 level recommending whether or not a s68 accounting concession should be granted and, if so, to propose the form of the s68 order and any conditions to which the order should be subject.

9. There may, however, be occasions when a company does not know quite what concession they should be seeking and/or does not present its argument very well. In such cases it may be necessary to arrange a meeting with the company during which the nature of the difficulties can be established.

Issued September 1991 **Guideline 9.2**

DTI's policy guidance notes (1991)

Guideline 9.2: Accounting Concessions (using Section 68 ICA 1982)

Only then can the precise form of concession, if one is considered appropriate, be considered. Following such a meeting, and possibly in other cases, if the supervisor is quite clear as to the concession required and the reason for it, rather than insisting on a written request with argument from the company, it may be appropriate for the supervisor to write to the company seeking its consent to the form of the concession and confirmation of the particulars.

10. Similarly, it will be appropriate for the supervisor to write to a company, setting out the detail and seeking its consent to the form of the concession, where we identify the need for an accounting concession and we are taking the initiative (see paragraphs 3 and 4 of Annex F for example).

11. Accounting concessions granted to particular companies need to be the subject of regular review to ensure that they remain relevant and appropriate and are not hindering our ability to effectively supervise. Such a review should take place, in respect of each company to which a s68 accounting concession has been issued, at least once a year following receipt of its annual return. Concessions granted prior to **September** 1991 need to be the subject of particular scrutiny. This is to ensure we are satisfied it is appropriate for a concession to remain in force and, if a concession remains appropriate, to consider whether the existing one should be varied in order to introduce, for example, a more acceptable form of financial reporting and one which can, in due course, be used as input for computer analysis. All reviews should initially be undertaken at EO and/or HEO level as part of the annual returns examination process, rather than as a separate exercise, with recommendations being put to SEOs and G7s.

12. Notes on background, current policy, and conditions to be attached, relating to some of the more common accounting concessions are contained in Annexes to this Guideline as follows:

Annex A - Group Accounting

Annex B - Modified and Abbreviated Returns

Annex C - Overseas Accounting

Annex D - Run-off Concessions

Annex E - Small Premium Income

Annex F - Three Year Accounting

Implications for our Understanding of a Company's Position

13. The making of an appropriate order under s68, directing that certain provisions of the legislation shall not apply or shall apply with modifications in respect of a particular company, may assist our understanding of that company's position and of its business. There are cases where a standard return in the format required by the 1983 Accounts and Statements Regulations would be largely inappropriate and would provide litle useful information. In such cases effective supervision depends on modifying the format of the return to be deposited. Conversely, the making of an inappropriate order may seriously impair our ability to understand a company's position.

14. A record of all extant concessions must be kept on the standard "top document" on the "Requirements, Concessions and Directions" file for each company. This enables supervisors at all levels to see at a glance, and easily locate, the concessions a company currently enjoys and the conditions, if any, to which they are subject. This does not remove the need for a record of all concessions granted to be recorded on the computer system "Company Profile".

Standard Drafts

15. Standard forms of "topping" and "tailing" for a s68 concession order, and for revocations and variations are Annexed to Guideline 9.1. However, no standard forms of words for particular accounting concession orders are provided here; but see paragraph 20 below.

DTI's policy guidance notes (1991)

Guideline 9.2: Accounting Concessions (using Section 68 ICA 1982)

Conditions to be Attached

16. It is usual, and appropriate, for each accounting concession order to be subject to conditions. They may vary in nature, extent and detail, depending on the nature of the concession and the circumstances of the particular company and our view of it. It is important to attach predetermined and standard conditions to certain types of concessions; these are referred to in the relevant Annex.

Legal Advice

17. Where the form of an order being considered for issue is on the lines of orders previously made in other cases and raises no new legal aspects, there should be no need for Sols B to be consulted. However, if there is doubt, including in relation to the wording to be used in the order, advice from Sols B should be sought. When seeking their advice the purpose of the proposed concession should be made clear. This should be in terms of what it is that is intended to be achieved and why.

18. The same considerations, as to whether it is appropriate to seek advice from Sols B, apply equally to proposed variations and revocations of concessions.

GAD

19. GAD should be consulted in every case where consideration is being given to the issue of an accounting concession which is in respect of long term business. GAD should also be consulted when a proposed concession in respect of the general business of a composite company will affect its long term business. An example is a group accounting concession (which can only be given for general business) when the long term solvency margin may not be met entirely from the long term business fund. Consult GAD if there is any doubt as to whether a particular concession will affect the long term business.
In any event, GAD should be advised of all concessions granted to composites.

20. In relation to companies writing only general business, judgement needs to be exercised on a case by case basis as to whether the advice of GAD should be sought. Clearly, GAD should be consulted in relation to any proposed accounting concession for any company with which it has recently been involved.

EC Aspects

21. There are no particular EC aspects although consideration must always be given as to whether a proposed concession, particularly if it does not follow an already established pattern, is contrary to any obligation contained in an EC Insurance Directive applicable to the insurance company in question.

On the Record Statements

22. None.

The Precedent Register

23. By using the Precedent Register examples of "model" accounting concessions can be identified, as can orders made in other cases, whether model examples or not.

24. So that the Precedent Register can be maintained, copies of all "top documents" (see para 12 above) should be copied to I1B1, as should a copy of any accounting concession order made after 1 September 1991 together with any professional advice obtained in a particular case.

Compliance Costs for Companies

25. The making of an appropriate accounting concession order may have positive compliance cost implications for an insurance company. It may also reduce our costs without impairing our supervisory ability. This is particularly the case when the full application of the Accounts and Statements Regulations would result in a company having to deposit a return which is not meaningful in relation to the nature of its business and the production and examination of which would be unnecessarily burdensome. However, an application for an accounting concession on compliance cost grounds alone should not be granted if it will significantly inhibit our ability to effectively supervise the company in question.

Issued September 1991 **Guideline 9.2**

DTI's policy guidance notes (1991)

Guideline 9.2: Accounting Concessions (using Section 68 ICA 1982)

Insurance Annual Report

26. To enable publication of details of the exercise of the Secretary of State's powers, a record must be kept of the number of occasions on which the powers contained in s68 ICA 1982 have been used. A pro-forma covering all uses of s68 is provided as an Annex to Guideline 9.1.

Policy Responsibility

27. No one person within the Division has been allocated policy responsibility for all accounting concession issues.

DTI's policy guidance notes (1991)

Guideline 10.2: Disclosure to and Liaison with Other UK Regulators

Guideline 10.2

Disclosure to and Liaison with Other UK Regulators

Synopsis
1. Guidance on when and how to pass information or allegations about companies or individuals to other UK Regulators. Except for routine matters, the decision to disclose should be taken by a Grade 7 or above. In cases of doubt, Solicitors' Division should be consulted.

Scope
2. The principal other regulators are those concerned with investment business carried on by life offices and composites, the Securities and Investments Board (SIB) and the self-regulatory bodies (SROs) it oversees (listed at Annex A). Along with the Bank of England and ourselves they participate in the College of Regulators which provides for co-operation in the supervision of financial conglomerates which are subject to regulation by more than one of the members. The principles set out in this guidance note apply also to relations with the Building Societies Commission, the Registrar of Friendly Societies and professional bodies such as the Insurance Brokers' Registration Council and the Institutes of Chartered Accountants.

The Legislation
3. There is no legislation which imposes an obligation on Insurance division to disclose information to other regulators. On the contrary there are restrictions both at common law and statutory which inhibit the disclosure of information.

4. The common law rules of confidentiality apply in most circumstances. Confidentiality is dealt with in Guidance Note 10.1. If the information is of a confidential nature and has been given to the Department in confidence, a judgement must be made whether the public interest in disclosure outweighs the duty of confidence. If the information is on a database regard must also be had to the Data Protection Act, for which also see Guidance Note 10.1.

5. The statutory restrictions, to be found in Section 47A ICA 1982, prohibit the disclosure of information relating to the business or other affairs of any person which has been obtained under Section 44(2) to (4) ICA 1982 without the consent of the person from whom the information was obtained and, if different, the person to whom it relates. Section 47A then makes exceptions to this general prohibition. These statutory exceptions, detailed in S47A, and in S449 Companies Act 1985 and S180 Financial Services Act 1986 are extremely complex. Advice about disclosure of S44 information should always be sought from lawyers.

6. Information obtained by other divisions in the exercise of their statutory powers (particularly Investigations division) is also subject to statutory restrictions on disclosure. Information obtained by other divisions should never be disclosed without reference to these divisions.

7. By S71 (4) (A) ICA 1982, disclosure of information in contravention of S47A is a criminal offence punishable by fine and/or imprisonment.

Exercise of SOS Functions
8. Liaison with other regulators aids the exercise of such functions as supervision of solvency (by increasing awareness of the financial position of the group as a whole and other regulated companies within the group); ensuring that notified persons are fit and proper and that authorisations are properly granted.

Insurance Division Objective
9. To avoid regulatory failures arising because an issue, company or group of companies or person falls between regulators. To prevent unfit people moving from one regulated area to another.

Best Practice
10. The general principle is that where the Department has adverse information about an individual or company we should always consider whether there are any circumstances which makes this information likely to be relevant to other regulators. Paragraphs 11 - 14 give more detail on the application of this principle in different circumstances.

Issued July 1992 Guideline 10.2

DTI's policy guidance notes (1991)

Guideline 10.2: Disclosure to and Liaison with Other UK Regulators

SIB/DTI information sharing agreement

11. The DTI and SIB have an agreement dated April 1991 about the exchange of information on investment business. The text is at Annex B. It requires both regular and ad hoc exchanges. The regular exchanges are triggered for Insurance Division by long term authorisations, a threat to the solvency margin of a long term business or a qualified auditor's report. SIB will inform us of any authorisation of an insurance company under their regime to carry on regulated investment business, or a breach of rules or serious concern aroused by such a business. In addition the agreement provides that at any time when there are doubts about the integrity or competence of management; or the financial soundness of a company in which we have a mutual interest; or if a formal investigation or the use of disciplinary or intervention powers are being considered SIB or the SRO (usually LAUTRO) and Insurance Divsion will inform each other.

12. Staff should be guided by the terms of this agreement. Information passed in this way may not be further disclosed by the recipient without the consent of the originator. Any release of other than routine information should be cleared by the Grade 7 responsible for the company concerned.

Regular exchanges on notified persons

13. Each week I1A circulates for comment a list of persons notified to the Department as being proposed for, or having recently filled, notifiable positions within a UK authorised insurance company. The list is circulated widely internally and is also sent to:

The Goverment Actuary's Department
Lloyd's
The Stock Exchange
The Securities and Investment Board
The Bank of England

In turn I1A checks names referred to it by these other regulators. Registration under the Data Protection Act permits such exchanges where information is held on computer data bases.

Handling allegations

14. If allegations are received about possible improprieties by someone active in the businesses which are the concern of other regulators, they must be referred to the relevant Grade 7. The Grade 7 will decide whether to pass the allegations on to the other regulators. The presumption should be in favour of disclosure where the allegations are being made by reputable people who are willing to identify themselves as the source. Regard should be had to the possibility of rumours being given added credibility simply because they are forwarded by the DTI.

15. There is some risk that the disclosure of information volunteered to the Department by third parties could be restrained by proceedings taken by the third party concerned, if it appeared that the information had been volunteered under an express or implied understanding that it would be treated as confidential. In a case where such an understanding might be argued to exist, and where it is impracticable or impolitic to seek the volunteer's consent to disclose the information, Solicitors should be consulted.

College of Regulators

16. The College of Regulators system allows individual regulators to retain full legal and operational responsibility for those parts of a conglomerate within their own area, while identifying a lead regulator for the group as a whole. The lead regulator, defined as the one most closely associated with the mind of the group, arranges for information to be pooled, convenes and chairs meetings of the college and co-ordinates action in relation to that group.

17. The terms of reference for the college arrangements are:

"To provide a forum in which financial regulators can together consider issues in the regulation of financial services, which arise across existing boundaries, and can

a. promote discussion and regular exchanges of information across regulatory boundaries, at working level;

b. review lessons to be learned from any individual cases of particular difficulty in conglomerate supervision;

c. offer guidance;

d. draw matters of concern to the notice of the appropriate authority".

Issued July 1992 Guideline 10.2

DTI's policy guidance notes (1991)

Guideline 10.2: Disclosure to and Liaison with Other UK Regulators

18. The lead regulators arrange meetings on a regular basis. The Department holds such meetings approximately every six months tied in with its visit programme. The Bank of England reviews the structure and performance of the groups for which it is responsible every year through meetings approximately every two months. Guidance for supervisors on briefing for such meetings which are normally attended by Grade 7s is at Annex C.

19. In addition, meetings may be called to discuss more general issues, or particularly urgent cases. An Aide-Memoire (at Annex D) has been prepared to assist regulators when serious problems arise in a group. It is not necessary to await a formal college meeting before contacting other regulators.

Implications for our Understanding of the Company's Position
20. Receipt of information about companies we supervise or associated companies aids supervision.

Company's Position
21. Exchange of information may prevent companies being run by unfit people or getting into financial difficulties because of problems in other parts of a group. However, they will not normally be aware of the exchanges taking place.

Standard Draft Letters
22. No standard draft letters have been prepared but a standard format for briefing for College of Regulator meetings is attached at Annex C.

Conditions to be attached
23. Remind other regulators receiving information of its degree of confidentiality and gateways, if appropriate.

Legal Advice
24. Unauthorised disclosure of information can result in civil proceedings against the Department and criminal proceedings against the individual officer. In all cases related to S44 and otherwise, unless there is a well established precedent, questions of disclosure should always be referred to Solicitors.

GAD
25. Actuaries in GAD's Insurance Division may be recipients of allegations, eg. from appointed actuaries, which they will pass to us for action.

EC Aspects
26. There is nothing in current EC Directives on insurance and banking affecting the disclosure of information and liaison with other UK regulators. However Directives agreed but not yet implemented, including the Third Non-Life Directive, include provisions affecting the disclosure of information.

On the Record Statements
27. None.

The Precedent Register
28. Routine exchanges of lists and authorisation details need not be recorded. Decisions about whether to pass on information should go on register, where considerations of confidentiality permit.

Compliance Cost for Companies
29. None

Insurance Annual Report
30. Not applicable.

Policy Responsibility
31. Head of Branch 2.

Issued July 1992 **Guideline 10.2**

DTI's policy guidance notes (1991)

Guideline 10.2: Disclosure to and Liaison with Other UK Regulators – Annex A

ANNEX A

SELF-REGULATORY BODIES OVERSEEN BY THE SECURITIES AND INVESTMENTS BOARD

FIMBRA - Financial Intermediaries, Managers and Brokers Regulatory Association, which embraces insurance and unit trust intermediaries, firms advising on and dealing in securities and collective investment products and investment management for private clients.

IMRO - Investment Management Regulatory Organisation, for investment managers, principally for institutions, unit trust managers and trustees.

LAUTRO - Life Assurance and Unit Trust Regulatory organisation, covering life assurance companies, unit trust managers and friendly societies.

SFA - Securities and Futures Authority (formally the The Securities Association and the Association of Futures Brokers and Dealers which merged on 1st April 1991 to form the SFA), for firms dealing and broking in securities and securities related instruments commodities, futures, options and derivative instruments.

Issued July 1992 Guideline 10.2

DTI's policy guidance notes (1991)

Guideline 10.2: Disclosure to and Liaison with Other UK Regulators – Annex B

SIB

ANNEX B

SECURITIES AND INVESTMENTS BOARD

Gavrelle House, 2-14 Bunhill Row, London EC1Y 8RA Telephone: 071-638 1240 Fax: 071-382 5900 Telex: 262433 MONREF G

[redacted]
Under Secretary
Department of Trade & Industry
10-18 Victoria Street
LONDON SW1H 0NN

22 April 1991

PL04221/LR 15

[redacted]

I attach a letter formally setting out the arrangements for information sharing between the Insurance Division, SIB and the SROs in respect of insurance companies, authorised by the Insurance Division and also regulated under the Financial Services Act.

The letter follows the draft outlined in your letter of 25 February 1991. This has been agreed with the SROs and I sign on their behalf.

The attached Annex I is a complete list of those insurance companies which are members of SROs or which are directly regulated by SIB. Could you check that these are currently authorised under the Insurance Companies Act and therefore subject to your regulatory oversight.

I would be grateful if you could confirm your acceptance of these arrangements. Copies of my letter go to [redacted] (IMRO) and [redacted] (LAUTRO).

In your letter of 25 February 1991, you indicated a college of regulators meeting was to be convened for a number of insurance groups for which the SROs have concerns. Are arrangements in hand for this?

[redacted]

Director, Financial Regulation

Encl.

Issued July 1992 — Guideline 10.2

DTI's policy guidance notes (1991)

Guideline 10.2: Disclosure to and Liaison with Other UK Regulators – Annex B

SIB

SECURITIES AND INVESTMENTS BOARD

Gavrelle House, 2-14 Bunhill Row, London EC1Y 8RA Telephone: 071-638 1240 Fax: 071-382 5900 Telex: 262433MONREF G

[redacted]
Under Secretary
Insurance Division
Department of Trade & Industry
10-18 Victoria Street
LONDON SW1H 0NN

19 April 1991

PL04193/C/F LR 15

[redacted]

This letter sets out the framework which has been agreed between the Department of Trade & Industry, Insurance Division (Insurance Division), the Securities and Investments Board (SIB) and the Self-Regulatory Organisations (SROs) for the exchange of information relating to insurance companies which undertake investment business under the Financial Services Act.

The Insurance Division is responsible, under the Insurance Companies Act 1982, for the prudential supervision of insurance companies. If an insurance company conducts investment business as defined by the Financial Services Act, it will be subject to the conduct of business rules of either SIB (to the extent described in that Act) or an SRO. The attached Annex I details those insurance companies which conduct investment business. (This list will be updated as necessary).

The exchange of information under these arrangements will be subject to any applicable legal constraints, notably those contained in s.47A of the Insurance Companies Act 1982 and s.179-181 of the Financial Services Act (or, in the case of an SRO, the confidentiality constraints contained in its rulebook). Information passed in this way may not be further disclosed by the recipient without the consent of the other, and such onward disclosure will be governed by those provisions.

Where, in the case of any insurance company listed in Annex I, either the Insurance Division, on the one hand, or SIB or any SRO of which the company is a member, on the other, become aware of information which appears to it likely to be relevant to the discharge of the supervising functions of the other, it will, normally inform the other and discuss what appropriate action, if any, need be taken to protect investors. A list of the kinds of information likely to require notification is contained in Annex II.

This list is not intended to be exhaustive and in all cases it is for each regulator to decide when it is appropriate to inform the other.

Issued July 1992 Guideline 10.2

DTI's policy guidance notes (1991)

Guideline 10.2: Disclosure to and Liaison with Other UK Regulators – Annex B

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The detailed arrangements made under this letter do not evidence or give rise to any legal obligations or liabilities on any of the parties and are not intended to do so. These arrangements will be reviewed periodically by SIB and Insurance Division in consultation with the SROs.

[redacted]

[redacted]
Director, Financial Regulation

Encl.

Issued July 1992 | Guideline 10.2

DTI's policy guidance notes (1991)

Guideline 10.2: Disclosure to and Liaison with Other UK Regulators – Annex II

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ANNEX II

Kinds of information likely to require notification

(a) SIB or the SRO and Insurance Division will inform each other where:

(i) there is ground for concern about the integrity or competence of direction and/or management of an insurance company or its subsidiaries;

(ii) there is otherwise ground for doubt about the financial soundness of the company or its subsidiaries (including serious problems with internal control and accounting systems);

(iii) consideration is being given to instigating a formal investigation or using disciplinary powers or powers of intervention against an insurance company or its subsidiaries or (if applicable) associates.

(b) Insurance Division will inform SIB or the SRO where:

(i) the DTI is considering authorising, or withdrawing the authorisation of, an insurance company which is also authorised under the Financial Services Act;

(ii) the margin of solvency falls below, or it is anticipated will fall below the required minimum margin under the Insurance Companies Regulations 1981:

(iii) there is a material qualification of an auditor's report or a concern arising out of the management letter.

Issued July 1992 Guideline 10.2

DTI's policy guidance notes (1991)

Guideline 10.2: Disclosure to and Liaison with Other UK Regulators – Annex II

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(c) SIB or the SRO will inform the Insurance Division where:

(i) SIB or the SRO is authorising an insurance company, and once authorised, if the insurance company wishes to significantly amend the scope of its business plan;

(ii) there is a serious breach of a conduct of business rule or a concern relating to the operations or controls of the business.

Issued July 1992 Guideline 10.2

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THE INSURANCE COMPANIES ACT 1982 ("the Act")

THE INSURANCE COMPANIES (ACCOUNTS AND STATEMENTS) REGULATIONS 1983

("the 1983 Regulations")

GUIDANCE NOTES

ON THE PREPARATION OF

ANNUAL RETURNS

These notes bring together and update the various guidance notes issued with the separate Statutory Instruments now consolidated into the 1983 Regulations which apply to financial years ending on or after 15 March 1984. They are designed to assist insurance companies and their advisers in the preparation of returns to the Department and attempt to clarify points which may not be immediately apparent from the relevant legislation. They do not, themselves, have the force of law.

It would be helpful if we could be notified of any legal advice readers may receive on the interpretation of the legislation which appears to be inconsistent with these notes.

Any enquiries on these notes should be sent to the address given below. Insurance companies are asked to address enquiries to the person with whom they normally correspond about their returns to the Department.

Insurance Division
Department of Trade and Industry
Sanctuary Buildings
16-20 Great Smith Street
LONDON SW1P 3DB

September 1984

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11. Schedule 3: Long term business revenue account and additional information (Forms 40 to 51)

12. Schedule 4: Valuation of long term business (including Forms 55 to 61)

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1. THE STATUTORY REQUIREMENTS TO PRODUCE RETURNS

1.1 Annual accounts and balance sheet (Section 17 of the Act)

1.1.1 The Act requires every company which carries on insurance business in the United Kingdom to prepare returns in respect of each of its financial years. These returns include a balance sheet as at the end of the year and a revenue account and a profit and loss account for the year.

1.1.2 These documents are to have the format and contents laid down in the 1983 Regulations and are to have annexed to them such notes, statements, reports or certificates as those regulations specify.

1.1.3 The balance sheet, accounts and annexed documents (with certain exceptions) must be audited. The form of the audit report and the description of the person to carry out the audit are specified in the 1983 Regulations.

1.2 Actuarial investigation of long term business (Section 18 of the Act)

1.2.1 An insurance company which carries on long term business is also required to cause an investigation to be made every year by its appointed actuary. The investigation includes a valuation of the liabilities of the long term business. Whenever an investigation is carried out in accordance with this requirement, or with a view to the distribution of profits or the results of which are made public, an abstract of the appointed actuary's report shall be made in accordance with Schedule 4 to the 1983 Regulations.

1.2.2 At least once in every period of five years the company is also required to prepare a statement of its long term business in accordance with Schedule 5 to the 1983 Regulations.

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1.3 Deposit of returns and provision of copies (Section 22 of the Act)

1.3.1 Every document mentioned above, including the auditors' report, must be printed and five copies deposited with the Secretary of State within six months of the end of the period to which the document relates.

1.3.2 The Secretary of State has power to extend the period for deposit by up to three months in appropriate cases. Applications for such an extension should be made to the Department in good time since an extension cannot be granted where application is not made within the six months' period. Similarly, if it becomes necessary to seek a further extension (within the limit of three months) beyond one already granted, application should be made by the expiry of the extension in operation.

1.3.3 One of the copies of each deposited document, other than the auditors' report, must be signed by the persons specified in Regulation 25.

1.3.4 The copy of the abstract of the actuary's report and of the statement of long term business must also be signed by the appointed actuary who carried out the investigation to which they relate.

1.3.5 One of the copies of the auditors' report must be signed by them.

1.3.6 If any of the documents appear to be inaccurate or incomplete the Secretary of State is required to communicate with the company with a view to having the matter put right.

1.3.7 A company is required to supply a copy of these documents to any shareholder or policyholder who applies for one.

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1.3.8 One copy of the documents deposited with the Secretary of State will be deposited by him with the Registrar of Companies and will be open to inspection by members of the public who may also obtain copies from the Registrar.

1.3.9 A company carrying on business in Northern Ireland must also deposit a copy with the Registrar of Companies in Belfast.

1.3.10 An insurance company which is a registered society under the Industrial and Provident Societies Acts must also deposit one signed copy of each document with the appropriate registrar under those Acts.

1.4 <u>Other returns to be made to the Secretary of State</u>

1.4.1 Section 20 of the Act provides for annual statements about particular classes of business to be required by regulations. Such statements must be signed, deposited, etc in the same way as the annual accounts except that they are not required to be audited. The only such statement currently required is that relating to general business reinsurance arrangements in Form 30 of the 1983 Regulations.

1.4.2 Section 22(2) of the Act requires five copies of a statement of connected intermediaries to be deposited with the annual return. This statement must be signed in the manner indicated in paragraph 1.3.3 above and the other provisions relating to the supply of copies, etc, also apply. The statement is not subject to audit. Where a company has no connected intermediaries a statement to that effect should be included with the return.

1.4.3 Section 22(6) of the Act requires a copy of any report on the affairs of the company submitted to the shareholders or policyholders to be deposited

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with the annual return. The Department would find it helpful if companies carrying on general business could supply two copies of the report and of any other report which falls within this requirement. Companies carrying on long term business should supply three copies of such reports.

1.4.4 Sections 25 and 26 of the Act allow the Secretary of State to make regulations requiring other returns to be made to him. No such regulations have been made.

2. THE 1983 REGULATIONS

2.1 The 1983 Regulations are the main instrument laying down the form and contents of the various documents referred to in section 1 of these notes. They also specify the scope of the audit and the qualifications for appointment of auditors and actuaries.

2.2 The following notes relate primarily to the interpretation of these regulations. They are designed to be read in conjunction with the regulations and not instead of them. Where no other indication is given references in these notes to the numbers of regulations, schedules, forms, etc, are references to the items bearing those numbers in the 1983 Regulations.

3. DEFINITIONS

3.1 A number of definitions are given in Regulation 3(1) preceded by the words "unless the context otherwise requires". Some of the phrases defined are in fact used with different meanings in parts of the return but the context always makes this clear. An example is "claims outstanding" which are shown as gross of reinsurance recoveries on Forms 11 and 12, but net thereof on Form 15.

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3.2 Other terms which are relevant only to particular Schedules are defined in the Schedule concerned.

3.3 Items may also be defined on the particular forms where they are used. A special type of definition here is the use of the column headed "source". The information included here is not just a helpful note about which figures on different forms should agree: it is a mandatory requirement of the regulations that the figure should be derived from the source shown.

3.4 "Fund" in relation to long term business is not defined as that word is used for different purposes throughout the regulations. Where it appears, it will be necessary to determine from the context which meaning is to be applied.

3.5 Words and phrases which are not defined in any of the ways specified above are taken to have the same meaning as they have in the Act. An example of this is "valuation regulations" which is defined in Section 96(1) of the Act.

4 TYPES OF RETURN ACCORDING TO CATEGORY OF COMPANY

4.1 Six categories of insurance company are defined in the regulations. The definitions are not mutually exclusive.

A pure reinsurer is authorised to carry on only reinsurance business in the UK.

A United Kingdom company has its head office in the UK.

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A Community company has its head office in a member State.

An external company has its head office outside the EEC and Section 9(2) of the Act does not apply to it.

A United Kingdom deposit company which is not a pure reinsurer, has its head office outside the EEC and has made a deposit in the UK under Section 9(2)(b) of the Act.

A Community deposit company which is not a pure reinsurer, has its head office outside the EEC and has made a deposit under Section 9(2)(b) of the Act in a member State other than the UK.

4.2 Depending on which of these definitions apply, Regulations 2(2) and 3(3) and (4) determine whether a company is required to produce returns covering its entire business (global), business carried on through an agency or branch in the UK (UK branch), business carried on through agencies or branches in the EEC (CM branch), or a combination of these, thus:-

Category of Company	Return required		
	UK branch	CM branch	Global
1. Pure reinsurer	NO	NO	YES
2. UK company	NO	NO	YES
3. Community company (other than 1 or 2 above)	YES	NO	NO
4. External company (other than 1 above)	YES	NO	YES
5. UK deposit company	NO	YES	YES
6. Community deposit company	YES	NO	NO

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5. VALUATION OF ASSETS AND LIABILITIES

5.1 Regulation 4 lays down the way in which assets and liabilities are to be valued for the purposes of preparing the returns and the following paragraphs explain its effect.

5.2 Paragraph (a) of Regulation 4 requires all assets and liabilities to be valued in accordance with any valuation regulations which are applicable to them. The current valuation regulations are to be found in Parts V and VI of the Insurance Companies Regulations 1981, (the 1981 Regulations). Additionally, Regulation 10 of the 1981 Regulations provides for the valuation of various other assets for solvency purposes subject to certain conditions.

5.3 Linked assets are not covered because Regulation 38(2) of the 1981 Regulations explicitly excludes them. Paragraph (b)(ii) requires these assets to be valued in accordance with "generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies". The reference to "other generally accepted methods ..." allows appropriate actuarial and statistical methods to be used.

5.4 Any other asset not covered by valuation regulations is required by paragraph (b)(i) to be valued for the purpose of the return as though the valuation regulations were applicable.

5.5 It will be noted that Regulation 4 begins with the words "unless otherwise provided in these Regulations". This relates only to line 94 of Form 13 which is to contain the amount of assets disallowed because of the application of the admissibility limits.

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5.6 The phrase "admissible asset" means an asset which is not inadmissible under Regulation 38(3) of the 1981 Regulations. It thus includes the types of assets for which valuation rules are laid down in Part V of those regulations and also linked assets and cash. Although an asset is itself "admissible", its value may nevertheless have to be restricted because of the admissibility limits in Schedule 8 to the said regulations.

6 COMPLETION OF FORMS

6.1 Forms required for different types of company

6.1.1 The forms which a company includes in its return depend on:

i. whether it carries on general business, long term business or both;

ii. the category of the company concerned (see paragraph 4.2); and

iii. the particular classes and types of general or long term business carried on by it.

6.1.2 Additional guidance on how branch returns should be completed is given in paragraph 19 below.

6.2 Conventions for showing figures

6.2.1 Some of the forms in the returns will be used by the Department to prepare data for its computer. It is therefore important that a standard notation is used in completing the forms and it would be helpful if the

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conventions given in the following paragraphs were strictly followed in completing Forms 9 to 16, 20 to 28, 31 to 37 and 40 to 42.

6.2.2 Zero values. Figures which are zero (including those which become zero after rounding) should be indicated by a dash.

6.2.3 Empty boxes. Boxes which can never contain a figure have been shaded on the forms. Other boxes which are not applicable to a particular company should be left blank (eg line 12 of Form 9 will be blank for a company not carrying on general business). Boxes should not, however, be left blank if they are applicable but the relevant figure happens to be zero (eg a company not paying commission for a particular type of business should show a dash for commission).

6.2.4 Negative values. Where it is acceptable to include negative values, they should be indicated by enclosing them in round brackets. Minus signs or the letters "DR" should not be used.

6.2.5 Thousands, etc., commas. Thousands and millions may be indicated by a comma or a space, but a full stop (as used in some European countries) must not be used for this purpose. Alternatively, no indication may be made of thousands and millions.

6.2.6 Decimal points. A full stop should be used in showing the decimal points in the claims frequency ratios on Form 32 and the currency rates on Form 36. Decimal points should not be used elsewhere in Forms 9 to 16, 20 to 28, 31 to 37 or 40 to 42.

6.2.7 Units. All amounts on Forms 9 to 16, 20 to 28, 30, 37 and 40 to 42 should be rounded and shown in £000 even if particular figures are so large or

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so small that normal accounting conventions would make this inappropriate. Amounts on Forms 29 and 31 to 35 which are in sterling should also be shown in £000 and the rules for dealing with amounts in other currencies are given in paragraph 4 of Schedule 2. Amounts in Forms 43 to 51 (Schedule 3) should be shown in £ or £000 as seems appropriate by the normal principles. Amounts in Schedules 4 and 5 should be shown in whatever way is appropriate. In all cases the units should be shown on the Forms.

6.2.8 Rounding. In rounding to the nearer thousand pounds £500 should be rounded up and £499 rounded down. Figures which are totals of other figures should be rounded after totalling the unrounded detail figures. If companies wish to eliminate any apparent inconsistencies in the figures then shown by adjusting the detail figures the Department will not object. It is acceptable, however, to avoid doing this unnecessarily - particularly in the detailed statistics on Forms 31 to 35.

6.2.9 The claims frequency ratios on Form 32 should be calculated from unrounded figures and then rounded to one place of decimals.

6.3 Completion of code boxes

6.3.1 Forms 9 to 16, 20 to 28, 31 to 37 and 40 to 42, each have a row of boxes above the main columns on the form in which are to be inserted the company's registration number, the period to which the return relates, and other information. The data included in these boxes is used by the Department's computer to determine the company, period, accounting class, etc to which the figures on the form relate.

6.3.2 Requirements for the completion of these boxes are given in paragraph 3 of Schedule 1, paragraphs 4 and 7 of Schedule 2 and paragraph 4 of Schedule

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3. If any company is not clear which number is to be entered as its registration number it should ask the Department so that a number can be agreed.

6.3.3 The ten accounting classes are set out in Regulation 3(1). Country codes are enumerated in Annex A.

6.3.4 Forms 45 to 51, 55 to 58 and 65 to 78 each have an OB/IB heading which should be used to indicate whether the Form refers to ordinary business or industrial assurance business. Exceptionally, in the case of Forms 45 and 46, if separate assets are not distinguished for OB and IB, the heading should indicate that the Form applies to both kinds of business.

6.4 <u>Printing, binding and signature of returns</u>

6.4.1 The Department will supply companies with preprinted Forms 9 to 16, 20 to 28, 31 to 37 and 40 to 42 on which to complete one copy of these parts of their return. The regulations require these forms to be completed exactly as set out in the Schedules. If for any reason a company does not use the preprinted forms supplied it must use identical forms which include all the thick lines and double lines (which are used in preparing computer data).

6.4.2 It would be appreciated if the copy on the preprinted or identical forms was left unbound and the forms held together with a tag through the hole punched in the corner. The forms are printed on A4 paper. Forms 9 to 16 and 20 to 28 are yellow, Forms 31 to 36 are pink, Form 37 is blue and Forms 4 0 to 42 are white. It would be helpful, but is not essential, if the parts of the return which are not on the preprinted forms supplied were printed on white paper.

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6.4.3 It is suggested that a convenient method of preparing the return will be to type the information on the loose preprinted forms and then use these as masters from which to prepare the other copies by litho printing or photocopying. These copies may be bound and it is suggested that one of them should be the signed copy. The Department will then receive one bound copy which is signed, one unsigned copy on the loose forms and three unsigned bound copies.

6.4.4 The Act requires one copy of each document to be signed but it is the Department's practice to accept one set of signatures to cover several documents provided they are securely bound together. If the whole return is bound in one volume it is suggested that the foot of Form 9 is the most suitable place for these signatures. Where there are several volumes it is suggested that those not containing Form 9 should each be signed on the last page. The certificates required to be signed by the directors and appointed actuary must always be separately signed and may not be included under the "general" signatures of a bound volume. The Department would be assisted if the names of signatories could be printed in the returns. If a partnership is the appointed actuary the Department would like companies to print in the returns both the name of the partnership and the actuary who made the investigation.

6.4.5 Although, strictly speaking, the regulations require certain forms for each accounting class the Department does not expect forms which would contain only blank boxes or dashes to be included.

6.5 Currency translation

6.5.1 Paragraphs 4 and 5 of Schedule 1 lay down the way in which overseas currencies are to be translated into sterling in the forms required by

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Schedules 1, 2 and 3. Translation shall be at end of year exchange rates except that income and expenditure relating to -

i. long term business;

ii. MAT business (accounting classes 3, 4 and 5) carried on in the UK;

iii. reinsurance treaties accepted (accounting classes 9 and 10) carried on in the UK; and

iv. home foreign business;

may be translated using other exchange rates (eg remittance rates) provided a note of the methods used is included in the return.

6.5.2 By using end of year rates it should be noted that figures shown as brought forward one year may be different from the corresponding figures shown as carried forward the previous year. Where any differences cannot be accounted for wholly by the use of different exchange rates (eg where there is a correction to last year's figure) a note of explanation should be included. Such differences may be apparent within one year's return where a form (eg Form 20) contains a column for previous year figures. In all cases the figures shown in the previous year column should be the same as those shown in that previous year's return.

6.5.3 Form 23 presents particular problems for currency translation and where overseas currencies are involved the practice outlined here should normally be followed. Column 1 shows the claims outstanding at the end of the year of origin. Figures in column 1 should be expressed in sterling using the

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appropriate exchange rates applying in the year of origin. The figure for any particular year of origin will therefore remain the same in the annual returns for succeeding financial years. Column 2 shows the cumulative claims paid since the year of origin (but not those paid in the year of origin itself) and the amounts paid in each financial year will be at the exchange rate applying for that financial year. A figure in column 2 can therefore consist of the sum of amounts translated into sterling at several different exchange rates. Column 3 shows the amount of claims outstanding at the end of the financial year to which the return relates; all currency translation should be at the exchange rates applying in that year.

Amounts in Forms 29, 31, 33, 34 and 35 relating to individual countries are to be expressed in the currencies of the countries concerned, except where the special provisions of paragraph 5 of Schedule 2 have been applied to Form 29. All other parts of Schedules 1, 2 and 3 are to have amounts shown in sterling.

6.5.4 Amounts in Schedule 4 are to be shown in sterling, other currencies being converted at the latest closing middle rate available on the date to which the valuation relates. In Schedule 5 amounts may be expressed in other currencies in the circumstances described in paragraph 2(3) of that Schedule.

6.6 Notes to the Forms

6.6.1 Certain matters are required to be shown in notes to the Forms. These include information about netting, (see paragraph 7.1) contingent liabilities, (see paragraph 7.2) currency translation (see paragraph 6.5) and the calculation of unearned premiums. Where such notes relate to Forms in the parts of the return subject to audit (Forms 9 to 16, 20 to 29, 31 to 37 and 40

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to 51) they should be kept separate from any notes relating to other parts of the return so that the auditors' report can readily refer to them.

6.6.2 On the preprinted Forms supplied by the Department there will often not be enough space to include a note. It is therefore suggested that the Form itself should just contain a cross-reference (see note x on page x) to the note which can then appear on a separate page with any other notes referring to audited Forms. Any notes to Form 30, which is not subject to audit and is not a form supplied by the Department, can be shown at the foot of the form or in the "Remarks" column.

6.6.3 It would facilitate the Department's computer processing if no notes, asterisks referring to footnotes or similar information are included in boxes which are intended to contain figures. This applies to Forms 9 to 16, 20 to 28, 31 to 37 and 40 to 42.

6.6.4 The notes appearing in the Companies Acts accounts, including accounting policies, are not required to be reproduced in the returns, but some of these notes may be necessary to comply with Regulation 5 of the 1983 Regulations and to make the returns more meaningful.

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EC 7. SCHEDULE 1 (FORMS 9 to 16)

7.1 Netting

7.1.1 Paragraph 8 of Schedule 1 permits the netting of amounts due to and from the same person and in this context amounts due to or from a person through an intermediary may be taken as legally due to or from the intermediary. This is principally of application to lines 51 to 53 of Form 13 and lines 31 to 33 of Forms 14 and 15. Net amounts must not be negative. Where the amount due to a person exceeds the amount due from the same person the net amount must be included in the returns as a liability item. Where the amount due from a person exceeds the amount due to the same person the net amount must be included in the returns as an asset.

7.1.2 If such net amounts are included in the forms a note to that effect must also be included. Where more than 25% of any net amount shown as due to the company is due from one intermediary or intermediary group the note must also mention that fact.

7.1.3 It should be noted that it is only amounts due from or to the same intermediary that may be netted. Amounts due from intermediary A may not be included net of amounts due to intermediary B. Facultative and treaty reinsurance can sometimes be written in the same Department, but otherwise companies should normally follow practice within the headings shown on the Forms (so that, for example, separate balances are included for treaties accepted and treaties ceded).

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7.2 Contingent liabilities

7.2.1 Paragraph 10 of Schedule 1 indicates that contingent liabilities are normally to be included in Forms 14 and 15. Certain other information is required to be given in a supplementary note to those Forms and is reproduced in lines 60 and 61 of Form 9.

7.2.2 Where any provision is made (other than within the mathematical reserves) for future liability to tax on unrealised capital gains this will be included in line 44 of Forms 14 and 15. A note to the Forms should indicate whether any such provision has been made and, if so, the amount. However, companies are not required to include in the notes an estimate of the total amount of tax which would be payable if all the assets were realised at the values shown in the return.

7.2.3 The notes on contingent liabilities should mention all non-insurance contingent liabilities which have not been included in Forms 14 and 15 together with an estimate of the amount of those liabilities wherever practicable.

7.3 Statement of solvency (Form 9)

7.3.1 Form 9 is required to be completed by every United Kingdom company, external company, United Kingdom deposit company and pure reinsurer - see

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Regulation 6(2). Annex B to these notes shows the inter-relationship of Forms 9 to 16 and 60 and 61.

7.3.2 Form 9, the statement of solvency, provides for there to be shown separately the required minimum margins for general business and long term business, as applicable, together with the amounts of the available assets and implicit items that may be counted against the solvency requirements. Under Regulation 10(4) of the 1981 Regulations, implicit items, ie future profits, zillmerising and hidden reserves, have no value expect in pursuance of an Order under Section 68 of the Act. Companies wishing to count such items against their solvency requirements should apply to the Department for the appropriate Order - see also paragraph 21 of these notes. For companies transacting both general and long term business the comparison is made separately for each type of business and the whole of the excess of the other than long term business assets over the other than long term business liabilities must be allocated to either the general business or the long term business solvency margin; identification of the corresponding underlying investments is not, however, required. For a proprietary company transacting only long term business, all other than long term business net assets are counted towards the long term business solvency margin.

7.3.3 The value of a dependant insurance company, as determined in accordance with Regulation 40 of the 1981 Regulations, may not correspond with the excess of net available assets over the required minimum margin shown in Form 9 for the dependant. This is because of the simplified formula for calculating the general business solvency margin attributed under Regulation 40(2)(c) to a dependant carrying on general business and because of the requirement under Regulation 40(2)(f) that the long term business liabilities of a dependant carrying on long term business shall be deemed to be not less than the value of the assets representing the long term business fund.

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7.4 Statement of net assets (Form 10)

7.4.1 Form 10 is required to be completed by every company - see Regulation 6(3).

7.4.2 Lines 11 and 12 should be completed only by companies carrying on long term business and the two lines will be equal to each other (except in the case of a company whose long term assets are not sufficient to cover its liabilities). Lines 21 to 29 should be completed by every company except a mutual company which has no assets other than long term assets.

7.4.3 Line 54 will contain all shareholders' funds not included in lines 51 to 53 and will be the balancing item to produce agreement between lines 59 and 29.

7.5 Calculation of required margin of solvency and statement of required minimum margin - general business (Forms 11 and 12)

7.5.1 Forms 11 and 12 show the calculation of the required margin of solvency for general business as laid down in Schedules 1 and 2 to the 1981 Regulations. The Forms are required to be completed by every United Kingdom company, external company, United Kingdom deposit company and pure reinsurer which carries on general business - see Regulation 6(4).

7.5.2. The Forms, which are not a strict "paragraph by paragraph" application of Schedules 1 and 2 to the 1981 Regulations, first call for the calculation of the required margin of solvency on the "premium" basis (Form 11) and then on the "claims" basis (Form 12). The higher of the two results establishes the amount of the required margin of solvency which is then shown

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at Form 12 line 43. The minimum guarantee fund, determined in accordance with Schedule 3 to the 1981 Regulations, is shown at Form 12 line 44. The required minimum margin which is shown at line 49 of Form 12 and at line 12 of Form 9 is the higher of the minimum guarantee fund (12.44) and the required margin of solvency (12.43) for global returns. In the case of branch returns it is the higher of half of the minimum guarantee fund shown at Form 12 line 44 and the required margin of solvency (12.43). A more detailed explanation of the various steps necessary to complete the Forms is given in the following paragraphs.

7.5.3 The steps in the calculation by the first method (premium basis) shown on Form 11 are -

a. Determine the gross premiums receivable in accordance with the note at the foot of Form 11.

b. Deduct premium taxes and levies and adjust the sum derived if the financial year runs for more or less than 12 months. The premium taxes and levies will include any local taxes or levies payable on overseas premiums (eg VAT) and in the case of UK premiums will include any general business levy under the Policyholders Protection Act 1975. (Paragraphs 3 and 4 of Schedule 1 to the 1981 Regulations).

c. Divide the amount arrived at between that which relates to health insurance, as defined in paragraph 8 of Schedule 1 to the 1981 Regulations and that which relates to other business. (The Department will advise, if requested, whether business carried on under a particular policy falls within the definition of health insurance). In the case of each amount, if appropriate, divide into

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two portions of 10 million European Currency Units and the excess over 10 million such units. (The sterling value of the European Currency Unit varies from year to year, the changes are published in the official Journal of the European Communities). Apply the appropriate percentages (18, 16, 6 or $5^1/_3$, as the case may be) to the totals arrived at and add together the resultant sums. (Paragraphs 5 to 9 of Schedule 1 to the 1981 Regulations).

d. Calculate (i) claims paid in the financial year (ii) the amount of claims outstanding at the end of the year and (iii) the amount of claims outstanding at the beginning of the year. Establish the amount of "claims incurred" in the year by adding (i) and (ii) and subtracting (iii). The figure for claims paid to be shown at 11.21.1 will be given by 22.11.2 + 22.14.2 + 24.21.5 + 24.22.5 + 27.22.3 for all accounting classes. For business accounted for on a one year basis the claims outstanding carried forward (11.23.1) will be 22.11.3 + 22.14.3 and claims outstanding brought forward (11.25.1) will be 22.11.1 + 22.14.1. The other Forms in the return do not give the data needed to determine the amount of claims outstanding where business is accounted for other than on a one-year basis (ie three year business and proportional treaties shown on Forms 27 and 28). These figures will have to be taken from other records or if necessary estimated, or a company may base its calculation on the "fund" figure which will include elements other than claims outstanding. The figures given must, however, be gross of reinsurance recoveries. (Paragraphs 10 to 12 of Schedule 1 to the 1981 Regulations).

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e. Deduct from the sum arrived at under sub-paragraph (d) above the total sum recoverable in respect of that amount under reinsurance contracts ceded. (Paragraph 13 of Schedule 1 to the 1981 Regulations).

f. Determine the fraction resulting from dividing the sum arrived at under sub-paragraph (e) above by the sum arrived at under sub-paragraph (d) above. (Paragraph 14 of Schedule 1 to the 1981 Regulations).

g. Multiply the sum arrived at under sub-paragraph (c) above by the fraction determined at sub-paragraph (f) above or if that fraction is less than one half, by one half. The product of this calculation is the First Result. (Paragraph 15 of Schedule 1 to the 1981 Regulations).

7.5.4 The steps in the calculation by the second method (claims basis) shown on Form 12 are -

h. Determine the reference period. If a company has not been in existence long enough to acquire a reference period this should be stated and lines 11 to 41 ignored. For the majority of companies the reference period will be the last three financial years. (Paragraphs 1 and 2 of Schedule 2 to the 1981 Regulations).

i. Establish the amount of "claims incurred" in a similar way to that explained in sub-paragraph (d) above but related throughout to the reference period rather than to the financial year. Claims in respect of both direct business and reinsurance business accepted

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should be included. (Paragraph 3 of Schedule 2 to the 1981 Regulations).

j. Reduce the sum derived to an annual figure by dividing by the number of months in the reference period and multiplying by 12.

k. Divide the amount arrived at between that which relates to health insurance and that which relates to other business. In the case of each amount, if appropriate, divide into two portions of 7 million European Currency Units and the excess over 7 million such units. Apply the appropriate percentages (26, 23, $8^2/_3$ or $7^2/_3$, as the case may be) to their respective portions and add together the resultant sums. (Paragraphs 5 to 9 of Schedule 2 to the 1981 Regulations).

l. The amount of the Second Result will then be achieved by multiplying the final sum resulting from the calculations at sub-paragraph (k) above by the same fraction as is required to be applied under sub-paragraph (g) above.

7.5.5. The amount of the minimum guarantee fund shown at 12.44.1 is calculated in accordance with Schedule 3 to the 1981 Regulations. In most cases it will be 400,000 European Currency Units translated to sterling.

7.6 Analysis of admissible assets (Form 13)

7.6.1 Form 13 is required to be completed for the total long term business assets and the total other assets for each return indicated in paragraph 4.2 above. The requirements in respect of branch returns are further explained in paragraph 19 below. Where separate assets are appropriated for separate long

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term funds or groups of funds, (other than internal linked funds,) additional Forms 13 are to be completed in respect of each such fund or groups of funds.

7.6.2 The category of assets to which a Form 13 relates is to be indicated in the appropriate code box. A list of the codes to be used is given in the Instructions for completion of the Form. (See page 37 of the 1983 Regulations).

7.6.3 All admissible assets must be included at the full value determined in accordance with Regulation 4 (see paragraph 5 above). The headings on Form 13 generally correspond to the types of assets for which separate valuation rules or admissibility limits are laid down in Part V of the 1981 Regulations.

7.6.4 The amount due in respect of long term business premiums shown at line 51 should include any amount due from the Inland Revenue in respect of life assurance tax relief. Such amounts should not be included in line 42.

7.6.5 In Forms 13 relating to long term assets, linked assets should be included in lines 85 and 86 and not in lines 11 to 83. Line 85 covers linked assets in internal linked funds and line 86 covers other linked assets (eg holdings in authorised unit trusts). Assets which are indirectly matching, or are notionally apportioned to meet,) liabilities in respect of property linked benefits but which are not themselves assets by reference to which the value of property linked benefits is determined should not be included in lines 85 and 86. However, if the linkage is to the <u>price</u> of a unit in an authorised unit trust, any holdings of units in that unit trust should be treated as linked assets and should be included in line 86 of of Form13.

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7.6.6 Line 87 should be left blank. It has been included in order to avoid reprinting the form if future amendments to the 1981 Regulations make any other type of asset admissible.

7.6.7 Line 94 should give the value of the admissible assets which has been excluded from the other lines because of the operation of the admissibility limits given in Schedule 8 to the 1981 Regulations. This will not necessarily be the figure which reconciles the total value of the assets shown on Form 13 with the total value of the assets shown in the Companies Acts accounts. Differences may arise because the basis of valuation of dependants, for example, is not the same. If companies consider it would be helpful for their own purpose to explain the differences, with or without quantification, this can be provided by way of note to either or both of the Insurance returns or the Companies Acts accounts.

7.7 <u>Long Term business liabilities and margins (Form 14)</u>

7.7.1 Form 14 should be completed by every company which carries on long term business. It shows long term asset margins as well as liabilities so that the total shown at line 59 will agree with the value of the long term assets shown on Form 13 even where the long term business funds are included at book value, except where the long term liabilities exceed the long term assets (see paragraph 7.4.2 above).

7.7.2 The constituent parts of the long term business funds are required to be shown on the form. Lines 11, 12, 15 and 16 require disclosure of the mathematical reserves and the balance of the fund as established by the

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actuary's valuation, reported on in accordance with Schedule 4. The amount of the mathematical reserves is to be shown after any increases resulting from the allocations of bonuses to policyholders as a result of the valuation.

7.7.3 Where cash bonuses have been allocated to policyholders and are due to be paid immediately, they are in the nature of a current liability. As such they should not be included in the mathematical reserves (and no factor need be applied to them in calculating the required margin of solvency). The Instructions to the Forms 9 and 14 provide for the amount of any cash bonuses to be stated in a footnote to Form 14 and included with other liabilities in line 24 of Form 9.

7.7.4 Lines 13 and 17 of Form 14 will be the sums of all figures shown at 40.16 in respect of ordinary and industrial business respectively. Lines 14 and 18 will be the sum of any valuation deficiencies in respect of ordinary and industrial business respectively; the figures should be included in Form 14 as positive amounts.

7.7.5 A figure will appear in line 51 only when the amount shown for the long term funds is not based on the full value allowed under the 1981 Regulations of the admissible assets representing those funds (ie when the funds are shown in the revenue account at book value). The amount of the margin to be entered in line 51 is determined by first subtracting the amount of the current liabilities (lines 21 to 47 of Form 14) from the total assets shown in 13.93 to give the value of the assets representing the funds and then subtracting from this figure the amount of those funds shown at 14.13 and 14.17. The resulting figure must not be negative since the funds may only be valued at book value where this produces a lower figure than the full value of

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the fund calculated in accordance with Part V of the 1981 Regulations. If a negative figure would otherwise result, the fund must be written down in line 3 of the relevant Form 40 before being included in Forms 14 and 58.

7.7.6 The second part of Instruction 3 to Form 14 requires a company to indicate whether any part of line 51 (the excess of the value of admissible assets representing the long term business funds over the amount of those funds) represents additions to the mathematical reserves shown in lines 11 and 15 which are required for the purpose of showing the solvency position in Form 9 or whether the amount shown in line 51 is wholly a free reserve. The issue arises because for the purpose of Schedule 1, including the Statement of solvency, assets are required to be valued in accordance with Part V of the 1981 Regulations (ie broadly on a market value basis) even where a long term fund is maintained and brought into account in the Schedule 4 report on the basis of lower book values. In such circumstances the mathematical reserves shown in Form 58 may not always constitute an appropriate assessment of the liabilities for Schedule 1 purposes.

7.7.7 Although the limits placed on the valuation rates of interest for the Schedule 4 valuation by Regulation 59 of the 1981 Regulations are determined in relation to the yields on the assets on the same basis as these are shown in Schedule 1, there are other respects in which the actuary's assessment of the mathematical reserves in the Schedule 4 report may have had regard to the lower book values where the assets have been brought into account on this basis; for example, in assessing the amount of a mismatching reserve in accordance with Regulation 55 of the 1981 Regulations or in a provision for future capital gains tax. For this reason in certifying the long term liabilities as required under Part II of Schedule 6, the actuary may find it necessary in some circumstances to make an addition to the mathematical

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reserves on the Schedule 4 basis shown in lines 11 and 15 of Form 14. It is anticipated that in practice for the majority of companies no adjustment will be required, but where an adjustment is made the amount stated in the actuary's certificate is to be shown in a footnote to Form 14 and included in the mathematical reserves shown in line 23 of Form 9.

7.7.8 The figures shown in line 62 of Form 14 should include the total of Form 56 column 14 (all funds) plus any liabilities in lines 21 to 47 in respect of property linked benefits.

7.8 <u>Liabilities - other than Long Term business (Form 15)</u>

7.8.1 Form 15 should be completed by all companies except a mutual company carrying on only long term business. It shows the amount of the liabilities other than long term business liabilities.

7.8.2 The figures for general business claims outstanding are shown net of reinsurance recoveries on this Form. A separate amount is required to be shown for the provision for "expenses for settling claims outstanding" which is designed to provide for the cost of the overheads which would be involved in running a claims department to settle outstanding claims if the company ceased to take on any new business. The expenses to be provided for here are those which will be classed as management expenses when they are incurred and not those which will be attributed to the cost of invididual claims. Provision for expenses attributable to individual claims should be included in claims outstanding (see definition in Regulation 3(1)).

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7.9 Statement of other income and expenditure (Form 16)

7.9.1 Form 16 is required as part of every return. The Form relates only to the results of the year and has no balance brought forward from previous years.

7.9.2 The figures shown at line 11 of Form 16 should be the sum of those shown at line 12 of Form 40 (the long term business revenue account) for all the long term funds including, where appropriate, industrial assurance.

7.9.3 Figures at lines 13, 14, 21 and 25 will exclude any amounts included in the general business revenue account (Form 20) or the long term business revenue account (Form 40) for those same items. Investment income from long term business assets must be shown in Form 40; other investment income must be shown either in Form 20 or in Form 16 or in a combination of both. Where a company wishes to credit the long term business fund with any investment income derived from the other than long term business assets, it must show this in the returns by making a transfer to the long term business revenue account in line 11 of Form 16 (ie a negative entry), and make a corresponding negative entry in line 12 of Form 40. Investment income may be shown net of management expenses incurred in respect of the investments.

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EC 8. SCHEDULE 2: GENERAL BUSINESS REVENUE ACCOUNT AND ADDITIONAL INFORMATION (FORMS 20 TO 29)

8.1 Accounting classes

8.1.1 The accounting classes for which the Forms in Schedule 2 are to be completed are given in Regulation 3(1). Direct insurance and facultative reinsurance acceptances are divided into 8 classes. Inwards reinsurance treaties are to be shown in two separate classes except that treaties relating to classes 3, 4 and 5 are included with the direct business of the appropriate class when this is accounted for on a three year basis.

8.2 UK and overseas premiums

8.2.1 Where the Forms require premiums to be shown separately in respect of UK and overseas business the division is to be madde on the basis of the place where the contract was made (in the case of direct insurance and facultative reinsurance) or the country where the cedant has its head office (in the case of a reinsurance treaty). Reinsurance outwards will follow the premiums to which it relates.

8.2.2 It is appreciated that this practice may produce unusual results in respect of treaties in some cases. Companies are, however, asked to follow the practice wherever possible but if a particular company has exceptional reasons for wanting to adopt an alternative practice in respect of specific types of business the Department will be prepared to consider agreeing to a modification for that company.

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8.3 Reinsurance portfolios

8.3.1 Regulation 3(1) defines the various types of portfolio payments which may be made between cedants and reinsurers in connection with the commencement, termination or variation of reinsurance treaties. It also lays down the way in which they are to be treated in the returns.

8.3.2 A portfolio paid on the transfer of liability for the unexpired portion of underlying policies is called a premium portfolio when it is paid by a reinsurer to a cedant and an unearned premium portfolio when it is paid by a cedant to a reinsurer. These payments are treated by cedants as reinsurance premiums payable (or a refund of such premiums) and are treated by reinsurers as premiums receivable (or a refund of such premiums).

8.3.3 A portfolio paid on the transfer of liability for claims which have already been incurred is called a loss portfolio when it is paid by a reinsurer to a cedant and an outstanding claims portfolio when it is paid by a cedant to a reinsurer. These payments are also treated by cedants as reinsurance premiums payable (or a refund of such premiums) and by reinsurers as premiums receivable (or a refund of such premiums). Portfolio payments must be treated in this way in the returns and not as claims paid or a refund of claims paid. Treatment as premiums is appropriate because they are payments to assume liabilities under insurance contracts and because the additional liabilities would not otherwise be properly reflected in the calculation of a company's required margin of solvency.

8.3.4 For accounting classes 9 and 10 provision is made on Forms 24, 26, 27 and 28 for portfolio payments to be separately recorded. For other classes, however, portfolios will be indistinguishable from other premium payments.

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8.4 Revenue account (Form 20)

8.4.1 Form 20 is required separately for each accounting class and a summary Form giving the total of all the classes is also required.

8.4.2 The lines to be completed on the Form will vary according to whether business in the class is accounted for on a one year basis or a funded basis. Lines 11 to 49 relate only to one year business and lines 51 to 59 relate only to funded business. The remaining lines are applicable irrespective of the method of accounting adopted. Where some business in a class is funded and some is not, one Form should be completed showing all the business in the class.

8.4.3 Almost all the figures on the Form are drawn from the more detailed analyses on Forms 21, 22, 24 and 27. The "source" column of the Form indicates from where the figures will be derived. Annex C to these notes shows the inter-relationships between Form 20 and the other Forms in Schedule 2.

8.4.4 Investment income may be shown in line 71 of Form 20, wholly in Form 16, or in a combination of both. It may be shown net of expenses in connection with the investments.

8.5 One year business (Forms 21 to 23)

8.5.1 Separate Forms 21, 22 and 23 are required for each accounting class in which business accounted for on a one year basis is written.

8.5.2 Form 21 should include all premiums receivable in the financial year. They are, however, to be allocated to years and months of inception within the

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Form on the basis of the date when the liability to risk under the contracts commenced. Exceptions to this rule are only permitted in the case of business included in the reconciliation return (see paragraph 9.2 below) or business which is obtained through an overseas agent (but not overseas business obtained directly by the company or its overseas branches). Where these exceptions are allowed the premiums may be allocated to years or months on the basis of date of debit (ie not later than the date when the company or its branch recorded that the risk had been accepted). The amounts of premiums allocated in this way are to be shown in column 7 of lines 41 to 43.

8.5.3 Premiums are to be divided into earned and unearned portions on Form 21 on the basis of the length of the unexpired period of cover. No attempt is to be made in this Form to allow for deductions for commission or other deferred acquisition costs (which are to be shown on Form 22). For annual premiums the apportionment should normally be made by the 365ths or 24ths method and the method used is to be stated in a note. Where the method used is less accurate than the 24ths method the note should include the reason for its adoption.

8.5.4 Late notified premiums are to be shown in line 11 where they were earned in previous years and in line 12 where they were not earned in previous years. Entries should be made in line 15 where the accounting period exceeds 12 months on the basis explained in the note at the foot of Form 21. Line 31 shows premiums receivable in earlier years but not earned by the end of the preceding year (ie unearned premiums brought forward at the start of this financial year).

8.5.5 Short period contracts should be included in lines 13 and 14. If, exceptionally, a premium is included as receivable this year in respect of a

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risk not incepting until next year it should be included in column 2 line 28 as being wholly unearned.

8.5.6 Columns 3 and 4 should show the reinsurance premiums payable in respect of the gross premiums shown in columns 1 and 2. On each line column 5 will be column 1 minus column 3; and column 6 will be column 2 minus column 4.

8.5.7 Form 22 should include in column 2 all claims recorded as paid in the financial year and all other expenses and commission which are payable or receivable in the financial year. The amounts in lines 11 to 22 are divided according to whether the incident occurred in this financial year or in a previous year but for this purpose claims included in the reconciliation return (see paragraph 9.2 below) may all be regarded as relating to incidents occurring this year. The effect of this will be that figures may appear in column 1 of lines 14 to 16 and 22 which will seem to be amounts brought forward from last year in respect of incidents which had not occurred until this year. A note at the foot of the Form explains this apparent anomaly.

8.5.8 Expenses, whether incurred through the employment of the company's own staff or otherwise, which are directly attributable to particular claims, eg legal, medical, engineer's or surveying costs, are to be included in lines 11 to 16. Other expenses in connection with the settlement of claims should be included in lines 21 and 22.

8.5.9 Column 1 of lines 11 to 16 represents claims outstanding brought forward at the beginning of the financial year and column 3 represents claims outstanding carried forward. Column 3 of lines 23 to 25 shows any deferred acquisition costs or commissions receivable which the company carries forward to the following year and which are deducted from (lines 23/24) or added to

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(line 25) this year's unearned premiums to give the reserve for unearned premiums included in line 21 of Form 15.

8.5.10 Form 23 should have one section completed for each accounting class accounted for on a one year basis. There are two sections on each printed Form. The Form analyses the amount of claims paid and outstanding net of reinsurance by the year of origin of the claims. Business which is included in the reconciliation return (see paragraph 9.2 below) is shown in line 19 and should not be shown by year of origin. Claims relating to years of origin commencing prior to 1 January 1981 should all be included in line 18 and are not to be analysed by year of origin.

8.5.11 Column 1 of Form 23 shows the estimate made at the end of a particular financial year in respect of the claims originating in that year. Column 2 shows the total amount paid in all financial years in respect of a particular year of origin since the end of that year. Column 3 shows the amount estimated at the end of the present financial year as still being outstanding in respect of the particular year of origin.

8.6 <u>Three year business (Forms 24 and 25)</u>

8.6.1 Forms 24 and 25 are to be completed in respect of each accounting class for which business is accounted for on a three year basis. Only classes 3, 4, 5 and 9 may be accounted for in this way, (see regulation 9) unless the company has obtained from the Department an Order under Section 68 of the Act extending the application of 3 year accounting.

8.6.2 In these Forms premiums, claims and other amounts are normally to be allocated to the year in which the contract commenced. For this purpose a policy providing permanent open cover is deemed to commence on each

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anniversary date. In the case of classes 3, 4 and 5, however, the year may be determined by the date when the policy was issued (ie the date of closing rather than the date of attachment). If attachment dates are not used a note must be included giving the basis on which the year has been determined.

8.6.3 Line 15 of Form 24 will be blank in the case of classes 3, 4 and 5 since outstanding claims portfolios and loss portfolios are to be included in line 12. For class 9 it will contain a figure derived from Form 26 (see the Instructions for Form 24 in the Regulations).

8.6.4 Line 31 of Form 24 should include the overheads of claims settlement as well as other management expenses. It should not, however, include expenses incurred in connection with the settlement of individual claims which are to form part of claims payments shown at lines 21 to 29.

8.6.5 Line 51 of Form 24 will show any profit taken from the closed years or any transfers into the fund. No profit can, of course, be taken from the two open years.

8.7 Non-proportional treaties (Form 26)

8.7.1 Form 26 is completed for accounting class 9 in addition to Forms 24 and 25.

8.8 Proportional treaties (Forms 27 and 28)

8.8.1 These forms should be completed for accounting class 10 only.

8.8.2 Figures for a treaty are to be included in column 1 (as a closed treaty year) for treaties for which end of year accounting information on

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unearned premiums/outstanding claims has been received. They may also be so included when such information is not received during the financial year if either it is received after the end of the financial year but before the return is prepared or the treaty has a date of commencement/renewal prior to the beginning of the financial year. Otherwise the information is to be included in column 2 (as an open treaty year). The balance of premiums less claims and expenses for the open year is added to the unearned premiums and outstanding claims for the closed year and carried forward to the next financial year as a fund. This procedure allows for the delays commonly found in reporting on treaties and will also provide for the situation where a treaty runs for a year which does not coincide with the company's financial year.

8.8.3 It follows from this method of accounting that no profit may be taken from the open year. If a transfer is made into the open year it will be shown at 27.51.2.

8.8.4 A note is required to be annexed to Form 27 reconciling all amounts shown on that Form with amounts shown on each Form 27 prepared pursuant to Regulation 22 and with amounts shown on each Form 29 (see paragraphs 10.1 and 10.2).

9. GENERAL BUSINESS ANALYSES OF EXPOSURE AND CLAIMS (FORMS 31 TO 36)

9.1 Risk groups

9.1.1 Regulation 10 deals with the way in which direct insurance and facultative reinsurance business within each accounting class is to be classified into risk groups for the purpose of completing Forms 31 to 35. The business carried on in each country is to be classified. The risk groups used

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may vary for different countries. The only detailed stipulation is that private motor car policies must be divided into comprehensive and non-comprehensive, in such a manner as may be appropriate, and that neither of these may be included in the same risk group as any other business. Either of these groups of private motor car policies may, of course, be further sub-divided into two or more risk groups if a company considers this appropriate.

9.1.2 Where there is only one risk group for an accounting class in a country, that risk group is to be described by the particular type of business carried on. Thus if a company's only motor vehicle business in a country is motor cycles the risk group should be described as "motor cycles" and not "motor vehicle".

9.1.3 For the purpose of the classification into risk groups and for completion of Forms 31 to 35 home foreign business is to be treated as though it is carried on in a separate country from other UK business. This applies to all accounting classes except 3, 4 and 5 since MAT business is not included in the definition of home foreign business (see Regulation 3(1)). Where a company wishes to sub-divide its home foreign business according to the country of risk or the currency in which the policy is written it may do so by using different risk groups (eg Country: home foreign, accounting class: property damage, risk group: United States commercial property).

9.2 Reconciliation returns

9.2.1 Regulation 12 avoids the need to provide the detailed analyses of premiums and claims in Forms 31 to 35 for particular countries and classes when the amount of relevant business is below certain limits. However, the totals of such business for each class (other than Form 32) must be given in a

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reconciliation return. Separate reconciliation returns are required for United Kingdom business (which includes home foreign business) and overseas business.

9.2.2 The information to be shown in the reconciliation return is given in the Instructions for each of the Forms.

9.2.3 The reconciliation return should include all business not included in the detailed analyses for whatever reason including that relating to:

a the current year and any earlier years which is excluded by the operation of Regulation 12(1) or the corresponding provision in the Accounts and Forms Regulations 1968 or the Accounts and Statements Regulations 1980

b any years prior to 1970 which have not yet been run off and which were not required to be reported under the 1968 Regulations

c the Atomic Energy, Electricity and similar pools for which sufficient detail is not available to complete the full forms

d small Marine and Aviation claims which were not reported under the 1968 Regulations.

Unless all business is included in Forms 31 and 33 to 35 they will not reconcile with the revenue information given in Forms 21, 22 and 24.

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9.3 One year business (Forms 31 to 33)

9.3.1 One section of Form 31 is to be completed for each risk group in an accounting class carried on in a particular country. Up to four risk groups can be accommodated on one form. Similar arrangements apply to Form 32 except that it is required only for accounting class 2 (motor vehicle).

9.3.2 Column 1 of Form 31 shows premiums receivable this year but earned last year ("late notified premiums"), column 2 shows the premiums earned this year and column 3 shows the unearned premiums carried forward to next year. Line 11 relates to premiums receivable in previous years (ie unearned premiums brought forward at the beginning of this year), line 12 to premiums receivable this year in respect of policies which incepted last year and line 13 to premiums receivable this year in respect of policies incepting this year. The figure at 31.19.5 will thus be the total written premium for the year in sterling and should agree with the appropriate 21.41.1 when all the forms for an accounting class are added together.

9.3.3 For each risk group in an accounting class carried on in a particular country one section of Form 33 is to be completed for each year of origin for which there were any liabilities at any time during the financial year. There are two sections to a form.

9.3.4 Column 2 of Form 33 shows the gross amount of claims paid in the financial year and the total of 33.29.2 for all forms relating to an accounting class should agree with 22.11.2 + 22.14.2. Column 3 shows the amount of claims paid in previous financial years and column 4 shows the estimated amount of claims still outstanding at the end of the financial year. The total of the figures shown at 33.29.4 for all forms relating to an

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accounting class should agree with the gross claims outstanding figure given at 22.11.3 + 22.14.3.

9.3.5 Some of the boxes on Form 33 which may at first appear to be incapable of ever containing a figure have been left unshaded because some companies may in practice find that they need to enter amounts there. Columns 2 and 3 of line 11 show amounts paid in respect of claims closed at no cost and allow for the possibility that an amount will be shown in column 3 as paid on account in a previous year which is balanced by a refund this year shown in column 2. Column 4 may contain an amount in lines 11, 12, 13 and 17 (claims outstanding on closed claims) if a company makes separate provision for the possibility that a proportion of closed claims will in practice be reopened later.

9.3.6 No information should be included in line 17 in respect of those reopened claims which were closed in the financial year or were still outstanding at the end of the year, even when Instruction 3 is being followed. Reopened claims which had been closed again in a previous financial year should be counted as one claim in 33.17.1. Thus the figure at 33.19.1 will always be the latest estimate of the total number of claims attributable to the year of origin, irrespective of how many times any of them have been reopened.

9.3.7 Where a number of small claims in respect of facultative reinsurance accepted ("inwards guarantees") are notified by the broker or leading reinsurer without details of the years of origin or amounts of the individual claims being given, such claims should be included in the most recent year to which any of them is likely to relate. Where the number of claims is also not known they should be regarded as one claim.

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9.4 Three year business (Forms 34 and 35)

9.4.1 Form 34 should be completed for each country with a section for each risk group in each accounting class. It will show the premiums receivable in the financial year and the total of 34.11.6 for all sections relating to an accounting class will equal 24.11.5 for that class.

9.4.2 Form 35 is required for each risk group in each accounting class in each country with a line completed for each year of origin for which there were any liabilities at any time during the financial year. The total of the claims paid figures given in 35.11.4 for an accounting class will be equal to that at 24.21.5.

9.4.3 Figures given in column 2 of Form 35 should include amounts estimated to be outstanding in respect of claims incurred but not reported (IBNRs) in respect of premiums included in Form 34.

9.5 Currency rates (Form 36)

9.5.1 Except in boxes where indicated, amounts on Forms 31, 33, 34 and 35 in respect of individual countries are required to be entered in the currency of the country concerned. When a return includes such amounts in a currency other than sterling, Form 36 is also required with a line for each currency showing the rate of exchange used to translate the overseas currency into sterling.

9.5.2 All amounts on forms relating to United Kingdom business, home foreign business and in reconciliation returns will be shown in sterling. If

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only such forms are included in the returns there will be no need for Form 36.

9.5.3 The rates of exchange shown on Form 36 should be the rates actually used without any rounding.

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10. ADDITIONAL INFORMATION ON GENERAL BUSINESS REINSURANCE ACCEPTED AND CEDED AND COMMUNITY CO-INSURANCE

10.1 Non-proportional reinsurance treaties accepted and certain proportional treaties (Form 29)

10.1.1 Under Regulation 21 every company which carries on general business is required to furnish the information specified on Form 29 in respect of

(i) Non-proportional treaty reinsurance business accepted

(ii) Marine and aviation proportional treaty reinsurance business accepted

(iii) Transport proportional treaty reinsurance business accepted (but only if such business is accounted for on a three year basis).

10.1.2 This business must be allocated to not more than ten separate categories including

(a) casualty (including classes 1, 2 and 13)

(b) property (including classes 4, 8, and 9)

(c) aviation (including classes 5 and 11)

(d) marine (including classes 6 and 12)

These references to numbered classes are references to the general business classes set out in Schedule 2 to the Act.

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10.1.3 It is permissible to use only these four categories, in which case long-tail business (other than MAT business) would normally be included in the "casualty" category. However, the company has the option of allocating any of the above mentioned classes, eg class 1 or 2 or both, to a separate category or categories limited to that class or those classes. This option is subject to the proviso that not more than ten categories are used in total for business covered by this Regulation (ie including, where they are relevant, the four specified above). Classes not mentioned above may be included in any appropriate category, whether specified or not, having regard to the likely time taken for claims to be settled.

10.1.4 It is important to note that any proportional business accepted by the company which comprises the retrocession of non-proportional treaty reinsurance business must be treated as non-proportional business unless the company is unable to provide the relevant information for Form 29. Where that is the case, information relating to those treaties of this nature for which Form 29 cannot be provided should be shown on Form 27 as an entirely separate category. Other treaties of this nature should still be shown on Form 29. If the information is given on Form 27 a note must be annexed to the Form explaining why this has been done. It should also be noted that a separate category (or categories) should also be used for all treaties accepted, not included in the categories specified in paragraph 10.1.2 above if it can reasonably be foreseen that a substantial proportion of claims will be settled more than ten years after the inception of the business.

10.1.5 Where information relating to a reinsurance treaty accepted falls within more than one category, the amounts may either be apportioned as appropriate to each category or else be placed within the category into which the greater part of the business falls. In either case, an explanatory note should be annexed to the Form or Forms 29 concerned showing the method of

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apportionment used and/or identifying the business falling outside the category within which it has been included. It is accepted that, in some cases, information shown on a single Form 29 as pertaining to one category may include at one and the same time treaties wholly appropriate to that category, treaties which have been apportioned between that and other categories and also treaties allocated to that category on the basis of "major risk". The only constraint is that the method of allocating information to categories must remain consistent except as provided for in paragraph 10.1.6 below.

10.1.6 The objective of Regulation 21(4)(a) is to provide that, once a treaty has been categorised for a given underwriting year, it remains so categorised for that underwriting year in the returns made for subsequent financial years. (A change in category is permitted from one underwriting year to another if a change occurs in the underlying nature of the treaty.) Further, Regulation 21(4)(b) has the objective of achieving consistency in the categorisation of business from one year to the next. In either case, exceptional changes are permitted if an explanatory note is annexed.

10.1.7 A separate Form 29 is required in respect of each category of business.

10.1.8 In the main, Form 29 provides an analysis by category of business of material already provided on Form 24. However, it will also extend the analysis by year of inception over a greater number of years than provided on Form 24 and will permit amounts to be shown in original currencies. In addition, where a company reports on Form 27 marine and aviation treaty reinsurance business accepted, (paragraph 10.1.1(ii) above) and certain business mentioned in paragraph 10.1.4 above, the amounts included there will also have to be analysed on Form 29.

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10.1.9 Information shown on the Forms 29 should, therefore, in aggregate reconcile with the corresponding information included in the Forms 24 and, where appropriate, Forms 27, and a reconciliation statement must be provided, showing how this has been achieved. Where amounts are reported on Form 29 in a currency other than sterling, the reconciliation statement should include a translation to the sterling equivalents included in Forms 24 and 27. The reconciliation statement should also bring into account sums treated as de minimis under the provisions of Regulation 21(6) (see paragraph 10.1.10 below) and will also have to reflect the necessary split of the figures in the expenses section on the Forms 24 for MAT classes, ie between those relating to direct and facultative business and those relating to treaty reinsurance business. An example of one way of presenting the reconciliation statement referred to above is given in Annex D.

10.1.10 Form 29 need not be completed if the gross premiums receivable by the reporting company in respect of its general business reinsurance treaties do not exceed 2½% of the gross premiums receivable by the company in that year in respect of all its general business. Additionally, if the gross premiums receivable in a financial year for a category which requires to be reported on Form 29 do not exceed either £100,000 or 2½% of gross premiums receivable in that year in respect of general business treaty reinsurance accepted then no information need be provided on Form 29 in respect of that category.

10.1.11 Notwithstanding the exclusions set out in the previous paragraph, where information in respect of an underwriting year has been given in the returns for a previous financial year (when the minimum levels were exceeded), then information about that business for that underwriting year will have to be given in subsequent financial years until the business has been finally run-off.

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10.1.12 Form 29 need not be prepared in respect of financial years beginning prior to 1 January 1983. Where information is shown on Form 29 for a reinsurance treaty accepted before the first financial year for which Form 29 is required to be prepared, the information regarding business incepted in earlier financial years from that treaty may be aggregated rather than being shown separately for each financial year, but if no relevant analysis of information has been maintained for business incepted prior to 1 January 1983, for example, because records relating to earlier years were not maintained in terms of categories, estimates (including estimates in respect of the amounts of funds brought forward or carried forward in respect of that business) should be made, in order that the form may be fully completed. The Department will take into account the uncertainties underlying some of these estimates when considering the returns submitted by companies.

10.1.13 The Form 29 layout in Schedule 2 will have to be adapted by companies in some respects to reflect the circumstances in which the returns for successive years will be prepared. When Form 29 is prepared for the first time, in respect of the 1983 financial year, three columns of financial data will be required. The first will contain amounts receivable or payable in 1983 in respect of treaties incepted in all years prior to the 1983 financial year. The second column will show the same information in respect of treaties incepted in 1983, and the third column will show the total of the other two. When the return for the 1984 financial year is prepared, a fourth column will be needed. Apart from the total column (which in this case will contain all sums receivable or payable in 1984), the others will show respectively reading from right to left, amounts in respect of treaties incepting in 1984; amounts in respect of treaties incepting in 1983; and amounts in respect of treaties incepting in all previous years. Subsequent returns will require the layout of the Form to be further extended to accommodate later financial years.

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10.1.14 Currency. The provisions of paragraphs 9.5.1 to 9.5.3 above regarding amounts to be entered in original currency apply also to Form 29 except that where premiums are receivable or claims are payable in a currency other than sterling, separate Forms 29 may be provided in sterling or in United States or Canadian dollars or in an appropriately weighted average of European currencies instead of in the original currency. A company may devise its own weighting for this calculation to suit the composition of its business. Whichever option is chosen as the basis for preparing Form 29, it must be applied consistently, in relation to any particular treaty, from one financial year to another, and a note must be included in the returns stating the method adopted (including the method used in calculating a weighted average of European currencies). Where the amounts of premium receivable or amounts of claims payable in a currrency other than sterling, United States or Canadian dollars exceed 10% of the total, a separate Form 29 may be provided in that currency provided that the method of selection adopted is used consistently from one financial year to another.

10.2 Other proportional treaties accepted (Form 27)

10.2.1 Regulation 22 covers all proportional treaty business accepted which is not covered by Regulation 21 and which does not have to be shown on Form 29. A number of paragraphs above relating to Regulation 21 apply equally to Regulation 22, as shown. It should be borne in mind that (except in paragraph 10.1.4) the references therein to Form 29 should be read as references to Form 27 in relation to Regulation 22. The paragraphs are:-

(a) Paragraphs 10.1.1 to 10.1.3 except that the mandatory categories for Regulation 22 are

(i) casualty (including classes 1, 2 and 13); and

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(ii) property (including classes 4, 8 and 9) only,

(b) Paragraphs 10.1.4 to 10.1.7

(c) Paragraphs 10.1.10 and 10.1.11 (but, as regards paragraph 10.1.11 only until the business in the open year has been closed).

10.2.2 A Form 27 does not have to be prepared in respect of separate categories in respect of financial years beginning prior to 1 January 1983.

10.2.3 It should be noted that the number of categories permitted is limited to 10, as for Regulation 21 business, but that these categories are in addition to those covered by that Regulation.

10.3 Summary of reinsurance business ceded (Form 30)

10.3.1 Form 30 should show all reinsurance arrangements for which premiums were payable in the financial year. Entries are required in the Form for each accounting class for which business is covered by outwards reinsurance. Entries per risk group are required if there are separate reinsurance arrrangements within an accounting class.

10.3.2 Preprinted copies of this Form are not supplied by the Department and companies are free to adapt the widths of the columns to fit the amount of information to be entered.

10.3.3 Column 6 should show the estimated total combined maximum amount recoverable from reinsurers under the appropriate treaty arrangement in respect of any one claim payable by the company or in respect of any one or more claims payable by the company arising out of any one event. The nature

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of the statement will depend upon the type of reinsurance cover and the wording of the reply must be adapted according to the circumstances. The replies might be in the following form:

i. Quota Share Arrangements

"30% of original gross cover subject to estimated maximum loss any one claim of £30,000 for reinsurer's account".

ii. Surplus or Facultative Obligatory Arrangements

"Seven times combined own net retained and quota share cover subject to estimated maximum loss any one claim of £700,000 for reinsurer's account".

iii. Excess of Loss Arrangement - Catastrophe

"£1 million any one event for own retained account". (Assuming no protection for other reinsurers). An indication of the excess points should be given if this is not obvious from columns 4 and 5.

iv. Excess of Loss Arrangements - Working

"£250,000 for any one claim for own net retained account". An indication of the excess points should be given if this is not obvious from columns 4 and 5.

10.3.4 In the case of facultative reinsurance cover full details are not required in all columns of the Form. The information required is set out in the Instructions for the Form, (see page 59 of the Regulations).

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10.3.5 The total reinsurance premiums recorded in columns 8 and 10 of Form 30 should be reconciled in total with the equivalent premiums recorded on Forms 21, 24 and 27 as appropriate. The corresponding amounts of premiums are shown at 21.41.3, 24.13.5, 24.14.5 and 27.14.3. An explanation should be given of any differences.

10.4 Statements on major reinsurers and treaty cedants

10.4.1 Regulation 17 requires every company which carries on general business and which cedes reinsurance on a treaty basis to furnish a statement giving the particulars set out in Regulation 17 (1) in respect of each of its major reinsurers, or else a statement that it has no major reinsurers.

10.4.2 Regulation 17 (2) defines a major reinsurer for this purpose, that is, in the context of general business treaty reinsurance. It should be noted that, while the basic criterion is the proportion of the business of the company making the return which is ceded to the reinsurer, the level at which a reinsurer qualifies as a major reinsurer varies as between proportional and non-proportional business. In the case of business ceded under proportional treaties, a major reinsurer is one to which the company making the return has ceded business under such treaties for which the reinsurance premiums payable amount to 2% or more of the gross premiums receivable by the company in respect of general business (of all kinds, both reinsurance and direct business). In the case of business ceded under non-proportional treaties, a major reinsurer is one to which the company has ceded business under such treaties for which the reinsurance premiums payable amount to 5% or more of the total of reinsurance premiums payable by the company in respect of all non-proportional treaties which it has ceded. In assessing premiums, it will be necessary to gross up those for MAT in cases where these are normally included in annual returns on a net basis.

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10.4.3 A reinsurer will be regarded as a major reinsurer if the proportion of business ceded to it reached the specified level in either the financial year to which the return relates or in any of the five immediately preceding financial years (although, under the transitional arrangements it will not be necessary to consider any year ended before 23 December 1982).

10.4.4 In some cases, there will be links of one sort or another between a company's reinsurers which will require their premium income to be aggregated for the purpose of identifying major reinsurers. What constitutes a connection between companies for this purpose is defined in Regulation 20 and is explained more fully in paragraph 10.4.16 below. Where reinsurers have to be counted together in this way, they should be regarded as major reinsurers if the aggregate volume of business of the group exceeds the specified level, but, where this happens, each reinsurer within the group becomes a major reinsurer and details are required of each one separately.

10.4.5 The statement of particulars must include

(i) The full name and address of each major reinsurer of the company making the return. (See also paragraph 10.4.14).

(ii) A note saying whether, and, if so, how, each of the major reinsurers was connected with the company making the statement at any time in the financial year to which the return relates. (See also paragraph 10.4.11).

(iii) A note of the amount payable to each major reinsurer during the financial year to which the return relates by way of premiums in respect of general business ceded under reinsurance treaties. The expression used, "reinsurance premiums payable" is defined in Regulation 3(1).

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(iv) A note of any amount due from each major reinsurer to the company at the end of the financial year to which the return relates under general business treaties. This will be the amount included in respect of each major reinsurer in the figure given in line 53 of Form 13 in the annual returns. The extent to which netting is permitted is dealt with in Regulation 20(5) and considered at paragraph 10.4.18 below.

10.4.6 The amounts referred to in items (iii) and (iv) above should cover all treaty general business reinsurance ceded to each major reinsurer during the year in question, that is, both proportional and non-proportional. In the event that a major reinsurer qualifies as such only on one kind of treaty business, the amounts shown should nonetheless cover both if business of both kinds was ceded to that major reinsurer in the year in question.

10.4.7 Regulation 18 requires every company which carries on general business and which places reinsurance on a facultative basis to furnish a statement giving the particulars set out in that regulation.

10.4.8 The statement of particulars must include

(i) The full name and address of each reinsurer included by the company making the return in the number of facultative reinsurers inserted in column 7 or column 9 of Form 30.

(ii) A note saying whether, and, if so, how, each of the listed facultative reinsurers was connected with the company making the statement at any time in the financial year to which the return relates.

(iii) A note of the amount payable to each named facultative reinsurer during the financial year to which the return relates by way of premiums in

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respect of general business facultative reinsurance and included by the company making the return in column 8 or column 10 of Form 30.

10.4.9 Regulation 19 requires every company which carries on general business and which accepts general business treaty reinsurance to furnish a statement giving the particulars specified in Regulation 19(1) in respect of each of its major cedants or else a statement that it has no major cedants. Regulation 19(2) defines a major cedant for this purpose.

10.4.10 A cedant will be regarded as a major cedant if the proportion of business ceded by it to the company making the return reached the specified level in either the financial year to which the return relates or in any of the three immediately preceding financial years (although, under transitional arrangements it will not be necessary to consider any financial year commencing before 1 January 1983). In assessing premiums for this purpose, it will be necessary to gross up those for MAT in cases where these are normally included in annual returns net of commission.

10.4.11 In some cases, there will be links between a company's cedants which will require their premiums payable to be aggregated for the purpose of identifying major cedants. What constitutes a connection between companies for this purpose is defined in Regulation 20 and is explained more fully in paragraph 10.4.16 below. Each cedant has to be considered separately in this way, and each will qualify as a major cedant if the aggregate volume of business of the group with which it is connected exceeds the specified level. Where this happens, details are required of each one separately.

10.4.12 Where a company has major cedants, the statement of particulars must include

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(i) The full name and address of each major cedant of the company making the return. (See also paragraph 10.4.14).

(ii) A note saying whether, and, if so, how, each of the major cedants was connected with the company making the statement at any time in the financial year to which the return relates. (See also paragraph 10.4.15).

(iii) The amount of the total gross premium receivable from each major cedant during the financial year to which the return relates in respect of general business accepted under reinsurance treaties. This should cover all general business treaty reinsurance ceded by each major cedant during the year in question, that is, both proportional and non-proportional.

10.4.13 Regulation 20 contains provisions supplemental to Regulations 17, 18 and 19 which must be observed when the statements described in paragraphs 10.4.1 to 10.4.12 above are being prepared.

10.4.14 The full name required to be shown in items (i) of paragraphs 10.4.5, 10.4.8 and 10.4.12 above should be, in the case of a body corporate, its corporate name. In the case of an individual or an unincorporated body, the name should be that under which the individual or body lawfully carries on business (ie in accordance with Section 63 of the Act). The address of a body corporate will be that of the registered office or of the principal office in the country of incorporation. In the case of an unincorporated body it will be the address of the principal office.

10.4.15 Two kinds of connection are covered by the Regulations. One arises where a company making a return is connected with a reinsurer or a major

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cedant listed under items (i) of paragraphs 10.4.5, 10.4.8 and 10.4.12 above. When this is so, a note of the connection is required under items (ii) of those paragraphs. In these circumstances the company making the return and a reinsurer (or major cedant) of that company are deemed to be connected:

(i) if the reinsurer (or major cedant), being a body corporate, is a subsidiary, holding company or fellow subsidiary of the company making the return; or

(ii) if one company controls the other or both are controlled by the same person. Regulation 20 (2) defines control for this purpose and Regulation 20 (4)(b) sets out the circumstances in which a number of persons (including a company and its directors) have to be treated as one.

10.4.16 The second kind of connection arises in paragraphs 10.4.4 and 10.4.11 above and is one between reinsurers (or cedants) which are not necessarily themselves connected with the company making the return but which, when taken together are major reinsurers (or major cedants) by virtue of their volume of business in aggregate. In this context, for two reinsurers (or cedants)to be connected, both must be corporate bodies. They are then connected if:

(i) one is a subsidiary, holding company or fellow subsidiary of the other (Regulation 20 (1)(a)); or

(ii) they are controlled by or control the company making the return; or

(iii) one reinsurer (or cedant) controls the other and also the company making the return; or

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(iv) they and the company making the return are all controlled by the same person. (Regulation 20(1)(b) as limited by 20(3)). Regulation 20(2) defines control for this purpose and 20(4)(b) sets out the circumstances in which a number of persons (including a company and its directors) have to be treated as one.

10.4.17 Regulation 20(1) introduces the concept of "reasonable enquiry". It is expected that the company making the return will know of any connections between its reinsurers (or cedants) and itself or companies with which it is connected (see Regulation 20(3)). However, the company making the return may not in all cases be aware of connections between its reinsurers (or cedants) which are not connected with it. It is recognised that there may be difficulty in establishing such connections. In order to comply with the requirement to make "reasonable enquiry", it will suffice for the company making the return to refer to the latest available published accounts or recognised industry reference document (provided that, in all cases, the source to which reference is made has been published within twelve months of the end of the financial year to which the return relates). Alternatively the company may request any or all of its reinsurers (or cedants) to provide details of their connected companies (within the terms of Regulation 20 (1)(a)). The latter course will have to be adopted if no information is available from acceptable published material. Where information is derived from acceptable published material, or obtained in response to a specific approach to a reinsurer (or cedant), the Department takes the view that, in the usual case, the obligation to make a "reasonable enquiry" will have been satisfied, and, should the information be found to be inaccurate or incomplete, no offence will have been committed under Section 71(1) of the Act by the company making the return. (However, possible breaches of the regulations will need to be considered case by case. The foregoing is therefore only a general guide to the Department's likely attitude).

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10.4.18 Regulation 20(5) applies certain paragraphs of Schedule 1. Paragraphs 4 and 5 of Schedule 1 prescribe the methods permitted for converting other currencies into sterling for figures in the returns. Sub-paragraphs (1) and (2) of paragraph 8 permit the use of net figures in the returns to express amounts due from major reinsurers to the company making the return.

10.4.19 Regulation 20(6) states that Regulations 17(2), 18(a) to (c) and 19 apply to the members of Lloyd's taken together as they apply to a single insurance company. Companies making returns under these Regulations need therefore only to identify the amount of reinsurance placed with (or ceded to them by) members of Lloyd's and determine whether, in total, it qualifies for inclusion in the statements required by these three Regulations. The provisions of Regulations 20(1) to (4) regarding connected persons are disapplied in respect of business placed with Lloyd's syndicates. Any links between members of Lloyd's or between a member and an insurance company may be ignored in respect of any such business.

10.4.20 Governments are not deemed to be "persons" in UK legislation. There is thus no connection between reinsurers or cedants as a result of their being owned or controlled by the same non-UK government.

10.4.21 No format is prescribed for these statements. Companies may use whatever layout proves most convenient for them.

10.5 Community co-insurance operations (Form 37)

10.5.1 For the purposes of Regulation 14 a "relevant co-insurance operation" is defined in Schedule 9 to the 1981 Regulations. Regulation 53 of those

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Regulations defines a "relevant company" as one carrying on insurance business in the UK who is concerned in the operation but is not the leading insurer.

10.5.2 Where a relevant company has participated in any relevant co-insurance operations in any financial year a Form 37 is to be prepared analysing total gross premiums receivable.

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EC 11. SCHEDULE 3: LONG TERM BUSINESS REVENUE ACCOUNT AND ADDITIONAL INFORMATION (FORMS 40 to 51)

11.1 When calculating the amount of premiums to be shown in the Forms companies should include that part of any premium which was or will be recoverable from the Inland Revenue.

11.2 Where contracts are required to be divided into United Kingdom and overseas contracts the allocation should be made on the basis of the place where the contract was made (in the case of direct insurance and inwards facultative reinsurance) or the country where the cedant's head office is situated (in the case of reinsurance treaties accepted). Although the Department appreciates that this may result in some unusual figures, it would nevertheless prefer that the practice should be followed in all cases. However, where a company has particularly strong reasons for wanting to adopt an alternative practice the Department is prepared to consider a proposal to do so.

11.3 Forms 40, 41 and 42 are to be completed in respect of each separate long term business fund. Where the rights of any long term policyholders to participate in profits relate to particular parts of a long term business fund, it is the practice of some companies to give a revenue account of that sub-fund in Schedule 3, which is then subject to audit. In such cases, a revenue account for each part of the fund should be given and a summary Form for that fund should be completed as indicated in paragraph 4(2) of Schedule 3. Where the practice of a company is not to put the revenue account of the sub-fund in Schedule 3, it must be put in Schedule 4 (see paragraph 11 of that Schedule) in the format of Form 40 and the actuary must state the principles and methods applied in apportioning various items in the account.

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11.4 Companies should number funds consecutively beginning with the number 1. Where parts of funds are included in Schedule 3, they should be similarly numbered. Where there is more than one fund a summary form must be completed and the number "99" inserted in the relevant box.

11.5 Where a company maintains more than one long term business fund, a statement of the principles and methods applied to apportioning various items in the revenue account must be appended to Form 40. Where any rights of any policyholders to participate in profits relate to profits from particular parts of a long term business fund, the company has the choice of either appending a statement giving those same principles and methods as an Annex to Form 40 or the actuary will have to provide similar information in the abstract of his report within Schedule 4 (see paragraph 11(b) of that Schedule).

11.6 Form 40 must show the expenses of management relating to the long term business at line 8. Those relating to the company's other business cannot, by virtue of Section 29(1)(a) of the Act (subject to the exception in Section 29(1)(b)), be paid out of the long term funds and must therefore be shown in the general business revenue account (Form 20) or the statement of other income and expenditure (Form 16).

11.7 Where a company decides to allocate to the long term business the whole or any part of investment income and/or net capital gains arising from assets not attributable to its long term business, both the income and any associated management expenses (which the company may net off under paragraph 7.9.3 above), must first be included in the statement of other income and expenditure (Form 16), with the amount to be allocated to the long term business to be shown as a transfer at line 11 of Form 16, line 12 of Form 40 and in Form 58.

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11.8 Where a company needs to specify more than one figure for "other income" or "other expenditure" in Form 40 single figures should be shown on lines 5 and 11. Detailed figures should be given in a note to the form.

11.9 Transfers from the investment reserve (if any), the writing down of fixed assets, the effects of "writing up" the book value of the fund (eg the amortization process of fixed interest securities), and the effects of a change in the amount of the inadmissible assets or limited admissibility of assets must be included in line 3 (or line 4, as appropriate) of Form 40.

11.10 In Form 41 premiums in respect of renewable group contracts and individual contracts issued on a recurrent single premium basis should be regarded as regular premiums. Both Pension Assurance and Pension Annuity contracts should be shown in lines 5 and 6.

11.11 The statement required by paragraph 5 of Schedule 3 is only needed when a substantial part of the day-to-day administration of a company is undertaken by another company. A typical case would be where a long established parent insurance company agrees to provide the administrative services for a new (linked) subsidiary in return for the charges which can be levied from the policies sold by the subsidiary. In the early years of such an arrangement, the figures shown for expenses in the returns for the subsidiary may well not reflect the true cost of running the company were the arrangement no longer to be in existence. The statement is intended to put the Department on warning of this situation. There may well be other circumstances in which a statement is required (for example where the agreement is with a non-insurance company) but it is not intended that a statement should be given in respect of brokers for example who, in respect of their own particular clients, provide a small administrative service for the insurance company in respect of premium payment reminders.

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Where the management agreement is between two insurance companies, the directors will need to consider very carefully the form of their certificate under Schedule 6 Part I paragraph 6(d).

11.12 Commission payable to employees of the company whose job is to sell policies should be included under "management expenses" (lines 14 and 15 of Form 41). On the other hand any commission payable to employees who sell policies on a casual basis should be included under "commission" (lines 12 and 13) along with that paid to other intermediaries and to cedants.

11.13 The accuracy of the sub-division of management expenses between lines 14 and 15 of Form 41 and between lines 17 and 18 will depend, to a large extent, on each company's financial controls and on a subjective analysis of how overheads and servicing costs, which cover several sub-heads, are allocated. Expenses which are incurred as a result of an amendment to an existing group life or group pension scheme should be included in line 15.

11.14 In Form 42, in the case of industrial assurance, claims payable on survival in respect of periodical endowment benefits should be included with claims payable on the maturity of contracts of industrial assurance, but should also be shown separately in a note. Widows' pensions in payment must be included in line 7 (or 12) and not in line 5 (or 10).

11.15 In Forms 43, 43A, 44 and 44A the term "annual premiums" refers to the total amount of premiums payable, under the terms of the contract, each year.

11.16 In Forms 43 and 44 any contract which consists of a combination of different types of insurance is to be treated as a number of separate contracts each dealing with one of the different types of insurance so combined. The amounts by which the total number of contracts shown on each of

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the forms exceed the actual number of contracts to which the forms relate should be stated.

11.17 In the case of renewable group contracts and individual contracts written on a recurrent single premium basis the information should be included in Form 44 only in the year of issue and classified as regular premium contracts.

11.18 In Forms 45 and 46 the yields in columns 3 and 4 respectively should be recorded to two decimal places. All columns must be completed in Forms 45 and 46 for all lines where there is a figure in column 1, except line 11 of Form 45. The running yield should be given for irredeemable stocks. Companies should note Instruction 2 of Form 45, which requires that the assets must be assumed to be held throughout the next financial year, applies both to income producing assets and to assets which are not producing income (eg tax recoveries due and premiums due).

11.19 Form 47 should not include units held in excess of the aggregrate of units allocated to the policyholders. Excess units should be shown as non-linked assets in Form 13 line 23. The Form should include details of holdings of units in authorised unit trusts where the units are held to meet liabilities which are linked to the price of units in those trusts.

11.20 Form 48 should give details of the assets which are matching liabilities in respect of property linked benefits other than holdings in authorised unit trusts (which are shown on Form 47) or internal linked funds (which are shown on Form 49). It will contain, for example, details of assets matching the liabilities of policies whose benefits are linked to the Financial Times share index. It will also contain details of assets which

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have been hypothecated to match liabilities in respect of property linked benefits where the link is not to the value of those assets.

11.21 In Form 49, line 9 relates only to investment income. Sundry debtors and prepayments should be shown at line 11. All assets held within internal linked funds must be included in Form 49, even if their value exceeds the corresponding value of linked liabilities to policyholders, through an investment by the shareholders' funds.

11.22 In Form 50, if the total number of units in force exceeds the number of the units allocated to policyholders, it would be helpful if companies stated the number of surplus units and included an additional column - "Value of surplus units excluding those held by other internal linked funds."

11.23 In Form 51, when the number of units created exceeds the number cancelled for the period to which the revenue account refers, the difference between the value of those units created and the value of those cancelled should be recorded at line 1. When the number cancelled exceeds the number created the difference between the value of those cancelled and those created should be recorded in line 6.

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12. SCHEDULE 4: VALUATION OF LONG TERM BUSINESS (INCLUDING FORMS 55 to 61)

12.1 Schedule 4 prescribes the format of the abstract of the report of the appointed actuary on his investigation into the financial condition of the long term business, required under Section 18 of the Act. The mathematical reserves determined by the actuary must conform with Regulation 54 of the 1981 Regulations and sufficient information must be given about the basis of the valuation to enable the Department to be satisfied about this, and in particular that the reserves meet the minimum standards required under Regulations 55 to 64 of the 1981 Regulations.

12.2 Certain paragraphs of the abstract of the valuation report relate exclusively to non-linked contracts (eg paragraphs 3 and 7), some are related exclusively to linked contracts (eg paragraphs 4 and 8), while others relate to both types of contract. Form 55, which like Form 56 has to be provided separately for ordinary long term business and industrial business, contains the valuation summary of non-linked contracts; Form 56 contains the valuation summary of linked contracts. The totals of the mathematical reserves for non-linked and linked contracts are carried from these forms to Form 58 which gives the valuation result and information on the composition and distribution of surplus.

12.3 Paragraph 3 should give details of any guarantees and options on non-linked contracts which the actuary considers to be significant. Common examples are guaranteed surrender values, guaranteed annuity rates, guaranteed minimum rates of interest on deposit administration contracts (including links to the Building Society Mortgage Lending Rate), and options to increase sums assured without evidence of health.

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12.4 The guarantees and options to be specified in paragraph 4(1)(a) should include details of any guaranteed surrender basis which is specified in the policy, whether expressed in monetary terms or as percentage deducations from the value of units etc.

12.5 When a company is allowed under the terms of contracts which are linked to internal funds to adjust its periodic charges, the maximum as well as the current charges should be given in answer to paragraph 4(2); if there is no upper limit to the charge which may be made, this should be stated.

12.6 When providing information on the general principles and methods adopted in the valuation under paragraph 5, the actuary should provide sufficient information to enable the Department to take a view, in relation to the issues specifically referred to in paragraph 5(1), on the adequacy of the reserving basis in relation to Regulations 54 to 64 of the 1981 Regulations. If the actuary has not carried out some of the tests implicit in the specific points raised in paragraph 5(1), (eg see paragraph 12.8 below) as he considers the margins in his basis are already large enough to meet the minimum standards required by Regulations 55 to 64, and to meet the requirements of Regulation 54, he should indicate this either directly or indirectly; he may, however, be required to justify his basis to the Department if it considers it is not self-evident that there are sufficient margins.

12.7 Regulation 55 of those regulations requires the actuary to take into account the nature and term of the assets and the value at which these have been brought into account when determining the appropriate provision against the effects of possible future changes in the value of the assets on their adequacy to meet the liabilities. If the assets in Schedule 4 are brought in at book values below the values in accordance with the regulations given in Form 13, and in determining the provision under this regulation the actuary

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has had regard to this fact, paragraph 5(2) requires a statement to this effect. This applies also when the basis of the provision made for any prospective liability for tax on unrealised capital gains is determined in the context of assets taken at their book value rather than their Form 13 value.

12.8 When stating, in paragraph 5(1)(a), the basis of the provision made for a mismatching reserve under Regulation 55, the actuary should indicate the principles and methods adopted in determining his provision, including the extent and nature of the change in the value of assets which he has assumed in his calculations, even when determining that no mismatching reserve is required.

12.9 In Form 60 figures relating to Supplementary Accident and Sickness insurance for which the required margin of solvency is shown in line 10 should not be included in lines 1 to 9.

12.10 The additional information to be provided in paragraph 7(d) (where the contracts do not fall within the circumstances of the proviso) must be sufficient to constitute the required demonstration. The information could take several different forms. For example the requirement would usually be met if the results of a net premium valuation for each of the relevant main categories of contract in the format of Form 55 were given, specifying the valuation rates of interest and mortality used, the zillmer adjustment and any other relevant information. Where a full net premium valuation has not been made, the requirement could be met by a comparison of specimen reserves for each of the main categories of contracts for various ages and durations on the basis used by the actuary in his report and on an appropriate net premium basis (specifying particulars of the basis as above) together with information about the distribution of the business in the form of appropriate weightings.

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In principle a method of demonstration which involved sampling could also be acceptable.

12.11 The information to be supplied in paragraph 8 should normally include the expenses of administration per policy for each policy type, the rate of future inflation of expenses and the rate of unit price growth (both gross and net of any relevant taxation) assumed in the valuation/test, and the extent to which account has been taken of any increases in management charges which are allowed under the terms of the policy. Other parameters will normally include the mortality rates and the rate of interest earned on sterling reserves assumed in the valuation/test.

12.12 In paragraph 10, certain information additional to that required under previous regulations is now required on reinsurance. In particular, information is to be provided about whether the reinsurer has an authorisation to carry on insurance business in the UK, whether there is a connection between the company and the reinsurer and whether any deposit back arrangements apply. In paragraph 10(2)(f) the reference to refund of reinsurance commission should be taken to include refunds of any form of financing advanced by the reinsurer.

12.13 Where, in accordance with paragraph 11 of Schedule 4, a revenue account for a particular part of a long term business fund is included in the abstract of the actuary's report, analyses of premiums, expenses, and claims in the format of Forms 41 and 42 are not required. The actuary must provide information on the principles and methods applied in apportioning various items in any such revenue account included in Schedule 4, and in any revenue account of a with-profit subfund which is given in Schedule 3 where the principles and methods of apportionment are not disclosed in that Schedule.

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12.14 Where the information given in Forms 55 and 56, together with any additional information required by Instruction 7 regarding the number of contracts does not enable a reconciliation to be made with the information supplied in Forms 43 and 44 an explanation should be given.

12.15 The aggregate of the amounts standing to the credit of policyholders' accounts should be shown in column 5 of Form 55 for non-linked deposit administration schemes, and should be distinquished from any other measures of benefit shown in that column for such contracts.

12.16 In Form 56, details of units which are discounted at different rates of interest (eg capital and accumulation units) should be shown separately. For all contracts where units are discounted the undiscounted unit liability should be shown under an additional column heading, in accordance with Instruction 9 for the completion of Forms 55 and 56; the discounted unit liability should be shown in column 11.

12.17 Where a linked contract also provides for non-linked benefits, the liability for the non-linked benefits should be shown separately within Form 56.

12.18 Risk premium reinsurance may be aggregated, separately for non-linked and linked business, and shown as a separate class in Form 55 and Form 56 respectively.

12.19 Valuation summaries for subfunds for which surpluses are required to be determined under Section 18 of the Act, and valuation summaries for linked and non-linked business should be treated as separate for the purpose of Instruction 10 for the completion of Forms 55 and 56.

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12.20 Where an interim, mortuary or terminal bonus was announced at or after the previous valuation, to be paid in anticipation of surplus arising at the present valuation, the amounts of such bonus which were actually paid in the period to the present valuation should be entered at lines 2 and 17 on Form 58. Where it is the practice of a company to meet the cost of such bonuses payable on future claims out of surplus arising at a current valuation such amount should be treated as an amount allocated to policyholders and included at line 20 on Form 58 and an appropriate note should be appended to the form identifying the various items. These amounts should not appear at lines 2 and 17 at the next valuation.

12.21 When a company records a transfer to the statement of other income and expenditure in a revenue account (Form 40) for a particular period, the amount of which has been derived from a valuation completed at the end of that period, that transfer should be shown in 58.3 so that the true surplus appears in 58.10.

12.22 Where a company decides to allocate to the long term business the whole or any part of the investment income and/or net capital gains arising from assets not attributable to its long term business, the allocation should be included in Form 58 as a transfer from the statement of other income and expenditure (see paragraph 11.6 above). This transfer should be included in either lines 3 and 5, or 12 and 14, depending on whether there is an overall net transfer out of or into the fund (or part of the fund) respectively (see Instruction 3 for the completion of Form 58).

12.23 Where, under Section 18(2)(b) of the Act, a surplus is determined for a part of a fund where the rights of any policyholders to participate in profits relates to that subfund, paragraph 18 of Schedule 4 requires a company

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to provide a Form 58 both in respect of the subfund and the fund of which it is a part.

12.24 In general, line 27 of Form 58 corresponds to the proportion which has to satisfy the criteria laid down in Section 30 of the Act, but this will not always be so. For example, where the with-profits policyholders are entitled to, say, 90% of the profits from the with-profit business but are also eligible to share in the profits arising on the non-profit business on a discretionary basis, line 27 would be relevant for the purpose of Section 30 (which relates to 'eligibility') only in the Form 58 for the long term fund as a whole and not in the Form 58 for the subfund.

12.25 The surplus shown in Form 58, in keeping with the definition in the primary legislation, represents the excess of the amount of the fund over the liabilities, but the wording in lines 10 and 24 is intended to make it clear that the surplus is not to be regarded as synonymous with disposable profits. The solvency margin requirements introduced under the legislation implementing the Life Directive make it imperative for a clear distinction to be drawn between the liabilities and the margins available to count towards a company's solvency margin. The surplus should not include any part of the mathematical reserves which the actuary considers are required to constitute the "proper provision" envisaged by Regulation 54 of the 1981 Regulations (these should be included in Forms 55 and/or 56 as appropriate), but it may include contingency and other reserves held which count towards the solvency margin.

12.26 Forms 60 and 61 set out the calculation of the required minimum margin (ie the greater of the required margin of solvency and the minimum guarantee fund) for long term business. The legislation provides for a solvency margin in respect of a company's long term business as a whole and where more than one long term business fund is maintained the information in

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Forms 60 and 61 will relate to all funds combined, including industrial business where this is transacted. Provision is made for the mathematical reserves and the calculation of the solvency margin to be shown separately for the main classes of long term business and, for the purposes of reconciliation, mathematical reserves attracting a nil rate of solvency margin are to be included. Class III includes contracts where the benefits are partially linked to investment funds or indices and any reserves for non-linked benefits under such contracts should be included under Class III business in the appropriate column in Form 60 and not with Class I and Class II business.

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13. SCHEDULE 5: STATEMENT OF LONG TERM BUSINESS (INCLUDING FORMS 65 to 78)

13.1 Schedule 5 requires separate statements for linked and non-linked contracts. Forms 65 to 70 are provided for different categories of non-linked contracts and Forms 72 to 77 for different categories of linked contracts. Contracts which are grouped under a miscellaneous heading in a valuation summary in Schedule 4 may be shown in Forms 71 and 78. Such miscellaneous headings may not exceed 5% of the total net liability shown in the appropriate valuation summary.

13.2 The final column of Forms 73, 74 and 75 (which gives details of linked regular premium assurances) shows the annual amount deemed invested in units in future. This refers to the proportion of premiums invested in units and, where this can vary, the instructions accompanying the forms require that this fact should be stated and additional information given.

13.3 Companies may amalgamate different categories of contract for risk premium reassurance business.

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14. INFORMATION ON APPOINTED ACTUARY

14.1 Regulation 29 calls for a statement of the information specified in sub-paragraphs (a) to (d) of Regulation 29 (1). The company is required to make a further statement that it has asked the actuary to provide it with the particulars set out in the sub-paragraphs and to identify in the statement the information which has been so provided. The company is required to supplement these particulars if there is further information of which it is aware additional to that provided by the actuary.

14.2 Paragraphs (1)(a) and (b) refer to "particulars" but this word is not defined in the Regulation. In the case of investments, the Department would expect particulars to include at least a general description of the investments, the name of the holder of the investment, the nominal or principal amount outstanding and, where applicable, the rate of interest and terms of repayment. In the case of a life policy particulars would include at least a general description of the terms of the policy, including the sum assured, the amount of the annual premium payable, the duration of the policy or year of maturity and, as appropriate, the amount of any reversionary bonuses declared. Where there is more than one policy, some form of aggregation of the information might be acceptable. Equivalent information should be given in respect of other transactions. In the case of transactions of a minor character falling under sub-paragraph (b), a general description need only be given and full particulars are not required.

14.3 As a result of Regulation 29 (3)(a) the particulars which have to be given apply not only to the interests of or amounts paid to the actuary but also to other persons specified in that paragraph. It is worth noting, however, that Regulation 29 (4) provides for the reporting company and other companies within the same group to be treated as one for the purpose of

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Regulation 29 (3)(a). The effect of the words in parenthesis in Regulation 29 (3)(a)(iii) and (iv), taken with Regulation 29 (4), is that payments made to the reporting company and to companies related to it will be excluded from the disclosure requirement.

14.4 Regulation 29 (3)(b) and (c) set out the circumstances in which a person shall be deemed to have an interest or benefit for the purpose of the Regulation. Regulation 29 (5) describes the circumstances in which a person shall be taken to control a body corporate for the purpose of Regulation 29 (3).

15. DIRECTORS' CERTIFICATE

15.1 Part I of Schedule 6 to the regulations specifies the statements to be included in the directors' certificate. These vary according to the type of company and the types of business which it writes.

15.2 Where in the opinion of those signing the certificate, the circumstances are such that any of the statements required by paragraphs 1 to 6 of the Schedule (other than sub-paragraphs (a), (c)(i) and (d)(i) of paragraph 3) cannot truthfully be made, the relevant statements shall be omitted, (see paragraph 8(1) of the Schedule). Where any statements have been omitted, this fact shall be stated in a note, (see paragraph 8(2) of the Schedule).

15.3 For companies which fall within the circumstances of the first half of paragraph 6(d) of Part I of Schedule 6, the directors will need to consider carefully whether the returns are distorted by any management services agreements - for example, where a parent insurance company subsidises its subsidiary in its infancy.

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16. CERTIFICATE BY THE APPOINTED ACTUARY AND QUALIFICATIONS FOR APPOINTMENT

16.1 Part II of Schedule 6 to the regulations sets out the statements to be included in the appointed actuary's certificate. The actuary is no longer required to certify that the long term liabilities do not exceed the value of the assets representing the long term business funds, as Form 9 demonstrates the position. Instead, he is required to certify the amount of the mathematical reserves and that, if such be the case, they have been calculated in accordance with the regulations and constitute proper provision for the liabilities to which they relate, in the context of assets valued in accordance with Part V of the 1981 Regulations, and as shown in Form 13. If, in giving this certificate, the actuary finds it necessary to make an addition to the amount of the mathematical reserves as shown in his Schedule 4 valuation report, the amount of any such addition is required to be stated in the certificate. The certificate must also include a statement of the required minimum margin applicable to the company's long term business.

16.2 Regulation 28(1) lays down that an actuary must be a Fellow of the Institute of Actuaries or the Faculty of Actuaries and aged at least 30 to be qualified for appointment under the Act. Regulation 28(2) automatically protects the position of an actuary who was already appointed when the Accounts and Statements Regulations 1980 came into force but who does not possess the new qualifications either because he is aged under 30 or because he has an overseas qualification and not Fellowship of the Institute or Faculty of Actuaries.

16.3 Where an overseas company wishes to appoint an actuary with an overseas actuarial qualification, the Department will be willing to consider

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the issue of an Order under Section 68 of the Act permitting this in appropriate cases.

16.4 If a company appoints a firm of consulting actuaries each of the partners in the firm must possess the prescribed qualifications. Where an individual member of a firm is appointed only that individual need be qualified.

17. AUDIT OF RETURNS

17.1 Regulation 27 specifies the scope of the audit. The contents of the auditors' report are set out in Part III of Schedule 6. Regulation 30 specifies the qualifications of an auditor.

17.2 The Consultative Committee of Accountancy Bodies issues separate guidance notes for auditors and it is recommended that auditors should refer to these.

17.3 The parts of the return which are subject to audit are Forms 9 to 16, 20 to 29, 31 to 37 and 40 to 51 and the statements furnished under Regulations 17 and 19. It should be noted that these do not include Form 30 (summary of reinsurance business ceded), Schedules 4 and 5 (which are signed by the appointed actuary) and the statements furnished under Regulations 18 and 29. The auditors are also required to report on whether the directors' certificate (other than so much of it as relates to information furnished under Regulations 18 and 29) has been properly prepared in accordance with the regulations and whether it was reasonable for the persons giving that certificate to have made the statements contained in it.

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17.4 Paragraph 11(c) of Schedule 6 provides for the auditors to state that, in giving their opinion, they have relied on the actuary's certificate with respect to the mathematical reserves and required minimum margins and on an order by the Secretary of State for the identity and value of any implicit items which are admitted.

17.5 Forms 33 and 35 relating to years of origin prior to 1981 will contain figures which include information about claims notified and payments made prior to the 1980 Regulations coming into force. Such information was not subject to audit under those regulations and the relevant figures are excluded from audit under the 1983 Regulations by Regulation 27(2)(a)(ii).

18. INDUSTRIAL ASSURANCE

18.1 The 1983 Regulations revoke the Industrial Assurance Companies (Accounts and Statements) Regulations 1980 and apply equally to industrial assurance as they do to ordinary long term business.

18.2 A company which carries on industrial assurance business must deposit with the Industrial Assurance Commissioner and the Industrial Assurance Commissioner for Northern Ireland a copy of any document relating to industrial assurance business which is deposited with the Secretary of State.

18.3 Section 82(6) of the Act requires a special report by the auditors on the apportionment of certain items between the industrial assurance business of a company and its other business. A copy of the auditors' report is required to be furnished to the Industrial Assurance Commissioner and the Industrial Assurance Commissioner for Northern Ireland.

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19 BRANCH RETURNS

19.1 Paragraph 4 of these notes explains the circumstances in which companies are required to make a return of their business carried on through an agency or branch in the United Kingdom (or agencies/branches in the Community). The following paragraphs explain the main differences which arise in completing a branch return from the procedures described elsewhere in these notes.

19.2 The Head Office Account of a branch will represent the Head Office's investment in the branch and the capital of the branch. It will include, inter alia, accumulated profits which are transferred to it each year and will be reduced by remittances from the branch to the Head Office. This net indebtedness will be shown at line 54 of Form 10 and nothing will be shown against lines 51, 52 and 53 of that Form. This item, which will also include the difference between the book values of assets and the values allowed under the 1981 Regulations, will represent the net assets of the branch available to meet the solvency margin requirement for branches of external companies and UK deposit companies. There is no solvency margin requirement for branches of non-UK Community companies or Community deposit companies. For the reasons given above the Head Office Account should never show a position of net indebtedness of the Head Office to the branch, ie a negative liability, as this would indicate a deficiency of net assets to meet the solvency margin requirement of branches of external companies and UK deposit companies or a failure to maintain sufficient assets to meet the liabilities of branches of non-UK Community companies and Community deposit companies.

19.3 For UK branches of external companies, the additional Forms 13 referred to in paragraph 7.6.1 above are required to show, separately for long term business and business other than long term, assets which are (i)

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deposited with the Accountant General, (ii) maintained in the UK and (iii) maintained in the UK and other member States. These three forms will be cumulative in that (ii) will include (i), and (iii) will include both (i) and (ii). For the Community branch returns of UK deposit companies the requirements are the same, except that they will cover business carried on in the Community and item (ii) will show assets maintained in the UK and other member States.

19.4 Form 16 will show nothing against line 24, "Dividends paid and/or recommended", and the excess of income over expenditure at line 39 will represent the surplus for the financial year transferred to the Head Office Account, (see paragraph 19.2 above).

19.5 In certificate 4(b) required of branches of Community companies (other than UK companies or pure reinsurance) and Community deposit companies the liabilities for which maintenance of assets is required are not to include indebtedness to the Head Office. Companies are required to comply with regulations under Section 35 of the Act concerning the form and situation of assets. The present requirements are contained in Regulations 25 to 28 of the 1981 Regulations. Provided these requirements are satisfied, assets held anywhere in the world may be attributed to the United Kingdom branch business for the purposes of Section 34 of the Act.

19.6 Difficulties may arise for auditors in satisfying themselves on the status and availability of the assets which an overseas company maintains in accordance with Section 34 of the Act; and therefore for them to give a report on the relevant certificate (paragraph 4(b) of Schedule 6, Part I). Where such difficulties arise the Department will be prepared to seek a mutually acceptable solution with the company and its auditors.

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20. QUARTERLY RETURNS

20.1 Where a company is subject to a notice of requirements requiring it to submit quarterly returns it should normally comply with the procedures given in these notes in so far as they relate to the Forms required to be included in the quarterly return.

20.2 In some cases it will be necessary to amend, as appropriate, the words "as at the end of the financial year" and "Financial year ended" where they appear in the certificates and Forms.

21. MODIFICATIONS AFFECTING PARTICULAR COMPANIES

21.1 Section 68 of the Act gives the Secretary of State power to make an Order modifying the requirements of the Act and regulations relating to annual returns as they apply to particular companies. This power is normally used where the circumstances of a company or the nature of the business it transacts are such that it is inappropriate for the requirements to apply in an unmodified form. Companies wishing to count implicit items against their solvency requirements should apply for the appropriate order - see also paragraph 7.3.2 of these notes.

21.2 Modifications may be made only if the company applies for or consents to the Order. A company which thinks it necessary for a modification to be made in relation to it should therefore discuss the circumstances with the Department.

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ANNEX A

351AAC
EC

COUNTRY CODES (FORMS 31 TO 37)

Afghanistan	QS	Haiti	GK
Albania	CE	Honduras	HC
Algeria	KA	Hong Kong	QE
Angola	MT	Hungary	CC
Antigua & Barbuda	GP	Iceland	BU
Argentina	JA	India	QB
Aruba	GM	Indonesia	QM
Australia	EA	Iran	PB
Austria	BL	Iraq	RJ
Bahamas	GD	Irish Republic	BC
Bahrain	PN	Isle of Man	BB
Bangladesh	QA	Israel	PC
Barbados	GA	Italy	BG
Belgium	BD	Ivory Coast	LH
Belize	HH	Jamaica	GB
Bermuda	GE	Japan	QK
Bolivia	JL	Jordan	PL
Botswana	MG	Kenya	MA
Brazil	JC	Korea	QR
Bulgaria	CD	Korea, North	QP
Burma	QH	Kuwait	PD
Cambodia	QU	Lebanon	PE
Cameroon	MV	Lesotho	MH
Canada	FA	Liberia	LG
Channel Islands	BA	Libya	KD
Chile	JB	Luxembourg	BH
China, Peoples Republic of	QJ	Madagascar	MS
China (Taiwan)	QQ	Malawi	MD
Colombia	JD	Malaysia	QF
Congo	MU	Mali	LE
Costa Rica	HF	Malta	DC
Cuba	GJ	Mauritius	ML
Curacao	GL	Mexico	HA
Cyprus	DA	Monaco	CF
Czechoslovakia	CB	Montserrat	GS
Denmark	BE	Morocco	KB
Dominica	GR	Mozambique	MR
Dominican Republic	GF	Nepal	QT
Ecuador	JF	Netherlands	BJ
Egypt	KE	New Zealand	EB
El Salvador	HB	Nicaragua	HE
Ethiopia	MP	Nigeria	LC
Finland	BR	Norway	BS
France	BF	Oman	PP
French Equitorial Africa	LF	Pakistan	QC
French Guiana	JK	Panama	HG
Gambia, The	LA	Paraquay	JM
German Democratic Republic	CA	Peru	JG
Germany, Federal Republic of	BK	Philippines	QL
Ghana	LB	Poland	BV
Gibraltar	DB	Portugal	BP
Grand Caymen Islands	GW	Puerto Rico	GG
Greece	BN	Qatar	PG
Grenada	GQ	Romania	BW
Guatemala	HD	St Kitts	GT
Guyana	JH	St Lucia	GV

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St Marteen	GN	Trinidad and Tobago	GC
St Vincent	GU	Tunisia	KC
Saudi Arabia	PF	Turkey	PA
Senegal	LJ	Uganda	MB
Sierra Leone	LD	United Arab Emirates	PH
Singapore	QG	United Kingdom	AA
Somalia	MQ	United Kingdom - Home Foreign	AB
South Africa	MK	Uruguay	JN
Spain	BQ	USA	FB
Sri Lanka	QD	USSR	RA
Sudan	MN	Venezuela	JE
Surinam	JJ	Vietnam	QW
Swaziland	MJ	Virgin Islands	GH
Sweden	BT	Yemen, South	PM
Switzerland	BM	Yugoslavia	BY
Syria	PK	Zaire	MM
Tahiti	QV	Zambia	ME
Tanzania	MC	Zimbabwe	MF
Thailand	QN		

Reconciliation Returns: United Kingdom AZ Overseas YZ

Codes for countries not included above will be allocated where necessary on application to Insurance Division, Department of Trade and Industry.

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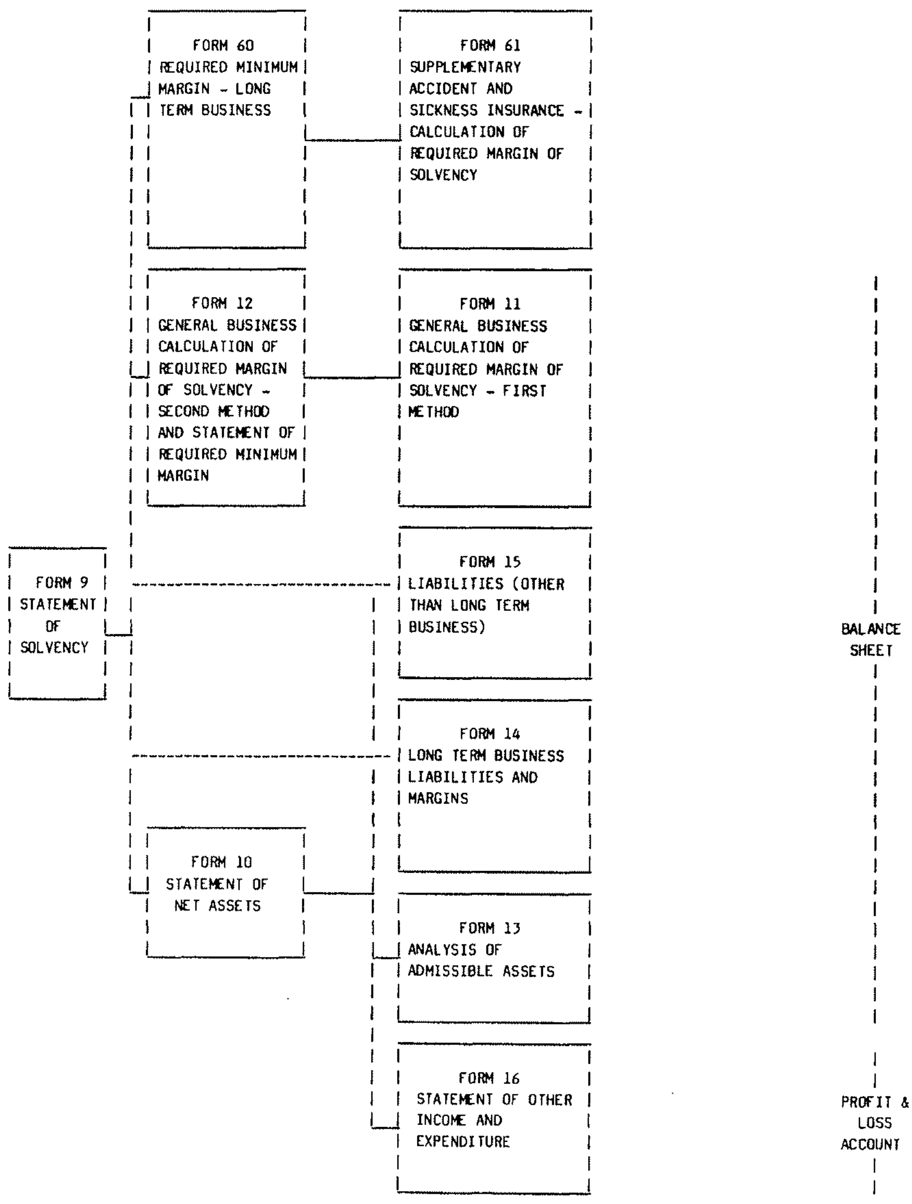
S51AAD
EC

ANNEX B

INTER-RELATIONSHIP OF FORMS 9 TO 16 AND 60 AND 61



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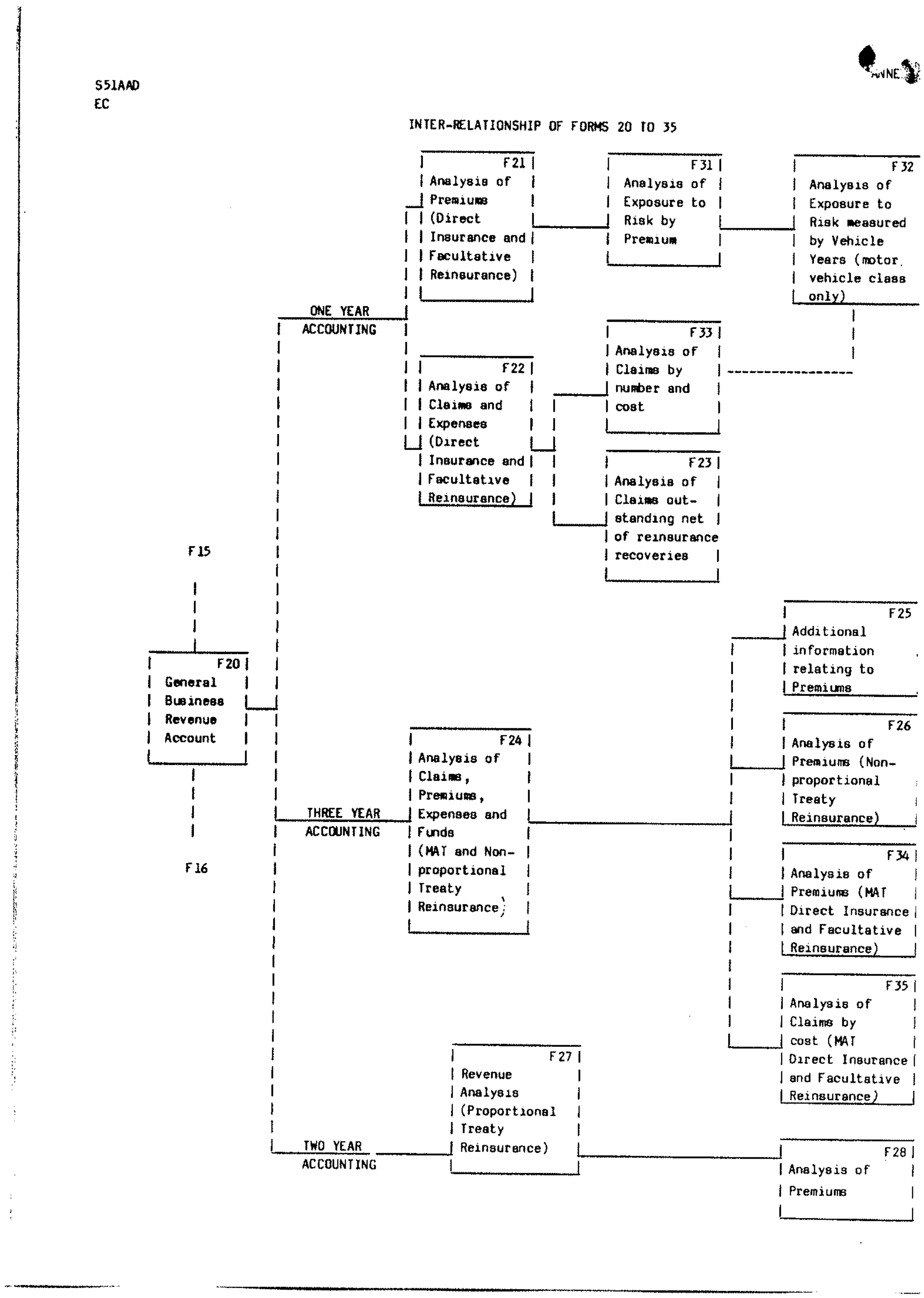

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ANNEX D

GENERAL BUSINESS TREATY REINSURANCE RECONCILIATION RETURN

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
	Amounts included in Forms 24 in respect of treaty reinsurance	Form 27 (Total)	(1)+(2)	Forms 24 De Minimis	Form 27 (Total) De Minimis	Amounts from Forms 24 to Forms 29	Amounts from Form 27 (Total) to Forms 29	Aggregate of column (6)+ column (7)	Amounts from Forms 24 to Forms 27 (Category)	Amounts from Form 27 (Total) to Forms 27 (Category)	Aggregate of column (9)+ column (10)	Reconciliation (4)+(5)+ (8)+(11)
PREMIUMS												
1 Receivable under Reinsurance Treaties Accepted	Σ24.12.5	27.12.3										
2 Payable to Retrocessionaires	Σ24.14.5	27.14.3										
3 Amounts receivable net of retrocessions in respect of outstanding claims and loss portfolios	Σ24.15.5	27.15.3										
4 Receivable Net	Σ24.19.5*	27.19.3										
CLAIMS												
5 Paid under Reinsurance Treaties Accepted	Σ24.22.5	27.22.3										
6 Recoverable from Retrocessionaires	Σ24.24.5	27.24.3										
7 Paid Net	Σ24.29.5*	27.29.3										
EXPENSES												
8 Expenses and Commissions (Net)	Σ24.39.5*	27.39.3										
FUNDS												
9 Brought Forward	Σ24.41.5*	27.41.3										
10 Carried Forward	Σ24.42.5*	27.46.3										
11 Increase (Decrease) in the Financial Year	Σ24.49.5*	27.49.3										
BALANCE												
12 Balance on each Underwriting Year	Σ24.51.5*	27.51.3										

* Amounts attributable to treaty reinsurance only

Column 12 should equal Column 3 in all cases

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Extracts: Sections 8 to 13 (inclusive) have been omitted

EXPLANATORY GUIDANCE TO AUTHORISED INSURANCE COMPANIES

ON

THE PREPARATION OF ANNUAL RETURNS

TO

INSURANCE DIRECTORATE OF HM TREASURY

PGN 1998/1

JANUARY 1998

Version 1.1 ***January 1998***

Other guidance by the prudential regulators

Prudential guidance on the preparation of regulatory returns
2 – the Treasury's explanatory guidance to authorised insurance companies on the preparation of annual returns (1998)

FOREWORD

This document has been issued by the Insurance Directorate of the HM Treasury to provide guidance to companies preparing returns for deposit with the Insurance Directorate under the Insurance Companies (Accounts and Statements) Regulations 1996, as amended by the 1997 Amendment Regulations ("the Insurance Annual Return). It also gives guidance for UK companies preparing statements of their insurance business in other EEA states under the European single market for deposit with the Treasury under Regulation 81 of the Insurance Companies Regulations 1994, ("Insurance Statistical return"). It revises and replaces the previous guidance PGN 1996/3. The changes from that document, unless trivial, are indicated by a side bar.

This document gives an overview of the requirements of those Regulations and, in particular, presents the Insurance Directorate's interpretation of those Regulations. It also describes the statutory background to the requirement to prepare the Returns and explains the relationship between the Insurance Companies (Accounts and Statements) Regulations 1996 and the other Regulations relevant to the preparation of the Returns including the Insurance Companies Regulations 1994. Chapter 11 includes guidance on the Insurance Companies (Equalisation Reserves) Regulations 1996.

This document is intended to be read in conjunction with the Regulations and statutory provisions referred to above which alone have the force of law and which must, in the case of seeming conflict, prevail.

This document is included in the Insurance Directorate's list of published guidance to which it expects companies to certify compliance under the provisions of paragraph 5 of Schedule 6 of the Insurance Companies (Accounts and Statements) Regulations 1996. See chapter 17 for further guidance on this area.

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CHAPTER ONE

1. THE STATUTORY REQUIREMENT TO PREPARE RETURNS

1.1 The basic requirement

1. The Annual Returns must be prepared by all insurance companies to which Part II of the Insurance Companies Act 1982 applies. This includes with certain exceptions all insurance companies, whether established within or outside the United Kingdom which carry on business within the United Kingdom.

2. The most important of the exceptions referred to above is an "EC company", (i.e. an insurance company, other than a pure reinsurer, with its head office in another EEA State which is authorised to carry on business in the UK by its home member State). See chapter two for further comment on their status.

1.2 The statutory basis of the Annual Return

1. The outline content of the Annual Returns is laid down by three sections of the Insurance Companies Act 1982.

- Section 17 provides for a "profit and loss account", "revenue account" and "balance sheet" together with "notes, statements and reports" and "certificates annexed thereto".
- Section 18 provides for an "abstract" of the annual investigation of the appointed actuary.
- Section 21 provides for an "auditors' report".

2. All three sections provide for Regulations to be made to prescribe the detailed content of the documents to be prepared. They form the statutory basis for the ***Insurance Companies (Accounts and Statements) Regulations 1996***, ("the 1996 Regulations"), which repeal and replace the Insurance Companies (Accounts and Statements) Regulations 1983, ("the 1983 Regulations").

1.3 Deposit of returns with the Treasury

1. Section 22(1) of the Insurance Companies Act 1982 requires that every document prepared under sections 17, 18 or 21 be printed and five copies be deposited with the Treasury within **six months** of the end of the period to which the documents relate. The Insurance Directorate requests

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that one of the five copies [not the signed one] is left unbound held together with a treasury tag in the top left-hand corner. However the Annual Returns need not (as was previously required) be printed on coloured paper. A company which opts for electronic submission (see below) need only deposit one printed copy, which should be a bound signed copy.

2. [In addition to the above a registered society should also deposit one copy with its registrar under the Industrial and Provident Societies Act 1965 or the Industrial and Provident Societies Act (Northern Ireland) 1969. A company which carries on industrial long term business should also deposit two copies with the Registrar of Friendly Societies.]

3. Section 22(3) requires that one copy of every document (other than the auditor's report) be signed by such persons as may be prescribed. Section 22(4) requires that one copy of the auditors' report be signed. Further details on the signature of returns is given in the next chapter.

4. The Treasury has power under section 22(1) to extend the period for deposit by up to three months if he thinks that "the circumstances are such that a longer period should be allowed". A company seeking such an extension should apply to its normal supervisory contact in the Insurance Directorate. The application should identify the "circumstances" being relied upon as justifying the extension and should be made as early as possible. Only in very exceptional circumstances will an application for an extension be granted where it is not made before the end of the six month period. Similarly, if it becomes necessary to seek a further extension beyond the one already granted (but within the overall limit of three months), application should be made before the expiry of the extension in operation.

5. A company wishing to deposit returns electronically may only do so with the prior approval of the Insurance Directorate. A separate document "Electronic Submission of Returns - Technical Specification" details the format in which an electronic return must be presented. The document described in paragraph 1.4.3 below details the validation rules which must be applied at source in the generation of the Annual Return. There are software packages commercially available for the generation of the Returns. It is likely that a return generated using such a package will be acceptable to the Insurance Directorate. A company wishing to use another package or bespoke software will need to satisfy the Insurance Directorate that the technical specification referred to above is met in full. Companies considering electronic submission should apply to:

[redacted]
the Insurance Directorate
HM Treasury

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1 Victoria Street
London SW1H 0ET

1.4 Inaccurate or incomplete returns

1. Section 22(5) requires the Treasury to consider the documents deposited under section 22(1) and, if any such document appears to him to be inaccurate or incomplete, to communicate with the company with a view to the correction of any such inaccuracies and the supply of deficiencies.

2. A letter from the Insurance Directorate under section 22(5) may draw attention to an apparent inaccuracy or incompleteness and ask for an explanation or it may also ask for the inaccurate or missing documents to be (re)submitted. In either case the company should consider the points raised in the letter and respond promptly either explaining why there is not in fact any inaccuracy or incompleteness, or (re)submitting the inaccurate or missing documents.

3. The validation of returns by the Insurance Directorate takes place at two levels. Firstly certain "absolute" relationships are expected always (subject to any section 68 order) to be present between data items in the Annual Return (and between those items and the data items in the previous return). Secondly the "reasonableness" of the data items is reviewed. This includes comparing data with other published sources such as the Companies Act accounts to test its consistency and completeness. A listing (in the form of a systems specification) of the "absolute" relationships which are validated is available on request from -

[redacted]
The Insurance Directorate
HM Treasury
1 Victoria Street
London SW1H 0ET

1.5 Other documents to be deposited with the Annual Returns

1. Section 22(6) requires that a company deposit with its return "any report on the affairs of the company submitted to shareholders or policyholders of the company in respect of the financial year to which the [return] relates". This includes, but is not limited to, the report and accounts of the company prepared under Schedule 9A of the Companies Act 1985 (or in the case of an overseas company prepared under section 700 of the Companies Act 1985).

2. Although strictly the section only requires one copy of any report, the Insurance Directorate would find it helpful if general business companies

would deposit ***two copies***, and long term business companies ***three copies***. [A registered society should also deposit a copy of such documents with its registrar under the Industrial and Provident Societies Act 1965 or the Industrial and Provident Societies Act (Northern Ireland) 1969. A company which carries on industrial long term business should also deposit two copies with the Registrar of Friendly Societies.]

1.6 Insurance fees

1. No later than when depositing the Annual Returns and other documents referred to above, a company should separately send a completed insurance fees form to the address shown on the Form and, where a fee is due, a cheque in payment. The insurance fees form should be returned even if it only evidences that no fees are payable.

2. Section 94A of the Insurance Companies Act 1982 provides that where a fee is due, the Annual Return shall not be regarded as deposited until that fee is paid.

1.7 Disclosure of the Annual Returns and other documents deposited with the Treasury

1. The returns and the documents deposited with them are publicised in two ways.

- Firstly under section 23(1) a company must send a copy to any shareholder or policyholder who requests it, and

- Secondly under sections 65 and 66 the Treasury must deposit with the Registrar of Companies the Annual Returns and other documents deposited with him. The documents deposited with the registrar of companies are available for public inspection.

2. Under section 23(2) the Treasury may exempt a company from the above disclosures but-

- only in respect of a statement or report annexed to the documents prepared under section 17, (e.g. not the abstract of the report of the appointed actuary), and

- only if in the opinion of the Treasury disclosure would be harmful to the business of the company or any of its subsidiaries.

3. This dispensation will only be given in exceptional circumstances, e.g. where disclosure would reveal that a company had significant trading

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links with two states at war with each other and thereby seriously prejudice its ability to continue to trade in one or both of those states.

1.8 Section 67, 68 and 69 orders

1. These sections of the Insurance Companies Act 1982 empower the Treasury in relation to a particular company (at the request, of or with the consent of, that company) -

- to modify or disapply certain provisions of that Act; [a section 68 order];

- to direct that, for certain specified purposes under the Act, long term business be treated as general business or *vice versa*; [a section 67 order];

- to extend or shorten, for the purposes of the Act, the company's financial year; [a section 69 order].

The purposes under the Act for which these orders may be used include, but are not confined to, the preparation of the Returns.

2. A company which wishes to apply for an order should do so through its normal supervisory contact at the Insurance Directorate. The application should identify the circumstances which the company considers justify the granting of an order. It is important that an application is made as early as possible, preferably as soon as the circumstances which justify it are known to have arisen.

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CHAPTER TWO

2. THE TYPES OF RETURN

2.1 An overview

There are three basic types of Annual return-

- a "global return" which reports the entire worldwide business of the insurance company,

- a "UK branch return" which reports only the business carried on through a branch in the United Kingdom, and

- an "EEA branches return" which reports the entire business carried on through all branches in EEA states (including the UK).

2.2 The detailed requirements

1. The following table summarises the types of return which insurance companies are required to prepare.

<--Type of company -->	<-------------------Location of Head Office ------------------->			
	United Kingdom	A member State[1] (other than U.K.)	An EFTA[2] state	Rest of the World[2]
Pure reinsurer	Global return	Global return	Global return	Global return
United Kingdom deposit company				Global return and EEA branches return
EEA deposit company				UK branch return
All other insurance companies	Global return	Exempt[3]	UK branch return	Global return and UK branch return.

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[(1) The member States are those States which are members of the European single market in insurance, i.e. the 15 EU States, Iceland, Norway and Liechtenstein.

(2) Special rules apply for Switzerland. A Swiss general insurance company reports as for a company with its head office in the EFTA. Other Swiss companies report as for companies with their head office in the "rest of the world".

(3) Exceptionally where an EC company is required to prepare returns under the paragraph 7 of Schedule 2F to the Insurance Companies Act 1982, the same rules apply as for an EFTA company.]

2. The above table summarises the requirements of Regulation 3(3) and 3(4). "United Kingdom deposit company", "EEA deposit company" and "pure reinsurer" are defined in Regulation 3(1).

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CHAPTER THREE

3. INTERPRETATION OF THE REGULATIONS

3.1 Definitions

1. Regulation 3(1) includes a list of about 60 defined words and expressions. In addition to these specific definitions Regulation 3(2) lays down two general rules of interpretation.

2. Unless the context otherwise requires words and expressions in any Form(1), or in any Regulation(2) requiring a statement to be annexed to the Forms, are to have the same meaning as applies in-

- the Regulations(3) which lay down the rules for valuing assets and liabilities and calculating the solvency margin, or

- the rules which lay down the form and content of accounts prepared under the Companies Act 1985.

In the case of any conflict the first of the two above rules prevails.

[(1) This should be taken to include the instructions to any Form.

(2) These are Regulations 19 to 21, 23, 24 and 26.

(3) These are Parts IV, VIII and IX and Schedules 3 and 12 of the Insurance Companies Regulations 1994.]

3.2 Valuation of assets and liabilities

1. Regulation 4 requires that, unless otherwise more specifically provided, assets (other than linked assets) and liabilities included in any document in the Annual Return should be valued using the valuation rules in the Insurance Companies Regulations 1994.

2. Linked assets (defined by Regulation 3(1) as long term business assets identified in the records of the company as being assets by reference to which property linked benefits are to be determined to the extent that they are held to match liabilities in respect of property linked benefits) should be valued in accordance with "generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies".

Other guidance by the prudential regulators

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3.3 Requirement to fairly state information

1. Regulation 5 requires that every revenue account, profit and loss account, balance sheet, note, statement, report and certificate required to be prepared under section 17 of the Insurance Companies Act be prepared in the manner specified and "fairly state the information provided on the basis of the Regulations". This is a closely analogous requirement to the 'true and fair' concept for Companies Act accounts. As with that concept it includes the concept of materiality where properly applied. Forthcoming guidance to be issued by the Auditing Practices Board will in great detail discuss the application of the materiality concept to the Annual Returns. [Nb. materiality is not an acceptable excuse for basic arithmetical or cross-referencing errors in or between Forms. Nor is it an acceptable excuse for the deliberate or reckless misstatement or omission of information required to be disclosed by the Regulations. Nor does it justify a lack of proper care to the preparation of such information.]

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CHAPTER FOUR

4. CONVENTIONS FOR THE COMPLETION OF ALL FORMS

4.1 Scope

1. The accounting rules and conventions described in this chapter apply (other than where the contrary is explicitly stated) to all documents in the Annual Return other than the Forms, notes, statements and certificates required under Schedules 4 to 6.

2. The accounting rules and many of the conventions for preparing the Annual Return which are presented in this chapter derive from Paragraphs 1 to 7 of Schedule 1. The other conventions although not directly arising from the Regulations are merely cosmetic and are requested to facilitate the Insurance Directorate's processing of the Annual Returns.

4.2 Completion of Forms

Signature of forms

1. The first Form in the Annual Return (normally Form 9 or 10) should be signed. If the Annual Return consists of more than one bound volume then the front Form of each volume should be signed. Where space does not allow the signatures to be affixed to the foot of this Form a covering sheet should be used. The covering sheet should have the same header information as Form 9* and should be entitled "Covering sheet to Form 9*".

* = or Form 10 as the case may be.

2. A global return should be signed by at least two directors and the chief executive. If there is only one director, he or she and the chief executive should sign. If there is no chief executive, or if there is only one director (other than the chief executive), the secretary should also sign. A UK branch return or EEA branches return should be signed by the Authorised UK representative and the Principal UK employee. See Regulation 27.

Use of own forms

3. A company may either submit its return on Forms printed by the Insurance Directorate or print its own Forms. However in the latter case it should make sure that they are laid out exactly as the Forms in the relevant Schedules to the Regulations. Companies wishing to print their own Forms are requested to contact Section 4c of the Insurance Directorate. In general, the Insurance Directorate will accept returns produced using a recognised forms generation package. Where a company is using a bespoke

software application, it will be requested to send specimen blank Forms to the Insurance Directorate well before they intend to use them.

Headings

4. After the heading "Name of company" the full registered name of the company should be given without abbreviation.

5. In the heading "Global business/UK branch business/EEA branch business" all except one of the three alternatives should be deleted according to whether the Form is part of a global return, UK branch return or EEA branches return (see chapter two).

6. The heading "Financial year ended" should be followed by the date of the last day of the financial year written in the style "dd-month-yy", e.g. "31 December 1996".

7. The "company registration box" should be completed with the number used for submission of returns under the 1983 Regulations. A company making a return for the first time should use the full registration number given by the Cardiff, Edinburgh or Belfast Registrar of Companies. If the company does not have such a number it should agree a suitable number with the Insurance Directorate (the Insurance Directorate - Section 4c). An overseas company should use its F-series number issued by the Registrar of Companies.

8. The "GL/UK/CM" should be completed with one of the three alternatives according to whether the Form is part of a global return, UK branch return or EEA branches return (see chapter two).

9. The "Period ended" box should be completed so as to show, in numerals, the date of the last day of the financial year to which the Annual Return relates. The "month" box should always be completed with a two-digit number, incorporating a leading zero where necessary.

Typewritten entries

10. The Insurance Directorate prefers typewritten entries to hand-written ones, but there should be not more than 5 characters per centimetre or 12 per inch.

Other text

11. No text or figures should be included in any box in a Form or anywhere else on the face of the Form other than as required by the Regulations. In particular no entries should be made-

- in any unused line or column on Forms 26 to 29, 31, 32 and 34 after the last accident year or underwriting year required to be reported,
- in any column headed "Source", and
- in any shaded box.

4.3 Currency

1. All forms (other than some of the Forms 26 to 29 and 31, 32 and 34) are to be completed in sterling with-

- assets and liabilities converted at the financial year end exchange rate, and
- income and expenditure converted using "such bases of conversion as are in accordance with generally accepted accounting practice".

2. Accounting practice allows several alternative accounting bases for the translation of income and expenditure. The Insurance Directorate expects companies to choose the same basis as it uses in its Companies Act accounts. Where the Companies Act accounts are drawn up in a currency other than Sterling it is acceptable for the company also to maintain the underlying records upon which the Annual Return is based, in that currency and to translate those currency amounts into Sterling at the rate ruling at the year end.

3. The above conversion rules do not apply to certain entries on Forms 23, 26, 27, 31, 32 and 34. The rules for these Forms are explained in chapter ten below.

4.4 Presentation of amounts

1. Negative amounts should be shown between round brackets. A minus sign or "DR" should not be used.

2. All sterling amounts in the forms (except valuation prices on Form 45) should be shown in units of £1000 rounded to the nearest £1000. This is required even if particular figures are so large or small that under normal accounting conventions it would be it inappropriate. If the entry in any box to be rounded is less than £500 that box should be left blank. The entry **"0"** should not be used.

3. Amounts required to be shown denominated in foreign currency in a Form should be shown in units of 1000 (of the principal monetary unit of

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that currency) rounded to the nearest 1000, and the entry "**000**" should be made in the "units" box of that Form. However if the £ to principal monetary unit exchange rate at the year end was in excess of 1000, amounts should be shown in units of 1,000,000 and "**000,000**" should be inserted in the "currency" box.

4. Figures which are totals of other figures (whether or not on the same Form) should be rounded after totalling the unrounded detail figures.

4.5 Comparative amounts and brought forward figures

1. Columns are included on Forms 9 to 17,20 and 40 for the disclosure of comparative amounts for the previous financial year. These amounts should be reported as stated in the previous return (after any correction under s22(5) - see paragraph 1.4 above), but without restatement for any prior year adjustment even where such restatement is permitted under generally accepted accounting practice.

2. Other than to reflect exchange rate reconversion, brought forward figures on the detailed general business Forms (21 to 39) should not, as a general rule, be restated as this destroys the continuity of the historical data triangles which the Insurance Directorate derives from these Forms. However the Insurance Directorate recognises that in exceptional cases, e.g. the correction of a fundamental error, restatement for other reasons may be desirable. The Insurance Directorate requests companies which wish to restate amounts (other than to reflect exchange rate reconversion), to discuss the proposed restatement with their usual supervisory contact at the Insurance Directorate prior to submitting their return.

3. Where any brought forward amount is restated (other than to reflect exchange rate reconversion) the reason for the restatement must be given in a supplementary note to the Form upon which the brought forward amount appears - see paragraph 7 of Schedule 1.

4. Special difficulties with brought forward and comparative figures arise for an established overseas insurance company newly authorised in the UK by the Insurance Directorate and preparing its first global return. Such a company may wish to seek guidance from its normal supervisory contact at the Insurance Directorate.

4.6 Supplementary notes

1. Supplementary notes should not be shown on the face of a Form but should be shown on a separate sheet or sheets of paper. It would be helpful if the notes for all Forms are bound together toward the end of the Annual

Return (but before the certificates) and not interleaved with the Forms to which they relate.

2. The requirements to prepare supplementary notes are variously located in the actual text of the Regulations, in the text of the Schedules to the Regulations and in the instructions to the Forms. However in each case the requirement to prepare the note identifies the Form to which it is to relate.

3. In the following chapters for each Form (under Schedules 1 to 3) a complete list of the required supplementary notes is provided. Each note in the list is given a unique reference code. The first two digits of the code are the number of the Form and the final two digits the number of the note. For example the 5th note in the list for Form 13 is coded "1305".

4. Each supplementary note included in the Annual Return should be given a title which identifies the Form or Forms to which it relates. The Insurance Directorate requests that (in respect of Forms prepared under Schedules 1 to 3) this be done by including the code as the first element in the title. For example the title for note 1601 might be -

1601 Basis of conversion of foreign currency

If there is more than one Form of the same number (e.g. Forms 24 for several accounting classes) only one title of the above type need be used to cover all such Forms.

5. Where a company wishes to include an extra note (beyond those required by the Regulations to be included) it should identify the Form to which it relates and give the note the next unused sequential code number for that Form. For example the Regulations specify seventeen coded notes for Form 13 which are respectively coded 1301 to 1317. If an extra note is to be added it should be coded 1318. The code 1318 should be used even if for the particular company there is no note 1317 (because the circumstances in which that note is required do not arise for that company).

6. Where the Regulations require a Form to be submitted but all entries (including comparatives) would be blank that Form may be omitted provided that a note coded FF00 (where FF is the Form number) is included stating that this is why the Form has been omitted. This note is not needed where a Form is omitted because the Regulations do not require it. For example a non-life company is not required to submit Life Forms 40 to 45 and so does not need supplementary notes 4000 etc.

7. Two or more supplementary notes should not be combined as a single text with a single title except where this avoids unnecessary repetition or leads to a clearer explanation. Where two or more supplementary notes are

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combined the codes of all the notes should be listed at the beginning of combined title.

8. Some supplementary notes are always required whenever the Form to which the note refers is required. Others, are only required on an exception reporting basis. The detailed guidance below on each supplementary note brings out this distinction.

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CHAPTER FIVE

5. FORMS 9 TO 17: STATEMENT OF SOLVENCY, BALANCE SHEET AND NON-TECHNICAL ACCOUNT

5.1 Statement of Solvency (Form 9)

Completion of the form

1. Form 9 is to be prepared by every company other than an EFTA company, a Swiss general insurance company or a EEA deposit company - see Regulation 6(2).

2. Form 9 shows separately for general business and long term business-

- the required minimum margin of solvency,
- the available assets,
- any implicit items (for long term business), and
- any contingent liabilities.

3. The entries on Form 9, other than for implicit items, derive from other forms within the Annual Return.

- The general business required margin of solvency derives from Forms 11 and 12 and the long term business required margin of solvency from Form 60.
- The available assets derive from Form 10. A composite insurer may apportion part of its "other than long term business - available assets" (line 29 on Form 10) to count against the required minimum margin for its long term business provided that such assets are in excess of the amount needed to match its general business required margin of solvency - see Regulation 17(5)(b) of the Insurance Companies Regulations 1994.
- The long term business liabilities derive from Form 14.
- The contingent liabilities for general business and long term business derive from supplementary notes to Forms 15 and 14 respectively.

4. Implicit items are certain special types of "asset", i.e. future profits, Zillmerising and hidden reserves, specified in Regulation 23(5) of the Insurance Companies Regulations 1994. They may be counted against a company's required minimum margin of solvency but only if, and to the extent, specifically allowed by an order issued to it by the Treasury under

Section 68 of the Insurance Companies Act 1982. A company wishing to count such items against its solvency requirement should apply to the Insurance Directorate for the appropriate order.

Supplementary notes

Two supplementary notes may be required to this Form: -

(1) Where a section 68 order has been issued disapplying or modifying any of the provisions of the 1996 Regulations, a note to Form 9 explaining the effect of the order is usually required. The requirement for such a note would be specified in the order itself. [Code 0901].

(2) Where a section 68 order has been issued to a company permitting it to take into account implicit items on long term business, that order may specify that a note is to be included in the Annual Return explaining such items. That noted should be included as a note to Form 9. [Code 0902].

5.2 Statement of Net Assets (Form 10)

Completion of the form

1. Form 10 is to be prepared by all companies - see Regulation 6(3).

2. Lines 11 and 12 are to be completed only by a company carrying on long term business and respectively derive from Forms 13 and 14. A company which carries on long term business is required by section 28 of the Insurance Companies Act 1982 to maintain a separate fund for that business. Lines 11 shows the value of the admissible assets in that fund. Lines 11 and 12 should equal each other.

3. All other lines on Form 10 are to be completed by every company, other than a mutual without share capital (or subordinated loan capital) which only carries on long term business. Line 56 is to be completed with the balancing figure so as to ensure that line 59 equals line 29.

4. Line 23 shows the net admissible assets, i.e. admissible assets less liabilities. Lines 24 and 25 show two types of asset which may not be taken into account in determining the net admissible assets but which, provided that net admissible assets are not negative, may (to a limited extent) be added to net admissible assets for the purpose of determining whether the company meets its required margin of solvency. Similarly lines 26 and 27 show two types of liability which are taken into account in net admissible assets but which, provided that net admissible assets are not negative, may (to a limited extent) be added-back for the purpose of determining whether the company meets its required margin of solvency. Thus where line 23 is negative no amounts may be included at lines 24 to 27. [See Regulation 23

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of the Insurance Companies Regulations 1994 for the detailed rules applicable to these types of assets and liabilities.]

5. Line 51 should include the share premium account.

Reconciliation of balance of net assets brought forward and carried forward

6. Line 61 to 69 reconcile the balance of net assets, (line 56), brought forward and carried forward. For these purposes the brought forward amount shown at line 61 should not be restated for any reason, even for exchange differences.

7. The three most frequent reasons for a movement in the net assets are listed respectively at lines 62 to 64. They are-

- the retained profit or loss for the financial year - sourced from Form 16,
- movements in the difference between the value of (other than long term) assets under the HM Treasury valuation rules and under the GAAP valuation rules - sourced from Form 13, and
- a decrease or increase in the provision for adverse changes (which is a provision made for HM Treasury purposes but which does not arise under GAAP) - sourced from Form 15.

8. Movements in the net assets which are not attributable to the three reasons given above should be included at line 65 and explained by way of supplementary note to the Form. [Code 1002].

9. The retained profit or loss (line 62) is sourced from Form 16 and, therefore, is for other than long term business determined in accordance with the same generally accepted accounting practice ("GAAP") as apply in UK Companies Act accounts. The long term business retained profit departs from GAAP in that it is based on the "statutory" method of reporting, not the "modified statutory" method.

10. The annex to this chapter gives two examples of this reconciliation.

Reconciliation of net assets to the accounts

11. In addition to the above reconciliation which appears on the face of Form 10, a further reconciliation is required by way of supplementary note to the Form. This takes net assets as per the Annual Return and reconciles them to net assets as they appear in the shareholder accounts. It is required for <u>every</u> insurance company which is not incorporated outside the UK, and which in consequence has to prepare Companies Act accounts in

accordance with Schedule 9A of the Companies Act 1985. See paragraph 14 of Schedule 1 of the 1996 Regulations.

12. For purposes of this reconciliation, net assets as per the Annual Return should be taken not from Form 10 but by netting assets taken from line 99 of the Form 13 (for the category of assets "1") and liabilities from line 59 of Form 15. The net assets as per the Companies Act accounts should be the amount shown under balance sheet item A "capital and reserves".

13. The reason for taking assets and liabilities from these sources within the Annual Return is to eliminate from the reconciliation differences due to the dissimilar asset and liability valuation rules as between the Annual Return and Companies Act accounts. [Lines 91 to 99 of Form 13 reconcile the valuation of assets as per the Annual Return rules and as per the Companies Act accounts rules. Line 99 shows the value after that reconciliation, i.e. the value as per the Companies Act accounts rules. Similarly line 59 of Form 15 shows liabilities sub-totalled excluding items which do not appear as liabilities in the Companies Act accounts, e.g. the provisions for adverse changes etc..]

14. As a result this reconciliation only needs to deal with differences which arise for other reasons. Such differences would include the following:

- The value of net assets within the long term business fund. This is included in the net assets taken from the Companies Act accounts (item A "capital and reserves") but is not included in net assets as sourced from Form 13 (category of assets "1") and Form 15.

- The amount of any subordinated loan capital. This is not deducted as a liability in the net assets as sourced, *inter alia*, from line 59 of Form 15, but is deducted as a liability in the net assets as sourced from the Companies Act accounts (item A "capital and reserves").

15. Other than as noted above companies should only rarely have any differences to report under this reconciliation; e.g. where there is a material adjusting post-balance sheet event which occurs after the date of sign off of the Companies Act accounts but before the date of sign off of the Returns.

16. Where for any reason a Company (other than one incorporated outside the UK) either does not prepare or has not yet prepared its Companies Act accounts a statement that this is the case should be included in the supplementary note instead of the above reconciliation. The Insurance Directorate would also find it helpful if the reason why accounts have not been prepared, (e.g. because they are drawn up to different year ends from the Annual Return), is also stated.

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17. The annex to this chapter gives an example of this reconciliation.

Supplementary notes

18. Three supplementary notes are specified -

(1) the supplementary note described in paragraphs 11 to 17 above - see paragraph 14 of Schedule 1; [Code 1001];

(2) particulars of any "other movements" shown at line 65; [Code 1002]; and

(3) particulars of any section 68 order allowing subordinated loan capital not to be treated as a liability for the purposes of determining whether the company holds net assets which match its required margin of solvency - the requirement for this note will be specified in the section 68 order itself; [Code 1003].

5.3 Calculation of required margin of solvency (Forms 11 and 12)

The margins of solvency

1. Forms 11 and 12 are to be completed by every company which carries on general business, other than an EFTA company, a Swiss general insurance company or an EEA deposit company - see Regulation 6(4).

2. All insurance companies (subject to certain exceptions described below) which are subject to Part II of the Insurance Companies Act 1982 are required to maintain a margin of solvency throughout the financial year. Forms 11 and 12 in the ***Global*** Annual return (see chapter two above) show the calculation of this margin of solvency in respect of general business.

3. For an insurance company (other than a pure reinsurer) with its head office outside the UK this margin of solvency relates to its entire worldwide business. Such an insurance company (unless an UK deposit company) must also maintain a "UK margin of solvency" in respect of its business carried on in the United Kingdom. Forms 11 and 12 in the ***UK Branch*** Annual return (see chapter two above) show the calculation of the UK margin of solvency in respect of general business. A UK deposit company must also maintain an "EEA margin of solvency" in respect of its business carried on within EEA states. Forms 11 and 12 in the ***EEA Branches*** Annual return (see chapter two above) show the calculation of the EEA margin of solvency in respect of general business.

4. The exceptions mentioned above are EFTA companies, Swiss general insurance companies and EEA deposit companies. They are excluded (under UK law) from the requirement to maintain any of the above types of margin

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of solvency. [This is because they are subject to equivalent solvency rules imposed by their home state or by another EEA state.] These companies do not prepare Forms 11 and 12.

5. The text on the face of the Forms only presents in outline the method of calculation of the general business margins of solvency. The detailed rules for the calculation are to be found in Schedules 3 to 5 of the Insurance Companies Regulations 1994, (the "1994 Regulations"), to which companies preparing these Forms should refer. The Forms should be interpreted in the light of these rules - see Paragraph 10(1) of Schedule 1.

6. The 1994 Regulations lay down that the margins of solvency are to be calculated as the highest result from the application of three alternative methods. These are the premium basis, the claims basis and the minimum guarantee fund. The first method is shown on Form 11 and the latter two methods together with the comparison of all three methods are shown on Form 12.

Form 11: the first method (i.e. the premium basis)

7. <u>Line 11</u>: determine the ***gross premium receivable*** in the financial year.

(1) "Gross premium" is defined by paragraph 1 & 2 of Schedule 3 of the 1994 Regulations as "premiums after deduction of discounts, refunds and rebates of premium and before deduction of premiums for reinsurance ceded and of commission payable”. It includes premiums receivable from reinsurance contracts accepted by the company. In effect, although the 1994 Regulations do not express themselves in this way, this has the same meaning (subject to one important exception described in sub-paragraph (4) below) as "gross premiums written" as it occurs in the other Forms in the Annual Return.

(2) The amount of "gross premium" to be taken is limited by the words "receivable". This is also defined by paragraph 1 of Schedule 3 of the 1994 Regulations and means "recorded in the company's books as due to the company ... in respect of risks incepted in the financial year". Policies transferred to a Company under a Schedule 2C transfer (or transfer under the equivalent law of another EEA state) should be considered to be incepted on the date of transfer.

(3) In effect therefore (subject to the exception described below), "gross premiums receivable" may be treated as being the same as that portion of "gross premiums written" which is in respect of risks incepted in the financial year. This may be derived from the other Forms in the Annual Return as follows: take the sum of the entries in columns 1 and 2 for lines 13 to 15 on all Forms 21 and of the entry at line 11 for the current underwriting year on all Forms 24. [In algebraic notation this is:

(21.13.1 + 21.13.2 + 21.14.1 + 21.14.2 + 21.15.1 + 21.15.2) for all Forms 21 + 24.11.(mm-yy) for all Forms 24; where mm-yy is the current financial year.]

(4) The exception referred to above occurs where premiums receivable are excluded from gross premiums written as shown in Forms 21 and 24 by virtue of the rule in paragraph 26 of Schedule 2 [of the 1996 Regulations]. This says that "amounts in respect of inwards and outwards contracts of insurance shall be classified for inclusion in Forms 20 to 39 according to their economic substance in accordance with generally accepted accounting practice". This, in effect, means that the accounting treatment for so-called financial reinsurances is to be the same in these Annual return Forms as in the Companies Act accounts. This is explained more fully in paragraph 8.2.2 below. The point to note here is that even where, under this rule, the consideration receivable under a contract of insurance is not classified as "gross premiums written" for the purposes of those HM Treasury Forms, it must be included as "premiums receivable" on Form 11. The Form 11 "premiums receivable" should include all consideration receivable in respect of contracts which constitute carrying on insurance business under the Insurance Companies Act 1982, and which therefore require authorisation under that Act.

8. Line 12: deduct premium taxes and levies, but only to the extent that: (i) in the case of taxes they are included in premiums and (ii) in respect of levies they are related to premiums and are "recorded in the company's books as payable in the last preceding financial year in respect of general business" - see Paragraph 3 of Schedule 3 of the 1994 Regulations. Under generally accepted accounting practice the UK Insurance Premium Tax is excluded from the amount shown for premiums. It should not, therefore, be deducted at line 12 on the Form. The anticipated Policyholder Protection Board levy in respect of business written during the year may be deducted, but only to the extent that a provision for that anticipated liability has been established.

9. Line 14: adjust the sub-total derived from the above to an annual figure if the financial year runs for more or less than 12 months - see paragraph 4 of the 1994 Regulations.

10. Lines 15 to 19: (i) analyse the amount arrived at in line 14 between "other" and "health insurance based on actuarial principles"; (ii) in the case of each amount, if appropriate, divide into two portions of 10 million European Currency Units and the excess over 10 million such units and (iii) apply the appropriate percentages (18, 16, 6 or $5^1/_3$, as the case may be) to the totals arrived at and add together the resultant sums to determine the ***Sub-total B*** - see Paragraphs 5 to 9 of Schedule 3 of the 1994 Regulations. The Insurance Directorate will advise, if requested, whether business carried on under a particular policy falls within the definition of "health

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insurance based on actuarial principles". The £/ECU rate of exchange to be used is that prevailing at the previous 31 October and is advised to companies each year via a HM Treasury market letter.

11. Lines 21 to 29: Determine (i) gross ***claims paid*** in the financial year; (ii) gross ***claims outstanding*** carried forward; and (iii) gross ***claims outstanding*** brought forward. Determine the gross claims incurred, ***Sub-total C***, as (i) plus (ii) less (iii).

(1) "Claims paid" and "claims outstanding" are defined in detail by paragraph 11 to 12 of Schedule 3 of the 1994 Regulations. In essence they refer to the amounts recorded in the company's books as -

- "paid in full or partial settlement of" or "set aside as likely to be sufficient to meet" claims under contracts of insurance; **or as**
- expenses "incurred" or "set aside" as likely to be incurred which are "directly attributable to the settlement of individual claims ..."; **less**
- related salvage recoveries, recoveries from third parties and recoveries from other insurers (but not reinsurance recoveries).

(2) The definition of "Claims outstanding" includes the provision for claims incurred but not reported.

(3) In effect, although the 1994 Regulations do not express themselves in these terms, the above definitions of "claims paid" and "claims outstanding" are equivalent (subject to one important exception described below) to the corresponding amounts included in Forms 22 and 25, but excluding the "claims management costs".

(4) For "claims paid" the equivalent amount is the sum of the amounts at lines 11 and 15 in column 2 in all Forms 22 and of the amounts line 21 of the total column in all Forms 24. [In algebraic notation this is: (22.11.2 + 22.15.2) for all Forms 22 + 24.21.(99-99) for all Forms 24.]

(5) For "claims outstanding" the equivalent amount is the sum of the amounts at lines 11 and 15 in column 3 in all Forms 22 and of the amounts lines 11 and 13 of the total column in all Forms 25. [In algebraic notation this is: (22.11.3 + 22.15.3) for all Forms 22 + {25.11.(99-99) + 25.13.(99-99)} for all Forms 24.] Nb. for a company which discounts its claims outstanding this requires that the undiscounted provision be taken. If necessary the brought forward amount (here and on Form 12) should be restated as undiscounted.

(6) The exception referred to above arises for the same reason as described in sub-paragraph (4) of paragraph 7 above. Amounts are classified for inclusion in Forms 22, 24 and 25 according to their economic substance

in accordance with generally accepted accounting practice. However in Forms 11 and 12 "claims paid" and "claims outstanding" should include all amounts "paid" or "set aside" for claims under contracts which constitute carrying on insurance business under the Insurance Companies Act 1982, and which therefore require authorisation under that Act, even where such amount are not classified as "claims paid" under generally accepted accounting practice.

12. Lines 30 to 39 :determine the net claims incurred, ***Sub-total D***, by deducting from the gross claims incurred, ***Sub-total C***, the total sum recoverable in respect of that amount under reinsurance contracts ceded See Paragraph 13 of Schedule 3 of the 1994 Regulations. Line 30 should only include amounts classified for inclusion as reinsurance in Forms 22, 24 and 25 according to their economic substance in accordance with generally accepted accounting practice [except that where gross premium has been included in line 11 only by virtue of paragraph 11(6) above, all reinsurance of that gross premium (whatever its economic substance) may be included in sub-total C.]

13. Line 41 :determine the ***First result*** by multiplying the ***Sub-total B*** by the ratio of the ***Sub-total D*** to the ***Sub-total C***, (or if that fraction is less than one half, by one half; or if the fraction is more than one, by one). See paragraph 14 and 15 of Schedule 3 of the 1994 Regulations.

The Second Method: the claims basis

14. Determine the reference period. If a company has not been in existence long enough to acquire a reference period this should be indicated by entering a zero at the box in line 11 and lines 21 to 41 ignored. For the majority of companies the reference period will be the last three financial years. See Paragraphs 1 and 2 of Schedule 4 of the 1994 Regulations.

15. Establish the amount of "claims incurred" in a similar way to that explained in paragraph 11 above but related throughout to the reference period rather than to the financial year. For example where the reference period is the last three financial years the "claims incurred" should be derived (using the formulae described above) from the amounts reported in the Returns for those last three years - see Paragraph 3 of Schedule 4 of the 1994 Regulations. However it is acceptable to restate amounts of "claims incurred" for currency movements.

16. Reduce the sum derived to an annual figure by multiplying by 12 and dividing by the number of months in the reference period.

17. Lines 32 to 39: (i) analyse ***Sub-total F*** between "other" and "health insurance based on actuarial principles" ; (ii) in the case of each amount, if appropriate, divide into two portions of 7 million European Currency Units

and the excess over 7 million such units and (iii) apply the appropriate percentages (26, 23, $8^2/_3$ or $7^2/_3$, as the case may be) to the totals arrived at and add together the resultant sums to determine the ***Sub-total G*** - see Paragraphs 5 to 9 of Schedule 4 of the 1994 Regulations. The definition of "health business" and the £/ECU rate are the same as apply in paragraph 10 above.

18. Line 41 :determine the ***Second result*** by multiplying the ***Sub-total G*** by the ratio of the ***Sub-total D*** to the ***Sub-total C***, (or if that fraction is less than one half, by one half; or if the fraction is more than one, by one). See paragraph 14 and 15 of Schedule 3 of the 1994 Regulations.

The Minimum Guarantee Fund

19. The amount of the minimum guarantee fund (line 44 on Form 12) is calculated by reference to the classes of business for which the company is authorised - see Schedule 5 of the 1994 Regulations. In most cases it will be 400,000 European Currency Units translated to sterling.

Supplementary notes

20. Two supplementary notes are specified.

(1) If any of the brought forward amounts differs from the corresponding carried forward amounts in the previous return the reason should be stated - see Paragraph 7 of Schedule 1. [Codes 1101 and 1201].

(2) If any of the amounts included in either Form 11 or 12 differ from the corresponding amounts in Forms 21 to 25 the amount of difference and the reason for it should be stated - see paragraph 10 of Schedule 1. The expected correspondence between amounts in Forms 11 & 12 and in Forms 21 to 25 and the reasons why they might differ are explained in paragraphs 7 and 11 above. [Codes 1102 and 1202]

5.4 Analysis of admissible assets (Form 13)

Different types of Form 13

1. Form 13 is to be prepared by every company for one or more categories of assets - see Regulation 6(5).

- Every company, (other than a mutual without share capital which only carries on long term business), is to prepare a Form 13 for its total other than long term assets.

- Every company which carries on long term business is to prepare a Form 13 for the total long term business assets.

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2. The "long term business assets" are the assets required by section 28 of the Insurance Companies Act 1982 to be maintained in the separate fund for long term business. Where separate assets within the section 28 fund are appropriated for separate long term funds or groups of funds, (other than internal linked funds), additional Forms 13 are to be completed in respect of each such fund or group of funds.

3. An external company, (other than an pure reinsurer), and a United Kingdom deposit company must complete certain additional forms. These are described in instruction 3 to Form 13. For the definitions of "external company", "pure reinsurer" and "United Kingdom deposit company" see Regulation 3.

4. The different Forms 13 are identified by the entry in the "category of assets" box in the heading. A list of codes to be used in the completion of that box is given in the instructions to Form 13.

Completion of the Form

5. Form 13 consists of three parts.

- Lines 11 to 89 provide a "line by line" analysis of the assets valued in accordance with the Regulation 4.
- Lines 91 to 99 provide a reconciliation of the total assets as valued in accordance with Regulation 4 and as valued in accordance with the Companies Act accounts rules.
- Line 100 discloses the value of the debts due from related companies, other than those under contracts of insurance or reinsurance.

6. The classifications used in lines 11 to 89 are based on those used in the balance sheet format in Schedule 9A of the Companies Act 1985, i.e. those which are required to be used in the preparation of the Companies Act accounts. In many cases, however, a single item in the Companies Act format is subdivided. The subdivisions typically reflect distinctions between types of assets found in the asset valuation Regulations, (i.e. Part VIII of the Insurance Companies Regulations 1994).

7. Lines 11 to 89 refer to the descriptions used in the Companies Act accounts balance sheet format solely for the purposes of indicating how assets are to be classified, i.e. to show at which line they are to be included. The Companies Act valuation rules are not to be followed. Assets at lines 11 to 89 are instead to be valued in accordance with Regulation 4 - see instruction 4 to the Form. Refer also to the Insurance Directorate's Prudential Guidance Note 1995/1

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8. Regulation 4 provides that-

- assets (other than referred to below) are to be valued in accordance with Part VIII of the Insurance Companies Regulations 1994, and

- assets matching property linked benefits are to be valued in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies. [See paragraph 12 below.]

9. Lines 11 to 86 show asset values after deductions for excesses over permitted asset exposure limits - see Regulation 57 of the Insurance Companies Regulations 1994. Where such a deduction relates to assets included at more than one line of Form 13 it should be apportioned pro rata. Negative amounts should not be shown at lines 11 to 86. If a deduction is more than the value of the assets to which it relates the 'excess' element of the deduction should be shown at line 87 as also should deductions for excesses over permitted counterparty limits and for excess concentrations over a number of counterparties. See Regulation 57(3) of the Insurance Companies Regulations 1994.

10. Where the value of any asset is denominated in a currency other than sterling it is to be converted into sterling using the year end closing middle rate - see Paragraph 4 of Schedule 1.

11. The amount of any asset in Form 13 should be shown gross of any set-off against any corresponding liability (which liability should be shown on Forms 14 or 15 as appropriate). The only exception to this is where-

- amounts are owed from and to the same person, and

- such netting is permitted under generally accepted accounting principles. [See in particular Financial Reporting Standard 5.]

"Person" refers not only to individuals but also to corporate bodies and unincorporated associations.

12. The above rule usually prevents the set-off of amounts due from and to the same broker/intermediary unless they relate to the same client of the broker. This is because typically such amounts are in law owed from and to not the broker/ intermediary but the client. The broker/intermediary merely acts as a collecting agent.

13. Lines 54 and 55 "Deposits with approved credit institutions and approved financial institutions" should only show relevant deposits subject to a time restriction on withdrawal. Such deposits not subject to such a time restriction should be shown at line 81. In the analysis between lines 54 and 55, "withdrawal subject to a time restriction of one month or less" and

"withdrawal subject to a time restriction of more than one month", the time restriction is to be measured relative to the date of the end of the financial year and not, if different, the date on which the deposits were originally made.

14. Lines 58 and 59 together show the "assets held to match linked liabilities". <u>This expression has the same meaning as in the Companies Act accounts and the items to be classified for inclusion under these lines should be the same as those included under the heading of the same name in the Companies Act accounts.</u> <u>However the valuation of the items to be included is not necessarily the same.</u> The valuation rules in Part VIII of the Insurance Companies Regulations 1994 apply to all items included at these lines other than those exempted by Regulation 45(2) of those Regulations. This only exempts "linked assets" (to the extent they are held in compliance with Section 35A of the Act) <u>which match liabilities</u> in respect of <u>property linked</u> benefits.

15. Insurance Directorate doubts whether either the heading in the Companies Act accounts or at lines 58 and 59 on Form 13 is apt to include assets backing surplus units in internal linked funds. However where such assets are included under this heading in the Companies Act accounts they should also be included at lines 58 and 59 on Form 13. [Nb. as such surplus assets are not exempted by Regulation 45(2), they must be valued in accordance with Part VIII of the Insurance Company Regulations 1994). See also paragraph 15.7.10 below. Insurance Directorate also is aware that companies adopt different treatments in their Companies Act accounts for index-linked liabilities backed by a derivative. Some include the derivative, any margining loan back (as a deduction) and the investments arising from the margining loan in "assets covering linked liabilities". Others only include some of these items under that heading and, perhaps, include the margining loan back as a liability. Insurance Directorate doubts whether all of these treatments necessarily always conform to Generally Accepted Accounting Practice, e.g. showing assets net of the margining loan is not permissible where there is no legal right of set-off. However where a company has adopted a treatment in its Companies Act accounts (and so implicitly come to the view the treatment accords with GAAP) it should adopt the same treatment in the Annual Returns.

16. Line 73 "salvage and subrogation recoveries" should only be used for such recoveries which fall to be classified as "debtors arising from insurance operations". Occasionally some salvage or subrogation recoveries may be classified under other headings in the Companies Act accounts in which case the same heading should be used in Form 13, but a supplementary note [code 1303] is required. See paragraph 16 below. If salvage and subrogation recoveries are shown in the Companies Act account as a deduction from liabilities rather than as asset, the same treatment should be adopted in the Annual Returns. That is line 73 should be left blank and

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the amount of liabilities shown on Form 14 be shown net of the salvage and subrogation recoveries.

17. Line 80 should include leased tangible assets where such are held under a finance lease and are brought into account as an asset in the Companies Act accounts in accordance with Statement of Standard Accounting Practice 21. [Paragraph 4.62 of PGN 1995/1 which gives contrary advice are hereby rescinded.]

18. Line 83 “Other assets” refers to the balance sheet heading in the Companies Act accounts of “Other Assets - other” (item Fv. in the balance sheet format in Schedule 9A to the Companies Act 1985). It should not be used for any other type of asset and even where used for an asset falling under the Companies Act account Fv. heading it should show only the admissible value, if any.

19 Lines 91 to 99 reconcile the admissible assets to the total assets determined in accordance with the Companies Act accounts rules. For guidance on the distinction between the different types or reconciling item (lines 92 to 95) - see examples 1 to 3 in Annex A to this chapter. This reconciliation must be completed by all companies whether or not they prepare Companies Act accounts. In this reconciliation a particular problem is caused by those assets which the Companies Act permits to be shown either as assets or as a deduction from liabilities. The main classes of such assets are-

- the reinsurers' share of technical provisions, and
- the deferred acquisition costs.

20. For general business these assets, to the extent admissible, should always be shown at lines 60 to 63 and 85 respectively. Further the total shown at line 99 ("assets determined in accordance with shareholder accounts rules") should always include such assets even where they are actually shown as a deduction from liabilities in the Companies Act accounts. For long term business these assets should never be shown at lines 60 to 63 and 85 and never be included in the total at line 99, even where they are shown as an asset in the shareholder accounts. In the category of assets Forms “3” to “5” lines 60 to 63 (reinsurers' share of technical provisions) and line 85 (deferred acquisition costs) should be left blank. [There is no requirement to maintain such assets either within the UK or any EEA states.]

21. Apart from the above the Insurance Directorate does not believe that - for a company which actually prepares Companies Act accounts - there is any other reason why an item should not be classified as an asset or a deduction from liabilities on Form 13 (line 99) and Forms 14/15 in the same way as in the Companies Act accounts. The same applies for the

classification of an item as a liability or a deduction from assets. Different methods of 'grossing up' should be avoided. [Nb. for the treatment of leased assets see paragraph 13A.]

22. The Companies Act accounts rules allow for some investments to be valued either at current value or at amortised cost. A company which does not prepare Companies Act accounts should choose the current value method for disclosure at line 99 on Form 13. Any other company should choose the same method for line 99 on Form 13 as it chooses for its Companies Act accounts.

23. Asset valuation differences arising in respect of shares in, or debts due or to become due from, dependants should be included:

(i) at line 92 in so far as they arise from the application of admissibility limits to the assets of that dependant;

(ii) at line 93 in so far as they arise from a solvency margin deduction made either because that dependant is itself an insurance company or because it (directly or indirectly) has invested in another dependant which is an insurance company; and

(iii) at line 94 in respect of any other causes of differences.

[Line 95 should not be used for differences arising in respect of shares in, or debts due or to become due from, dependants. Such shares or debts are not themselves "assets of type not valued", and this is still true even if the dependants themselves invest in assets of a type not valued.]

Supplementary notes

24. There are nine specified supplementary notes. Each note (other than No.(3) below) should be given separately for long term business and other than long term business, (i.e. separately for the category of assets "1" and "10" Forms 13). Further separate disclosure for category of assets "2" to "5" or "11" onwards is not needed. The notes are coded 1301 to 1307, 1314 & 1315 for other than long term business and 1308 to 1313, 1316 & 1317 for long term business.

(1) The aggregate value of (i) unlisted investments, (ii) certain listed investments, (iii) units or beneficial interests in certain collective investment schemes and (iv) reversionary interests or remainders in property other than land or buildings, together with a description of the assets in question - see instruction 5 to the form; [Codes 1301 and 1308];

(2) the aggregate value of hybrid securities - see instruction 6 to the Form; [Codes 1302 and 1309];

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(3) the amounts of any non-debtor salvage or subrogation recoveries - see instruction 7 to the Form; [Code 1303];

(4) a statement that amounts have been set off to the extent permitted by generally accepted accounting principles (if this option has been exercised) - see Paragraph 8 of Schedule 1; [Code 1304 and 1310];

(5) the maximum counterparty limit permitted by the company's investment guidelines (and any separate limit for counterparties other than "approved counterparties") together with an account of any breaches during the year of those limits - see Paragraph 11(1) of Schedule 1; [Code 1305 and code 1311];

(6) the amount and nature of the exposure at the year end to large counterparties (i.e. greater than 5% of the general business or long term business amounts) - see Paragraph 11(2) of Schedule 1; [Code 1306 and 1312];

(7) The aggregate value of certain fully secured rights - see paragraph 11(3) of Schedule 1; [code 1307 and 1313].

(8) The amount of any tangible lease assets included at line 80 - not required by the Regulations but disclosure requested by the Insurance Directorate; [code 1314 and 1316] ; and

(9) Particulars of any 'Other assets' included at line 83 - see the face of the form; [code 1315 and 1317].

Note 1

25. A single figure with a simple description will suffice. For example: ***The company held £xm in unlisted securities and £ym in unregulated collective investment schemes, almost all of which was of the latter type.*** The assets covered by this note are those which count towards the 10% permitted asset exposure limit at paragraph 12 of Part II of Schedule 12 of the Insurance Companies Regulations 1994. For detailed definitions of the type of assets to be included, see Part VIII of those Regulations.

Note 2

26. For a definition of hybrid securities see Schedule 12 of the Insurance Companies Regulations 1994.

Note 3

27. A single aggregate figure is sufficient disclosure. This should only include salvage and subrogation rights (other than shown at line 73) brought

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into account under the valuation rule in Regulation 48(9) of the Insurance Companies Regulations 1994. The exercise of salvage rights which have resulted in the company acquiring an asset which is admissible in its own right, (e.g. land and buildings received by a DMI insurer), need not be included.

Note 4

28. The amounts set off do not need to be disclosed in this note.

Note 5

29. The precise content of this "account" of any breach is not specified in the Regulations. However the Insurance Directorate expects it typically at least to include an estimate of the amount of the excess and the reasons why it was permitted to arise. [The requirement to give an account of any breaches during the year should not be read as implying that real-time monitoring of the exposures is necessary. Rather, the frequency of the monitoring should be appropriate to the make-up of the investment portfolio.]

30. For the purposes of making the disclosures required by supplementary notes 1305, 1306, 1311 and 1312 "counterparty" has the same meaning as in paragraph 1 of Schedule 12 to the Insurance Companies Regulations 1994. Also the amount of any counterparty exposure should be calculated using the rules laid down in paragraphs 13 to 15 of the Schedule, except that asset values should not be limited to the amounts of any permitted asset limits. The amount of any counterparty exposure should be stated before deduction of any excess counterparty exposure or excess concentration with a number of counterparties.

31. Assets excluded from the scope of the counterparty exposure rules may also be disregarded for the purposes of these supplementary notes disclosure. This excludes -

linked assets held to match property linked liabilities; and

assets of the type listed in paragraph (5) of Regulation 57. [For a list of such asset types see paragraph 5.25 of the Prudential Guidance Note 1995/1 "Guidance Notes on the Valuation of Assets Regulations".]

Note 6

32. The limit of 5% of the long term business amount should be used for counterparty exposures which arise from the long term business assets and such other than long term business assets as are allocated toward the long term business required minimum margin (see line 22 of Form 9). This does not apply to a composite insurer which must use the general business

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amount for such assets. The limit of 5% of the general business amount should be used for all other counterparty exposures.

33. Paragraphs 21a. and 21b. above also apply to this note.

Note 7

34. This disclosure covers those secured assets which are exempted from counting towards the appropriate permitted counterparty exposure limit by virtue of paragraph 14 of Part I of Schedule 12 of the Insurance Companies Regulations 1994. (NB By no means all secured assets are so exempted.) Secured assets which are exempted from the limit by virtue of some other provision, (e.g. Regulation 47A in relation to stock-lending collateral), should not be included. A single aggregate figure is sufficient disclosure.

Note 8

35. cf. paragraph 13A above.

Note 9

36. cf. paragraph 13B above.

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5.5 Long term business liabilities and margins (Form 14)

Completion of the Form

1. Form 14 should be completed by every company which carries on long term business in respect of:

(i) its total long term business liabilities and margins; and
(ii) the long term business liabilities and margins for each separate long term business fund or group of funds for which separate assets have been appropriated;

- see Regulation 6(6) as amended.

2. The effect of item (ii) above is that a separate Form 14 is required for each fund or group of funds whenever a separate Form 13 is required for that fund or group of funds - see Paragraph 5.4.2 above. The "category of assets" box in the header of Form 14 is to be completed with the same codes as are used for the corresponding box in the header of Form 13, except that there are no Forms 14 required which correspond to the Form 13 category of assets, "1" to "9".

3. Form 14 shows the liabilities and margins in respect of long term business. It is helpful to consider these under three separate headings:

- the liabilities, (lines 11, 12 and 15 to 49);
- the "margins", (lines 13 and 51); and
- the footnote to the Form, (lines 61 to 63).

Liabilities

4. There are three basic types of liability which fall to be disclosed:

- long term business liabilities not yet fallen due, (lines 11, 12 and 23);
- 'accounting' liabilities including long term business liabilities which had fallen due, (lines 15 to 22 and 31 to 39); and
- the provision for adverse changes, (line 41)

Different rules apply for determining the amount of each of these types of liability. Long term business liabilities (other than liabilities which had fallen due for payment before the valuation date) are determined on actuarial principles and the 'accounting' liabilities are determined using generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies - see Part

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IX of the Insurance Companies Regulations 1994. In effect 'accounting' liabilities are to be determined for inclusion in Form 14, (lines 15 to 22 and 31 to 39), in the same way as for Companies Act accounts. However if the Companies Act accounts are signed off earlier or later than the Annual Returns differences may still arise despite the application of the same rules. This might be due to, say, the occurrence of an adjusting post-balance sheet event in the intervening period. It is important to identify whether a liability falls to be determined under the 'actuarial' or 'accounting' rules as they may produce very different results.

5. Long term business liabilities are liabilities arising under or in connection with contracts for long term business, including liabilities arising from deposit back arrangements. Liabilities from deposit back arrangements (line 23) should be determined on actuarial principles in accordance with Regulations 64 to 75 of Part IX of the Insurance Companies Regulations 1994. They include the amount of the deposit (as disclosed under Paragraph 12(2)(f) in the Abstract of Valuation Report prepared by the Appointed Actuary -Schedule 4) together with any additional provision which the Appointed Actuary considers to be required in accordance with actuarial principles. Mathematical reserves are defined so as to include all long term liabilities (other than those fallen due) with the exception of liabilities arising from deposit back arrangements. They are shown, other than for cash bonuses, at line 11 and, for cash bonuses, at line 12. The amounts shown are taken from the appointed actuary's valuation as recorded in Form 58 - see instructions 2 and 3 to Form 14 - and include any increases resulting from the allocation of bonuses to policyholders as a result of the valuation. Subject to one exception, the 'accounting liabilities' (lines 15 to 22 and 31 to 39) should not include any amounts in respect of technical provisions and the fund for future appropriations which appear in Companies Act accounts as these are already, to the extent necessary, taken into account in setting the mathematical reserves. The exception is claims outstanding which had fallen due for payment at or prior to the financial year end - see lines 15 to 17 on Form 14.

6. The Insurance Directorate interprets "liabilities arising under or in connection with contracts for long term business" to include liabilities arising under reinsurances of those contracts for long term business. This includes liabilities under financial reinsurances and by extension even liabilities under non-reinsurance financing arrangements provided the liability under the financing arrangement is closely linked to the performance of contracts for long term business. Therefore liabilities under financial reinsurances and such analogous financing arrangements - subject to the exception of liabilities which had fallen due - are to be determined under actuarial principles. This is important as the crystallisation of such liabilities is often - although not invariably - linked to the emergence of future profits. Future profits are not in themselves an asset admissible to match liabilities and may not be included on Form 13, (lines 11 to 89). However provided the reinsurance or financing liability is repayable - as a

matter of legal form and economic substance - only upon the emergence of the future profit, actuarial principles may sometimes allow the future profit to be taken into account in determining the amount of the liability. 'Accounting' rules do not permit this treatment. They prohibit the offset of an asset against a liability except where they are amounts due to and from the same person and also impose other conditions - see Financial Reporting Standard 5.

7. The provision for adverse changes is an extra provision in addition to that which would be required under either actuarial or accounting principles. It arises when an investment (or transaction associated with an investment) will, or may, give rise to a liability in future and the company does not have the appropriate assets to cover that liability. (Most commonly, but not exclusively, this issue arises in respect of derivative contracts.) The provision is to be determined in accordance with Regulation 61 of the Insurance Companies Regulations 1994.

Margins

8. The "margins" are the amounts by which the "net admissible asset value" of the long term business fund(s) exceed the mathematical reserves and cash bonuses for that fund. The "margins" are to be calculated in two stages as follows.

(1)First, the amount of the long term business fund(s) as per Form 40 is compared with the mathematical reserves including cash bonuses (lines 11 and 12 on Form 14). The amounts of any excess/(deficit) is to be shown at line 13.

(2)Secondly, the "net admissible asset" value of the long term fund(s) - being the assets as per line 89 on Form 13 less the liabilities as per line 49 on Form 14 - is to be compared with the value of the long term fund as per Form 40. The amount of any excess is to be shown at line 51. An excess may only arise in those cases where the company has chosen to report its long term business funds on Form 40 at a value other than the value of net admissible asset, e.g. using book costs for asset values. It is not permissible to report the fund at a value on Form 40 which is higher than the value of net admissible assets. Therefore a deficit should never need to be shown at line 51.

The footnotes to the Form

9. Lines 61 and 62 to the Form show respectively the amounts included in the total liabilities and margins which is attributable to-

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- liabilities to related companies, other than those under contracts of insurance; and
- liabilities in respect of property linked benefits.

10. The scope (but not the value) of the line 62 disclosure corresponds to technical provisions in the shareholder accounts (i.e. headings C and D in the balance sheet format in Schedule 9A to the Companies Act 1985), but only in so far as they relate to property linked benefits. Line 62 shows the amounts of those liability items shown at heading C and D in the Companies Act accounts, but evaluates them using the Form 14 valuation rules and not (where different) the Companies Act rules. The Form 14 valuation rules are discussed at paragraphs 4 to 7 above. [Nb. The effect of this guidance (which differs materially from that given previously) is that line 62 shows the amount of the 'property linked liabilities' which are excluded from the calculation of the long term business amount for the purpose of applying counterparty limits - cf. Paragraph 2 of Part I of Schedule 12 to the Insurance Companies Regulations 1994.]

11. Line 63 requires a company to disclose whether any part of the amount shown at line 51 represents an amount taken into account by the actuary to support the mathematical reserves (as shown in Form 58) in giving his certificate. This issue arises because the assets shown on Form 9, which are sourced from Form 13, are shown at their admissible value even where the long term business fund is maintained and brought into account in the Schedule 4 report on the basis of lower book values. In such circumstances the mathematical reserves shown in Form 58 may not always constitute an appropriate assessment of the liabilities for the purposes of comparison with the assets stated at admissible value. For this reason in certifying the long term liabilities as required under Part II of Schedule 6, the actuary may find it necessary in some circumstances to make an addition to the mathematical reserves on the Schedule 4 basis shown at line 11 of Form 14.

Supplementary notes

12. Two supplementary notes are specified.

(1) The methods and assumptions used to determine the amount of any provision for adverse changes (as shown at line 41 of the Form), or if there is no such provision the methods and assumptions used to determine that no provision is required, should be stated - see Paragraph 12 of Schedule 1. [Code 1401]

(2) Specified details should be stated of (a) any charges over assets, (b) potential capital gains tax liability, (c) contingent liabilities, (d) guarantees, indemnities or other contractual commitments effected other than in the ordinary course of insurance business and in respect of

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related companies, and (e) any other fundamental uncertainty - see Paragraph 13(1) of Schedule 1. [Code 1402]. This note is to be given in respect of long term business assets and liabilities. A similar note (code 1502) is to be given in respect of other than long term business assets and liabilities. The guidance given below for that note (see paragraphs 5.6.16 to 5.6.30) also applies here.

5.6 Liabilities - other than long term business (Form 15)

Completion of the Form

1. Form 15 should be completed by all companies except a company not trading for profit (i.e. a mutual) carrying on only long term business - see Regulation 6(7).

2. Form 15 shows all liabilities of the insurance company other than long term business liabilities which are shown instead on Form 14.

3. Form 15 consists of three parts.

- Lines 11 to 59 provide a "line by line" analysis of the liabilities (other than share capital and reserves and exclusively long term business items) corresponding to the balance sheet format in Schedule 9A of the Companies Act 1985, i.e. the format required to be used in the preparation of the Companies Act accounts. In a few cases, however, a single item in that format is subdivided in Form 15.

- Lines 61 to 63 list three further items of liability - (i) the provision for adverse changes, (ii) cumulative preference share capital and (iii) subordinated loan capital.

- Line 71 discloses the value (as included in the above items) of the liabilities to related companies, other than those under contracts of insurance or reinsurance.

Determination of liabilities

Lines 11 to 59

4. The liabilities at lines 11 to 59 should be valued in accordance with Part IX of the Insurance Companies Regulations 1994, the main provision of which is Regulation 60 which provides that-

> *"(1) ... the amount of liabilities of an insurance company shall be determined in accordance with generally accepted accounting concepts, bases and policies or other generally accepted methods appropriate for insurance companies."*

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> *"(2) In determining under paragraph (1) above the amount of liabilities of an insurance company, all contingent and prospective liabilities shall be taken into account [including all liabilities in respect of cumulative preference share capital but excluding other liabilities in respect of share capital]."*

5. Paragraph (2) above does not require that the "amount" of every prospective and contingent liability be set equal to the full extent of its nominal value regardless of the remoteness of the contingency it represents. The requirement is merely that all prospective and contingent liabilities "be taken into account", i.e. considered. The amount of every liability whether present, prospective or contingent should be set as required by paragraph (1) in accordance with generally accepted accounting concepts etc.

6. The paragraph (1) requirement that generally accepted accounting concepts etc. be used ***in effect means that the liabilities at lines 11 to 59 are to be valued for the Returns in the same way as for the Companies Act accounts***. For technical provisions this is indeed explicitly stated by Regulation 62 of the Insurance Companies Regulations 1994 which refers to the rules in Section D [of Chapter II] of Schedule 9A of the Companies Act 1985.

7. However the above does not mean that the value shown for such liabilities in the Annual Return will always necessarily be the same as that shown in the Companies Act accounts. Exceptionally differences may occur if the Annual Return and Companies Act accounts are either-

- drawn up to different balance sheet dates, or
- even if drawn up to the same balance sheet date signed off at different dates.

8. In the latter case it is possible that a material adjusting post-balance sheet event may have occurred between the date of the sign off of the Companies Act accounts and the date of the sign off of the Annual Return (or vice versa).

9. The technical provision for "claims outstanding" (line 12) should be shown before or after reduction for anticipated salvage and subrogation recoveries according to the treatment adopted in preparing Form 13. See paragraph 5.4.16 above. [cf. the possibly different treatment in the technical account, Forms 20 to 39 - see paragraph 8.2.6 below]

<u>Lines 61 to 63</u>

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10. The provision for adverse changes (line 61) is an extra provision which arises when an investment (or transaction associated with an investment) will, or may, give rise to a liability in future and the company does not have the appropriate assets to cover that liability. (Most commonly, but not exclusively, this issue arises in respect of derivative contracts.) The provision is in addition to any liability which would be required to be provided in accordance with generally accepted accounting practice. It is required to be determined in accordance with Regulation 61 of the Insurance Companies Regulations 1994.

11. Share capital is not normally to be considered a liability for the purposes of completing the Annual Return - see Regulation 60(2) of the Insurance Companies Regulations 1994 quoted above. The only exception (see Regulation 23(3) to the same Regulations) is cumulative preference share capital, but this exception is in turn subject to a partial exception as explained below.

12. In determining whether an insurance company has assets in excess of its liabilities the full nominal value (plus any premium on redemption if redeemable) of all cumulative preference share capital is to be counted as a liability. If the assets exceed liabilities then part (sometimes all) of the liability from the preference share capital may be disregarded in determining whether the net assets exceed the required margin of solvency.

13. In Form 15 (line 62) the full value of cumulative preference share capital is to be shown, i.e. the value to be used in determining whether the company has assets in excess of liabilities. This full value then forms part of the total liabilities which are taken from Form 15 to Form 10 where they are compared with the total assets taken from Form 13. If assets exceed liabilities the part of the liability for preference share capital which may be disregarded in determining whether the net assets exceed the required margin of solvency, is added back as an adjustment to net assets on Form 10. No adjustment is to be made on Form 15. See paragraph 5.2.6 above on Form 10 above for further guidance.

14. Subordinated loan capital is to be valued according to the basic rule in Regulation 60 quoted above, i.e. in accordance with generally accepted accounting concepts etc.. Where a company has been granted an order under section 68 of the Insurance Companies Act 1982 permitting it to disregard all or part of the liability for its subordinated loan capital in determining whether its net assets exceed its required minimum margin, the adjustment for the amount to be disregarded is to be made solely on Form 10 and not on Form 15. (The reason for this treatment of the add-back is the same as that described above for the add-back in respect of preference share capital.)

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15. Three supplementary notes are specified.

(1) The methods and assumptions used to determine the amount of any provision for adverse changes (as shown at line 51 of the Form), or if there is no such provision the methods and assumptions used to determine that no provision is required, should be stated - see Paragraph 12 of Schedule 1. [Code 1501]

(2) Specified details should be stated of (a) any charges over assets, (b) potential capital gains tax liability, (c) contingent liabilities, (d) guarantees, indemnities or other contractual commitments, effected other than in the ordinary course of insurance business, in respect of related companies, and (e) any other fundamental uncertainty - see Paragraph 13(1) of Schedule 1. Guidance is given below on each of the items (a) to (e) to be included in this note and in the corresponding note (code 1403) to Form 14, (see item (4) in paragraph 5.5.14 above). [Code 1502]

(3) The aggregate amount of any accrued dividend on any cumulative preference share capital issued by the company should be stated - see instruction 2 to Form 15. [Code 1503]

<u>Guidance on note 1502</u>

16. Where for any of the items (a) to (e) there is no charge, potential capital gains tax liability, contingent liability, guarantee etc., or fundamental uncertainty to report
this should be stated.

<u>Item (a)</u>

17. The details to be disclosed of any charge over assets are-

- the nature of the charge, including a brief description of the terms which are relevant to securing the prior claim of any person to assets which are subject to the charge;
- for each line in Form 13, the amount included in respect of assets which are subject to the charge; and
- for each line in Form 14 or 15, the amount included in respect of liabilities which are secured by the charge.

18. "Charge" is given a wide definition - see Paragraph 13(5) of Schedule 1. It includes not merely formal charges over assets which are registered under the Companies Act 1985 but also "any arrangement whatsoever, whether contractual or otherwise, which operates to secure the prior claim

of any person over the general creditors to any assets on a winding up of the company". It thus amongst other items includes-

- arrangements whereby assets of the insurance company are placed in trust for the prior benefit of only some creditors;
- assets held as collateral by creditors or by issuers of letters of credit;
- fixed and floating charges, and
- equivalent arrangements under the laws of overseas countries.

19. It also in principle applies to set offs, i.e. where a person owed amounts by the insurance company may in a winding up set off amounts owed by it to the insurance company. However in practice where the insurance company has accounted for set offs in accordance with generally accepted accounting principles the assets shown in Form 13 will already be net of such set offs and so no disclosure under this note will be needed. The amounts of preferential creditors (e.g. PAYE) need not be disclosed.

20. A charge should be disclosed even where it only serves to secure the prior claim of a contingent or potential creditor which has not resulted in any provision for liability in either Forms 14 or 15.

21. The sub-paragraph requiring the note refers to any charge, thus in principle requiring separate disclosure of each arrangement which falls within the definition of "charge". However where clarity or brevity require, it is acceptable to disclose in aggregate charges which arise from the same related series of transactions or charges which are of the same "nature" and have substantially the same "relevant terms".

22. The disclosure of charges is subject to a de minimis exemption. One or more charges need not to be disclosed, provided that the aggregate value (as show on Form 13) of all the assets subject to the non-disclosed charges does not exceed 2 1/2 per cent of the general business or long term business amount as appropriate.

Item (b)

23. The total potential liability should be calculated on the basis of a hypothetical disposal of all assets immediately after the year end. It should include liability to foreign taxes on capital gains.

Item (c)

24. Statement of Standard Accounting Practice 18 (SSAP 18) defines a "contingency" as "a condition which exists at the balance sheet date where the outcome will be confirmed only on the occurrence or non-occurrence of

one or more uncertain future events". A contingent liability is a loss dependent on a contingency. SSAP 18 distinguishes between contingent liabilities which are probable or remote. A remote contingent liability need not be disclosed in this note.

25. "Inward" in the expression "inward contracts of insurance and reinsurance" is intended to exclude from the exemption contracts of reinsurance where the reporting insurance company is the reinsured.

26. The disclosure of contingent liabilities is subject to a de minimis exemption. One or more contingent liabilities need not be disclosed provided that the aggregate value of the non-disclosed contingent liabilities does not exceed 2 1/2 per cent of the general business or long term business amount as appropriate.

<u>Item (d)</u>

27. "Related company" is defined in Regulation 44 of the Insurance Companies Regulations as-

- a dependant of the insurance company,
- a company of which the insurance company is a dependant, or
- a dependant of a company of which the insurance company is a dependant

where "dependant" means "subsidiary undertaking" as defined in the Companies Act 1985.

28. In the Insurance Directorate's view a guarantee, indemnity or other contractual commitment should not be considered as "given other than in the ordinary course of [an insurance company's] business" where guarantees, indemnities or other contractual commitments on substantially the same terms and conditions are not regularly given to non-related entities in similar circumstances. An example of a contractual commitment which need not to be disclosed might be where a motor insurer insures the motor car fleet of a related company using the same underwriting principles as it uses for its other fleet business.

29. The sub-paragraph requiring the note refers to (i) "maximum liability ... specified in such guarantee, indemnity or contractual commitment", (ii) "amount of provision" and (iii) "amount reported under sub-paragraph (c)", (i.e. reported as a contingent liability). The distinction between these three items may be illustrated by an example.

An insurance company guarantees the bank overdraft of its two fellow subsidiaries up to an aggregate of £100,000. At the year end-

fellow subsidiary A is insolvent and has an overdraft of £5000, and

fellow subsidiary B is believed (on the balance of probabilities) to be solvent and has an overdraft of £10,000.
A provision of £5000 (in respect of A) would be made in Form 15 and a contingent liability of £10,000 (in respect of B) would be included in the disclosure under sub-paragraph (c).

The disclosure under sub-paragraph (d) would then be-

(i) maximum liability specified in the guarantee = £100,000,

(ii) provision = £5,000 and

(iii) contingent liability = £10,000

together, of course, with a brief description of the terms and circumstances of the guarantee including the identity of the person to whom the guarantee is given and of the persons in respect of whom it was given and of the relationship with the latter (and, if applicable, with the former).

<u>Item (e)</u>

30. This sub-paragraph is intended to cause to be disclosed the circumstances of any uncertainty which is of a fundamental nature. Note that this sub-paragraph, unlike sub-paragraph (c), does <u>not</u> exempt uncertainties arising from inward contracts of insurance or reinsurance.

<u>5.7 Profit and loss account (non-technical account) (Form 16)</u>

Completion of the form

1. Form 16 should be completed by all companies - see Regulation 7. However for a mutual company carrying on only long term business the form usually will include no entries. [Where this is the case for both the current and previous financial year the blank form may be omitted provided the supplementary note, [Code 1600], referred to paragraph 4.6.6 above is included in the Annual Return.]

2. The headings used on Form 16 are based on those used in the "Profit and Loss Account - Non Technical Account" format in Schedule 9A of the Companies Act 1985 (i.e. the format to be used in preparing Companies Act accounts) and, except where referenced to other Forms, the amounts included under those headings should be determined using the same rules as apply for the Companies Act accounts.

3. One such exception occurs at line 13 (Transfer from the long term business revenue account) which is referenced to Form 40. As a result, for long term business Form 16 presents a profit for the financial year determined on the "statutory basis" and not the "modified statutory basis".

4. Unrealised gains and losses on investments (other than for investments in the long term fund) should be included in their entirety at lines 15 and 18, even if different accounting treatment is adopted in the Companies Act accounts. [Unrealised gains and losses should be measured by reference to the value included for the investment at line 99 on Form 13, i.e. the Companies Act accounts value. A company which includes investments at amortised cost at line 99 on Form 13 (see paragraph 5.4.22 above) should show the unrealised gain and loss relative to that amortised cost not to current market value.]

Supplementary notes

5. Four supplementary notes are specified.

(1) The bases of conversion adopted in respect of foreign currency for income and expenditure should be stated - see paragraph 5(2) of the Schedule 1. [Code 1601]

(2) In addition to the above the Insurance Directorate requests that where any brought forward amounts on any Form are restated due to currency reconversion this fact be briefly stated in a supplementary note to Form 16. A simple statement of this fact is all that is needed, e.g. "Some of the brought forward amounts shown in the Forms [xx to xx] have been restated from the corresponding carried forward amounts included in the previous years' return due to the reconversion of foreign currency amounts at a different rate of exchange." No further details need be given. This note is requested to facilitate the Insurance Directorate's computerised validation of the Annual Return. [Code 1602]

(3) Particulars of any amounts included at lines 21 on Forms 16 should be stated - see the face of Form 16. [Code 1603]

(4) Particulars of any amounts included at lines 41 on Forms 16 should be stated - see the face of Form 16. [Code 1604]

5.8 Analysis of derivative contracts (Form 17)

1. A Form 17 should be submitted for each category of assets for which a Form 13 is submitted (other than categories of assets "2" to "9") - see Regulation 6(5) and instruction 1 to the Form.

Other guidance by the prudential regulators

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2. The paragraphs below consider the following points:

- which derivatives need to be entered on the form
- what needs to be recorded in respect of the amounts of margin paid or received
- what reconciliation there is to other Forms
- what approach is needed for instruments which are required, under the Asset Valuation Rules, to be treated as derivatives even though they may have some other legal form (i.e. quasi-derivatives or "contracts or assets having the effect of a derivative contract").

3. Derivatives used for the purpose of matching index linked or property linked liabilities are not to be recorded on Form 17. (These are covered on Forms 55 or 56.) However, to the extent that the company holds derivative contracts in connection with linked contracts but additional to the amounts necessary to match linked liabilities, these should be recorded on Form 17. For example, if a company has transacted a tranche of derivatives to match linked liabilities in the expectation of selling a particular volume of linked business but where the actual volume fell short of expectations, the excess would be recorded on Form 17. Similarly, if a company retains excess derivatives no longer necessary for matching purposes (for example, as a result of policy surrenders), these would also be recorded on Form 17.

4. Quasi-derivatives are not recorded on the face of Form 17 but are required to be shown as a supplementary note [code 1702] - see paragraphs 25 and 26 below.

5. Where a provision for adverse changes is required in accordance with Regulation 61, no adjustment is to be made on Form 17 to the value of the derivative which gave rise to the provision. The provision itself is to be shown on Form 14 or 15, as appropriate.

Instructions to the Form

6. *Instruction* 1: A Form 17 should be completed for the "other than long term assets" and the "long term assets" separately. Each long term business fund separately accounted for by a separate Form 13 should also have a Form 17 completed - see instruction 1 to the Form. A sub fund whose accounting details are only given as part of Schedule 4 should be covered by a commentary in that Schedule.

7. *Instruction* 2: The same codes should be used for the "category of assets" header box on Form 17 as on the corresponding Form 13.

Other guidance by the prudential regulators

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8. *Instruction* 3: Analysis is by the principal underlying asset. When there is a mixture of asset types the derivative should be split if it is sensible to do so, if not then it should be categorised under the most significant asset type.

9. *Instruction* 4: Derivatives are to be assigned to the "assets" and "liabilities" columns according to whether the gross position is an asset or a liability and irrespective of the net position after margin.

10. *Instruction* 5: The asset values to be shown are gross of any variation margins received (or, unusually, paid) - i.e. assuming such margin has been reversed. The asset values are to be as determined under the Asset Valuation Rules, i.e. before the further liability of Regulation 61 (which of course can apply to an uncovered asset). Form 17 does not therefore deal with economic exposure to various asset classes (as for example, in a "LIFFE-style" presentation). This issue is dealt with in the supplementary information provided in accordance with Regulation 23.

11. *Instruction* 6: Netting of derivative positions may be permissible for the purpose of completing Form 17, provided it would be permissible under generally accepted accounting practice. However, there are additional pre-conditions to netting. Within a Form 17, derivatives which partly or wholly offset one another (for example, a bought future and a sold future on the same index) cannot be netted to one net asset or liability figure unless there is a legal right of set off with the counterparty concerned, or between the counterparties concerned. Where the derivatives are with the same counterparty and legal set off applies, <u>but</u> the derivatives are not symmetrical, i.e. they do not cancel or part cancel out a given position, then gross figures should be shown. Where a legal right of set off applies but the derivatives have to be reported on separate Forms 17, they should be shown gross in each form.

12. *Instruction* 7: The aggregate amount of variation margin then to be offset is to be shown at line 41.

13. *Instruction* 8: The assets shown at line 49, column 1 should be included at line 44 in Form 13. Where line 49, column 1 also includes deductions for applicable margins this should be included either in Forms 14 or 15 as liabilities or in Form 13 as deductions from assets according to the same accounting treatment as is adopted in the Companies Act accounts, (or if there are no such accounts according to Generally Accepted Accounting Practice). Other general buffer or good faith margins paid out (initial margins) are expected to appear on Form 13, probably on line 78.

14. *Instruction* 9: Similarly the liabilities shown at line 49, column 2 should be in Form 14 (if long term) or Form 15 (if other than long term) at lines 38 and 49 respectively. Also similarly deductions for applicable margins which are included at line 49, column 2 should be included in Form

13, or 14/15 according to the same accounting treatment as adopted in the Companies Act accounts (or if there are no such accounts according to Generally Accepted Accounting Practice)

15. *Instruction* 10: No entry is to be made on Form 17 in respect of initial margin paid or received.

Further points on margins

16. The variation margin received for assets acts as an offset to the value of the derivative that flows through to Form 13, and such margin then needs to be categorised itself in Form 13, probably under deposits if the margin payment is deposited with the insurer's bankers. Initial margins should however appear in Form 13, normally line 78, i.e. unsecured amounts due to the insurer, unless the insurer has more unusually received initial margin and so the amount is a creditor. The Regulations now define both variation and initial margin. It should be noted that the definition of variation margin may be wider than a market understanding as it includes all collateral arrangements. It is this wider definition which should be followed in completion of Form 17.

17. In the unusual situation of a variation margin payment to the broker on a asset then such an amount should appear on Form 17 as a positive entry at line 41, and thus an appropriate increase to the asset.

18. Liabilities follow the normal accounting rules of Regulation 60. Again the inclusion of all variation margins is necessary, even if this makes the resultant entry on Forms 14 of 15 as appropriate become negative. The offset of margins paid against the amount of the liability means no further entries are needed, as the net entry at line 47 of Forms 14 or 15 encapsulates the offset of the derivative liability and the sums put up in surety for such liability. In the unusual case of amounts received from the broker on a liability such amount should appear in Form 17 as a positive entry at line 41, thus an appropriate increase to the liability.

19. Asset and liability margin payments must be accounted for separately. Margin is that actually received as cash or securities from a broker or paid to a broker. Amounts due to be paid by either party, or amounts held in an account at the broker where the company has no legal rights over such account, are not transferred margin and should not be presented as such. Form 17 must demonstrate the margins actually received into the possession of the insurer or released by the insurer. Thus, at any reporting date, even daily margined contracts may be a day behind as the margin process is not instantaneous.

20. Margin received or paid to different counterparties cannot be offset under any circumstances, even where the counterparties are connected companies of one another. Similarly, margin paid to and received from a

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single counterparty cannot be offset, where no legal right of offset applies. Thus one over margined asset cannot have its deduction for margin on Form 17 reduced to allow the reduction of a Form 17 margin on an over margined liability unless legal rights of offset apply.

21. Margin must mean the amounts transferred back and forth under part of the terms of the derivative. Only amounts closely connected to the derivative under a formal agreement that has legal rights of offset between the margin payment and the settlement of the derivative should be included, and not other deposits from or with the counterparty.

22. Where margin payment is by pledges of assets, such as short gilts, then the same approach should be followed. Unconditional granting of title to a broker will mean the asset can no longer be recorded as that of the insurer, and has been replaced by a debt due from the broker.

Supplementary notes

23. Two supplementary notes are specified in paragraphs 16 and 17 of Schedule 1, covering treatment of variation margin [code 1701] and use of quasi-derivatives [code 1702].

<u>Note 1</u>

24. This note (see paragraph 16 of Schedule 1) needs 3 separate items, as follows:

- the aggregate amount of an "excess" variation margin which has been received by the company, the excess being due to market movements which have subsequently been partly or wholly reversed.

- how variation margin received is distributed amongst the different lines of Form 13.

- the extent to which the amount recorded in any line of Form 13 has been reduced to reflect the liability to repay any excess referred to above.

<u>Note 2</u>

25. A further supplementary note is prescribed covering quasi-derivatives - see paragraph 17 of Schedule 1. These are exempt from special disclosure provided that, in aggregate, they are below the "materiality threshold" set out in paragraph 17. Separate thresholds apply for assets and liabilities and are to be calculated prior to any adjustment for variation margin.

26. For quasi-derivatives which are assets, the test at paragraph 17 of Schedule 1 is whether the aggregate value of all such quasi derivatives

exceeds 2½% of the total Form 13 asset value (i.e. for the long term business fund or a long term business sub fund the non linked, property linked and index linked assets totalled at line 89 of the particular Form 13). No attempt should be made to value the "derivative component" of a quasi-derivative separately and apply the materiality test to that component; the test should be applied to the value of the instrument as a single entity.

27. For quasi derivatives that are liabilities the test of disclosure is in some ways more demanding, being whether the aggregate liability of all such quasi derivatives would exceed 2.5% of the non insurance liabilities of Forms 15 or the relevant Form 14 as appropriate. Any provision under Regulation 61 would count towards this aggregate liability, even where it arises from a quasi derivative that is currently an asset.

28. If the holdings are sufficiently significant to trigger disclosure, then the (non-zero) amounts contributed by quasi-derivatives to each line in Forms 13, 14 and 15 are to be stated. In addition, the information specified under Note 1 is also required in respect of such contracts.

29. Leaving aside quasi-derivatives used for the purpose of matching linked liabilities, it would be a little unusual for quasi-derivatives to be subject to margining arrangements. In any event, the rules for the valuation of assets and determination of liabilities in the Insurance Companies Regulations 1994 make no provision for valuation of *quasi-derivatives* net of value of margin (or collateral) and the appropriate values for the purposes of this disclosure are therefore the gross asset or liability values. Any margins paid or received should appear in Forms 13, 14 or 15 as debtor or creditor items.

30. An example of the disclosure required when the materiality test is passed is as follows:

> *"A FTSE-linked bond with embedded option to achieve a guaranteed maturity value of £10m was included in line 48 of Form 13. The current value of the bond is £11m. The bond is not margined and was held for the full year."*

Examples

31. A number of illustrative examples of completion of Form 17 are given in annex B to this chapter.

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ANNEX A TO CHAPTER FIVE

Examples of the completion of the reconciliation's at the foot of Forms 10 and 13.

5.A.1 Example one: the reconciliation on Form 13

In this example a company shows the following assets in its Companies Act accounts.

Assets	1996	1995
Shares in UK insurance subsidiary	1000	1000
Cash at bank	2000	1500
Gold	100	-
	3100	2500

In preparing Form 13 of its Annual return the company must revalue its assets using the valuation rules in the Insurance Companies Regulations 1994. Let us say the revised values are as follows.

Balance sheet: Assets	1996	1995
Investment in insurance dependant		
Basic "look through" value	900	800
Disallowed under admissibility rules	(100)	(100)
Solvency margin deduction	(200)	(200)
	600	500
Cash at bank		
Valuation	2000	1500
Disallowed under admissibility rules	(200)	(100)
	1800	1400
Gold	nil	nil

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Form 13 should be prepared with the following entries.

Form 13		1996	1995
UK insurance dependants - shares	21	600	500
Cash at bank - deposits	82	1800	1400
Grand total of admissible assets	89	2400	1900

Form 13 (continued) *Reconciliation*			
Total - as per line 89 above	91	2400	1900
Total assets in excess of admissibility limits(1)	92	300	200
Solvency margin deduction(2)	93	200	200
Other differences(4)	94	100	200
Assets of a type not valued above(3)	95	100	-
Total assets determined in accordance with the shareholder accounts rules	99	3100	2500

Explanations of the above

(1) 300 = 100 + 200; being the amounts shown above as disallowable under the admissibility limits respectively for the investment in dependant (100) and the cash at bank (200).

(2) This the solvency margin deduction for the insurance dependant.

(3) This is the value of the gold as per the Companies Act accounts. There is no valuation rule, and hence nil value, for gold under the HM Treasury rules.

(4) This the total of all other valuation differences not dealt with at lines 92, 93 or 95. In this examples there is only one such difference: that is the difference between the Companies Act accounts value of the insurance dependant (£1000) and the basic "look through" value (£900).

Other guidance by the prudential regulators

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5.A.2 Example two: the reconciliation on Form 10 for a general business company

In this example a company has the same assets as in example one above and shows the following amounts for liabilities in its Companies Act accounts.

Balance sheet: liabilities	1996	1995
Share capital	1000	1000
Profit and loss account	1000	700
	2000	1700
Technical provisions	1000	700
Creditors	100	100
	3100	2500

The company's Form 13 is as in example one above and its Form 10 as follows.

Form 10(1)		1996	1995
Other than Ltb - admissible assets(2)	21	2400	1900
Other than Ltb - liabilities(3)	22	1,100	800
Available assets	29	1300	1100
Represented by			
Paid up share capital	51	1000	1000
Balance of net assets(4)	56	300	100
Total - equal to line 29 above	59	1300	1100
Movement of balance of net assets			
Balance brought forward	61	100	50(6)
Retained profit	62	300	50(6)
Movement in asset valuation difference(5)	63	(100)	
Balance carried forward as per line 56	69	300	100

Explanations of the above
(1) Blank lines have been omitted.
(2) This is taken from line 89 in Form 13 - see example one above.
(3) This is technical provisions (1000) plus creditors (100).
(4) This is the balancing figure.
(5) This is the difference for lines 92 to 95 on Forms 13 between the comparative amounts, (200 + 200 + 200) and the present year amounts (300 + 200 + 100 + 100) - see example one above.

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(6) The comparative amounts at lines 61 and 62 are illustrative only. They cannot be derived from the other data given in this example.

5.A.3 Example three: the reconciliation on Form 10 for a long term business company

In this example a company shows the following amounts in its Companies Act accounts.

Assets	1996	1995
Investments	1000	1200
Cash	800	400
Deferred acquisition costs	40	20
	1840	**1620**
Share capital	100	100
Profit & loss account	350	220
Fund for future appropriations	700	600
Technical provisions	490	400
Creditors	200	300
	1840	**1620**

The profit and loss account for 1996 shows a transfer to the Fund for Future Appropriations of 100 and a retained profit of 130. In the Annual Return the following items are shown on Forms 13 to 16.

Form 13		**Long term business**		**Other than long term business**	
		1996	1995	1996	1995
Equity shares	41	600	650	200	250
Cash at bank -deposits	81	700	300	100	105
Grand total of admissible assets	89	**1300**	**950**	**300**	**355**
Excess of admissibility limits	92	100	150	100	145
Total assets determined in accordance with the shareholder accounts rules*	99	**1400**	**1100**	**400**	**500**

[* This amount should not include long term business deferred acquisition costs -see paragraph 5.4.20 above.]

Other guidance by the prudential regulators

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Form 14 (part)		1996	1995
Mathematical reserve	11	507	404
Balance of long term funds	13	193	156
		700	**560**
Creditors etc.	49	150	100
Excess assets etc.	51	450	290
Total	59	**1300**	**950**

Form 15 (part)		1996	1995
Total liabilities	59	50	200
Provision for adverse changes	61	18	12
Total	69	**68**	**212**

Form 16 (part)		1996	1995
line 59 - retained profit		**50**	**100**

Form 10 should now be completed as follows:

Form 10		1996	1995[5]
Long term business - assets	11	1300	950
Long term business - liabilities	12	1300	950
Other than LTB - assets	21	300	355
Other than LTB - liabilities	22	68	212
Available assets	29	232	143
Paid up share capital	51	100	100
Balance of net assets	56	132	43
	59	232	143
Balance of net assets - b/f	61	43	73
Retained profit[1]	62	50	100
Movement in asset valuation differences[2]	63	45	(90)
Increase in provision for adverse changes[3]	64	(6)	(40)
Other movements[4]	65	-	-
Balance of net assets - c/f	69	132	43

[Footnotes (1) to (5) from above are explained on the next page.]

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Supplementary notes to Form 10

1002 Reconciliation to shareholder accounts	1996 £'000	1995 £'000
Net assets as per Annual return		
line 99 on Form 13 (OLTB)	400	500
line 59 on Form 15	(50)	200
	350	300
Capital and reserves as per shareholder accounts	450	320
Difference due to assets retained in the long term business fund in excess of the fund for future appropriations(6)	100	20

Explanations of the above

(1) This is the retained profit as per Form 16.
(2) This is the difference for lines 92 to 95 on Forms 13 between the comparative amounts, (145) and the present year amounts (100).
(3) This the increase in the provision for adverse changes as shown on Form 15 only.
(4) This is the balancing figure, i.e. the differences not shown at the other lines.
(5) The comparative amounts at lines 61 to 69 of Form 10 are illustrative only. They cannot be derived from the other data given in this example.
(6) This is taken from the Companies Act accounts as follows: value of assets in the long term business fund (1400 + 40) less long term business technical provisions (490) less long term business creditors (150) less fund for future appropriations (700).

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ANNEX B TO CHAPTER FIVE

Examples of completion of Forms 13, 14, 15 and 17 in respect of derivative holdings

5.B.1 ***Introduction to the Examples***

1. The examples introduced below illustrate the inter-relationship between Forms 13, 14 (or 15) and 17. Some of them relate to illustrative examples described in Prudential Note 1995/3 . The derivatives used in the examples are described in section 5.B.2.

2. The examples can be summarised as follows:

Example 1 - Derivatives used to rebalance portfolio (much as example C in Prudential Note 1995/3 but reversed to illustrate treatment of assets). Initial margin not accounted for on Form 17.

Example 2 - Treatment of simple derivative (option) which is a liability. Illustration that, in accordance with Instruction 4 to Form 17 (see paragraph 5.8.9), "negative assets or liabilities" can arise as a result of margining.

Example 3 - Two equity futures and a currency forward (as example X in Prudential Note 1995/3)

Example 4 - Direct asset, derivative and both inadmissible asset and Regulation 61 items (as example SS in Prudential Note 1995/3, amended slightly to allow inadmissibility offset.) Provision for adverse changes also required.

Example 5 - Range of direct assets and derivative with counterparty inadmissibility. The asset inadmissibility has been ignored to avoid making the example overly complex.

Example 6 - Sterling to DM interest rate swap. Illustrates provision for adverse changes on uncovered swap.

5.B.2 Derivatives used in the examples.

1. These are defined here so that the examples can refer to the instruments involved in a more abbreviated form (the bold part of each description). The example defines whether the derivative is bought or sold.

Futures

2. A **traded Long Gilt future** from 7/12/94 for settlement March 1995 at a price then of 101 15/32. This was valued at 31/12/94 at 100 23/32

(after 100 15/32 on 30/12/94) giving a liability per bought contract of £50,000 times 24/32ths or £375.
The initial margin was £1000 per contract and variation margin of £500 per contract had been paid to date.

3. A **Currency Forward for US dollars** for settlement in March 1995. This was valued at 31/12/94 at a 3 month rate of exchange of 0.6393 when the cash market was 0.6391, taken (for simplicity of illustration) as a liability of £(0.6393-0.6391) per $1,000,000 purchase or £200

<u>Options</u>

4. A **traded BP call option at 420p** from 7/12/94 for expiry by April 1995.
This was valued at 25p at 31/12/94 (after 26p at 30/12/94) and thus 25p x 1000 or £250 per contract. Initial margin as writer £1000 and variation margin of £50 paid to date.

5. A **traded BP put option at 420p** from 7/12/94 for expiry by April 1995.
This was valued at 14p at 31/12/94 (after 13p at 30/12/94) and thus 14p x 1000 or £140 per contract. Initial margin as writer £1000 and no variation margin to date.

6. A **traded FTSE 100 call option at 3100** from 7/12/94 for expiry by June 1995. This was valued at 143 at 31/12/94 (after 145 at 30/12/94) and thus 143 x £10 or £1430 per contract. Initial margin as writer £1000 and variation to date of £1450.

<u>Contracts for differences</u>

7. A **traded FTSE 100 future** from 7/12/94 for settlement March 1995 at a price then of 3036. This was valued at 31/12/94 at 3092 (cash market 3065.5) after 3077 on 30/12/94 and thus (3092-3036) x £25 or £1400 per contract. The initial margin was £2000 per contract and variation margin of £1025 per contract had been paid to date.

8. A **traded S&P 500 Future** from 7/12/94 for settlement March 1995 at a price then of 457.0. This was valued at 31/12/94 at 461.35 (cash market 459.27) after 464.6 on 30/12/94 and thus (461.35-457.0) x $500 or $2175 per contract. The maintenance margin was $1500 per contract and had been topped up by $4000 per contract to date.

9. A **Swap of sterling to DM short interest rates** on £30m of sterling, expiring May 1995. This was valued at a liability of £500,000 at 31/12/94.

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5.B.3 Example one: much as example C in Prudential Note 1995/3 page 9

100 bought **Traded FTSE 100 future** contracts, total asset £140,000

150 sold **Traded Long Gilt future** contracts, total asset £56,250

Total margin £97,500 on FTSE 100 future with broker, £200,000 paid to broker as initial and £102,500 received from broker as variation margin.

Total margin £75,000 on Long Gilt with broker, £150,000 paid to broker as initial and £75,000 received from broker as variation margin.

Initial margin taken to line 56 of Form 13, receipt of variation margin assumed on deposit, thus line 54 of Form 13.

FORM 14 (part)		
Long Term business liabilities and margins		As at the end of the financial year
Other Creditors	38	
Provision for adverse changes	41	
TOTAL	59	

FORM 13 (part)		
Admissible assets		As at the end of the financial year
Equity shares	41	
Rights under derivative contracts	44	19
Deposits less than 1 month	54	177
Deposits more than 1 month	55	
Other financial investments - other	56	350
TOTAL	99	546

FORM 17				
Derivative Contracts			As at the end of the financial year	
			Assets	Liabilities
Futures Contracts	Fixed interest	11	56	
	Equity shares	12		
	Land	13		
	Currencies	14		
	Other	15		
Options	Fixed interest	21		
	Equity shares	22		
	Land	23		
	Currencies	24		
	Other	25		
Contracts for differences	Fixed interest	31		
	Equity shares	32	140	
	Land	33		
	Currencies	34		
	Other	35		
Adjustment for margins		41	(177)	
TOTAL (11 to 42)		51	19	

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5.B.4 Example two

100 sold **Traded FTSE 100 call options** contracts of liability £143,000

Total margin £245,000 on FTSE 100 option with broker, £100,000 paid to broker as initial and
£145,000 paid to broker as variation margin.

FORM 14 (part)		
Long Term business liabilities and margins		As at the end of the financial year
Other Creditors	38	(2)
Provision for adverse changes	41	
TOTAL	59	(2)

FORM 13 (part) Admissible assets		As at the end of the financial year
Equity shares	41	
Rights under derivative contracts	44	
Deposits less than 1 month	54	
Deposits more than 1 month	55	
Other financial investments - other	56	100
TOTAL	99	100

FORM 17				
Derivative Contracts			As at the end of the financial year	
			Assets	Liabilities
Futures Contracts	Fixed interest	11		
	Equity shares	12		
	Land	13		
	Currencies	14		
	Other	15		
Options	Fixed interest	21		
	Equity shares	22		143
	Land	23		
	Currencies	24		
	Other	25		
Contracts for differences	Fixed interest	31		
	Equity shares	32		
	Land	33		
	Currencies	34		
	Other	35		
Adjustment for margins		41		(145)
TOTAL (11 to 42)		51		(2)

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5.B.5 Example three - as example X in Prudential Note 1995/3 page 28

100 sold **Traded FTSE 100 Future** contracts of total liability £140,000
Bought **Currency Forward for US Dollar** for £7,750,000 of total liability £2425
60 bought **Traded S&P 500 Future** contracts valued at $130,500 or £83,403

All contracts due to complete in 3 months time

Total margin £302,500 on FTSE 100 future with broker, £200,000 paid to broker as initial, and £102,500 paid to broker as variation margin.

No margin on currency forward.

Total margin $90,000 on S&P 500 future with broker, $90,000 paid to broker as initial only.
Value at 31/12/94 £57,519.

FORM 14 (part)		
Long Term business liabilities and margins		As at the end of the financial year
Other Creditors	38	40
Provision for adverse changes	41	
TOTAL	59	40

FORM 13 (part)		
Admissible assets		As at the end of the financial year
Equity shares	41	
Rights under derivative contracts	44	83
Deposits less than 1 month	54	
Deposits more than 1 month	55	
Other financial investments - other	76	258 (i.e.200 plus 58)
TOTAL	99	341

FORM 17				
Derivative Contracts			As at the end of the financial year	
			Assets	Liabilities
Futures Contracts	Fixed interest	11		
	Equity shares	12		
	Land	13		
	Currencies	14		2
	Other	15		
Options	Fixed interest	21		
	Equity shares	22		
	Land	23		
	Currencies	24		
	Other	25		
Contracts for differences	Fixed interest	31		
	Equity shares	32	83	140
	Land	33		
	Currencies	34		
	Other	35		
Adjustment for margins		41		(102)
TOTAL (11 to 42)		51	83	40

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5.B.6 Example four - much as example SS in Prudential Note 1995/3 page 48

400,000 holding of **BP shares** at 425.5p per share, total asset £1,702,000

3000 written **traded BP put option at 420p**, valued at £420,000 liability.

Total margin £3,000,000 on traded option, all initial.

General Business Amount (GBA) £400m. 2.5% of GBA equals £10m and total exposure is to 3.4m shares worth £14,467,000. Inadmissible asset is thus £4,467,000, with first offset to direct equity holding and balance to line 87 of Form 13.

Regulation 61 liability taken as say 50% fall in price i.e. (4.255x50%-4.20) x 1000 x 3000 thus £6,217,500, less any Regulation 60 liability (i.e. £420,000), less any relief from inadmissibility that such a fall would cause (£3,616,000 - see below) therefore £2,181,500 provision.

The inadmissibility offset and provision for adverse changes are calculated as follows

£000s	**Year end**	**50% fall**	
Margin deposit	3000	3000	
Direct shares	1702	851	
Put Option	(420)	(6218)	
Inadmissibility deduction	(4467)	-	3.4m shares worth under 2.5%
Total	(185)	(2367)	**difference i.e. £ 2181.5k is minimum Reg 61 amount**

Layout of forms 13, 15, 17 overleaf.

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Example four (continued)

FORM 15 (part)		
Liabilities (other than long term business)		As at the end of the financial year
Other Creditors	49	420
Provision for adverse changes	61	2182
TOTAL	69	2602

FORM 13 (part)		
Admissible assets		As at the end of the financial year
Equity shares	41	0 (i.e. 1702 less 1702)
Rights under derivative contracts	44	
Deposits less than 1 month	54	
Deposits more than 1 month	55	
Other financial investments - other	56	3000
Deduction for inadmissible assets	87	(2765)
TOTAL	99	235

FORM 17				
Derivative Contracts			As at the end of the financial year	
			Assets	Liabilities
Futures Contracts	Fixed interest	11		
	Equity shares	12		
	Land	13		
	Currencies	14		
	Other	15		
Options	Fixed interest	21		
	Equity shares	22		420
	Land	23		
	Currencies	24		
	Other	25		
Contracts for differences	Fixed interest	31		
	Equity shares	32		
	Land	33		
	Currencies	34		
	Other	35		
Adjustment for margins		41		
TOTAL (11 to 42)		51		420

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5.B.7 Example five

£450,000 **debt** due from XYZ stockbrokers.
£1,200,000 **deposit** with XYZ Bank (an approved credit institution) on a 15 month fixed term.
£250,000 worth of **shares** in XYZ Holdings.
2000 **BP traded call options at 420p** with XYZ Market makers (an approved counterparty) worth £500,000 but offset by £100,000 received from broker as variation margin and put on deposit with a non XYZ bank.

General Business Amount is £20,000,000.

Total inadmissible by counterparty limits is £300,000. (None of above exposures are via short-term deposits, therefore 10% counterparty exposure limit applies.) Inadmissibility of exposure to BP shares (via call options) ignored for simplicity.

FORM 15 (part)		
Liabilities (other than long term business)		As at the end of the financial year
Other Creditors	49	
Provision for adverse changes	61	
TOTAL	69	

FORM 13 (part)		
Admissible assets		As at the end of the financial year
Equity shares	41	250
Rights under derivative contracts	44	400
Deposits less than 1 month	54	100
Deposits more than 1 month	55	1200
Other financial investments - other	56	450
Deduction for excess counterparty exposure	87	(300)
TOTAL	99	2100

FORM 17				
Derivative Contracts			As at the end of the financial year	
			Assets	Liabilities
Futures Contracts	Fixed interest	11		
	Equity shares	12		
	Land	13		
	Currencies	14		
	Other	15		
Options	Fixed interest	21		
	Equity shares	22	500	
	Land	23		
	Currencies	24		
	Other	25		
Contracts for differences	Fixed interest	31		
	Equity shares	32		
	Land	33		
	Currencies	34		
	Other	35		
Adjustment for margins		41	(100)	
TOTAL (11 to 42)		51	400	

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5.B.8 Example six

£30m Swap of sterling to DM short interest rates, total liability £500,000

Provision for Regulation 61 taken as if interest rate margin between sterling and DM widens by
2%, as contract uncovered. Provision £250,000.

FORM 14 (part)

Long Term business liabilities and margins		As at the end of the financial year
Other Creditors	38	500
Provision for adverse changes	41	250
TOTAL	59	750

FORM 13 (part)

Admissible assets		As at the end of the financial year
Equity shares	41	
Rights under derivative contracts	44	
Deposits less than 1 month	54	
Deposits more than 1 month	55	
Other financial investments - other	56	
TOTAL	99	

FORM 17

Derivative Contracts			As at the end of the financial year Assets	Liabilities
Futures Contracts	Fixed interest	11		
	Equity shares	12		
	Land	13		
	Currencies	14		
	Other	15		
Options	Fixed interest	21		
	Equity shares	22		
	Land	23		
	Currencies	24		
	Other	25		
Contracts for differences	Fixed interest	31		
	Equity shares	32		
	Land	33		
	Currencies	34	500	
	Other	35		
Adjustment for margins		41		
TOTAL (11 to 42)		51	500	

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CHAPTER SIX

6. THE REGULATION 23 STATEMENT: DERIVATIVES

6.1 Scope of the statement

1. Every company is required to make a Regulation 23 statement, whether or not it used derivatives in the year in question. For this purpose, "derivatives" is defined by the Regulation to include not only contracts which have the legal form of a derivative contract but also the quasi-derivatives defined in Regulation 56 of the Asset Valuation Rules. The latter category includes a number of instruments which are in common use and which have certain characteristics of a derivative, such as partly-paid shares and convertible bonds. It is likely, therefore, that many companies will have something of substance to say in their statement, even though they would not normally consider themselves to be users of derivatives.

2. For those companies whose policy and practice is to use neither derivatives nor quasi-derivatives, a short statement to this effect is all that is necessary.

3. It is worth noting that the statement has been expanded beyond its original limits set down in Regulations in 1994 and (to a lesser extent) beyond the limits which applied to Annual Returns submitted from 30 April 1996 under the transitional arrangements set out in Regulation 34.

6.2 Contents of the statement

1. Regulation 23 calls for a "brief description" of certain details of the use of derivatives. There is no subtlety about the use of the term "brief description". What is needed is a description which is just long enough to give the reader a reasonable flavour of the use of derivatives, including certain key points concerning use of derivatives to effect significant switches in the balance of portfolio or use of unusual or exotic derivatives. The detailed requirements of the statement are set out below, referenced by the sub-paragraphs of Regulation 23(1).

2. *(a) any investment guidelines ... for the use of derivative contracts*

The company's policy needs to be explained, even if that policy is not to use derivatives. (In this context it is worth remembering that forward currency derivatives are not derivatives for the purposes of the Regulations if they satisfy the requirements of Regulation 45(9) of the Insurance Companies Regulations 1994). A statement that derivatives are only used to match policy liabilities is however, too brief and a fuller description of the criteria used must be given.

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3. *(b) ...guidelines ... for the use of contracts ... not ... reasonably likely to be exercised*

The company must state whether such contracts are allowable under its guidelines. Thus the restriction of the use of derivatives to those bought and sold to deal at prices close to the market price of the underlying asset at outset would allow a negative reply to this question. Conversely, if the guidelines allow the practice for example of selling options out of the money, or purchasing barrier options, neither of which were expected to be called, this would need detailing together with its purpose. Where such contracts have been entered into in the year, or subsisted over the year, then a brief description is required by sub-paragraph (c) of the size (in economic exposure) of the contracts and the approximate market movement that would trigger them.

4. *(d) ...amounts recorded in Form 13*

Insurers may find a LIFFE style report the most suitable to present the changes to Form 13, i.e. a presentation of the current Form 13 by broad asset class amended by the impact of futures on economic exposure. The prudence required in the context of options is not the same as that when considering the inadmissibility limits of Regulation 57 where the maximum exposure to an asset is in question. For sub-paragraph (d), merely options that are currently expected to be exercised should be assumed to be exercised. This would normally follow the value of the option at the accounting date; if of high value then exercise is likely but if close to valueless then exercise is unlikely. Further information is required under sub-paragraph (f) only if the impact of derivatives in amending economic exposure has been materially different at other times of the year, not merely if the overall economic exposure of the insurer has been different.

5. *(e) ...to the maximum extent*

Sub paragraph (d) requires the expected changes to exposure to be stated. Sub-paragraph (e) requires the same information as (d) but assuming that derivatives are exercised against the insurer so as to create the largest changes in the economic exposures of the insurer in its major asset classes. While derivative positions that net out, or can be used to net out exposures, will not contribute to this presentation, any other optional derivative positions are to be assumed to be exercised so as to create the most extreme exposures potentially possible.

6. *(f) how different .... other time of the financial year ... maximum extent*

This requires the analysis of (d) and (e) above to be tested for other points of the year. Where a more significant position occurred other than at the financial year end the position then needs to be described. As noted above for the test under (d) the company must look for times when the use of derivatives to amend economic exposure has been significantly different at other times of the year, not when the direct exposure of the company has been different. For the test under (e) the purpose is to gauge whether during the year the company's use of more exotic or obscure derivatives has been greater than at the financial year end. The description may thus need to refer to several different times during the year where there was significant activity that was different in nature.

7. *(g) maximum loss:*

The requirement for the maximum exposure to a counterparty failure at the year end requires this to be tested as well "in the event of other foreseeable market conditions". This means a test of individual counterparty exposure (not just the counterparty giving the maximum exposure at the accounting date) under typical market movements and the current margining arrangements. If this gives a higher figure (perhaps due to infrequent margining) then this higher figure should be stated.

8. *(h) ...does not fall within Regulation 55(2) .. or ... paragraph 15:*

Structured products that fail the test in Regulation 56(4), and are thus valued purely as unconditional debt under the terms of Regulation 56(5), should be described under this section. (To save correspondence the value assigned to such assets in the relevant Form 13 should be stated). Other derivatives that are not permitted (or admissible) derivatives held in the internal property linked funds, the rest of the long term business fund, or the other than long term business fund must also be described here.

9. *(i) ...fixed consideration:*

A note is required of what fixed sums have been earned by the insurer (for example, premiums received by the insurer for selling options), and a summary of the contracts involved over the period of the Annual Returns (not merely those in force at the year end).

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CHAPTER SEVEN

7. THE REGULATION 24 STATEMENT: SHAREHOLDER CONTROLLERS

1. The Regulation 24 statement is only required for an insurance company which falls within the definition in section 5 of the Insurance Companies Act 1982 of "UK company".

2. A "UK company" is any authorised insurance company (other than certain small mutuals) -

- which is incorporated in, and has its head office in, the United Kingdom; and

- whose business is not restricted to reinsurance.

3. Regulation 24 requires a list of all persons who were, to the company's knowledge, <u>at any time during the financial year</u> shareholder controllers of the company together with their percentage share holding and voting power <u>at the end of the financial year</u> in the insurance company (or in another company of which the insurance company is a subsidiary undertaking).

4. The duty to list shareholder controllers under Regulation 24 is separate and distinct from the requirement to notify those persons under sections 61 to 62. Including such a person in the Regulation 24 list does not relieve him/her of the duty to make notifications under those sections nor *vice versa*. [Guidance on the duty to report under those sections is given in Prudential Guidance Note 1995/5 issued by the Insurance Directorate.]

5. A shareholder controller is defined by section 96C of the Insurance Companies Act 1982 as any person who either alone or with any associate or associates -

- holds 10 per cent. or more of the shares in the company or another company of which it is a subsidiary undertaking;

- is entitled to exercise, or control the exercise of, 10 per cent. or more of the voting power at any general meeting of the company or another company of which it is a subsidiary undertaking; or

- is able to exercise a significant influence over the management of the company (or of another company of which it is a subsidiary undertaking) by virtue of -

  (i) a holding of shares in; or

  (ii) an entitlement to exercise, or to control the exercise of, the voting power at any general meeting of,

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- the company or, as the case may be, that other company.

In the statement for a company that is part of a group with more than one intermediate holding companies, there may be several levels of shareholder controllers to list since each intermediate holding company has to be reported.

6. For the above an "associate" of a person is -

- the wife or husband or minor son or daughter of that person;
- the trustees of any settlement under which that person has a life interest in possession, or, in Scotland, a life interest;
- any company of which that person is a director;
- any person who is an employee or partner of that person;
- if that person is a company -

  (i) any director of that company;

  (ii) any subsidiary undertaking of that company;

  (iii) any director or employee of any such subsidiary undertaking; and

- any other person with whom that person has made an agreement or arrangement -

  (i) with respect to the acquisition, holding or disposal of shares or other interests in the company concerned or another company of which it is a subsidiary undertaking; or

  (ii) under which they undertake to act together in exercising their voting power in relation to the company concerned or another company of which it is such an undertaking.

7. Further guidance on the definition of shareholder controller is given in the Prudential Guidance Note 1995/5 referred to in paragraph 4 above.

8. The percentage shareholder and voting rights to be disclosed in the Regulation 24 statement should include the holding/rights of associates.

9. Where there are no shareholder controllers to report the Regulation 24 statement state this.

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CHAPTER FOURTEEN

14. FORMS 40 TO 45: THE LONG TERM BUSINESS REVENUE ACCOUNT

14.1 Form 40

Different types of Form 40

1 Form 40 presents a revenue account for long term business. It should be prepared separately for each long term business fund maintained by the company. If there is more than one such fund for either ordinary or industrial long term business a summary Form 40 for ordinary or industrial business (as the case may be) should be prepared. See Regulation 8(b).

2. The separate Forms 40 for different funds and for the summary are distinguished by the entry in the heading box "No. of Fund/Summary". Paragraph 4(2) of Schedule 3 specifies how this is to be completed.

3. Where the rights of a group of with profits policyholders are defined by reference to a specified part of the fund, paragraph 13 of Schedule 4 requires that the Appointed Actuary include in his/her valuation report -

- a revenue account for each such sub-fund in the format of Form 40; and
- a description of "the principles and methods applied in apportioning the investment income, increase or decrease in value of assets brought into account, expenses and taxation between each part"

where this information is not provided elsewhere.

4. It has been the practice of some companies (as allowed by the above) to provide -

- Forms 40 for each sub-fund; and
- the description of principles etc. as a supplementary note to those Forms;

within the Schedule 3 part of the Annual Return, which is signed off by the directors and is subject to audit. Where this is the case the company should also prepare a Form 40 for the whole fund. The Forms 40 for the sub-funds should be distinguished by the entry in the heading box "No. of part of fund". Paragraph 4(2) of Schedule 3 specifies how this is to be completed.

Relationships with other Forms and between different Forms 40

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5. The amounts included in the Form for earned premiums, claims incurred and expenses payable are to be derived from Forms 41 and Form 42 in accordance with instruction 1.

6. Where a company decides to allocate to the long term business the whole or any part of investment income and/or net capital gains arising from assets not attributable to its long term business, both the income and any associated investment management charges, must first be included in the non-technical account (Form 16), with the amount to be allocated to the long term business shown as a transfer at line 13 of Form 16, line 26 of Form 40 and in Form 58. See instruction 3.

7. The amount shown for transfers to the non-technical account (line 26) should agree with the equivalent amount disclosed at line 47 on Form 58 - see instruction 4. However, if there is a net transfer into the fund, the entry at line 26 will be negative, and by virtue of instruction 3 to Form 58 there will be a positive entry in line 34, lines 15 and 47 remaining blank.

8. The amount of any transfer to and from other funds should be included in the Form 40 of the transferee and transferor funds respectively at line 15 and line 25 - see instruction 4.

Completion of the Form

9. The instructions to the Form specify the rules for its completion. These rules differ in several respects from those which are used in the preparation of the Companies Act accounts. The following table identifies for each line in the Form the most closely corresponding items from long term business technical account specified in the Companies Act and describes some major differences between the accounting rules for those items and for Form 40.

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Line in Form 40	Item(s) in the technical account	Major points of difference in accounting treatment
Line 11- "Earned premiums"	II.1 "Earned premiums"	In preparing the technical account the company may choose whether or not to include the change in the provision for unearned premiums under this item. In Form 40 only the latter treatment is acceptable, i.e. the change in unearned premiums must be excluded. [This is also by far the more commonly used of the two permitted treatments in the technical account.]
Line 12 - "Investment income receivable before deduction of tax"	II.2 "Investment income", (but excluding items II.2.(c) and (d) - see below).	The items II.2(c) and (d) under the heading investment income in the technical account refer to value re-adjustments and realised gains on investments. In Form 40 no amounts for gains or loss on investments should be included in investment income. The treatment in the Annual Returns of tax borne on franked investment income should be consistent with guidance issued for the Companies Act accounts by the Accounting Standards Board and the Association of British Insurers.

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Line in Form 40	Item(s) in the technical account	Major points of difference in accounting treatment
Line 13 - "Increase (decrease) in the value of non-linked assets, brought into account" Line 14 - "increase (decrease) in the value of linked assets"	II.2.(c) "Investment income - value readjustments on investments" II.2(d) "Investment income - gains on realisation of investments" II.3 "Unrealised gains on investments" II.9(b) "Investment expenses and charges - value readjustments on investments" II.9(c) "Investment expenses and charges - losses on realisation of investments" II.10 "Unrealised losses on investments"	(1) The technical account includes all investment gains and losses (realised and unrealised). In Form 40 such gains and losses (other than in respect of linked assets) are only included to the extent they are "brought into account". Form 40 includes all gains and losses in respect of linked assets. (2) In Form 40 the increase/(decrease) in value shown includes the changes in the valuation differences shown at lines 92 to 95 of Form 13 (for long term business assets).
Line 15 - "Other income"	II.4 "Other technical income, net of reinsurance"	

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Line 21 - "Claims incurred"	II.5 "Claims incurred, net of reinsurance" II.7 "Bonuses and rebates, net of reinsurance" but only to the extent that they are cash bonuses (which do not therefore increase technical reserves).	(1) In the technical account claims incurred includes claims management expenses. In Form 40 these are to be included under "expenses payable" not "claims incurred". (2) In the technical account claims incurred includes the change in the provision for claims outstanding. In Form 40 this change (except to the extent it relates that part of the provision not included in mathematical reserves) is not to be included as it is already taken into account in the movement of the fund shown at line 39. [The mathematical reserves take into account outstanding claims except where they have already fallen due at the valuation date.]

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Line in Form 40	Item(s) in the technical account	Major points of difference in accounting treatment
Line 22 - "Expenses payable"	Claims management expenses included in item II.5 above. II.8 Net operating expenses II.9(a) "Investment expenses and charges - investment management expenses, including interest"	(1) In the technical account net operating expenses are adjusted to take account of the change in the amount carried forward for deferred acquisition costs. In Form 40 all acquisition expenses incurred during the year should be included at line 22 and no amounts should be carried forward. (2) Any interest payable included in net operating expenses in the technical account should be included in Form 40 at line 23 not line 22.
Line 23 - "Interest payable before deduction of tax"	Interest included in item II.9(a) above. Interest included in item II.8 above.	
Line 24 - "Taxation"	II.12 "Tax attributable to long term business"	
Line 25 - "Other expenditure"	II.11 "Other technical charges, net of reinsurance"	

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Line 26 - "Transfer to (from) non-technical account"	II.12 "Allocated investment return transferred to (from) the non-technical account" II.13 "Balance on the technical account - long term business"	The main reasons for differences between the amounts transferred to the non-technical account and the technical account are typically - (1) the deferral in the technical account of acquisition expenses; (2) the transfer in the technical account of amounts to or from the fund for future appropriations; (3) valuation differences as between mathematical reserves in the Annual Return and the technical provisions in the technical account; and (4) investment gains not brought into account in Form 40.

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Line in Form 40	Item(s) in the technical account	Major points of difference in accounting treatment
Line 39 - "Increase in fund in financial year"	II.7 "Bonuses and rebates, net of reinsurance" but only to the extent that they increase the technical provisions II.6 "Change in other technical provisions, net of reinsurance, not shown under other headings" II.12a "Transfers to or from the fund for future appropriations"	These items are not directly comparable as different valuation rules apply in the Returns and Companies Act accounts.

Supplementary notes

10. Eight supplementary notes are specified to Form 40.

(1) If any of the brought forward amounts differs from the corresponding carried forward amounts in the previous return the reason should be stated - see Paragraph 7 of Schedule 1. [Code 4001].

(2) Particulars of the amounts included at lines 15 and 25 for "other income" and "other expenditure" should be stated - see instruction 2 to the Form. [Code 4002]

(3) Particulars of the amount of any investment income and/or net capital gains allocation included at line 26 in Form 40 should be stated - see instruction 3 to the Form (and also paragraph 14.1.11 above). [Code 4003]

(4) A specification of any transfer of reserves associated with a transfer of contracts from one fund to another should be stated - see instruction 4 to the Form. [Code 4004]

(5) Unless already stated in a note to Form 16, the bases of conversion adopted in respect of foreign currency for income and expenditure should be stated - see paragraph 5(2) of Schedule 1. [Code 4005]

(6) Where a company maintains more than one long term business fund, it should state the principles and methods applied to apportioning the investment income, the increase or decrease in the value of assets brought into account, expenses and taxation between the different fund - see paragraph 4(1) of Schedule 3. [Code 4006]
(7) The information required by Paragraph 13(b) of Schedule 3 to be stated in the appointed actuary's report may instead be stated as a note to Form 40 - see paragraph 4 above. [Code 4007]

(8) Where arrangements have been in force during the financial year for the provision either by or to the company of management services, this fact should be stated together with the name of the other party (to whom or from whom such services were provided or received) - see paragraph 5 of Schedule 3. This statement is only needed where a substantial part of the day-to-day administration of a company is undertaken by another company or *vice versa*. [Note that where the arrangement is between two insurance companies, the directors will need to consider very carefully the form of their certificate under Schedule 6 Part I paragraph 4(e).] [Code 4008]

14.2 Forms 41 to 45

Completion of the Forms

1. Forms 41 to 45 should be prepared separately for each fund and sub-fund for which a Form 40 is prepared and also (except for Form 45) in summary where a summary Form 40 is prepared - see Regulation 17. These Forms supplement Forms 40. Form 41 provides an analysis of premiums and expenses, Form 42 of claims, Form 43 a summarised balance sheet for internal linked funds, Form 44 an aggregate revenue account for internal linked funds and Form 45 supplementary information on internal linked funds.

2. Instruction 2 to Form 41 provides for the reporting of repeated or recurrent single premium business as regular premium business. The purpose of this is to differentiate business which may be expected to produce an ongoing premium income for the company ("regular premium") from business which is "one-off" in nature ("single premium"). It is typical of "regular premium" business that the office will issue a renewal notice for the expected amount of premium, albeit that the policyholder may have a contractual right to pay a different amount, or nothing at all. Another characteristic might be that premium collection is by a direct debit or other payment order. Contracts set up to receive minimum contributions from the Department of Social Security should be treated as single premiums. [This differentiation between single and regular premiums used in Form 41 should also be used in Form 46 and Form 47, and the total single premiums on Form 41 should equal that for Form 47 - see paragraph 15.6.2 below.]

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3. The instructions to the Forms provide, amongst other items, for -

- the reporting of industrial assurance "claims incurred on survival in respect of periodical benefits" as surrenders (Form 42);
- the reporting of derivative contracts (Form 43);
- the elimination of cross-investment between internal linked funds (Form 44);
- the separate disclosure of gross units created and gross units cancelled in internal linked funds (Form 44) so that turnover can be monitored. Each day's movements may be netted or recorded as two separate entries, one positive and one negative, as is administratively convenient; the total net positive and negative movements will be recorded on lines 11 or 21 as appropriate;
- the method of disclosure of the provision for capital gains tax on unrealised and realised capital gains in internal linked funds and of the valuation price of units in internal linked funds (Form 45).

4. In addition to the above the following points should be noted.

- The differentiation between UK contracts and overseas contracts (Forms 41 and 42) must be in accordance with paragraph 3 to Schedule 3. The definition does not correspond with the definitions of overseas life assurance business for Inland Revenue purposes.
- The earned premiums shown in Form 41 should include that part of the premium which was or will be recoverable from the Inland Revenue.
- The expenses shown in Form 41 should be those which relate only to the company's long term business. Those relating to the company's other business cannot, by virtue of Section 29(l)(a) of the Insurance Companies Act 1982 (subject to the exception in Section 29(l)(b)), be paid out of the long term funds and must therefore be shown in the general business technical account (Form 20) or the non-technical account (Form 16).
- In dividing management expenses between lines 43, 44 and 45 of Form 41:-
  (a) costs of a non-recurring nature, such as those incurred in developing new systems, new premises, or the costs of corporate restructuring, should normally be reported in line 45;
  (b) the costs incurred in writing new business (or in obtaining incremental (but not indexed) premiums on existing business), such as underwriting, policy issue, setting up (or amending)

records and the maintenance and development of the sales and marketing organisation should be reported at line 43;

(c) the balancing item will be expenses related to the ongoing costs throughout the year of maintaining the business in force (including any investment management costs) and should be reported in line 44.

- Commission payable to employees of the company whose job is to sell policies should be included under "management expenses" (lines 43 and 44 of Form 41). On the other hand any commission payable to employees who sell policies on a casual basis should be included under "Commission" (lines 41 and 42) along with that paid to other intermediaries and to cedants.

- All assets held within internal linked funds must be included in Form 43, even if their value exceeds the amount at the unit liability, cf. paragraph 3.6 of Prudential Guidance Note 1996/2. [Note: the valuation of assets regulations apply in full to these excess assets (see Regulation 45 (2) of the Insurance Companies Regulations 1994 and Regulation 4(a) of these Regulations).]

- The figures shown in column 2 of Form 45 shall be those appropriate at the end of the financial year, net of any indexation allowances. Each percentage shown in column 3 shall be the appropriate figure shown in column 5 of Form 43 expressed as a percentage of the appropriate figure in column 2 of Form 45.

- The figures shown in column 4 of Form 45 shall be the total deductions made from each fund for the financial year in respect of tax on realised capital gains (as included in line 24 of Form 44) expressed as a percentage of the taxable net realised capital gains arising in the period.

Supplementary notes

5. Three supplementary notes to Form 43 are specified.

(1) The basis on which assets have been valued should be stated - see instruction 1. [Code 4301]

(2) The aggregate value of rights and liabilities, both gross and net of variation margin, under derivative contracts should be stated - see instruction 2. [Code 4302]

(3) Certain specified details on the netting of the liability to repay "variation margin" on derivative contracts (and contracts having the effect of derivative contracts) should be stated - see instruction 3. [Code 4303]

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6. Two supplementary notes to Form 44 are specified.

(1) If any of the brought forward amounts differs from the corresponding carried forward amounts in the previous return the reason should be stated - see Paragraph 7 of Schedule 1. [Code 4401].

(2) Particulars of items reported as "other income" or "other expenditure" on Form 44 should be stated - see instruction 2. [Code 4402]

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CHAPTER FIFTEEN

15. FORMS 46 TO 61: THE ABSTRACT OF THE ACTUARIAL VALUATION

15.1 Overview

1. Schedule 4 prescribes the format of the abstract of the report of the Appointed Actuary on his investigation into the financial condition of the long term business, required under section 18 of the Act.

2. The preamble to the Schedule provides for certain provisions to be applied to the report from Schedule 1 and Schedule 3. These include the requirement that supplementary notes to forms shall be separate statements and not footnotes, the method for completing the identification boxes on the forms, the treatment of currencies other than sterling, negative numbers within round brackets, dealing with differences between brought forward numbers and last year's return, and the definition of UK and overseas contracts. More information on these can be found in the notes relating to the relevant Schedule. The Appointed Actuary should note that throughout the Schedule and in these notes references to "surrender" should be taken to include all similar expressions, including transfer as applied to pension contracts. The preamble also requires that the answers provided by the Appointed Actuary be numbered to accord with the numbers of the corresponding paragraphs. This instructions is also intended to apply to the numbering of the sub-paragraphs.

3. Paragraph 3 refers to the requirement that the valuation is conducted so that the liabilities conform to Regulation 64 of the Insurance Companies Regulations 1994. Sufficient information should be provided within the report to enable the Insurance Directorate to form a view about this, and in particular that the reserves meet each of the minimum standards required under regulations 65 to 75 of those regulations. It is not normally necessary to supply detailed supporting information, except where otherwise stated in these notes or in the regulations.

4. The preamble also defines the report period in terms of the period since the last investigation under section 18. Paragraph 2 also requires the date of this last investigation to be given. This relates to any investigation under the section, which includes any interim valuation for publication or distribution of profits which has been fully dealt with under the requirements, but does not apply to any informal valuation, nor normally to one produced under section 42 of the Act.

5. Certain paragraphs relate exclusively to non linked contracts (e.g. paragraph 4), some are related exclusively to linked contracts (e.g. paragraph 5), while others relate to both types of contract. The definition of a linked contract under regulations (Regulation 3(1)) includes any contract under which linked benefits as defined in section 35A of the Act are provided. This includes a number of types of contract not traditionally

regarded as linked (e.g. RPI-linked annuities) - see Prudential Note 1996/2 for further guidance. Except where there are specific requirements to do otherwise, a contract with both linked and non linked benefits is to be treated as a linked contract.

15.2 Paragraph 4 - non-linked contracts

1. Paragraph 4 requires specific information to be given in respect of two types of non linked contract. The regulations define (Regulation 3(1)) accumulating with profits policies which are to be reported under sub-paragraph (1)(a). Broadly speaking these are policies of the type sometimes known as unitised with-profits, but the definition is slightly broader. Firstly, it is not necessary that the benefits are in any way 'unitised' for the definition to apply. In particular, any with profits deposit administration contract would normally fall within this definition. Further, most recurrent single premium with profits contracts are also likely to fall within this definition. It is not considered that a traditional single premium with profits policy falls within this definition where the guaranteed benefit is fully expressed in terms of the amount payable at maturity if that sum is not explicitly related to the premiums, and more importantly to any additional premiums which may be allowed under the contract. That said, it is considered by the Insurance Directorate that contracts where there is doubt should be reported under this heading.

2. Sub-paragraph 4(1)(a)(i) requires the description of all deductions from the current benefit used in determining values under the policy. This will include all charges fixed under the policy, as well as any discretionary charges permitted. In particular, where there is a provision for a 'market value adjustment' or a similar deduction, this should be disclosed in terms of when it might apply. This does not refer to when it is in practice being applied.

3. Sub-paragraph 4(1)(a)(ii) requires the description of how any discretionary adjustments such as are covered in (i) have been applied if the determination of the mathematical reserves (excluding any reserves under Regulation 75 of the Insurance Companies Regulations 1994, including a resilience reserve) has taken credit for these adjustments. Where there are powers to vary an adjustment which is laid down in the policy (as may be the case with initial or capital units), but the company has not exercised its discretion to vary these adjustments from the levels prescribed in the policy, this need not be considered as triggering this sub-paragraph. Where any discretion has been exercised in respect of a charge taken credit for in the valuation, or where the charge is provided for but no level is specified in the policy, then it is necessary to describe all such discretionary charges levied in the report period.

4. Paragraph 4 also requires specific information in respect of a further class under sub-paragraph (1)(b) which is intended to include policies of the

type known as deposit administration, unless they are with profits policies, which should be included under (a). Sub-paragraph (1)(c) covers any other types of non linked policy not covered under (a) or (b) which require amplification of the entry in Form 51. This will include any contracts which have any supplementary guarantees or options which the Appointed Actuary considers to be significant.

5. All sections of paragraph 4 require information to be supplied on any material options. Options should be interpreted widely, though it is for the Appointed Actuary to decide what is material. An option to surrender on guaranteed terms, or to convert on guaranteed terms to another form of benefit, or to increase benefits without evidence of health, should generally be considered material. Guarantees on interest rates include both fixed guarantees and guarantees which may be related to some external reference rate. Guaranteed surrender values may similarly be guaranteed by amount or by reference to some formula.

6. Sub-paragraph (2) provides an exemption from the disclosure requirements of sub-paragraph (1) but only where both of conditions (a) and (b) are satisfied.

<u>15.3 Paragraph 5 - linked contracts</u>

1. Paragraph 5 provides for information to be supplied on linked contracts. Similar considerations to those described in the preceding paragraphs, and in particular paragraph 15.2.5, in relation to paragraph 4 of the Schedule apply also to this paragraph. Paragraph 5(2) requires any with profits option to be reported as under 4(1)(a).

2. Paragraph 5(4) requires the disclosure of the methods used in creating and cancelling units and in their allocation to and de-allocation from policies. This requirement should include information on the basis of valuation of assets and how it is selected (for example, "offer" basis for net creations of units and "bid" basis for net "cancellations"), including the timing of the asset valuation used in respect of such operations in relation to the time at which both the operation is decided upon and effected. When at any one time different pricing bases may apply to different policies, then details of the circumstances which give rise to the difference should be provided. Where assets are units in collective investment schemes or similar assets, particular reference should be made to precisely what price is used, and the relationship between the last opportunity to deal at that price and the time of the valuation. In summary, the Insurance Directorate should be provided with sufficient information to demonstrate that incoming, outgoing and continuing policyholders are treated equitably. It will be acceptable for reference to be made to compliance with published guidance to the extent that such guidance covers the above issues.

3. The information under paragraph 5(5) should include the treatment of any tax on notional realisations where provision for these is made under the Taxes Acts. In particular, reference should be made to whether the liability for such tax, when it falls due, is retained within an internal fund, or has been transferred out of that fund in exchange for a tax deduction. The rate of such tax deduction should be stated.

15.4 Paragraphs 6 to 12 - bases, principles, methods etc.

1. When providing the information on the general principles and methods adopted in the valuation under paragraph 6, the Appointed Actuary should provide sufficient explanation to enable the Insurance Directorate to take a view, in relation to the issues specifically referred to in paragraph 6(1), on the adequacy of the reserving basis in relation to regulations 64 to 75 of the Insurance Companies Regulations 1994. Where the Appointed Actuary has not undertaken any specific tests implicit in the points raised in paragraph 6, as he considers the margins in his basis are already sufficiently large to meet each of the minimum requirements of regulations 65 to 75 and of Regulation 64, he should indicate this either directly or indirectly; he may, however, be required to justify his basis to the Insurance Directorate if it considers it is not self-evident that there are sufficient margins. The Appointed Actuary should include broad details of the type of investigations he has conducted to meet the requirements of professional guidance in respect of sub-paragraph (1)(b).

2. Regulation 75 of those regulations requires the Appointed Actuary to take into account the nature and term of the assets and the value at which these have been brought into account when determining the appropriate provision against the effects of possible future changes in the value of the assets on their adequacy to meet the liabilities. If the assets in Schedule 4 are brought in at book values below the values in accordance with the regulations given in Form 13, and in determining the provision under this Regulation the Appointed Actuary has had regard to this fact, paragraph 6(2) requires a statement to this effect. This applies also when the basis of the provision made for any prospective liability for tax on unrealised capital gains is determined in the context of assets taken at their book value rather than their Form 13 value.

3. Paragraph 7(3) requires reference to how the tables of mortality and morbidity assumed have regard to the State of commitment. This is a reflection of the requirements of the 3rd Life Directive as brought into UK law in Regulation 70 of the Insurance Companies Regulations 1994. This reference does not add to the duty on the Appointed Actuary under the Insurance Companies Regulations 1994, and if the Appointed Actuary has determined that the degree of variation of mortality or morbidity between states does not give rise to a material effect in the valuation it is sufficient for this to be stated.

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4. Paragraph 7(4) requires details of any allowance made for future reductions in the rates of mortality in tables used in valuing annuities. Many such tables have a built-in allowance, and it is not necessary for the Appointed Actuary to give explicit details of this allowance if the table is in common usage in the United Kingdom. To the extent that the Appointed Actuary has determined to make additional allowance to that intrinsic to such a table, he should give details. This includes the making of an adjustment to the table which is intended to allow for future reductions, but does not include any adjustment made in respect of reductions already evidenced at the valuation date.

5. Paragraph 7(5) will include any allowance made for the effects of the Human Immuno-Deficiency Viruses, but is not necessarily limited to those viruses. It does not require the Appointed Actuary to make an allowance for any particular change, but to disclose any allowance he may have made. This paragraph does not add any additional requirement to include any particular reserve not required by the Insurance Companies Regulations 1994.

6. Paragraphs 7(6), (7) and (8) cover the requirements of Regulation 75 of the Insurance Companies Regulations 1994. Paragraph (6) requires only a description of the various scenarios tested and identification of the most onerous of those scenarios. It does not require the results of such scenarios to be stated. It should be noted that currency variations are included in this requirement.

7. It is not always straight-forward to divide the reserve under Regulation 75(a) from that under 75(b). Reserves under 75(b) will often exceed those under 75(a), particularly where there is a significant volume of with-profits business, and in this case, if the conditions giving rise to the envisaged change in the value of assets embrace those tested under Regulation 75(a), it is sufficient to state this in paragraph 7(7). However, it is not necessarily the case that the most onerous conditions under 75(b) allow for all the effects under Regulation 75(a), and the response to 7(7) must make clear to what extent the reserve under 75(b) is taken into account.

8. The information required under paragraph 7(8) is only in respect of that scenario tested which gives rise to the greatest requirement, but it applies even if the reserve required is zero. If no scenario gives rise to an additional reserve, the most onerous scenario is that which allows the smallest reduction in reserves, whilst the basis remains consistent with the Insurance Companies Regulations 1994. Sub-paragraph (8)(a) requires any changes in assumptions, excepting only the interest rate, to be described. This includes, for example, the introduction of a zillmer adjustment within that permitted in the regulations, the application of any adjustment to accumulating with profits policies reserves to reflect discretionary charges

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on surrender, the reduction of bonuses allowed for in the valuation, or any other change in assumptions whether explicit or implicit. Sub-paragraph (b) requires a description of the method used in determining the requirement. This needs only to be sufficiently detailed to enable the Insurance Directorate to understand the techniques employed, any changes in the hypothecation of assets to liabilities, assumed changes in the exercise of discretion, and other changes outside the valuation basis or otherwise.

9. The additional information to be provided in paragraph 8(d) (where the contracts do not fall within the circumstances of the proviso) must be sufficient to constitute the required demonstration. The information could take several different forms. For example the requirement would usually be met if the results of a net premium valuation for each of the relevant main categories of contract in the format of Form 51 or 52 were given, specifying the valuation rates of interest and mortality used, the zillmer adjustment and any other relevant information. Where a full net premium valuation has not been made, the requirement could be met by a comparison of specimen reserves for each of the main categories of contracts for various ages and durations on the basis used by the Appointed Actuary in his report and on an appropriate net premium basis (specifying particulars of the basis as above) together with information about the distribution of the business in the form of appropriate weightings. In principle a method of demonstration which involved sampling could also be acceptable.

10. The information to be supplied in paragraph 9 should normally include the expenses of administration per policy for each policy type, the rate of future inflation, and the rate of unit price growth (both gross and net of any relevant taxation, but before management charges) assumed in the valuation/test and the extent to which account has been taken of any increases in management charges, including those increasing with reference to a published index, which are allowed under the terms of the policy. Other parameters will normally include the mortality and morbidity rates and the rate of interest earned on sterling reserves assumed in the valuation/test.

11. Paragraph 10 is intended to identify the contribution towards future management expenses derived from the assumptions made by the Appointed Actuary in the valuation basis for meeting future expenses. It is a request for statements of the actual results of applying the valuation basis. Thus sub-paragraph (1) requires a description of the rates of inflation assumed and how inflation is allowed for in the valuation. Sub-paragraph (2) calls for the aggregate amount of expense contributions over the first year, with a general description of the sources, whether they be differences between net premiums and office premiums, or explicit allowances in the basis. Where with profits business valued on a net premium basis is concerned, it is not necessary to determine a precise split between the amount set aside for expenses and that for future bonuses. It is sufficient for the Appointed Actuary to describe the amount he considers appropriate

to set aside for expenses on the basis of information readily available at the time. The Insurance Directorate would normally expect there to be a correlation between the amount disclosed by the Appointed Actuary and the figure included in line 44 of Form 41.

12. Sub-paragraph 10(3) requires a description of the method and details of the basis used to calculate whether there is a need for a reserve in respect of continuing to write new business. This will require general statements as to the levels of business assumed for this purpose (perhaps in relation to that written the previous year), and broad assumptions as to costs (such as stating that he has assumed the continuation of the previous year's costs plus inflation, or by stating that he has used company budgets), product terms (such as stating he has assumed the continuation of the products on offer at the valuation date, or that he has reflected changes made after the valuation date but before the date of the certificate) etc. It does not require identification of explicit items in monetary terms, nor details of the precise assumptions. This is similarly true of sub-paragraph (4), where for example the Appointed Actuary might disclose that redundancy costs have been taken into account, if such be the case, or the costs of terminating management agreements, but not the amount of such costs.

13. Paragraph 11 is a requirement to identify the extent of currency matching. The requirement is driven from the liabilities, and requires the liabilities included within the actuarial certificate (which includes liabilities in respect of deposits received from reinsurers), but excluding property-linked liabilities, to be analysed by currency. The assets reported as matching these liabilities, which should correspond with those reported for the same liabilities in other matching schedules within the Annual Returns, are similarly to be analysed by currency. The de minimis exemption for 2% of the liabilities is intended to avoid unnecessary detail for small exposures, but the degree of mismatching still needs to be given. This mismatching should be taken as the sum of all liabilities reported in the "other currencies" heading matched by assets in other currencies divided by the total liabilities under that heading. This figure should be given as a percentage and to the nearest whole number.

14. The information on reinsurance required under paragraph 12 is largely self explanatory. It is acceptable for the Appointed Actuary to aggregate arrangements with a single reinsurer that are similar in nature. The requirements under paragraph 12(3) relate to both facultative and treaty reinsurance. The definition of a financing arrangement is intended to be wide and may include arrangements with non-insurance companies. It is likely that many original terms reinsurances with advanced commissions will constitute financing arrangements. Financing arrangements cease to be such once all elements of the financing have been repaid, earned or otherwise reduced to zero. The Appointed Actuary should exercise reasonable discretion in reporting under this heading, particularly in

relation to facultative business. It is acceptable where the financing arises from facultative reinsurances under a common overall agreement as to the general terms, for a grouped figure to be provided for the agreement, rather than for each contract.

15.5 Paragraphs 13 to 16 - profit distribution

1. Where, in accordance with paragraph 13 of Schedule 4, a revenue account for a particular part of a long term business fund is included in the abstract of the Appointed Actuary's report, analyses of premiums, expenses and claims in the format of Forms 41 and 42 are not required. The Appointed Actuary must provide information on the principles and methods applied in apportioning various items in any such revenue account included in Schedule 4, and in any revenue account of a with-profit sub-fund which is given in Schedule 3 where the principles and methods of apportionment are not disclosed in that Schedule.

2. Paragraph 14 is intended to supply sufficient information to enable the Insurance Directorate to understand the criteria used in setting bonus rates. Sub-paragraph (1) is a widened version of the previous requirement. It is important the information which is derived from each of the sources is identified, and if the various sources differ in any respect, the information must be identified by source. In this context “advertisement” has the wide meaning, and should include any sales and marketing literature. The references to policies issued by the company, and to advertisements, should be taken to mean any policy still in force, or any advertisement issued in a period from which with profits policies are still in force. It is not necessary to refer to policies which no longer exist. Sub-paragraphs (2) and (3) are intended to describe in broad terms how the bonus scales are arrived at. Although an answer that the distributions are based upon asset shares might be acceptable, it is necessary to indicate the approach to smoothing which it is intended to apply, the particular application to deaths and maturities, and the extent to which any ‘charges’ on asset shares are applied to maintain equity between classes or generations. The descriptions of the method should include any items excluded from or charged to any asset shares if that is the basic method.

15.6 Paragraphs 17 to 19 - Forms 46 to 49

1. In Forms 46, 46A, 47 and 47A, the term “annual premiums” refers to the total amount of premium payable, under the terms of the contract, each year. In Forms 46 and 47 any contract which consists of a combination of different types of insurance (as defined by instruction 5 to Form 47) is to be treated as a number of separate contracts each dealing with one of the different types of business so combined. The amounts by which the total number of contracts shown on each of the forms exceed the total number of

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contracts to which the forms relate should be stated by way of a supplementary note. In determining whether or not a contract consists of a combination of different types of business, the Appointed Actuary should exercise his discretion in interpreting differences in the same way as for Forms 51 to 54. Where the information given in Forms 51 to 54, together with any additional information required by Instruction 10 regarding the number of contracts does not enable a reconciliation to be made with the information supplied in Form 46 an explanation should be given. The instruction in respect of hybrid linked contracts should be interpreted in accordance with the definition in Regulation 3(1). In Form 47, any contract which falls within more than one of the categories described in instruction 6 shall be shown only once, in the most appropriate category.

2. Attention is drawn to the instructions to Forms 46 and 47 in respect of regular premium and recurrent single premium contracts, and in respect of increases to existing contracts. These instructions differ from those applicable to the forms under the old regulations which these forms replace. It is essential that consistent treatment of individual contracts is adopted between Forms 46 and 47, and that all new business is reported under some heading within Form 47. Contracts set up to receive minimum contributions from the Department of Social Security should be treated as single premium business. Additional single premiums paid in respect of existing individual contracts should be shown separately from new business in Form 47. In Form 47, a single premium contract where there is a likelihood that there will be future premiums, but which do not meet the definition of regular premium contracts because their level of premiums is not defined, should be considered as not having an expectation of continuing premiums at regular intervals, and therefore be included within the single premium categories. (See also paragraph 14.2.2 above).

3. In Forms 48 and 49 the element of accrued interest or income in respect of any asset is required to be allocated to that asset class. Thus any accrued income on a government stock shall be reported under approved securities, and not under other assets. The yields required shall be calculated with the value of the stock including this accrued interest or income element, but with full credit for the whole interest payment being taken in the expected receipts. Separate forms should be produced if and only if funds have assets separately appropriated. The treatment of tax borne on franked investment income should be consistent with guidance issued by the Accounting Standards Board and the Association of British Insurers. A supplementary note to the Forms is needed where for any asset the payment of interest is in arrears. It should state the treatment of expected income from any such asset and the amount of the interest involved. See paragraph 6 to Form 48.

4. The required statements in respect of derivatives under paragraphs 19 extend those applicable under the previous regulations, but are similar to those introduced into the 1983 Regulations by the 1996 Regulations for returns submitted from 30 April 1996. The Appointed Actuary should follow the same principles as are described in chapter 6 above in respect of asset values. It is not generally necessary to quantify the changes in yields on Form 48 which would arise. A broad description would normally suffice, unless the options concerned have the effect of locking in particular yields not immediately identifiable from the description. Where and to the extent that the information provided by the company under Regulation 23 is sufficiently complete to answer this requirement, it is sufficient for the Appointed Actuary to refer to that information in the Annual Return.

<u>15.7 Paragraph 20 - Forms 51 to 56</u>

1. The aggregate of the amounts standing to the credit of policyholders' accounts should be shown in column 5 of Form 51 for non-linked non profit deposit administration schemes, and should be distinguished from any other measures of benefit shown in that column for such contracts.

2. In Forms 51 to 54, wherever different rates of interest are used, the results should be shown separately.

3. In Forms 53 and 54, if discounting applies to any type of contract, then columns 11 and 12 must be completed for all contracts. Column 12 may be left blank only if there is no discounting at all for that valuation summary. In Form 53, details of units which are discounted at different rates of interest (e.g. capital and accumulation units) should be shown separately.

4. Where a linked contract includes non linked benefits except where there are accumulating with profits benefits, these should be shown separately on whichever of Forms 53 or 54 includes the linked benefits. Where accumulating with profits benefits are included, the treatment should follow instruction 12, and other non linked benefits may be included with either the linked or accumulating with profits benefits, provided the treatment is disclosed in the note required under instruction 12.

5. Within Forms 51 to 54 it is required to report separately under instruction 10 combinations of different types of insurance. The Appointed Actuary is required to determine when such different types of insurance are present in one contract. If he considers that such separate reporting would be misleading, or would not materially alter the amounts reported under each type of insurance, due to the trivial nature of one or more types of insurance in a contract, this would be an indication that there may not, in practice, be more than one type of insurance present. This is not likely to be the case, however, where supplementary benefits of a different class of business under Schedule 1 to the Act are concerned. For this purpose, it

should be noted that non linked benefits under a linked contract still fall within class III.

6. Risk premium reinsurance may be aggregated, separately for, and shown as a separate class in Forms 51, 52, 53 and 54 respectively. Where risk premium reinsurance applies to a contract which is split between forms, the risk premium reinsurance should be reported on the same form as the benefits to which it applies. Where it is not possible to do this, the reason shall be given in a supplementary note, and the treatment shall be described.

7 Note the proviso to instruction 6 to Forms 51-54, which allows duplicate data on reassurance ceded to be aggregated. A similar easing of reporting requirements is provided by instruction 7 to Form 55 in respect of unit liabilities wholly reinsured. However in this case paragraph 20(3) requires a statement that section 35A has been complied with.

8. Valuation summaries for sub-funds for which surpluses are required to be determined under Section 18 of the Act, and valuation summaries for non-linked, accumulating with profits, property-linked and index-linked business should be treated as separate for the purpose of Instruction 15 for the completion of Forms 51 to 54.

9. The relationships between Forms 55 and 56 and the related items in Schedules 1 and 3 are important. Considering first Form 55 (property linked), Form 13 line 59 which shows assets matching linked liabilities does not necessarily include the assets backing the surplus units in Form 55. [See paragraph 5.4.15 above.] Where the reconciliation between the amounts shown in Form 55 and line 59 of Form 13 is not readily apparent it should be described in a supplementary note to Form 55. Also, Form 55 should, where appropriate, correspond with the assets in Form 43, which includes all assets in an internal fund, and reconciliation with that form should be readily apparent.

10. Similarly for Form 56 (index-linked) the assets shown do not necessarily correspond with those shown in line 58 of Form 13. [See paragraph 5.4.15 above.] Where the reconciliation between the amounts shown in Form 56 and line 58 of Form 13 is not readily apparent it should be described in a supplementary note. Note, also, that Form 56 represents holdings of assets, not liabilities, and that the long-term liability represented by the mathematical reserve on Form 54 should not be entered on the form. Form 56 recognises that index-linked liabilities will often be matched by derivative or quasi-derivative instruments, the nature of which may contain elements both of asset and of liability and this is reflected in the heading to the form and in column 2.

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11. For both Forms 55 and 56 it would be helpful if the actuary included a note of any circumstances which make the natural relationships break down (e.g. particular tax treatments).

12. Where unit liabilities are reassured and deposited back with the ceding company, the amounts deposited back are to be treated in accordance with paragraph 20(2) in all respects as though they are unit liabilities.

15.8 Paragraph 21 - Form 57

1. Paragraph 21 refers to the new Form 57 and requires the forms submitted to cover all long term liabilities except unit liabilities in respect of property and index-linked benefits, CGT reserves and unit liabilities deposited back for linked contracts. The intention of the form is to identify suitable blocks of assets which can notionally be allocated to cover each block of liabilities. Note that there is no provision that the form must include all of the non-linked assets in Form 13. However, the assets covering any resilience or mis-matching reserve (Regulation 75) should be included, generally on the "balance" form provided under instruction 6. For each form completed, the total assets for the valuation entered at line 29, column 1 should be equal to the liability entered at line 33, column 1.

2. An analysis of those same assets and liabilities is also required under the "most onerous" scenario identified by the actuary in sub-paragraph 6 of paragraph 7. Column 3 re-values the assets included in column 1 on the assumptions of the resilience scenario; column 4 shows the value of any assets notionally re-allocated to the block of liabilities in order that they are still covered under the resilience scenario; and columns 5 and 6 show the new re-allocation in total. For each form completed, the total assets for the valuation entered at line 29, column 5 should be equal to or greater than the liability entered at line 33, column 5. In most circumstances, one would expect the assets allocated to the resilience reserve and included on the "balance" form under the valuation to be re-allocated so that this liability and its matching assets disappear from the "balance" form under the resilience scenario.

3. The instructions to Form 57 require separate forms to be prepared among other reasons for each rate of interest used in the valuation. However, in respect of Instruction 5, where a contract or group of contracts is valued at a lower rate of interest to reflect an implicit margin for expenses described in the abstract, or to reflect an implicit provision for future bonuses, then they may be amalgamated with contracts valued at the higher rate without such implicit margins, and reported as if valued at the higher rate. Where this has been done, a supplementary note should record this. Instruction 5 also provides for contracts valued at a lower rate of interest to be grouped together with those at a higher rate, provided

that the rationale for doing so is explained in a note. Note, however, that it is not acceptable to combine the separate forms required by instructions 2 and 3. Where more than one Form is provided for a particular rate of interest, a supplementary note should identify the contracts included in each form. The totals under the resilience scenario recorded in column 5 shall be those under the scenario which is most onerous and is the subject of paragraph 7(8) (see paragraph 15.4.6 above).

4. In relation to the risk adjustments disclosed in answering paragraph 21, it is not necessary to disclose these for individual assets, nor to provide any individual justifications for the adjustment. The Appointed Actuary may be asked to supply such justification to the Insurance Directorate if it is not clear the basis upon which the adjustment was determined.

15.9 Paragraph 22 - Form 58

1. When a company records a transfer to the non-technical account or to another fund or part of the fund in a revenue account (Form 40) for a particular period, the amount of which has been derived from a valuation completed at the end of that period, that transfer should be shown in 58.13 or 58.14 as appropriate so that the true surplus appears in 58.29.

2. Where a company decides to allocate to the long term business the whole or any part of the investment income and/or net capital gains arising from assets not attributable to its long term business, the allocation should be included in Form 58 as a transfer from the non-technical account (see paragraph 14.1.6 above). This transfer should be included in either lines 13 and 15, or 32 and 34, depending on whether there is an overall net transfer out of or into the fund (or part of the fund) respectively (see Instruction 3 for the completion of Form 58).

3. Where, under Section 18(2)(b) of the Act, a surplus is determined for a part of a fund where the rights of any policyholders to participate in profits relates to that sub-fund, paragraph 22 requires a company to provide a Form 58 both in respect of the sub-fund and the fund of which it is a part.

4. In general, line 61 of Form 58 corresponds to the proportion which has to satisfy the criteria laid down in Section 30 of the Act, but this will not always be so. For example, where the with-profits policyholders are entitled to, say, 90% of the profits from the with-profit business but are also eligible to share in the profits arising on the non-profit business on a discretionary basis, line 61 would be relevant for the purpose of Section 30 (which relates to 'eligibility') only in the Form 58 for the long term fund as a whole and not in the Form 58 for the sub-fund.

5. The surplus shown in Form 58, in keeping with the definition in the primary legislation, represents the excess of the amount of the fund over

the liabilities, but the wording in lines 29 and 49 is intended to make it clear that the surplus is not to be regarded as synonymous with disposable profits. The solvency margin requirements introduced under the legislation implementing the First Life Directive make it imperative for a clear distinction to be drawn between the liabilities and the margins available to count towards a company's solvency margin. The surplus should not include any part of the mathematical reserves which the Appointed Actuary considers are required to constitute the "proper provision" envisaged by Regulation 64 of the Insurance Companies Regulations 1994 (these should be included in Forms 51 to 54 as appropriate), but it may include contingency and other reserves held which count towards the solvency margin.

15.10 Paragraph 23 - Forms 60 to 61

1. Forms 60 and 61 set out the calculation of the required minimum margin (i.e. the greater of the required margin of solvency and the minimum guarantee fund) for long term business. The legislation provides for a solvency margin in respect of a company's long term business as a whole and where more than one long term business fund is maintained the information in Forms 60 and 61 will relate to all funds combined, including industrial business where this is transacted. Provision is made for the mathematical reserves and the calculation of the solvency margin to be shown separately for the main classes of long term business and, for the purposes of reconciliation, mathematical reserves attracting a nil rate of solvency margin are to be included. Class III includes contracts where the benefits are partially linked to investment funds or indices and any reserves for non-linked benefits under such contracts, including those relating to accumulating with profits benefits, should be included under Class III business in the appropriate column in Form 60. The presence of non-linked benefits, including accumulating with-profits benefits, does not generally alter the appropriate column for linked benefits.

2. In Form 60, line 51 should equal the figure in line 59 of Form 61, together with any class V margin included in the note under instruction 6.

3. Where cash bonuses have been allocated to policyholders and are due to be paid, they are in the nature a current liability. As such they should not be included in the amount of mathematical reserves included in Form 60. No factor need to be applied to cash bonuses in calculating the required margin of solvency.

Other guidance by the prudential regulators

Prudential guidance on the preparation of regulatory returns
2 – the Treasury's explanatory guidance to authorised insurance companies on the preparation of annual returns (1998)

CHAPTER SIXTEEN

16. THE REGULATION 31 STATEMENT: INFORMATION ON THE APPOINTED ACTUARY

1. Regulation 31 calls for a statement of the information specified in sub-paragraphs (a) to (d) of Regulation 31(1). The company is required to make a further statement that it has asked the actuary to provide it with the particulars set out in the sub-paragraphs and to identify in the statement the information which has been so provided. The company is required to supplement these particulars if there is further information of which it is aware additional to that provided by the actuary.

2 Paragraphs (1)(a) and (b) refer to "particulars" but this word is not defined in the Regulation. In the case of investments, the Insurance Directorate would expect particulars to include at least a general description of the investments, the name of the holder of the investment, the nominal or principal amount outstanding and, where applicable, the rate of interest and terms of repayment. In the case of a life policy or policies, it will usually be sufficient to show total annual premiums. In the case of transactions of a minor character falling under sub-paragraph (b), a general description need only be given and full particulars are not required.

3 As a result of Regulation 31(3)(a) the particulars which have to be given apply not only to the interests of or amounts paid to the actuary but also to other person specified in that paragraph. It is worth noting, however, that Regulation 31(4) provides for the reporting company and other companies within the same group to be treated as one for the purpose of Regulation 31(3)(a). The effect of the words in parenthesis in Regulation 31 (3)(a)(iii) and (iv), taken with Regulation 31(4), is that payments made to the reporting company and to companies related to it will be excluded from the disclosure requirement.

4 Regulation 31(3)(b) and (c) set out the circumstances in which a person shall be deemed to have an interest or benefit for the purpose of the Regulation. Regulation 31 (5) describes the circumstances in which a person shall be taken to control a body corporate for the purpose of Regulation 31 (3).

5. The information required by Regulation 31 should be given in respect of each person who was the appointed actuary at any time during the financial year. Also it is good practice to give the information in respect of the person who prepared the Schedule 4 report for the financial year even if he or she was only appointed as actuary after the year end. It is also good practice to name each appointed actuary especially if more than one is referred to in the Regulation 31 disclosure.

Other guidance by the prudential regulators

Prudential guidance on the preparation of regulatory returns
2 – the Treasury's explanatory guidance to authorised insurance companies on the preparation of annual returns (1998)

CHAPTER SEVENTEEN

17. CERTIFICATES BY DIRECTORS AND ACTUARY AND REPORT OF AUDITORS

17.1 Certificate by the directors etc.

1. Part I of Schedule 6 to the Regulations specifies the statements to be included in the directors' certificate. These vary according to the type of company and the types of business which it writes.

2 Where in the opinion of those signing the certificate, the circumstances are such that any of the statements required by paragraphs 1 to 6 of the Schedule cannot truthfully be made, the relevant statements shall be omitted, (see paragraph 7(1) of the Schedule). Where any statements have been omitted, this fact shall be stated in a note, (see paragraph 7(2) of the Schedule) and reasons given.

3 For companies which fall within the circumstances of the first half of paragraph 4(e) of Part I of Schedule 6, the directors will need to consider carefully whether the Annual Returns are distorted by any management services agreements - for example, where a parent insurance company subsidises its subsidiary in its infancy.

4 Paragraph 5 of Part 1 of Schedule 6 covers directors' certificates in respect of two types of published guidance - "systems of control" and "preparation of returns" guidance. The Insurance Directorate will circulate from time to time a list of the published guidance which it considers relevant for this purpose.

5 In order to certify compliance with "systems of control" guidance, it is necessary for the directors to be satisfied that the control system was in place at the end of the financial year in question and that it was reasonable to believe that the systems continued to be in place after that date and will continue to be in place for the foreseeable future. In this instance the beliefs which the directors hold at the time of signature of the Annual Returns are the relevant ones. For example, if the system was believed to be in place at the end of the financial year in question, had clearly - but unexpectedly - failed shortly afterwards and was once again believed to be in place at the time of signature of the Annual Returns, the certificate could <u>not</u> properly be given.

6 As to the standard of compliance required, HM Treasury recognises that absolute assurance is most unlikely to be achieved. By way of illustration, an isolated human error would not of itself be considered a failure of the system provided that the system is capable of recognising and rectifying the error swiftly. Frequent or repeated errors would however cast doubts on the integrity of the system.

Prudential guidance on the preparation of regulatory returns
2 – the Treasury's explanatory guidance to authorised insurance companies on the preparation of annual returns (1998)

7 A list of the guidance complied with is sufficient. Where only part of a published guidance note is complied with, it is acceptable to claim compliance with that part. Where directors do not know or cannot satisfy themselves whether guidance has been complied with, such guidance should be omitted from the list. It is not necessary to state which guidance has not been complied with except in rare cases when no published guidance has been complied with (in which case the negative disclosure referred to in paragraph 2 above comes into play).

17.2 The actuary's certificate

1. Part II of Schedule 6 to the Regulations sets out the statements to be included in the appointed actuary's certificate.

2 Regulation 30(1) lays down that an actuary must be a Fellow of the Institute of Actuaries or the Faculty of Actuaries and aged at least 30 to be qualified for appointment under the Act. Regulation 30(2) automatically protects the position of an actuary who was already appointed when the Insurance Companies (Accounts and Statements) Regulations 1980 came into force but who does not possess the new qualifications either because he is aged under 30 or because he has an overseas qualification and not Fellowship of the Institute or Faculty of Actuaries.

3 Where an overseas company wishes to appoint an actuary with an overseas actuarial qualification, the Insurance Directorate will be willing to consider the issue of an Order under Section 68 of the Act permitting this in appropriate cases.

4 If a company appoints a firm of consulting actuaries each of the partners in the firm must possess the prescribed qualifications. Where an individual member of a firm is appointed only that individual need be qualified.

17.3 The auditors' report

1. Regulation 29 specifies the scope of the audit. The contents of the auditors' report are set out in Part III of Schedule 6. Regulation 32 specifies the qualifications of an auditor. It provides, in outline, that an auditor should be a person who would be eligible for appointment as a company auditor (under the Companies Act). This test is so phrased to apply even if the insurance company is an unregistered company, (e.g. an unincorporated association or overseas company). The test of eligibility for appointment as a company auditor under the Companies Act is twofold -

- first the proposed auditor must be a "registered auditor" under UK legislation; and

Prudential guidance on the preparation of regulatory returns
2 – the Treasury's explanatory guidance to authorised insurance companies on the preparation of annual returns (1998)

- second they must not be prohibited from appointment to that particular company by some close connection to it, (e.g. because a partner in the audit firm is also a director of the company).

2 The Auditing Practices Board issues separate guidance notes specifically for auditors of insurance companies and it is recommended that auditors should refer to these. A revised version of this guidance is expected in February or March 1998.

3 The parts of the Annual Return which are subject to audit are -

- Forms 9 to 17, and 20 to 45;

- the statements furnished under Regulations 19, 20, 21 and 23; and

4. The unaudited parts of the Annual Return are -

- the statements furnished under Regulations 24, 26 and 31;

- the information provided in accordance with Schedule 4 (including Forms 46 to 61);

- the certificate of the appointed actuary prepared under Part II of Schedule 6.

5. The auditors are also required to report on whether the directors' certificate except for paragraph 4(d) of the certificate and, in so far it relates to published guidance which either states that compliance need not be audited or which relates to controls with respect to money laundering, except for paragraph 5 of the certificate. The auditor's report must state whether the certificate has been properly prepared in accordance with the Regulations and whether or not it was unreasonable for the persons giving that certificate to have made the statements contained in it. Paragraph 11 provides that to the extent the information and explanations the auditors have received do not allow them to express this opinion they should add to their report "such qualification, amplification or explanation as may be appropriate".

6. The Insurance Directorate considers that it is appropriate for compliance with most, but not necessarily all, relevant published guidance to be subject to the audit opinion described above. When, periodically, a list of relevant published guidance is circulated (as mentioned in Section 17.1 above), the Insurance Directorate will make clear whether or not it would normally expect an audit opinion in respect of compliance with that guidance. Where audit of compliance with a guidance note is inappropriate (or has not been carried out for some reason), the auditor would be expected to invoke paragraph 11 of Schedule 6 to record the fact.

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2 – the Treasury's explanatory guidance to authorised insurance companies on the preparation of annual returns (1998)

7. Paragraph 10(c) of Schedule 6 provides for the auditors to state the extent to which, in giving their opinion, they have relied on the actuary's certificate with respect to the mathematical reserves and required minimum margins and on an order by the Treasury for the identity and value of any implicit items which are admitted.

8. Forms 31 and 34 relating to years of origin prior to 1981 will contain figures which include information about claims notified and payments made prior to the 1980 Regulations coming into force. Such information was not subject to audit under those Regulations and the relevant figures are excluded from audit under the 1983 Regulations and this exemption was carried forward in the 1996 Regulations by Regulation 29(2)(a)(ii). This is now only relevant to Forms 31 and 34 for accounting class 7, as these forms for the other accounting classes have a ten-year cut off.

9. Paragraph 12 of Schedule 6 provides that where the auditors refer in their report or in any note attached thereto to any uncertainty, the report shall also state whether in the auditor's opinion that uncertainty is material to determining whether the company has available assets over the appropriate solvency margin. This paragraph should not be read as requiring the auditors to refer to an uncertainty. It merely provides that if they do so an additional opinion is required. The Insurance Directorate expects an uncertainty to be treated as material for these purposes if, upon the crystallisation of so much of the uncertainty as is not remote, the required level of available assets would not be met.

Other guidance by the prudential regulators

Prudential guidance on the preparation of regulatory returns
2 – the Treasury's explanatory guidance to authorised insurance companies on the preparation of annual returns (1998)

CHAPTER EIGHTEEN

18. STATISTICAL RETURNS: FORMS 91 TO 94

18.1 Background

1. Forms 91 to 94 do not form part of the Returns but constitute a separate return which must be deposited with the Treasury, (the "statistical return").

2. The statistical return reports insurance business transacted by a UK company in other European Economic Area states either through a branch in that country or on a services basis into that country from an establishment in the UK or another EEA state. For the definition of "UK company" see section 5 of the Insurance Companies Act 1982.

[3. UK companies who wish to establish a branch in or provide services into another EEA state must make the requisite notification to the Treasury under Schedule 2G of the Insurance Companies Act 1982.]

4. The EEA states (other than the UK) are the 14 other EU states (Portugal, Spain, France, Italy, Ireland, Belgium, Luxembourg, the Netherlands, Denmark, Germany, Greece, Austria, Sweden and Finland) and 3 other European states (Norway, Iceland and Liechtenstein).

18.2 The statutory requirement to deposit Forms 91 to 94

1. The requirement to prepare and deposit Forms 91 to 94 is set out in Regulation 81 of the Insurance Companies Regulations 1994. The format of these Forms is laid out in Schedule 16 of those Regulations.

2. A UK company which in any calendar year -

- carries on general business in an EEA state (other than the UK) through a branch in that state should prepare Form 91;
- provides general insurance in an EEA state (other than the UK) through an establishment in the UK or in another EEA state should prepare Form 92;
- carries on long term business in an EEA state (other than the UK) through a branch in that state should prepare Form 93;
- provides long term insurance in an EEA state (other than the UK) through an establishment in the UK or in another EEA state should prepare Form 94.

3. The Forms should be prepared separately in respect of each EEA state in which the company carries on business or provides insurance.

4. The Forms relate to calendar years not necessarily financial years. Three copies of each Form (where required) should be deposited with Treasury within **nine months** of the end of each calendar year. One of the copies should be signed by a director, chief executive or secretary of the company.

5. Where the insurance company has made a notification of its intention to establish a branch in an EEA state or to provide insurance in an EEA state (see paragraph 18.1.3 above) but does not in any calendar year carry on insurance business or provide insurance in that EEA state, it should send notification of that fact to the Treasury within **nine months** of the end of each calendar year signed by a director, chief executive or secretary of the company.

6. Forms 91 to 94 are not subject to audit.

7. No section 68 concession may be granted modifying or exempting companies from the requirement to deposit Forms 91 to 94.

18.3 Inaccurate or incomplete returns

1. Regulation 81 of the Insurance Companies Regulations 1994 requires the Treasury to consider the Forms 91 to 94 or notification deposited under that Regulation and, if any such document appears to him to be inaccurate or incomplete, to communicate with the company with a view to the correction of any such inaccuracies and the supply of deficiencies.

2. The procedure is similar to that described in paragraph 1.4 above for the Returns and the listing of validation rules described in that paragraph as available upon request includes Forms 91 to 94.

18.4 Conventions for completing the Forms

1. The conventions described in chapter four above for the Annual Return Forms should also be applied to the preparation of these Forms, (other than in respect of signature of the Annual Returns for which see paragraph 18.2.4 above).

2. The box in the heading entitled "Member state in which branch is situated" or "Member state in which risk is situated" should be completed with the country code of that EEA state to which the Form relates. [See the annex to chapter ten for these codes.]

18.5 Accounting rules

Other guidance by the prudential regulators

Prudential guidance on the preparation of regulatory returns
2 – the Treasury's explanatory guidance to authorised insurance companies on the preparation of annual returns (1998)

1. The Forms variously call for amounts in respect of premiums, claims, commissions etc. in respect of the branch or services business in the EEA state to which they relate. These amounts should be determined using the same accounting rules as are applied in the preparation of the Returns.

18.6 Forms 82 to 85

1. There are also other statistical Forms (82 to 85) which Regulation 80 of the Insurance Companies Regulations 1994 requires to be prepared in respect of EFTA states and/or in respect of EFTA companies. However at the time of writing there are no EFTA states (within the Insurance Companies Act meaning of that word) and no EFTA companies. Therefore no guidance is given on those Forms.

Dear Director letter 1994/1 – Sound and prudent management: prudential guidance and directors' certificates

The Chief Executive
Any insurance company authorised by DTI
to carry on insurance business

Department of
Trade and Industry

10-18 Victoria Street
London SW1H 0NN

Enquiries
071-215-5000

Fax 071-215-3505

Direct line
Our Ref DD 1994/1
Your ref
Date 1 December 1994

Dear Chief Executive

SOUND AND PRUDENT MANAGEMENT: PRUDENTIAL GUIDANCE AND DIRECTORS' CERTIFICATES

I am writing to draw your attention to two new series of prudential guidance notes and to the implications of such guidance for the Directors' certificate required under paragraph 6A of the Insurance Companies (Accounts and Statements) Regulations 1983, as amended. Under this requirement, on submitting the DTI Return, Directors must list "any published guidance with which the company's systems of control comply or in accordance with which the return has been prepared". Appendix A to this letter sets out the background to two types of guidance - "Systems of Control" and "Preparation of Returns" guidance - which are relevant to the requirement. It also sets out how, in general, DTI insurance supervisors expect to react to the presence or absence of a claim of compliance with published guidance in the Directors' certificate.

For completeness, I should add that by no means all guidance issued by DTI falls into either of the above categories. I attach at Appendix B a list of the guidance issued already or expected to be issued in the remainder of this year. From time to time, we will circulate a list of the guidance which we consider to be "Systems of Control" or "Preparation of Returns" guidance and which are therefore relevant to the Directors' certificate.

The "Preparation of Returns" series of guidance will set out DTI's interpretation of those aspects of the law which are reported on in the DTI Returns. We have always expected companies and their auditors to have appropriate regard to our interpretation during the preparation of the Returns. The new certificate simply formalises this.

Dear Director letter 1994/1 – Sound and prudent management: prudential guidance and directors' certificates

The "Systems of Control" series will set out our views on the issues to be taken into account in setting up and maintaining control systems. It will not contain prescriptive rules for the design of systems.

I am enclosing with this letter a copy of Prudential Guidance Note 1994/6, the first in the series of "Systems of Control" guidance notes. This deals with systems of control over investments and counterparty exposure. It refers particularly to controls over the use of derivatives. As you no doubt know, we lay great stress on the need for a company using derivatives to control that use appropriately. Skilful use of derivatives has great potential for risk reduction and for efficient management of the investment portfolio. However, if inadequately controlled, they also have enormous potential for loss, as a regular stream of case histories in the financial press reveals.

As you will see, Guidance Note 1994/6 is effective in respect of financial years starting on or after 1 January 1995. **We do not therefore expect companies to list compliance with it when submitting their returns in respect of the current financial year (although there is nothing to prevent them from doing so).** However, we do expect companies to make rapid progress towards developing systems which comply with the guidance (or alternatively provide an equivalent level of assurance).

Would you therefore please let the normal DTI supervisor for your company have, after consulting your auditors, and by 31 March 1995, a "state of play" report summarising the extent to which your company's systems already comply with Guidance Note 1994/6 and, if necessary, what remedial action is being undertaken.

If you have any questions arising from this letter, please speak to the normal DTI supervisor for your company or to [redacted].

[redacted]

Head of Insurance Division

"Dear Director" Letter - DD 1994/1

APPENDIX A: BACKGROUND TO GUIDANCE NOTES ON SYSTEMS OF CONTROL AND ON PREPARATION OF RETURNS

Sound and prudent management: adequate systems of control

Following implementation of the 3rd EC Insurance Directives, there is an explicit requirement in the Act that companies are managed "in accordance with the principles of sound and prudent management". The criteria are set out in Schedule 2A to the Act. One of these criteria, listed at paragraph 6(1)(b) of the Schedule is that:

> ***The insurance company shall not be regarded as conducting its business in a sound and prudent manner unless it maintains adequate systems of control over its business and records***

The new Directors' certificate

A new requirement placed on Directors (at paragraph 6A of Schedule 6 to the Insurance Companies (Accounts and Statements) Regulations 1983, as amended) is related to this criterion. On submitting the annual return, Directors are required to list "any published guidance with which the company's systems of control comply or in accordance with with the return has been prepared". Auditors are required to comment on the reasonableness of the Director's statement.

Two kinds of guidance

The regulation envisages two kinds of guidance therefore - "systems of control" guidance and "preparation of returns" guidance.

DTI is working up guidance on various topics in these areas, for example:

- Prudential Guidance Note 1994/6 on systems of control over investments ("systems of control")

- Prudential Guidance Note 1994/7 on Asset Valuation ("preparation of returns")

See Appendix B for a complete current list. However, the wording of the Regulation does not require directors to restrict themselves to listing compliance with guidance produced or endorsed by DTI. They may claim compliance with any published guidance which they consider to be appropriate.

Aims of DTI guidance

The aim of "systems of control" guidance notes is to set out the issues which DTI believes it is important for Directors to consider when setting up their control systems. Guidance will not contain prescriptive rules on how to set up a system.

"Dear Director" Letter - DD 1994/1

Dear Director letter 1994/1 – Sound and prudent management: prudential guidance and directors' certificates

The aim of "preparation of returns" guidance notes is to set out DTI's interpretation of the valuation regulations and other legal provisions relevant to the preparation of the DTI Returns.

Status of guidance

It is not compulsory for companies to comply with guidance. There is no requirement for Directors to state that their systems have failed to comply with guidance. However, it is compulsory for Directors to put in place adequate systems of control. Therefore failure to list compliance with "systems of control" guidance is bound to raise questions in DTI over whether adequate systems of control are in place. Similarly, failure to list compliance with the "preparation of returns" guidance raises questions as to whether the valuation regulations, for example, have been complied with.

Action to be taken by DTI

DTI will publish from time to time a list of the published guidance it considers to be relevant for the purposes of the Directors' certificate. That certificate, when backed up by an audit opinion, will normally be taken to be evidence of adequate control of the areas covered by the guidance. Failure of Directors to give an expected certificate or inability of auditors to give an expected opinion will normally lead to enquiries by DTI as to whether the relevant control system is adequate. This may lead DTI to require the company to commission a comprehensive report from the auditors on the relevant control system or take other appropriate action.

Consultation

DTI will consult companies, the auditing and actuarial professions in preparing its guidance. It will keep the guidance under review in the light of feedback.

"Dear Director" Letter - DD 1994/1

DTI guidance on future profits implicit items (1984)

GUIDANCE NOTE ON APPLICATIONS FOR ORDERS TO COUNT IMPLICIT ITEMS UNDER REGULATIONS 10 TO 13 OF THE INSURANCE COMPANIES REGULATIONS 1981 IN RESPECT OF LONG TERM BUSINESS

INTRODUCTION

1. Article 18.3 of the EC Life Directive provides for three kinds of implicit items, namely "future profits", "zillmerising" and "hidden reserves", to be counted within certain limits towards meeting a company's required margin of solvency in respect of its long term business, at the discretion of the head office supervisor. Effect is given to this in Regulations 11 to 13 of the Insurance Companies Regulations 1981. However, the Regulations define the maxima which can be taken into account and Regulation 10(4) provides that the implicit items shall have no value except in pursuance of an Order under what is now section 68 of the Insurance Companies Act 1982 ("the Act").

2. This Guidance Note sets out the procedures to be followed and the form of calculations and data to be submitted by companies in making applications for orders in respect of long term business. Orders in respect of future profits and zillmerising will be readily available, provided that the relevant requirements set out in this Guidance Note have been satisfied. Orders in respect of hidden reserves will only exceptionally be given.

TIMING

3. Ideally Orders relating to the position at an accounting date would in all cases be issued in time to be brought into account in the statement of solvency forming part of the returns relating to that date. Problems of timing, however, are likely to make it difficult to achieve this aim in practice. The information that will be required to enable an application to be considered, set out in detail below, will in most cases constitute a major part of the information required in the annual returns. Some companies may have difficulty in furnishing this information, certified by the auditors or appointed actuary as appropriate, far in advance of the due date for the submission of the returns. A further practical consideration of particular significance for the many companies with a 31 December accounting date, is that the resources available to the Department and its actuarial advisers will not enable a large number of applications to be processed over a short period.

4. An implicit item in respect of zillmerising or hidden reserves must be closely related to the basis on which liabilities or assets have been valued; also in the case of hidden reserves, as explained below, the granting of an Order will be dependent on the overall solvency position of the company. Orders in respect of these implicit items will, therefore, only be made in relation to the position shown in a particular set of returns and it will be essential for companies to submit applications to the Department well in advance of the latest date for the submission of the relevant returns.

5. The future profits implicit item is calculated on the basis of the average profits over a five year period and it is less important that an Order reflecting the position at the latest

DTI guidance on future profits implicit items (1984)

accounting date should be available at the time that the returns are submitted. In view of the practical considerations referred to above, it will be acceptable for returns to be submitted which demonstrate cover for the required solvency margin on the basis of a current Order in respect of a future profits implicit item issued during the course of the preceding 12 months on the basis of information contained in the previous set of returns. All such returns, however, must be accompanied by an application, certified by the appointed actuary, for a further Order in respect of a future profits implicit item for an amount not less than the amount for which credit has been taken in the returns.

6 Orders cannot be back-dated and may be withdrawn at any time eg on the issue of a new Order based on a further year's returns or where there are grounds for doubt about whether the amount in respect of which an Order has been given can still be justified, having regard to changes in the company's position or as a result of queries arising on the detailed scrutiny of the company's returns.

FUTURE PROFITS

Overriding Limit

7. The maximum amount of the implicit item relating to future profits is determined in Regulation 11 as 50% of the product of the estimated annual profit and of the average period (not exceeding 10 years) to run on the policies in the portfolio. In determining the amount within this limit in respect of which an Order should be made, the Department will wish to be satisfied that the amount does not exceed the value of the margins in the premiums and reserves for the existing business which would in reality be available to meet the effects of adverse contingencies which might arise in the future. The Department will require any application for a section 68 Order in respect of this item to be supported by a certificate from the appointed actuary that the amount sought by the company does not exceed the present value of the profits that may be expected to arise in the future on the long term business in force on the valuation date (see paragraph 23).

Definition of profits

8. The estimated annual profit is to be taken as the average annual surplus arising in the long term fund over the last five years up to the date of the most recent available valuation under Section 18 of the Act which has been submitted to the Department prior to or together with the application. For this purpose deficiencies arising are to be treated as negative surpluses. Where valuations have not been made annually, or a company's accounting year has altered, the surplus arising in a period falling partly outside the relevant five year period should be assumed to accrue uniformly over the period in question for the purpose of estimating the profits arising within the five year period.

9. Where a company has been carrying on long term business for less than 5 years, the total profits made during the past 5 years will be taken to be the aggregate of any surpluses that have arisen

during the period in which long term business has been carried on, less any deficiencies that may have arisen during that period. The resulting total must still be divided by five to obtain the estimated annual profit.

Exceptional items

10. Paragraph (3) of Regulation 11 requires substantial items of an exceptional nature to be excluded from the calculation of the estimated annual profit. For this purpose, such items would include profits arising from an exceptional change in the value at which assets are brought into account, where this is not reflected in a similar change in the amount of the liabilities, and profits arising from a change in the overall valuation approach between one year and another. An exceptional loss (ie a reduction of an exceptional nature in the surplus arising) may be excluded from the calculation only to the extent that it can be set against a profit or profits up to the amount of the loss and arising from a similar cause. It is not intended, however, that any adjustment should be made for the effect on surplus of a net strengthening of reserves nor of costs associated with an expansion of business nor of special capital expenditure, such as the purchase of a computer.

Double Counting

11. The inclusion of investment income arising from the assets representing the explicit components of the solvency margin as part of the estimated annual profit for the purpose of determining the future profits implicit item would result in double-counting. If those assets were required to meet the effects of adverse developments, this would automatically result in the cessation of the contribution to profits from the associated investment income. It would clearly not be appropriate for the Secretary of State to issue an Order which would enable a company to meet the solvency margin requirement on the basis of counting both the capital values of the assets and the value of the income flow which they can be expected to generate.

12. The definition in Regulation 11(4) of the estimated annual profit as the surplus arising in the long term fund* ensures that any contribution to surplus arising from transfers from the profit and loss account, including investment income on shareholders' assets, is not included in the estimated annual profit. Thus double-counting should not arise in respect of shareholders' assets. Double-counting may arise, however, in respect of the investment income from the assets representing the explicit components of the solvency margin carried within the long term fund (eg surplus carried forward or investment reserves) but the amount of such investment income is not separately identified in the returns. Where there is reason to suspect that the elimination of any such double-counting would reduce a company's solvency margin to close to or below the required level, or would otherwise be significant, further information will be sought with a view to taking account of this factor in determining the amount of the implicit item in respect of which an Order is made. It is not

* line 15 on Form 58

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necessary for such additional information concerning investment income to be furnished with an application for a Section 68 Order, unless a company believes that any double-counting would fall into one of the categories mentioned.

AVERAGE PERIOD TO RUN

Basis of calculation

13. The average number of years remaining to run on policies should be calculated on the basis of the weighted average of the periods for individual contracts, using as weights the actuarial present value of the benefits payable under the contracts. An early opportunity will be sought to provide for this in the regulations. A separate weighted average should be calculated for each of the various categories of contract and the results combined to obtain the weighted average for the portfolio as a whole. Approximate methods of calculation, expected to give results similar to the full calculation, will be permitted and, in particular, the calculation of an average period to run for a specific category of contract on the basis of the average valuation factor for future benefits derived from Schedule 4 data will be accepted. A company will be required to demonstrate the validity of the method adopted only where an abnormal distribution of the business in force gives grounds for doubt about its accuracy.

14. Calculations will be required only for the main categories of business, accounting for not less than 90% of the mathematical reserves, except where there are grounds for expecting that the exclusion of certain categories of policies under this provision might have a significant effect on the resulting average period to run. Detailed calculations will not be required where a section 68 Order is sought in respect of a low multiple of the annual profits, well within the average period to run for the company.

15. Where, for a particular category of business, a method of valuation is used which does not involve the calculation of the value of future benefits and which is significant for the company in question, the calculation of the average period to run should be used on estimates of the value of future benefits. For non-linked benefits, these estimates would normally be available from the demonstration required under para 7(d) of Schedule 4 that the reserves are not less than those obtained on the basis of a net premium valuation; otherwise special estimates of the value of future benefits may have to be made specifically for the purpose of the application. In the case of regular premium unit linked contracts, where the method of valuation does not involve estimating the value of benefits to be purchased by further premiums, the value of benefits should be taken to be the reserves currently held (unit and non-unit liabilities) together with the present value of the portions of future premiums which are to be invested in units under the terms of the contracts.

Premature termination of contracts

16. Allowance must be made for the premature termination of contracts, based on the actual experience of the office over the preceding five years, and taking into account specific features of

contracts such as options which can be expected to lead to premature termination, eg guaranteed surrender values on income bonds written as long term contracts and option dates on flexible whole - life contracts. The adjustment should be made separately for each of the main categories of business. The use of industry-wide rates of termination will be acceptable where the actuary is satisfied that this will result in sufficient allowance being made having regard to the office's own experience. Methods of calculation which involve a degree of approximation will be permitted.

17. For certain types of contract, where the period left to run is most naturally defined as the term of a fixed maturity or expiry date, the allowance for premature termination will also need to take into account terminations resulting from death.

Overall limit

18. The overall average period left to run calculated as described above must be limited to a maximum of ten years before applying it to the estimated annual profit in order to determine the maximum value of the future profits implicit item.

Definition of period to run

19. The definition of the period to run and the basis of the allowance for early termination must clearly be considered together. For certain types of contracts, eg pension contracts with a range of retirement ages or other options, there is inherent uncertainty about the likely term to run. In such circumstances any estimate for determining the amount of the future profits implicit item for which an Order is sought must be based on prudent assumptions tending, if anything, to underestimate the average period to run.

20. On this basis, suitable definitions of the period to run for the various types of contract for the purpose of the calculations are shown in an Annex to this note. Except for group pension schemes, the definitions are before allowance for premature termination on account of lapse or surrender. Applications based on alternative definitions of the period to run will be considered as long as it can be shown that the definitions used in conjunction with the allowance for premature termination may be expected to result in a conservative estimate of the average period to run.

21. The rationale for the definitions shown will in general be self-evident but some explanation may be appropriate for the standard period to run of ten years suggested for group pension schemes. It is recognised that the operations of group pension schemes normally extend over very long periods. However, the terms on which the business is transacted are often not guaranteed very far ahead and for the more common types of contract there is no financial penalty on the discontinuance of future premiums, which are in any event indeterminate. Having regard to the changes which have occurred in the methods of funding occupational schemes and in the choice of investment media over relatively short periods in the past, it is not considered that there is any basis for determining prudent assumptions in regard to rates of discontinuance of future

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premiums under these schemes. There are also major practical difficulties in determining the amounts and the incidence of payment of future benefits under schemes.

22. In these circumstances, both to ensure a prudent result and on practical grounds, it is considered that for the purpose of determining the weight to be given to group pensions business in determining the average period to run for a company's business as a whole, regard should be had only to the value of benefits secured by past premiums; and that having regard also to the limit of ten years on the overall average period to run, this period should normally be taken, arbitrarily, as the average period to run for all group pensions business, other than for schemes funded by individual regular premium deferred annuity contracts.

<u>Actuary's certificate</u>

23. An application for a Section 68 Order in respect of a future profits implicit item should be supported by a certificate from the appointed actuary stating that the amount sought by the company does not exceed the lower of:

(i) the amount calculated in accordance with Regulation 11 applied on the basis set out in the Guidance Note on Applications for Orders to Count Implicit Items; and

(ii) the present value of the profits that may be expected to arise in the future on the long term business in force on the valuation date.

24. For the purpose of (ii), "profits" is to be defined as the surplus arising in the long term fund attributable to the business in force at the valuation date. To avoid double counting, no account shall be taken of any future surplus arising from assets corresponding to explicit items which have been counted towards the solvency margin such as shareholders funds, surplus carried forward or investment reserves; also regard shall be had to the capitalisation of future profits implicit in any Order in respect of a zillmerising implicit item (see paragraph 27 below).

25. In giving his certificate, the actuary's assessment of future profits under (ii) above should be based on cautious assumptions in regard to the future experience, in many respects similar to those required for the minimum basis for calculating mathematical reserves. However, the retention of the 7½% contingency margin in the rate of interest is not required for this purpose, and credit may be taken on a prudent basis for margins in the future premiums payable under existing contracts. Credit may also be taken where appropriate for future increases in equity dividends and rents on prudent assumptions consistent with the assumptions in regard to future rates of interest and inflation of expenses.

26. Where the Department considers it necessary, information will be sought from the appointed actuary on the assumptions underlying his assessment of future profits for the purpose of his certificate but a statement of the basis need not be included as part of the application for an Order. It is likely, however, that this additional information will be requested in all cases where there

are grounds for suspecting that recurrent profits from the business in force do not account for the major part of the past profits brought into account.

ZILLMERISING

27. Regulation 12 provides for an implicit item to be counted towards the required solvency margin in respect of unzillmerised or only partially zillmerised reserves. The maximum additional amount which may be counted is defined as the amount by which the reserves would have been reduced if they had been zillmerised at a rate equal to the loading for acquisition costs included or allowed for in the premiums, subject to this not exceeding 3.5% of the aggregate of the difference between the mathematical reserves and the relevant capital sums.

28. The reduced mathematical reserves which are implicit when an amount on account of zillmerising is counted towards the solvency margin must still satisfy the requirements of Part VI of the Insurance Companies Regulations 1981. An application for an Order must be supported by a certificate from the appointed actuary that the amount applied for has been calculated in accordance with Regulation 12.

29. An implicit item in respect of zillmerising is not permitted for term assurance or permanent health insurance and will only be applicable in the case of linked contracts where a net premium method of valuation has been used. It is recognised that some modification of the definition in Regulation 12(4)(e) of the relevant capital sum for linked contracts is required and companies wishing to apply for an Order for an implicit item on account of zillmerising for this type of business should seek further guidance from the Department.

HIDDEN RESERVES

30. The provisions for counting hidden reserves as an implicit item towards the solvency margin specifically exclude hidden reserves arising from the overestimation of the mathematical reserves, so that this item can arise only in respect of undervaluation of assets or overestimation of balance sheet liabilities other than mathematical reserves.

31. Undervaluation of assets could occur in principle, where the Regulations do not permit any value to be ascribed to certain categories of assets, or where the value to be taken into account has been limited by the admissibility rules under the Regulations, or where an up to date valuation of investments in property has not been obtained.

32. To allow amounts explicitly excluded under the asset valuation regulations to be counted towards the solvency margin would be tantamount to nullifying the effect of those regulations. It is envisaged that concessions allowing such inadmissible assets will rarely, if ever, be given.

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INFORMATION TO BE FURNISHED

33. An application to the Department for an Order under Section 68 should state clearly the nature and the amounts of the implicit items which a company wishes to count against its required margin of solvency. The application should be accompanied by full supporting information to enable the Department to arrive at a decision on the merits of the case, including where appropriate the certificates of the appointed actuary referred to in paragraphs 23 and 28 above.

34. Applications for an Order in respect of a hidden reserves implicit item will normally be considered only if accompanied by the full Schedule 1, 3 and 4 returns. Applications for a future profits implicit item should be supported by Forms 13, 14, 40, 41, 42, 45, 46, the answers to questions 1 to 10 of Schedule 4 and Forms 55, 56 and 58; for a zillmerisation implicit item only the last four items listed ie those forming part of Schedule 4 will be required.

35. In addition the following information relating to the calculation of the amounts claimed should be supplied:-

Future profits: the profits made in each of the preceding five years and the amounts and nature of any exceptional items left out of account; the method used for calculating the average period to run and the results for each of the main categories of business, both before and after allowing for premature termination (where the calculation has been made in two stages) and the basis on which this allowance has been made.

Zillmerising: the categories of contracts for which an item has been calculated and the percentages of the relevant capital sum in respect of which an adjustment has been made.

Hidden reserves: particulars, with supporting evidence, of the undervaluation of assets or the overvaluation of liabilities (other than mathematical reserves) for which recognition is sought.

Department of Trade and Industry

October 1984

ANNEX

Definitions of the period left to run for various types of contracts for the purpose of Regulation 11(2) of I.C.R. 1981

Whole life assurances.

The expectation of life

Open ended whole-life assurance.

The expectation of life

Endowment assurances and pure endowments.

The period to the fixed maturity date.*

Flexible endowments.

The period to the first date of a guaranteed cash option.*

Temporary assurances.

The period to the expiry date.*

Deferred annuities with cash options.

The period to the vesting date; where the annuity can be taken at any age falling within a prescribed range, the earliest date.*

Deferred annuities without cash options.

The expectation of life for the age attained.

Annuities in payment.

The expectation of life; for temporary annuities, the period to the expiry date.*

Group life schemes.

The unexpired duration of the period for which the premium rates are guaranteed.

Group pension schemes

(i) by individual deferred annuity contracts
as under deferred annuities above.

(ii) by deferred annuities under controlled funding
a period of 10 years.

* In these cases mortality during the term should be covered by the adjustment for the premature termination of contracts.

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(iii) by deposit administration
a period of 10 years

(iv) by managed fund.
a period of 10 years.

Permanent Health Insurance.

For individual policies, the period to the expiry date;* for group contracts, the unexpired duration of the period for which the premium rates are guaranteed.

Capital redemption

The period to the fixed maturity date.

Income and growth bonds

The period to the expected date of surrender.

* In these cases mortality during the term should be covered by the adjustment for the premature termination of contracts.

CONTENTS

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GOVERNMENT ACTUARY'S DEPARTMENT

INSURANCE SUPERVISORY WORK

GUIDANCE MANUAL

A. INTRODUCTION

A.1 This manual is intended to help staff in C division, in carrying out scrutinies of long term business returns.

A.2 The manual guides the reader through the basic or standard aspects of the scrutiny work. It gives a structure for dealing with matters that are common to all or nearly all scrutinies or which frequently arise. The manual does not remove the need for actuaries to exercise professional judgement and to consider matters not covered by the manual.

A.3 The manual is looseleaf and it is intended that it will be kept up to date, by the provision of amended pages. Anyone becoming aware of errors or omissions is asked to draw them to the attention of the editor for the time being. This edition was revised in April 1992 by [redacted]. [redacted] is the current editor.

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B. ABBREVIATIONS

DTI	-	Department of Trade and Industry
DTIGN	-	Guidance Notes on the Preparation of Annual Returns issued by DTI in September 1984.
FSA 1986	-	Financial Services Act 1986
GAD	-	Government Actuary's Department
G.N.8.	-	Guidance Note 8 issued by the Institute and Faculty of Actuaries.
The Act	-	Insurance Companies Act 1982 (unless in the context another act is clearly being referred to)
ICR 1981	-	The Insurance Companies Regulations 1981 (SI 1981 No. 1654) as amended by The Insurance Companies (Amendment) Regulations 1985
ICAS 1983	-	The Insurance Companies (Accounts & Statements) Regulations 1983 (SI 1983 No. 1811)
EEC	-	European Economic Community

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C. GENERAL FRAMEWORK OF SUPERVISION

C.1 All companies doing insurance business in the UK are subject to supervision by the DTI. Companies wishing to do business must apply to the DTI for authorisation.

C.2 Companies whose head office is in an EEC country other than the UK are subject to supervision by their own authorities, and DTI supervises only the company's UK business. An exception to this is where the company does reinsurance business only. Such pure reinsurers are not supervised in other EEC countries. If they do business in the UK they are subject to full control by DTI.

C.3 The reason for the exceptional treatment of reinsurers is (briefly) that in continental countries the practice is for reinsurers to deposit reserves with the ceding company, so the insolvency of a reinsurer would have little effect on the ceding company, or its policyholders. In the UK it is more common for reinsurers to hold substantial reserves.

C.4 DTI supervises the whole business of a company which does business both in the UK and overseas, subject to C2 and C3 above and to some special arrangements in individual cases.

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C.5 The main object of supervision by DTI is to ensure that a company has at the time of the relevant returns adequate assets to meet its liabilities and solvency margin, the assets and liabilities being assessed in accordance with standards laid down by legislation, and supported by actuarial practice. DTI is also concerned as to whether a company is likely to remain solvent, having regard to its future new business plans and plans for capital injection. On a rather different issue, DTI is concerned to ensure that policyholders' "reasonable expectations" will be met.

C.6 DTI does not have any obligation to regulate the market, or to ensure that companies can operate profitably. The EEC Life Directive prohibits Member States from taking the economic requirements of the market into account when dealing with applications for authorisation.

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C.7 The main legislation which enables DTI to try and achieve these objectives is as follows:-

(i) Insurance Companies Act 1982, which was itself a consolidation of earlier legislation.

(ii) The Insurance Companies Regulations 1981 (SI 1981 No. 1654). These are the main regulations under the Act, and came into force on various dates up to 1.10.82.

(iii) The Insurance Companies (Accounts & Statements) Regulations 1983 (SI 1983 No. 1811). These state the information which must be given in the returns and specify the forms to be used.

Regulations such as these cover matters on which the relevant Act enpowers the Secretary of State to make regulations. For completeness, each regulation should be read in conjunction with the section of the Act from which it arises.

ICR 1981 cover matters of action, as distinct from ICAS 1983 which cover matters of report.

The *Financial Services Act 1986* created the supervisory bodies, SIB, LAUTRO, FIMBRA etc and regulated the selling of insurance as well as other financial services. Section 136 of FSA created a new Section 31A in ICA. 1982.

The Policyholders' Protection Act 1975 is occasionally relevant. It sets up a fund, for indemnifying UK policyholders of failed companies. The fund is supported by a levy made from time to time on authorised companies carrying on business.

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:.8 Insurance companies legislation currently in force.

SI No		Title
1981/1654		The Insurance Cos. Regs. 1981, as amended by:
	1982/675	The Insurance Companies (Amendment) Regulations 1982
	1983/396	The Insurance Cos. (Advertisements) (Amendment) (No 2) Regs 1983
	1985/1419	The Insurance Companies (Amendment) Regulations 1985
	1988/673	The Insurance Companies (Amendment) Regulations 1988
	1990/1333	The Insurance Companies (Amendment) Regulations 1990
1983/224		The Insurance (Lloyd's) Regulations 1983
1983/1811		The Ins. Cos. (Accounts and Statements) Regs. 1983
	1988/672	The Insurance Cos. (Accounts and Statements (Amendment) Regs. 1988
	1989/1952	The Insurance Cos. (Accounts and Statement) (Amendment) Regs. 1989
1985/95		The Insurance Companies (Winding-Up) Rules 1985
1986/2002		The Insurance Cos. (Winding-Up) (Amendment) Rules 1986
1986/1918		The Insurance Cos. (Winding-Up) (Scotland) Rules 1986
1987/2118		The Insurance Cos. (Mergers and Divisions) Regs. 1987
1987/2130		The Insurance Companies (Assistance) Regulations 1987
1991/621		The Insurance (Fees) Regulations 1991
1990/1159		The Insurance Cos. (Legal Expenses Insurance) 1990
1990/1160		The Insurance Companies (Legal Expenses Insurance) (Application for Authorisation) Regulations 1990
1990/1181		The Insurance Companies (Credit Insurance) Regulations 1990
1990/1207		The Insurance Companies (Transfer of Long Term Business) Regulations 1990
1991/2511		The Insurance Companies (Linked Contracts) (Amendment) Regulations 1991
1991/1999		The Insurance Cos. (Amendment) Regulations 1991

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C.9 The Act and the regulations impose a number of obligations on companies.

(i) For Long Term business, an actuary must be appointed, possessing prescribed qualifications. S19 of the Act & Reg. 28 of ICAS 1983.

(ii) Adequate mathematical reserves must be kept. Minimum bases for this purpose for valuation of liabilities and assets are laid down. Regs 37-64 of ICR 1981.

(iii) Assets representing the long term fund must be segregated from other assets. S28 of the Act. S29 is also relevant.

(iv) In addition, a solvency margin must be maintained. S32 of the Act & Regs. 3-13 of ICR 1981.

(v) Extensive returns must be made to DTI to demonstrate compliance with (ii) (iii), and (iv) and for other purposes. S17 & S18 of the Act.

(vi) There are requirements relating to the proportions of surplus distributed to policyholders. S30 of the Act.

(vii) There are numerous other provisions, most of which are of lesser importance as far as GAD is concerned, though they may be of considerable importance to the company or its policyholders.

Under S68 of the Act DTI have the power to direct that some of these obligations are not applied or are modified.

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C.10 At the discretion of DTI, it can impose other sanctions:

(i) Authorisation will not be granted, or an existing authorisation may be withdrawn if any of the directors or controllers are not "fit and proper". S60 (3) of the Act.

(ii) It can ask for a valuation report in mid-year. S42 of the Act.

(iii) It can require assets to be held in trust. S40 of the Act.

(iv) It can withdraw authorisation to write new business or limit the amount written. S11 of the Act.

(v) As a last resort it can present a petition for the winding up of the company. S54 of the Act.

(vi) DTI's powers in relation to recently authorised companies ("companies under tutellage") are somewhat more extensive than for others. In particular such companies may have to submit quarterly returns. Companies whose controllers have changed also come under this heading.

C.11 No control is exercised over the level of premium rates. In this respect the UK differs sharply from many other countries. Our main concern, where rates are thought to be inadequate, is that adequate reserves are maintained. We are also, of course concerned that the company remains solvent in spite of the new business strain.

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C.12 The reader should be aware of the EEC Life Directive. Unlike most other EC Directives, the Life Directive does not have direct legislative effect in the UK, but most of its provisions have been incorporated in the Act.

C.13 The various guidance notes issued by the Faculty and Institute do not, yet, have the force of law, and DTI have no powers to require Fellows to comply. Nevertheless it is possible to exert considerable pressure on actuaries to comply (whether Fellows or not), and it is reasonable to regard the guides as a de facto part of the general framework of supervision.

C.14 The Insurance Division of the DTI issued in September 1984 a document entitled

"Guidance Notes on the Preparation of Annual Returns"

This document is too bulky for it to be sensible to reproduce it in this manual, but actuaries who carry out detailed scrutinies should be aware of its contents and may need to refer to it when writing to companies or to the DTI.

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D. THE FUNCTIONS OF GAD IN CARRYING OUT SCRUTINIES OF LONG TERM BUSINESS

D. 1 GAD advises DTI and the final decision on formal action on behalf of the Secretary of State must always be taken by DTI. However, GAD may initiate enquiries direct to companies (but not to auditors nor, in the first instance, to appointed actuaries). The relationship between GAD and DTI is set out in an agreement between the two departments dated 12 June 1984. The key points of the agreement are covered by these Guidance Notes.

D. 2 GAD is given the major share of the responsibility for the examination of the statutory returns relating to long term business and for pursuing technical questions arising directly therefrom with insurance companies.

D. 3 The primary objectives of each scrutiny are:

(i) to form a view about the solvency position of the company in respect of its long term business and to determine whether, at the date of the return, the company had and whether, in the foreseeable future, it seems likely to continue to have, the margin of solvency required in respect of that business.

(ii) to determine whether the return in respect of long term business appears to comply with relevant statutory requirements (whether arising from legislation, directions, notices of requirements or conditions contained in concessionary orders) or with undertakings given by the company.

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D. 4 In scrutinising the returns of recently authorised companies we should check the results against the new business plan and query any material departures, particularly if any increased strain is possible.

D. 5 Many newly authorised companies will have Requirements to produce quarterly returns. The object of getting these is to spot undesirable trends without waiting for the next annual returns, which may be received up to 15 months later. This should be borne in mind when deciding whether to raise any questions. Compliance failures should be dealt with if there is any danger of the mistake being repeated in the annual returns, or if they are otherwise important.

D. 6 DTI have their own legal and accounting advisers and any opinions we express in these areas should be subject to confirmation by the adviser. There are some matters on which it would be undesirable for us to comment at all, but on other matters our specialised experience may help us to see matters more clearly than these advisers (who may have little experience of life assurance).

D. 7 In our work on individual companies we act as advisers to DTI. We may raise with a company or, with its agreement, its appointed actuary any points on its annual return which we consider require clarification. Any correspondence between us and a company and its advisers and notes of any meetings held with them should be copied to DTI. If we feel some formal action by DTI may be necessary we should write to them explaining the circumstances.

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D. 8 We can say to an actuary through his company that a basis conflicts with Regulations, but in questioning his judgement some tact is necessary. "What are the actuary's reasons for not holding such and such a reserve?" rather than "The actuary must keep a reserve...". Occasionally we can say "As a matter of policy this department considers that ...".

D. 9 If a company's business is straightforward and we have no concerns we should not ask for information which is not required, explicitly or implicitly, by the Regulations, but where there is anything which suggests concern we should not hesitate to ask for further information to be given. If the matter is one the public should know about, particularly where the returns are misleading, we should ask through DTI for an amendment to the returns. A middle course is to ask for an answer by letter and for future returns to be amended.

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D. 10 The progress of each company's Returns through the stages of Scrutiny is recorded as a progress schedule produced on the network computer. This schedule also provides a reminder system for correspondence.

The progress codes are as follows:

1. Returns received from DTI.

2. Forms A1, B and C completed.

3. Initial scrutiny completed.

4. Detailed scrutiny started.

5. Detailed scrutiny letter and report issued.

6. Final report sent to DTI, points in detailed scrutiny letter having been cleared.

7. Returns not due to be received from company (or other special situation).

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E. INITIAL SCRUTINIES

E.1 The main purpose of the initial scrutiny of returns is to determine whether there is a serious problem in relation to the company. We also want to do sufficient work on the returns to be able to allocate an appropriate priority for the detailed scrutiny.

E.2 We should notify DTI of any obvious points best raised straight away with the company. These generally come into one of two categories. Major matters on which we want an immediate answer and minor matters (such as the absence of information on the appointed actuary's earnings) which are straightforward matters on which there is little point in delaying, once they have been identified.

E.3 Forms A1, A2, B and C give a guide to matters which should be examined at the initial scrutiny stage. A general brief browse through the returns is however also appropriate.

E.4 Most matters should merely be identified (rather than fully investigated) at the initial scrutiny stage, as time spent on these scrutinies should be kept to the minimum consistent with identifying the main aspects.

E.5 The following extract from the agreement between DTI & GAD sets out in detail the points to be covered by initial scrutinies.

ACTIVITIES TO BE CARRIED OUT BY GAD

<u>Initial action on the annual returns by GAD</u>	24	GAD will advise I Division if the annual return of a company has not not been received by GAD within six weeks of the due date (allowing for any extension granted to the company).

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25 As soon as possible after the receipt of the annual return of a company from I Division, GAD will carry out an initial scrutiny of the return with a view to advising I Division of any serious solvency or compliance problems in respect of the company's long term business and to determine an order of priority for GAD's main examination of the returns. This will be carried out in accordance with the following paragraphs.

26 GAD will advise I Division immediately if the return suggests that a company has failed to meet the long term business solvency margin requirements or is otherwise in financial difficulty.

27 GAD will examine the directors', actuary's and auditors' certificates to ensure that they have been properly completed in accordance with the regulations in respect of long term business. GAD will advise I Division immediately of any serious cases of non-compliance, which will require amended certificates to be submitted. GAD will draw attention at the same time to any significant qualifications in any of the certificates.

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28. GAD will make an initial examination of those parts of the return relating to long term business which are not subject to computerisation (Form 43-51 of Schedule 3 and Schedules 4 and 5) and check that they appear to have been properly completed. GAD will advise I Division immediately if it appears that any significant information has not been provided or that there are significant errors in the information which will require revised or additional information to be submitted by the company.

29. GAD will make an initial examination of Form 58 (Valuation result and distribution of surplus) to determine whether it suggests that there has been a breach of Section 30 of the Act (allocation of surplus to with-profits policyholders). GAD will advise I Division immediately if any such breach appears to have occurred.

Classification of companies by priority

30 As a result of their initial scrutiny of the annual returns, including consideration of the actuary's valuation basis, GAD will give each company a priority rating for the purpose of carrying out the main examination of the returns. There will be four categories of priority rating determined in accordance with criteria set out at Annex A.

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NGS TO BE ADOPTED BY GAD

ANNEX A

RITY		CRITERIA	EXAMINATION PROGRAMME
nt	i)	Company has failed to maintain its required solvency margin (RSM); or	Detailed examination to be carried out within days of receipt of the company's return by GAD.
	ii)	apparent weaknesses in the valuation basis suggest that the RSM might not be covered.	
1 Priority	i)	Company has maintained its RSM but its declared solvency margin is less than 125% of RSM and there is no reason to suppose that significant hidden margins exist; or	Detailed examination to be carried out as soon as possible. Even less urgent companies in this category would normally all be examined within four months of the due date for submission of the returns to I Division.
	ii)	Company appears to have failed to comply with the regulations in material respects.	
dium Priority	i)	Company has a declared solvency margin of between 125% of RSM having regard to the likely level of hidden margins and has no obvious problems of compliance; or	Detailed examination normally to be carried out within ten months of the due date for submission of the returns to I Division.
	ii)	Company has higher solvency margin cover but doubts exist over certain aspects of the returns.	
ow Priority	i)	Company appears to have a solvency margin of at least 200% of RSM having regard to the likely level of hidden margins and has no obvious problems of compliance; or	Detailed examination to be carried out at least once in every three years (see examinations will be carried out within twelve months of the due date for submission of the returns to I Division.
	ii)	Business of company is inherently low risk and solvency margin appears adequately covered.	

E.6 Those companies which have had a detailed scrutiny in the previous year, or the year before that will be rated priority 5 (this is an internal GAD rating and not a DTI rating). A fuller initial scrutiny will be made and DTI notified that no further detailed scrutiny will be made in respect of these returns.

MAN/E6/4.92

F. RECOMMENDED STRUCTURE FOR DETAILED SCRUTINY

F. 1 Each actuary will want to develop his own system. The system described below may however provide a helpful base - in that it has some logic, and covers in general terms the various aspects.

F. 2 Start a "note sheet". Notes will be accumulated on this sheet throughout the detailed scrutiny and used as a basis for the report to DTI and letter to the company. Normally it will be appropriate to put the note sheet on the file after the report and letter have been drafted.

F. 3 Transfer initial scrutiny notes to the note sheet.

F. 4 Look through the file for the past few years and note key points on the note sheet, including matters from the previous year's return which we expect to be treated differently in the current year's return, and points from press cuttings which may be relevant to the scrutiny.

F. 5 Go through the Report & Accounts and returns, making notes on the note sheet of matters that probably need to be raised. It is probably best at this stage not to spend too long investigating particular points. That can come after all the points have been noted. In this way the flow of the job is not interrupted.

F. 6 Compare the current year's returns with the previous year's. This brings out the differences, which may need special consideration. Make notes on the note sheet as necessary.

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F. 7 Add to the note sheet any "standard" points such as "Comment on valuation basis" or "Report on Bonuses to DTI" or "Comment on free reserves", if these matters have not yet found their way to the note sheet.

F. 8 Go through the points on the note sheet, investigating those that need to be investigated, deleting those which on further consideration need no comment to company or DTI, and marking the remainder C, A or D, according to whether they are matters for the company, the actuary or DTI. (This process may reveal further points that need to be noted).

F. 9 Write to the company & DTI, using the items marked C, A or D as a basis, and putting a tick through the letters C, A or D as they are incorporated. This provides a simple check that items have not been omitted.

F. 10 For detailed scrutinies where there are a lot of points to be raised, it may be helpful to write about each point on a separate sheet of paper, and then arrange the sheets in a sensible order. This avoids having to think about the structure of the letter/DTI report, while composing the individual parts.

F. 11 The letter to the company should normally start with a paragraph on the following lines:

> "We have some comments and questions on the returns and would be glad to have your response, to assist us in advising the Department of Trade and Industry. Points .... are matters for the company and the remaining points are matters for the appointed actuary, from whom we would be glad to hear directly, if that would suit both you and him."

MAN/F7-11/4.92

G. RETURNS - GENERAL

G.1 Check or spot check that previous year's column 1 entries are in general reproduced in the current year's column 2 (where there is provision for previous year's figures). DTIGN 6.5.2

G.2 Consider whether any further checking of the points in the initial scrutiny Form A1 is required, as these answers will not have been independently checked.

G.3 1990 and Later Returns

Form A1 will have been annotated to show whether the Directors' Certificate includes the new subparagraph 6(e) "in the case of a company to which Section 31A of the Insurance Companies Act 1982 applies, that the company has fully complied with the requirements of that Section."

As this will apply, almost without exception, to the long term companies scrutinized by GAD, any omission of 6(e) should be reported to DTI.

MAN/G1-3/4.92

H. RETURNS - SCHEDULE 1 OF A & B REGS 1983

Check that there is a note in terms of section 10 (2).

FORM 9 - Statement of Solvency

(This form brings forward a Summary of the most significant figures from elsewhere in the Returns).

Consider ratio of 9.34.1 to 9.41.1 compare with same ratio for previous years. Is there cause for concern? Relate to surplus or deficiency arising (58.15).

In practice only implicit items in respect of future profits are allowed and must be subject to a Section 68 Order. Reference to that Order must be made in the Notes to the Returns. For procedure to approve application for such an order see Section S.

Note allocation between 9.51.1 and 9.52.1. 9.13.1 will show the excess of available assets allocated to general business; this excess may be of a size to give some comfort.

FORM 10 - Statement of Net assets

(Another Summary form).

Compare 10.29.1 minus 10.29.2 with 16.39.1. If unequal look for an explanation (eg increase in share capital or change in amount of inadmissible assets). Otherwise consider asking for a reconciliation.

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__FORM 13__ - Analysis of Admissible Assets. There must be a separate Form 13 for the "Other than Long Term" Fund and for each Long Term Fund. (DTIGN 7.6.1)

The detail will give a general indication of whether types of investment are similar to or different from previous year's. If different consider why, and perhaps ask.

Remember that 13.85 = 49.12 and 13.86 reconciles with F.47.

13.94.1 may be of interest. A high figure may indicate scope for increasing admissible assets by sale of inadmissible and purchase of admissibles.

Consider checking Form 13 against Form 45 to ensure that Form 45 entries correspond.

See Section R for guidance on loans.

Net amounts must not be negative (DTIGN 7.1.1)

Check that value of subsidiary insurance companies is in accordance with ICR 40. (DTIGN 7.3.3)

[redacted] has produced a note (see over) indicating the changes that have occurred during 1991. Any marked divergence in the performance of asset value of a particular company is an indication that further investigation is needed.

MAN/H13/4.92

LIFE COMPANY
ASSET PERFORMANCE IN 1991

A. STOCK EXCHANGE SECURITIES
Equities
Equity portfolios should have increased in value by about 15%.

The FT-Actuaries All-Share Index rose 15.06%.
The larger company FTSE-100 Index rose 16.3%.
Diversification overseas should have improved on these capital gains.
Although Germany (up 8.1%, in Sterling terms) and Japan (up 12.3%, thanks to a rise in the Yen) might have slightly inhibited performance, overall Europe Ex.UK rose by 11.7%, while the USA and Australian markets both showed Sterling index gains of over 31%, with Hong Kong up by 49%. (See attached sheet for details.)

Fixed Interest Investments
British Government Fixed Interest stocks rose by about 5%, while other high quality fixed interest stocks climbed further, by up to 10%, as long yields fell.

(**Index-Linked Gilts** showed capital appreciation of only about 2%, although short dated issues rose by up to 10%.)

B. PROPERTY
While Property Company shares fell in value by about 18% during 1991, this poor performance was exacerbated by their gearing and greater involvement in new developments. I would expect to see most direct investment property portfolios written down by between 5% and 15%.

C. MORTGAGE LOANS
This is again likely to be the most problematic investment area. Defaults in interest payments lead on to questions relating to the security of capital. In many cases, provisions should have been set up against both interest arrears and capital values.
A particularly vulnerable area relates to loans to subsidiaries, which are themselves involved in either mortgage lending or property development.

CONCLUSIONS
A standard office (with an investment portfolio split 60% Equity, 25% Fixed Interest, 10% Property and 5% Cash, say), should show capital appreciation of nearly 10%.
However, a company with large property holdings will have done worse, and a company with property lending commitments may have needed to make substantial provisions against capital losses.

NOTE - Expected Prospective Portfolio Yields as at 31.12.1991

Equities:	Between 5% (UK) and 3.5% (if spread overseas)
Fixed Interest Gilts:	Between 10% and 9.5%
Other Fixed Interest:	Between 12% and 11%

MAN/H.13/4.92

MOVEMENT IN FT-ACTUARIES WORLD INDICES OVER 1991

MARKET	LOCAL CURRENCY 31.12.90	31.12.91	% CHANGE	STERLING INDEX 31.12.90	31.12.91	% CHANGE
Australia	101.80	132.03	29.70	90.69	119.53	31.80
Austria	152.97	131.21	-14.23	151.06	131.96	-12.64
Belgium	100.92	111.24	10.23	101.57	114.38	12.61
Canada	109.27	114.14	4.46	99.89	108.00	8.12
Denmark	182.80	214.65	17.42	178.71	211.69	18.45
Finland	78.46	67.71	-13.70	79.23	61.82	-21.97
France	105.14	122.30	16.32	101.21	119.21	17.78
Germany	86.98	92.53	6.38	85.96	92.97	8.15
Hong Kong	121.97	176.14	44.41	93.57	139.75	49.35
Ireland	117.69	135.31	14.97	114.05	132.97	16.59
Italy	65.97	64.67	-1.97	60.16	59.74	-0.70
Japan	106.98	107.28	0.28	95.84	107.63	12.30
Malaysia	220.67	224.45	1.71	162.96	169.72	4.15
Mexico	1886.99	4625.45	145.12	448.97	1102.37	145.53
Netherlands	103.12	119.09	15.49	102.92	120.98	17.55
New Zealand	39.21	46.17	17.75	33.34	37.23	11.67
Norway	163.03	144.75	-11.21	156.92	141.67	-9.72
Singapore	127.60	164.00	28.53	122.35	174.08	42.28
South Africa	136.21	172.99	27.00	140.49	197.23	40.39
Spain	101.57	114.58	12.81	107.79	123.94	14.98
Sweden	132.77	148.63	11.95	122.49	143.54	17.19
Switzerland	70.30	84.31	19.93	68.32	79.53	16.41
United Kingdom	127.27	146.86	15.39	127.27	146.86	15.39
U.S.A.	133.31	169.88	27.43	102.41	134.62	31.45
Europe	104.37	117.46	12.54	103.34	117.03	13.25
Pacific Basin	106.99	109.86	2.68	95.35	108.66	13.96
Europe Ex.U.K.	90.98	100.60	10.57	88.73	99.16	11.75
World Ex.U.K.	114.31	130.73	14.36	97.03	117.28	20.87
WORLD INDEX	115.59	132.28	14.44	99.71	119.86	20.21

MAN/H.13/4.92

FORM 14 - Long Term business liabilities and margins

(This and Form 13 correspond to the two sides of a Balance Sheet).

Observe whether there is and consider whether there should be a note in terms of instruction 3, i.e. in respect of mismatching (resilience) reserves.

Comment if entries appear odd e.g. if there are nil entries where this seems unlikely to be correct.

Consider whether lines 41 and 42 indicate the possibility of excessively high gearing of investments.

FORM 16 - Statement of Income and Expenditure

(This form constitutes part of the Shareholders Profit and Loss Account).

The Form will not be applicable to Mutual companies.

Check that entries appear reasonable. There should normally be entries in lines 13 and 21. If not consider asking why not. (DTIGN 7.9.3)

Shareholders' investment income should not be put directly into the long term fund. It should appear in line 13 and, to the extent required, be transferred via line 11 to Form 40.

MAN/H14-16 / 4.92

J. RETURNS - SCHEDULE 3 OF A & S REGS 1983

J.1 Check that, where there are sub funds, there is a statement in terms of paragraph 4 (1) and that separate Forms 40,41,42,45 and 46 have been provided in terms of paragraph 9. (DTIGN 11.3 and 11.5)

J.2 Check that, where management services are provided by another company, there is a statement in terms of paragraph 5 (DTIGN 11.11)

J.3 If there is a Form 47 or a Form 48 or both, check that paragraph 10 has been complied with.

J.4 If there are Forms 49 to 51 check that there is a statement in terms of paragraph 11 giving the basis on which the assets have been valued and the amount of unrealised capital gains or losses.

(N.B the references are to paragraphs in SCH 3.)

MAN/J1-4/ 4.92

FORM 40

Comparison of column 1 with column 2 will give a general indication of differences between the year of the returns and the previous year. Consider whether differences are surprising - or otherwise give rise to the need for comment.

Are the entries in column 1 reasonable?

If there are entries in 40.5 and/or 40.11, have particulars been specified?

Is the fund increasing/decreasing/stationary (40.14.1)?

Compare line 40.1 with premium income in form 43 and in forms 55 & 56.

Compare line 40.2 with expected income shown in form 45 for current and previous year, after allowing for income on linked funds.

FORM 41

Compare lines 12 to 15 (column 3) with previous year's figures, and consider whether changes are reasonable - particularly in 41.15.3. Abnormally high expenses are likely to be an indicator of trouble.

Split of expenses between lines 14 and 15 will be on an approximate basis. Watch for possible bias (intentional or otherwise), and consider implications. (DTIGN 11.13).

MAN/J40-41/ 4.92

FORM 42

Note any figures which seem abnormally high, and consider implications.

FORM 43

Compare line 1 with line 12 for the previous year. (Difference in annual premiums may be due to changes in currency values.)

Check that line 12 (with relevant notes) is consistent with Form 55 and 56 entries.

Note high figures for forfeitures and report to DTI.

Note 7 of Schedule 3 to ICAS 1983 requires Group business to be dealt with by a note.

Note high/low new business figures and consider implications for new business strain and long term prospects of office.

FORM 45

Check that yields look reasonable. (A program in Lotus 1-2-3 is available to compare yields in forms 45 & 46 and to check consistency with form 13.)

Check that

45.2.3	equals 46.9.4
45.3.2	equals 46.18.4
45.12.3	is calculated in accordance with Instruction 5.

Consider whether all assets shown as income producing are in fact likely to be income producing; are yields otherwise reasonable?

Yields should be to two decimal places. (DTIGN 11.18)

MAN/J42-45/ 4.92

FORM 46

Consider checking that redemption yield (column 4) looks reasonable having regard to running yield and profit or loss on redemption. The test is crude - but may prompt a request to the company to review calculations. As mentioned in previous paragraph a testing program is available.

Yields should be to two decimal places. (DTIGN 11.18)

FORM 47

Check that valuation prices (column 3) are the same as in Form 57.2.

Compare value of assets with value of liabilities in Form 57 and consider implications of mismatching.

Form 47 should not include units held in excess of the aggregate of units allocated to policyholders (DTIGN 11.19)

FORM 48

Compare value of assets with value of liabilities in Form 57 and consider implications of mismatching.

See DTIGN 11.20.

MAN/ J46-48/ 4.92

FORM 49

Check that net asset values (line 20) are the same also in Form 50 and in Form 51.15.

Check that entries in 49.15 are equal to previous year's 49.15 entries plus this year's 51.10 entries. If not, why not?

Check that types of investment are in accordance with Schedule 4 - paragraph 4 (2) (a).

Consider whether the extent of liquidity of any property funds is satisfactory.

The funds should be set out in the same order by Forms 49, 50 & 51. This is mandatory for Form 49 & Form 51. It would be helpful if Form 50 & Form 57 followed suit.

It can be instructive to trace the progress of a particular fund by comparing Revenue A/cs & Balance Sheets over the previous years.

FORM 50

The layout can be confusing and some companies become confused. The entry in column 7 on page 88 of ICAS 1983 shows the value of units held by Fund B in Fund A. (Held in LEFT by ABOVE may be a helpful way of remembering.)

Check that valuation prices of units are the same as in Form 57.

Form 50 shows assets actually held in respect of units, whilst Form 57 shows the value of the liabilities (ie the assets that should be held). These need not be identical but consider the implications of mismatching.

MAN/J49 - 50/4.92

K. RETURNS - SCHEDULE 4 OF A & S REGS 1983

GENERAL

K.1 Information in Schedule 4 should be consistent with information in Schedules 1 to 3.

K.2 It is implicit in the Regulations that the liabilities should be valued on the basis that no further new business will be written.

K.3 If there are only a few policies left on the books, consider the effect of exceptionally adverse mortality.

K.4 Refunds of commission may be due to a reassurer, if policies lapse. Reserves must provide for this.

K.5 In general, it is not necessary to look at interest, mortality and expenses in watertight compartments. The main point is whether the valuation basis as a whole is adequate. However where weaknesses in one area are offset by strengths in another, we may need to ask questions to establish that the overall result is adequate.

If the valuation rate of interest in an unmodified net premium valuation is reduced, net premiums will increase and premium margins will reduce - thus affecting the implicit expense reserve.

K.6 It is important to establish whether the office is paying tax on interest less expenses or whether it is paying no tax because expenses have exceeded (and still do exceed) interest, and to consider the implications.

MAN/K1-6 /4.92

K.7 It appears that some companies have been misclassifying linked PHI (especially stand-alone Dread Disease) contracts as Class III business, and could thereby improve their I -E position. We should write to each such company to enquire whether the tax position of such policies have been cleared with the Inland Revenue.

K.8 Offices in a gross tax position (expenses not yet offset by interest) sometimes offer attractive terms for single premium business - giving away some of the advantage of the gross position. We need to beware of double counting of gross interest.

K.9 Changes in asset values can arise as a side effect of the Regulations, for example where the value is limited by Regulations 49 and the fund is expanding.

Is investment policy for with profit business (or with profits sub funds) reasonable?

Is investment policy for non-profit business reasonable?

K.10 The experience of many companies of PHI sickness rates on their group business has deteriorated over the 10 to 15 years to 1988. We may need to ask questions particularly if the company is specially exposed to the risk.

As a standard GAD allows the actuary to use a zillmer adjustment for PHI benefits based on the expenses and commission actually loaded for in the premium.

MAN/K7-10/4.92

Section 3 and 4	Have contracts been adequately described? In particular we should ensure that the description of any deposit administration contracts includes a description of any guarantees and surrender options contained in such contracts. We should require a description of the proportion of the fund which can be claimed on surrender, the period over which, and the manner in which, that surrender value may be deferred, and any interest guarantees built into the contract.
Section 4	Check that investments of linked funds are consistent with publicity regarding these funds.
Section 5 (i) (a)	Consider resilience test matching by term, nature and currency matching (DTIGN 12.8) On 13 November 1985 the former Government Actuary wrote an informal letter to all Appointed Actuaries setting out GAD's working rule for a resilience test (mismatching reserve). This benchmark requires that the reserves should be sufficient to absorb the effect of a rise or fall of 3% in the yield on fixed interest securities and a fall of 25% in equity and property prices. In a further letter dated 31 July 1992 the present Government Actuary stated that, whilst in most financial conditions the benchmark was unaltered, an appointed actuary should, in more extreme circumstances, discuss with GAD the possible tapering of these parameters.

MAN/K-Sch4(a)/12.92

DETAIL OF SCHEDULE 4

Section 5 (i) (e) Replies on capital gains tax are sometimes rather brief and unhelpful. The reason for a nil provision should be stated. Ensure that any provision can be identified in F.14, F.55 or F.56. In (i) F.55 or F.56 either implicitly or explicitly or (ii) in F.14 line 51 and Note 3 to F.14 or (iii) in F.14 line 44. In the last case the reserve does not attract solvency margin.

(f) The reserve for maturity guarantees should be calculated in accordance with the basis in the Report of the Maturity Guarantees Working Party (JIA Vol 107 Part II pp 106/7 and 149).

GAD normally adopts as a standard the setting up of a reserve which uses appropriate parameters and which is based on either a risk of ruin of 1 in 1000 with a conservative allowance for future withdrawals, or a risk of ruin of 1 in 100 with no allowance for future withdrawals.

MAN/K-Sch4(b)/4.92

Mortality and Interest

Section 6 6.1 The actuary is required by Regulation 60 of ICR 1981 to take into account, where relevant, both published tables and the company's past experience.

6.2 The actuary should also take account of the following, to the extent they apply

- a small amount of business, giving rise to a greater chance of variation from the average.
- special features, such as the type of client, giving rise perhaps to the likelihood of abnormally heavy or light mortality.
- The relative importance of mortality; for example, mortality would be particularly important in a company writing only non profit term assurance.

6.3 We may need to ask the actuary to state how he justifies a particular basis, perhaps by asking for details of investigations carried out to test it.

6.4 As a working standard we should look for bases not weaker than those shown below, to cover risks other than the AIDS risk.

Table 6.5 covers the latest tables, but if offices use the older tables the standards are as in 6.6.

MAN/K-Sch4(c)/4.92

6.5 - New Tables

Assurances	Males	Females
UK assurances combined	100% AM 80	100% AF 80
UK assurances, non-smoker	85% AM 80	85% AF 80
UK assurances, smoker	125% AM 80	125% AF 80
Ireland Assurances, combined	115% AM 80	115% AF 80
Annuitants		
Immediate annuities	100% PMA 80 C00	100% PFA 80 C00
Pensioners		
Immediate annuities	100% PMA 80 C10	100% PFA 80 C10
Deferred annuities	100% PMA 80 C10 or 80% AM 80	100% PFA 80 C10 or 80% AF 80

Notes

a) For term assurances, the table TM may be substituted for AM 80.

b) The table AM 80 (or TM 80) with up to a 4 year age reduction may be substituted for AF 80.

c) Mortality rates for assurances exclude any addition required for AIDS, or options, guarantees etc.

d) An age rating of 1 year may be regarded as equivalent to a 10% adjustment.

e) Annuitant or pensioner tables may be based on a projected calendar year later than 2000 or 2010 respectively.

f) A margin of 0.1% pa may be taken in the assumed rate of interest for deferred annuities along with 100% AM 80 or AF 80/

MAN/K-Sch4(d)/4.92

6.6 - Old Tables

Assurances	Males	Females
UK assurances combined	85% A67/70	90% FA 75 - 78
UK assurances, non-smoker	70% A67/70	75% FA 75 - 78
UK assurances, smoker	110% A67/70	115% FA 75 - 78
Ireland assurances, combined	100% A67/70	105% FA 75 - 78
Annuitants		
Immediate annuities	a(90) - 1 YR	a(90) - 1 YR
Pensioners		
Immediate annuities	PA(90) - 2 YRS	PA(90) - 2 YRS
Deferred annuities	65% A67/70	70% FA 75 - 78

Notes

a) The table A67/70 with up to a 4 year age reduction may be substituted for FA 75 - 78.

b) Mortality rates for assurances exclude any addition required for AIDS, or options, guarantees etc.

c) For pensions in payment, the table a(90) - ½ yr may be substituted for PA (90) - 2 yrs.

d) An age rating of 1 year may be regarded as equivalent to a 10% adjustment.

e) A margin of 0.2% pa may be taken in the assumed rate of interest for deferred annuities along with 100% A67/70 or FA 75 -78 mortality.

MAN/K-Sch4(e)/4.92

6.7 AIDS

The latest letter regarding AIDS was sent by the Government Actuary to appointed actuaries on 7 December 1989. The last paragraph is an attempted compromise to meet DTI's view that they would prefer GAD to recommend the use of Basis R (adjusted for post-2000 deaths for heterosexual spread) as the insured mortality basis. GAD's view however is that Basis R is a population mortality basis, and actuaries are entitled, if they can justify it, to use a modification of R for their insured experience.

6.8 In carrying out scrutinies, particular attention in respect of AIDS should be paid to:

- guaranteed insurability options
- overseas business
- permanent health contracts
- any other special circumstances

6.9 INTEREST

Check whether the interest rates are supportable by the Form 45 & 46 yields and comply with Regulation 59. In doubtful cases it may be necessary to ask for a "matching rectangle".

MAN/K-Sch4(f)/4.92

Section 7 (b) Consider adequacy of expense provision.

Points to bear in mind include the following.

i) Continuation of the Form 41.15 expenses, excluding exceptional items, should where appropriate be provided for in the valuation, with an allowance for inflation. Renewal commission should also be allowed for in this way, where appropriate.

ii) Companies should ensure their expense reserves are sufficient to allow for the running off of the existing business as a closed fund, with a further "over-run" allowance to allow for the time lag before the organisation can be run down to that appropriate to running off a closed fund.

(iii) If we are doubtful about the adequacy of the expense provision we should ask the actuary to explain his rationale, having regard to current expenses for existing business and an appropriate allowance for inflation.

(c) & (d) Check whether the actuary has given details of the net premium valuation (including interest and mortality bases) which he has used to test a non-net premium basis.

Section 8 (a) Check that basis for non-unit reserves meets GAD criteria, currently a 2% real rate of return, and ask the actuary what would be the effect on the reserves of assuming an 8% rate of inflation for expenses with a 10% rate of growth in units, before tax etc.

(b) Consider need for overrun expense reserves

MAN/K-Sch4(g)/4.92

Section 9 — The answer indicates whether a currency mismatching reserve should have been considered.

Section 10 — Check that details have been given as required ie that (2)(a) to (g) have been answered. Consider the appropriateness of the size of the retention limit, especially for smaller and new offices.

Check (2)(a) whether any reinsurers are not authorised to carry on insurance business in the UK. Consider whether the size of reassurance with these companies gives cause for concern, and if necessary query with Actuary and/or report to DTI.

On (2)(e) check whether deposits back have been treated as long term liabilities in terms of Regulation 50 of ICR 1981 as amended by paragraph 13 of I.C. (A) Regs 1985. If there is doubt ask.

Beware of reassurance on a different basis from the main valuation basis, thereby creating an asset.

Section 11 — Check this through, if there is a with profit sub-fund.

Section 13 to 16 — Draw DTI's attention to changes in bonus rates, compared to those of the previous year (or at previous declarations).

MAN/K-Sch4(h)/4.92

FORM 56

Check whether the unit liability (column 11) agrees with the Form 57.4 total.

Consider commenting on any negative total non-unit mortality and expense liability. It may be sensible to ask whether the net reserve for each policy is at least equal to the surrender value. Also one may want to know which liability the asset (negative liability) matches.

FORM 58

Check - whether lines 10, 16 and 26 are equal

- whether line 11 equals the previous year's line 25

- whether any entries in lines 3, 4, 5, 12, 13, 14 and 23 are positive, as they should be (see Instruction 3).

- consistency with Forms 14 and 40.

- the relationship between the percentage in line 27 and the percentage in line 28, and consider section 30 of the 1982 Act. (DTIGN 12.24). Section 30 limits by ½%p.a the amount by which the with profits policyholder's share of distributed surplus can be reduced.

Separate Forms 58 are required for sub funds (DTIGN 12.23).

FORM 60

It may be necessary to ask which class III contracts appear in each of the 4% 1% and nil columns, to ensure that this matter has been dealt with correctly.

If there is no upper limit to the charges that can be made in relation to internal linked fund contracts, this should be stated in answers to Schedule 4. para 4 (DTIGN 12.5)

MAN/K56-60/4.92

FORM 60 - MINIMUM GUARANTEE FUND

The amount of the Minimum Guarantee Fund is 800,000 ECUs for a proprietary company and 600,000 ECUs for a mutual company, and half these amounts for a UK branch of an overseas company. The ECU is defined in Council Reg (EEC) NO 3180/78 of 18/12/78 see GAD File 6629/1 ref 18.

The rate of ECU to £ applies for 31st December one year to 30th December following year.

Effective period of Rate, inclusive	Rate £ per 100 ECU	Proprietary Company 800,000 ECUs	Mutual Company 600,000 ECUs
31.12.83 - 30.12.84	£57.4723	£459,778	£344,834
31.12.84 - 30.12.85	£60.4059	£483.247	£362,435
31.12.85 - 30.12.86	£58.5670	£468,536	£351,402
31.12.86 - 30.12.87	£72.0932	£576,746	£432,559
31.12.87 - 30.12.88	£69.2616	£554,093	£415,570
31.12.88 - 30.12.89	£65.8170	£526,536	£394,902
31.12.89 - 30.12.90	£70.6719	£565,375	£424,031
31.12.90 - 30.12.91	£69.7265	£557,812	£418,359
31.12.91 - 30.12.92	£70.2425	£561,940	£421,455
31.12.92 - 30.12.93	£81.5887	£652,710	£489,532
31.12.93 - 30.12.94	£76.7145	£613,716	£460,287
31.12.94 - 30.12.95	£78.1528	£625,222	£468,917
31.12.95 - 30.12.96	£84.1142	£672,914	£504,685
31.12.96 - 30.12.97	£78.2167	£625,733	£469,300

MAN/K60/11.96

L. RETURNS - SCHEDULE 5

L.1 GAD normally refers to Schedule 5 to check out specific points, though a general browse through the Schedule should be made whenever it is produced.

L. 2 There is no specific requirement to comment to DTI on Schedule 5, but any errors or omissionS that come to light should be reported.

MAN/L1-2/4.92

L. RETURNS - SCHEDULE 5

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MAN/L1-2/4.92

Detailed Scrutiny Report

The following extract from the agreement with DTI sets out the points that must be covered in the report to DTI.

"37. Upon completion of their detailed examination of the annual return of an insurance company GAD will send I Division a report on any significant matters which have emerged as a result of the examination drawing attention to matters of importance being raised with the company. When such matters have been clarified or when GAD feels that some form of formal action is required GAD will further advise I Division.

38. Each report shall include the following information as appropriate:

i) A general description of any identifiable major developments or changes during the period covered by the report and relating to the company's long term business. This should include any significant changes in the philosophy or business approach of the company, possibly resulting from a change in ownership or control or in the attitude of the company's shareholders; any significant change in the volume, type or mix of the long term business written by the company; and any internal or external factors which may have had a special effect on the company.

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ii) A general commentary on the present and prospective financial position of the company. GAD will draw attention to any major weaknesses in the basis of valuation adopted by the appointed actuary in his (Schedule 4) Valuation Report and to any significant changes (including changes in reinsurance arrangements) in the company's financial affairs since the time of GAD's previous report.

iii) If the company provides quarterly returns, attention shall be drawn to any significant differences between the figures in the annual return and those in the corresponding quarterly return and to any significant developments since the date of the last annual return which have been revealed by quarterly returns.

iv) If the company has provided a business plan, attention should be drawn to any significant deviations from the plan.

v) Details of any breaches or possible breaches of statutory requirements (however arising) (including sections 28-31 of the Act) or of undertakings given by the company revealed as a result of the examination of the company's return.

MAN/M38(b)/04.92

vi) Details of any significant errors or omissions in the return (including the directors' actuary's and auditor's certificates) or of any other significant instances of non-compliance noted during the course of the examination. If the company has already rectified the position (as the result, for example, of action taken under paragraph 18) this shall be stated in the report. In other cases, the report shall explain whether or not GAD is drawing the company's attention to the defects.

vii) Details of any qualifications contained in any certificate given by the directors, actuary or auditors. If amended certificates have already been provided by the company this shall be stated in the report. In other cases, the report shall state whether GAD is raising the matter with the company.

viii) An indication if the lapse experience of the company appears to be high for the type of business and whether information available in the return suggests that it may be deteriorating.

x) Reference to any correspondence in respect of the examination between GAD and the company or its actuary. A copy shold be appended to the report if it has not already been provided to I Division."

MAN/M38(c)/4.92

N. FRIENDLY SOCIETIES

N. 1 GAD performs a similar task for the Registry of Friendly Societies, as it does for the DTI, in respect of returns from Directive Friendly Societies i.e those societies whose size and classes of business make them comparable to life assurance companies.

N. 2 The Friendly Societies Act and Regulations impose broadly similar requirements in respect of the Annual Returns , but use different form numbers.

N. 3 Procedure within GAD is similar to that for DTI Returns, i.e. initial scrutinies followed by detailed Scrutinies within the time limits set by the assigned priority code. The major differences are that

(i) there is no formal agreement between GAD and RFS.

(ii) all correspondence is with RFS who then write to the Friendly Societies, unless it has been specially agreed that we write direct to the Society or its Actuary.

MAN/N1-3/4.92

O. QUARTERLY RETURNS

O. 1 New companies and others under special requirements have to submit quarterly returns. These usually consist of Forms 10, 13, 14, 40, 41, 42, summaries of new business, surrenders, lapses, forfeitures etc and where applicable Forms 49, 50 & 51 but there will not be an actuarial valuation.

O. 2 The objective of quarterly returns is to monitor the progress of the company within a time span that enables DTI to take action before too late. Usually a company producing quarterly returns will have recently submitted a business plan.

O. 3 Key points to look at and compare with business plans:-

Compliance with requirements imposed.
Maintenance of Solvency
Level of new premium income
Level of expenses
Level of withdrawals
Changes in assets
Any sudden movement in any factors

O. 4 A record of the key financial figures for each quarter is kept in the "Floating Cover" of the departmental company file.

O. 5 Quarterly Returns are unaudited. A comparison between the last quarterly returns of the year and the full DTI return sometimes reveals marked differences which may be as a result of the audit.

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P. OTHER REFERENCES, CORRESPONDENCE & MEETINGS

P. 1 New companies and others that for some reason have had requirements imposed upon are required to submit details of new products issued and reinsurance or other agreements entered into as well as quarterly returns. Also DTI might for other reasons refer other literature or documents received from a company for comments by GAD.

New Products

P. 2 In commenting to DTI on new products GAD should make it clear that the comments are from a supervisory point of view only. The point behind this is that GAD is NOT commenting on, for example, legal implications or appropriateness in relation to LAUTRO rules. It is suggested that we use a sentence such as

"We do not consider there are any comments that your Department needs to make to the company about the ...... *contract in the context of the company's* financial resources."

To indicate that our concern has only been to examine the product in the context of the company's new business plan and its capital requirements.

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P. 3 **Reinsurance Agreements** - points to consider:-

If the agreement is not with a company that is authorised to transact business within the U.K, do we know enough about it? Is it commercially sound? It may be necessary for DTI to write to the authority that supervises ~~to~~ the reinsurer's home country to obtain more information.

Does the agreement give appropriate cover? Too much? Too little?

Are the arrangements (eg commission and other payments) on a fair commercial basis?

P. 4 **Correspondence**

All correspondence received directly from a company should be copied to DTI, as should all letters sent by GAD. A record of meetings held with the Actuary or other company representative should be placed on the file and copied to DTI.

P. 5 **Meetings with Actuaries**

The Government Actuary should be sent a copy of the notes of any meeting at which an Appointed Actuary and a member of GAD is present. The purpose is to help the GA to keep in touch with matters affecting appointed actuaries.

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Q. MANAGEMENT AGREEMENTS

Q. 1 A company may operate on the basis of a management agreement with another company in the group, under which that other company services the business either partly or fully.

Q. 2 The main point from the supervisory point of view is to ensure that the charge for the services is based on actual costs, and is not such as to distort the true position. It is particularly important that the charge does not effectively milk the long term fund.

Q. 3 DTI normally expects the following additional points to be observed and, where appropriate, to be specifically covered in the management agreement:

3.1 the management company and its employees recognise the requirements which the Secretary of State has imposed and can impose on the insurance company and will observe such requirements in carrying out the duties of a manager of the insurance company;

3.2 the insurance company should have all books, papers and records of its business handed over to it on termination of the agreement without further payment (no penalty clauses); computer software should be made available to the insurance company on termination of the agreement;

3.3 there should be an adequate termination period (say six months) to allow the insurance company time to obtain suitable alternative management;

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3.4 there should be an obligation that all books, papers and records relating to the business of the insurance company will be made available to any duly authorised officers of the Department of Trade and Industry on demand;

3.5 a majority of the Directors of the Board of the insurance company should be independent of the management company and should have adequate insurance experience;

3.6 the insurance company should reserve the right to determine the terms for acceptance of risks and meeting of claims; the Directors and Actuary who are independent of the management company should determine the basis for calculating the value of the units for linked business;

3.7 an annual budget should be prepared for total cost of management expenses in operating the business; the management agreement should specify that without the agreement of the insurance company the budget would not be exceeded by more than, say, 10%; the insurance company should be notified of any matters which might cause it to alter or consider altering its objectives, budgets, plans or instructions to the management company.

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Q. 4 Particular care should be taken to examine whether with profit funds (including with profit sub-funds) are being treated fairly, where a management services agreement (or similar informal arrangement) is in force. Similarly, if there are linked contracts in respect of which charges can be varied to reflect expenses, it is important that the charges reflect the true running expenses.

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R. LOANS

R. 1 Loans and Debts due to long-term fund

In carrying out the detailed scrutiny of a company's returns, one item that is worthwhile examining is the level of any unsecured loans, especially loans to individuals.

The nature of the various loans can be assessed roughly by a comparison of Forms 13 and 45.

The various debts and loans are ascribed to the relevant line in each form by looking at the nature of the loan and matching this against the first appropriate description from the following list taking each item in descending order.

Forms 13

Lines 51, 52, 53, 54	Insurance debts in respect of premium income etc.
Lines 30, 32, 34	Debts due from dependants
Line 41	Loans secured on policies
Lines 64, 66	Debts due from individuals
Lines 61, 62	Debts due from companies and other bodies that are fully secured on land
Lines 63, 65	Debts due from companies and other bodies that are not fully secured on land

Form 45

Lines 8, 9	Debts secured on land
Lines 10, 11	All other debts and loans etc.

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This will mean in particular that debts due from individuals (other than policy loans or outstanding premiums etc.) will be recorded on lines 64 and 66 of Form 13 whether or not secured on land. However, these same loans will be divided on Form 45 (as indicated by the instruction to Form 45) to show loans to individuals that are secured on land within lines 8 and 9 of Form 45, and other loans to individuals within lines 10 and 11 of Form 45.

The size of the loans to individuals that are secured on land should then be determinable by looking at

(A) =	F.45.8.1 - F.13.61.1	for loans due after more than 12 months
(B) =	F.45.9.1 - F.13.62.1	for loans due within 12 months

Conversely, the size of the loans to individuals that are not secured on land would equal

(C) =	F.13.64.1 - (A)	for loans due after more than 12 months
(D) =	F.13.66.1 - (B)	for loans due within 12 months

Where the amounts of (D) and more especially (C) are significant, it would be appropriate to query the rationale for these unsecured loans to individuals when writing to the company.

Similarly, it may be necessary to query any sizeable amounts due from companies after 12 months shown on line 63 of Form 13 in respect of debts that due not appear to be fully secured. Further information about such loans may though be available in the first instance from the notes to the Shareholder Company Act Accounts.

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R. 2 Loans with Companies

DTI take the view that it is inappropriate for one part of a company to take credit in the returns for a loan from another part of the company. For example the company should not take credit in the long term fund for a loan from the shareholders' fund. The point has in the past caused some difficulties between some large companies and DTI. GAD should normally confine its activities to drawing the matter to the company's and DTI's attention and leave DTI to argue the matter.

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8. IMPLICIT ITEMS

The following is a copy of the letter dated 5 October 1984 issued by the Department of Trade and Industry, and of the Guidance Notes referred to in that letter.

MAN/S/4.92

DEPARTMENT OF TRADE AND INDUSTRY
SANCTUARY BUILDINGS
16 – 20 GREAT SMITH STREET
LONDON SW1P 3DB
Telephone (Direct dialling) 01-215 5910
GTN 215
(Switchboard) 01-215 7877

5 October 1984

Dear Sir

IMPLICIT ITEMS UNDER REGULATIONS 10 TO 13 OF THE INSURANCE COMPANIES REGULATIONS 1981

I enclose a Guidance Note which sets out the procedures to be followed in making applications for orders in respect of implicit items under the above regulations in respect of long term business. The Guidance Note has been prepared after consultation with the insurance associations and with the actuarial profession.

I would draw your attention particularly to paragraphs 3-6 of the guidance note regarding the timing of applications. We expect requests for section 68 orders in respect of the future profits implicit item will normally be made at the same time as the annual returns are submitted and the order will then apply for the next twelve months (or in practice fifteen months) until the next order is issued. If you wish to make an application in respect of the current financial year, however, you should do so as soon as possible based on the results of the latest submitted returns.

Orders in respect of the zillmerising implicit item will only be made in relation to the position shown in a particular set of returns. Applications for such orders should be received by us not later than four months after the end of the relevant financial year and accompanied by a full set of draft returns, with statements by the auditors and the appointed actuary that they are satisfied with those parts of the return for which they are responsible.

I am enclosing one additional copy of the Guidance Note for the information of your appointed actuary.

Yours faithfully

[redacted]

enc.

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GUIDANCE NOTE ON APPLICATIONS FOR ORDERS TO COUNT IMPLICIT ITEMS UNDER REGULATIONS 10 TO 13 OF THE INSURANCE COMPANIES REGULATIONS 1981 IN RESPECT OF LONG TERM BUSINESS

INTRODUCTION

1. Article 18.3 of the EC Life Directive provides for three kinds of implicit items, namely "future profits", "zillmerising" and "hidden reserves", to be counted within certain limits towards meeting a company's required margin of solvency in respect of its long term business, at the discretion of the head office supervisor. Effect is given to this in Regulations 11 to 13 of the Insurance Companies Regulations 1981. However, the Regulations define the maxima which can be taken into account and Regulation 10(4) provides that the implicit items shall have no value except in pursuance of an Order under what is now section 68 of the Insurance Companies Act 1982 ("the Act").

2. This Guidance Note sets out the procedures to be followed and the form of calculations and data to be submitted by companies in making applications for orders in respect of long term business. Orders in respect of future profits and zillmerising will be readily available, provided that the relevant requirements set out in this Guidance Note have been satisfied. Orders in respect of hidden reserves will only exceptionally be given.

TIMING

3. Ideally Orders relating to the position at an accounting date would in all cases be issued in time to be brought into account in the statement of solvency forming part of the returns relating to that date. Problems of timing, however, are likely to make it difficult to achieve this aim in practice. The information that will be required to enable an application to be considered, set out in detail below, will in most cases constitute a major part of the information required in the annual returns. Some companies may have difficulty in furnishing this information, certified by the auditors or appointed actuary as appropriate, far in advance of the due date for the submission of the returns. A further practical consideration of particular significance for the many companies with a 31 December accounting date, is that the resources available to the Department and its actuarial advisers will not enable a large number of applications to be processed over a short period.

4. An implicit item in respect of zillmerising or hidden reserves must be closely related to the basis on which liabilities or assets have been valued; also in the case of hidden reserves, as explained below, the granting of an Order will be dependent on the overall solvency position of the company. Orders in respect of these implicit items will, therefore, only be made in relation to the position shown in a particular set of returns and it will be essential for companies to submit applications to the Department well in advance of the latest date for the submission of the relevant returns.

5. The future profits implicit item is calculated on the basis of the average profits over a five year period and it is less important that an Order reflecting the position at the latest

accounting date should be available at the time that the returns are submitted. In view of the practical considerations referred to above, it will be acceptable for returns to be submitted which demonstrate cover for the required solvency margin on the basis of a current Order in respect of a future profits implicit item issued during the course of the preceding 12 months on the basis of information contained in the previous set of returns. All such returns, however, must be accompanied by an application, certified by the appointed actuary, for a further Order in respect of a future profits implicit item for an amount not less than the amount for which credit has been taken in the returns.

6 Orders cannot be back-dated and may be withdrawn at any time eg on the issue of a new Order based on a further year's returns or where there are grounds for doubt about whether the amount in respect of which an Order has been given can still be justified, having regard to changes in the company's position or as a result of queries arising on the detailed scrutiny of the company's returns.

FUTURE PROFITS

Overriding Limit

7. The maximum amount of the implicit item relating to future profits is determined in Regulation 11 as 50% of the product of the estimated annual profit and of the average period (not exceeding 10 years) to run on the policies in the portfolio. In determining the amount within this limit in respect of which an Order should be made, the Department will wish to be satisfied that the amount does not exceed the value of the margins in the premiums and reserves for the existing business which would in reality be available to meet the effects of adverse contingencies which might arise in the future. The Department will require any application for a section 68 Order in respect of this item to be supported by a certificate from the appointed actuary that the amount sought by the company does not exceed the present value of the profits that may be expected to arise in the future on the long term business in force on the valuation date (see paragraph 23).

Definition of profits

8. The estimated annual profit is to be taken as the average annual surplus arising in the long term fund over the last five years up to the date of the most recent available valuation under Section 18 of the Act which has been submitted to the Department prior to or together with the application. For this purpose deficiencies arising are to be treated as negative surpluses. Where valuations have not been made annually, or a company's accounting year has altered, the surplus arising in a period falling partly outside the relevant five year period should be assumed to accrue uniformly over the period in question for the purpose of estimating the profits arising within the five year period.

9. Where a company has been carrying on long term business for less than 5 years, the total profits made during the past 5 years will be taken to be the aggregate of any surpluses that have arisen

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during the period in which long term business has been carried on, less any deficiencies that may have arisen during that period. The resulting total must still be divided by five to obtain the estimated annual profit.

Exceptional items

10. Paragraph (3) of Regulation 11 requires substantial items of an exceptional nature to be excluded from the calculation of the estimated annual profit. For this purpose, such items would include profits arising from an exceptional change in the value at which assets are brought into account, where this is not reflected in a similar change in the amount of the liabilities, and profits arising from a change in the overall valuation approach between one year and another. An exceptional loss (ie a reduction of an exceptional nature in the surplus arising) may be excluded from the calculation only to the extent that it can be set against a profit or profits up to the amount of the loss and arising from a similar cause. It is not intended, however, that any adjustment should be made for the effect on surplus of a net strengthening of reserves nor of costs associated with an expansion of business nor of special capital expenditure, such as the purchase of a computer.

Double Counting

11. The inclusion of investment income arising from the assets representing the explicit components of the solvency margin as part of the estimated annual profit for the purpose of determining the future profits implicit item would result in double-counting. If those assets were required to meet the effects of adverse developments, this would automatically result in the cessation of the contribution to profits from the associated investment income. It would clearly not be appropriate for the Secretary of State to issue an Order which would enable a company to meet the solvency margin requirement on the basis of counting both the capital values of the assets and the value of the income flow which they can be expected to generate.

12. The definition in Regulation 11(4) of the estimated annual profit as the surplus arising in the long term fund* ensures that any contribution to surplus arising from transfers from the profit and loss account, including investment income on shareholders' assets, is not included in the estimated annual profit. Thus double-counting should not arise in respect of shareholders' assets. Double-counting may arise, however, in respect of the investment income from the assets representing the explicit components of the solvency margin carried within the long term fund (eg surplus carried forward or investment reserves) but the amount of such investment income is not separately identified in the returns. Where there is reason to suspect that the elimination of any such double-counting would reduce a company's solvency margin to close to or below the required level, or would otherwise be significant, further information will be sought with a view to taking account of this factor in determining the amount of the implicit item in respect of which an Order is made. It is not

* line 15 on Form 58

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necessary for such additional information concerning investment income to be furnished with an application for a Section 68 Order, unless a company believes that any double-counting would fall into one of the categories mentioned.

AVERAGE PERIOD TO RUN

Basis of calculation

13. The average number of years remaining to run on policies should be calculated on the basis of the weighted average of the periods for individual contracts, using as weights the actuarial present value of the benefits payable under the contracts. An early opportunity will be sought to provide for this in the regulations. A separate weighted average should be calculated for each of the various categories of contract and the results combined to obtain the weighted average for the portfolio as a whole. Approximate methods of calculation, expected to give results similar to the full calculation, will be permitted and, in particular, the calculation of an average period to run for a specific category of contract on the basis of the average valuation factor for future benefits derived from Schedule 4 data will be accepted. A company will be required to demonstrate the validity of the method adopted only where an abnormal distribution of the business in force gives grounds for doubt about its accuracy.

14. Calculations will be required only for the main categories of business, accounting for not less than 90% of the mathematical reserves, except where there are grounds for expecting that the exclusion of certain categories of policies under this provision might have a significant effect on the resulting average period to run. Detailed calculations will not be required where a section 68 Order is sought in respect of a low multiple of the annual profits, well within the average period to run for the company.

15. Where, for a particular category of business, a method of valuation is used which does not involve the calculation of the value of future benefits and which is significant for the company in question, the calculation of the average period to run should be used on estimates of the value of future benefits. For non-linked benefits, these estimates would normally be available from the demonstration required under para 7(d) of Schedule 4 that the reserves are not less than those obtained on the basis of a net premium valuation; otherwise special estimates of the value of future benefits may have to be made specifically for the purpose of the application. In the case of regular premium unit linked contracts, where the method of valuation does not involve estimating the value of benefits to be purchased by further premiums, the value of benefits should be taken to be the reserves currently held (unit and non-unit liabilities) together with the present value of the portions of future premiums which are to be invested in units under the terms of the contracts.

Premature termination of contracts

16. Allowance must be made for the premature termination of contracts, based on the actual experience of the office over the preceding five years, and taking into account specific features of

contracts such as options which can be expected to lead to premature termination, eg guaranteed surrender values on income bonds written as long term contracts and option dates on flexible whole - life contracts. The adjustment should be made separately for each of the main categories of business. The use of industry-wide rates of termination will be acceptable where the actuary is satisfied that this will result in sufficient allowance being made having regard to the office's own experience. Methods of calculation which involve a degree of approximation will be permitted.

17. For certain types of contract, where the period left to run is most naturally defined as the term of a fixed maturity or expiry date, the allowance for premature termination will also need to take into account terminations resulting from death.

Overall limit

18. The overall average period left to run calculated as described above must be limited to a maximum of ten years before applying it to the estimated annual profit in order to determine the maximum value of the future profits implicit item.

Definition of period to run

19. The definition of the period to run and the basis of the allowance for early termination must clearly be considered together. For certain types of contracts, eg pension contracts with a range of retirement ages or other options, there is inherent uncertainty about the likely term to run. In such circumstances any estimate for determining the amount of the future profits implicit item for which an Order is sought must be based on prudent assumptions tending, if anything, to underestimate the average period to run.

20. On this basis, suitable definitions of the period to run for the various types of contract for the purpose of the calculations are shown in an Annex to this note. Except for group pension schemes, the definitions are before allowance for premature termination on account of lapse or surrender. Applications based on alternative definitions of the period to run will be considered as long as it can be shown that the definitions used in conjunction with the allowance for premature termination may be expected to result in a conservative estimate of the average period to run.

21. The rationale for the definitions shown will in general be self-evident but some explanation may be appropriate for the standard period to run of ten years suggested for group pension schemes. It is recognised that the operations of group pension schemes normally extend over very long periods. However, the terms on which the business is transacted are often not guaranteed very far ahead and for the more common types of contract there is no financial penalty on the discontinuance of future premiums, which are in any event indeterminate. Having regard to the changes which have occurred in the methods of funding occupational schemes and in the choice of investment media over relatively short periods in the past, it is not considered that there is any basis for determining prudent assumptions in regard to rates of discontinuance of future

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premiums under these schemes. There are also major practical difficulties in determining the amounts and the incidence of payment of future benefits under schemes.

22. In these circumstances, both to ensure a prudent result and on practical grounds, it is considered that for the purpose of determining the weight to be given to group pensions business in determining the average period to run for a company's business as a whole, regard should be had only to the value of benefits secured by past premiums; and that having regard also to the limit of ten years on the overall average period to run, this period should normally be taken, arbitrarily, as the average period to run for all group pensions business, other than for schemes funded by individual regular premium deferred annuity contracts.

<u>Actuary's certificate</u>

23. An application for a Section 68 Order in respect of a future profits implicit item should be supported by a certificate from the appointed actuary stating that the amount sought by the company does not exceed the lower of:

(i) the amount calculated in accordance with Regulation 11 applied on the basis set out in the Guidance Note on Applications for Orders to Count Implicit Items; and

(ii) the present value of the profits that may be expected to arise in the future on the long term business in force on the valuation date.

24. For the purpose of (ii), "profits" is to be defined as the surplus arising in the long term fund attributable to the business in force at the valuation date. To avoid double counting, no account shall be taken of any future surplus arising from assets corresponding to explicit items which have been counted towards the solvency margin such as shareholders funds, surplus carried forward or investment reserves; also regard shall be had to the capitalisation of future profits implicit in any Order in respect of a zillmerising implicit item (see paragraph 27 below).

25. In giving his certificate, the actuary's assessment of future profits under (ii) above should be based on cautious assumptions in regard to the future experience, <u>in many respects similar to those required for the minimum basis for calculating mathematical reserves</u>. However, the retention of the 7½% contingency margin in the rate of interest is not required for this purpose, and credit may be taken on a prudent basis for margins in the future premiums payable under existing contracts. Credit may also be taken where appropriate for future increases in equity dividends and rents on prudent assumptions consistent with the assumptions in regard to future rates of interest and inflation of expenses.

26. Where the Department considers it necessary, information will be sought from the appointed actuary on the assumptions underlying his assessment of future profits for the purpose of his certificate but a statement of the basis need not be included as part of the application for an Order. It is likely, however, that this additional information will be requested in all cases where there

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are grounds for suspecting that recurrent profits from the busine in force do not account for the major part of the past profits brought into account.

ZILLMERISING

27. Regulation 12 provides for an implicit item to be counted towards the required solvency margin in respect of unzillmerised c only partially zillmerised reserves. The maximum additional amour which may be counted is defined as the amount by which the reserve would have been reduced if they had been zillmerised at a rate equal to the loading for acquisition costs included or allowed for in the premiums, subject to this not exceeding 3.5% of the aggregate of the difference between the mathematical reserves and the relevant capital sums.

28. The reduced mathematical reserves which are implicit when an amount on account of zillmerising is counted towards the solvency margin must still satisfy the requirements of Part VI of the Insurance Companies Regulations 1981. An application for an Order must be supported by a certificate from the appointed actuary that the amount applied for has been calculated in accordance with Regulation 12.

29. An implicit item in respect of zillmerising is not permitted for term assurance or permanent health insurance and will only be applicable in the case of linked contracts where a net premium method of valuation has been used. It is recognised that some modification of the definition in Regulation 12(4)(e) of the relevant capital sum for linked contracts is required and companies wishing to apply for an Order for an implicit item on account of zillmerising for this type of business should seek further guidance from the Department.

HIDDEN RESERVES

30. The provisions for counting hidden reserves as an implicit item towards the solvency margin specifically exclude hidden reserves arising from the overestimation of the mathematical reserves, so that this item can arise only in respect of undervaluation of assets or overestimation of balance sheet liabilities other than mathematical reserves.

31. Undervaluation of assets could occur in principle, where the Regulations do not permit any value to be ascribed to certain categories of assets, or where the value to be taken into account has been limited by the admissibility rules under the Regulations, or where an up to date valuation of investments in property has not been obtained.

32. To allow amounts explicitly excluded under the asset valuation regulations to be counted towards the solvency margin would be tantamount to nullifying the effect of those regulations. It is envisaged that concessions allowing such inadmissible assets will rarely, if ever, be given.

MON/SC/1/9

INFORMATION TO BE FURNISHED

33. An application to the Department for an Order under Section 68 should state clearly the nature and the amounts of the implicit items which a company wishes to count against its required margin of solvency. The application should be accompanied by full supporting information to enable the Department to arrive at a decision on the merits of the case, including where appropriate the certificates of the appointed actuary referred to in paragraphs 23 and 28 above.

34. Applications for an Order in respect of a hidden reserves implicit item will normally be considered only if accompanied by the full Schedule 1, 3 and 4 returns. Applications for a future profits implicit item should be supported by Forms 13, 14, 40, 41, 42, 45, 46, the answers to questions 1 to 10 of Schedule 4 and Forms 55, 56 and 58; for a zillmerisation implicit item only the last four items listed ie those forming part of Schedule 4 will be required.

35. In addition the following information relating to the calculation of the amounts claimed should be supplied:-

Future profits: the profits made in each of the preceding five years and the amounts and nature of any exceptional items left out of account; the method used for calculating the average period to run and the results for each of the main categories of business, both before and after allowing for premature termination (where the calculation has been made in two stages) and the basis on which this allowance has been made.

Zillmerising: the categories of contracts for which an item has been calculated and the percentages of the relevant capital sum in respect of which an adjustment has been made.

Hidden reserves: particulars, with supporting evidence, of the undervaluation of assets or the overvaluation of liabilities (other than mathematical reserves) for which recognition is sought.

Department of Trade and Industry

October 1984

MAN/S 10/6.38

ANNEX

Definitions of the period left to run for various types of contracts for the purpose of Regulation 11(2) of I.C.R. 1981

Whole life assurances.

The expectation of life

Open ended whole-life assurance.

The expectation of life

Endowment assurances and pure endowments.

The period to the fixed maturity date.*

Flexible endowments.

The period to the first date of a guaranteed cash option.*

Temporary assurances.

The period to the expiry date.*

Deferred annuities with cash options.

The period to the vesting date; where the annuity can be taken at any age falling within a prescribed range, the earliest date.*

Deferred annuities without cash options.

The expectation of life for the age attained.

Annuities in payment.

The expectation of life; for temporary annuities, the period to the expiry date.*

Group life schemes.

The unexpired duration of the period for which the premium rates are guaranteed.

Group pension schemes

(i) by individual deferred annuity contracts
as under deferred annuities above.

(ii) by deferred annuities under controlled funding
a period of 10 years.

* In these cases mortality during the term should be covered by the adjustment for the premature termination of contracts.

(iii) by deposit administration
a period of 10 years

(iv) by managed fund.
a period of 10 years.

Permanent Health Insurance.

For individual policies, the period to the expiry date;* for group contracts, the unexpired duration of the period for which the premium rates are guaranteed.

Capital redemption

The period to the fixed maturity date.

Income and growth bonds

The period to the expected date of surrender.

* In these cases mortality during the term should be covered by the adjustment for the premature termination of contracts.

MAN/S.12 /6

T. OLD NOTES AND PRECEDENTS

T. 1 The editor of the manual ([redacted]) has a set of files of old instructions. These will not normally be required, but the point is mentioned, as these old instructions are generally more detailed that the notes in this manual, and could on occasions provide useful background reading.

T. 2 A file No 8334 setting out precedents has been set up and is stored in Room 216. As precedents are developed the files should be added to. The details of the topics covered by the parts of the file are:-

MAN/T1-2/4.92

PART	TOPICS likely to be covered
1. CONDUCT OF INSURANCE BUSINESS (Sections 16,28-31,78 of ICA 1982)	
COVERS	
1 Restriction of business to Insurance (Section 16)	Trustees, guarantees to subsidiaries, mortgage business, provision of managment service agreements. Cross Ref. to Pt 7 for Class VII business and other "non insurance" policies.
2 Separate Accounts for LT business/Use of LT assets (Sections 28,29)	Managed Pension Fund charges, loans to shareholders. Cross Ref. to Pt 2 for IB/OB transfer and to Part 3 as required.
3 Allocations to policyholders (Section 30)	Transfers from with profit subfunds, (Cross Ref. to Pt 2 for setting them up), breaches (Cross Ref. to Pt 3 for interest on shareholders' funds).
4 Dealings with Connected Persons (Section 31)	
5 Permitted links (Section 78)	Traded options etc.

MAN/T2(2)/6.88

PART	TOPICS likely to be covered
1. CONDUCT OF INSURANCE BUSINESS (Cont..)	
6 Notice of Requirements breaches.	
2 SPECIAL SITUATIONS	
COVERS	
1 Section 49 Transfers of Business	
2 Transfers from IB to OB	
3 Setting up With Profits Subfund	
4 Submission of Business Plan etc. under Sections 32,33	
5 Winding Up	
3 ACCOUNTS & STATEMENTS	
COVERS	
1 Interfund loans etc within the company	Loans from shareholders' fund to LTBF, crediting interest on shareholders' funds directly to LTBF, subordinated loans, interbranch loans. (Cross Ref. to Pt 4 for use of interest on shareholders' funds to justify valuation basis).
2 General accounting	"Single sheets" for run offs,

MAN/T2(3)/1.22

PART	TOPICS likely to be covered
3 ACCOUNTS & STATEMENTS (Cont..)	
concessions	overseas insurers, group concessions (Cross Ref. to Pt 4 for valuation of assets concessions to overseas insurers)
3 Schedule 1-3	Accounting for unit linked internal funds (aggregating individual funds etc) Forms 45-46 problems (eg. Convertible stocks)
4 Schedule 4-6	Demonstration that reserves > net premium reserves. Cross Ref. to Pt 4 for V2/V3 method and tests of linked expenses etc.
4 VALUATION BASIS	
COVERS	
1 Assets	Inadmissibility, Concessions to overseas insurers
2 Expenses	Indemnity commission, linked and non-linked expense reserves, expense overrun, effect of management services agreement, use of interest on shareholders' funds to cover expenses
3 Tax	Linked and non linked CGT, Excess E, effect of assuming closed to new business, disputes with Inland

MAN/T2(4)/63.

PART		TOPICS likely to be covered
4	VALUATION BASIS (Cont..)	
		Revenue (Cross Ref. to Pt 6 for Reassurance tax avoidance arrangements)
4	Mortality	
5	Matching	(including currency and linked business mismatching as well as normal asset mismatching)
6	V2,V3 and other unusual methods	
7	Rate of Interest	Cross Ref. to cover 3 for excess E etc.
8	Options & Guarantees (including Maturity Guarantees)	(Cross Ref to cover 9 for linked policies where (100+x)% of future premiums invested)
9	Unit Liabilities	(discounting capital (& accumulat-- units, Reg 56 etc)
10	Other	Deposit admin schemes Cross Ref. to Pt 6 for valuing deposits back.

MAN/T2(5)/6.88

PART	TOPICS likely to be covered
5 SOLVENCY MARGINS	
COVERS	
1 Calculation	(linked business, "global" CGT reserves etc)
2 Concessions	(to Cos. running off)
3 Implicit items	(future profits, hidden reserves)
6 REASSURANCE	
COVERS	
1 Financing Arrangements	
2 Tax Avoidance	
3 Deposit Back Arrangements	(including valuation aspects)
4 Stop Loss Arrangements	
7 CONTRACTS & MARKETING ASPECTS (INCLUDING LAPSE RATES)	
COVERS	
1 Class VII Business	
2 Non Life Riders	(Short term sickness & redundancy benefits)

MAN/T2(6)/6.85

PART	TOPICS likely to be covered
7	CONTRACTS & MARKETING ASPECTS (INCLUDING LAPSE RATES)

3 Sum Assured on Linked Contracts

4 Unusual Contracts

5 Projected Benefits & Reasonable Expectations

6 Other Policy Marketing Issues

7 Lapse Rates

MAN/T2(7)/6.3?

V P Knowles

To: [redacted]

CC: [redacted]

From: [redacted]

Hd/I1
Room 722
10-18 Victoria Street
215 3150

8 December, 1994

RECEIVED
12 DEC 1994
GOVERNMENT ACTUARY'S DEPARTMENT

INSURANCE SUPERVISORY POLICY AND PRACTICE

I attach a briefing note which summarises our underlying philosophy towards the regulation of insurance companies and how in practice we carry out our supervisory responsibilities.

2 We would of course be happy to develop any aspects of this further, either by way of a note or in discussion, if you wished.

[redacted]

INSURANCE SUPERVISORY POWERS AND PRACTICE

PHILOSOPHY

1 The regulatory system for UK insurance companies is founded on the principle of "freedom with disclosure" in a freely competitive market place. Companies have considerable freedom to follow their commercial judgement within a broadly defined and non-intrusive regulatory framework. But they are required to place on the public record a considerable amount of detail concerning the business they have accepted and their solvency position.

2 Consequently, policyholders, competitors, brokers, market analysts and journalists have access to the information contained in the annual DTI Returns. This has resulted in a growing number of comparative analyses of data and an increasing market in insurance information - producing a more informed market in insurance products and their financial security.

3 We believe that the broad commercial freedom which has long been a part of the UK insurance scene is one of its strengths which will help UK companies compete successfully in the European Single Market. We have successfully exported this regime to the rest of the EU following implementation of the most recent EC Directives. Since July this year, we have taken over responsibility for financial and prudential supervision of the activities of our companies throughout the EU, not just for the UK. Conversely, we no longer supervise the UK branches and agencies of EU companies. This is in accordance with the principle of home state supervision.

4 In a competitive market, it is not realistic to expect that all failures can be prevented. The risk of some companies going out of business has been regarded as an acceptable price for an innovative and price competitive market, operating in the interests of its customers. But our aim is to get as much early warning as possible about developing problems and take appropriately robust action to prevent or minimise damage to policyholders.

SUPERVISORY PRACTICE

5 The Department's objective is to supervise the insurance industry effectively so that policyholders are protected against the risk that insurance companies will not meet their liabilities, or will not fulfil their reasonable expectations. Its main weapons in achieving this are ; authorisation, financial supervision and "fit and proper" controls (now subsumed under the concept of

sound and prudent management). These are all now required by EC law though the details are left to member states under the principle of subsidiarity.

i. Authorisation: an insurer wishing to conduct insurance business in the UK must be authorised to do so. Entry of companies into the market is controlled so as to ensure as far as is possible that every new company has adequate capitalisation as well as a sound business plan and thus stands a good chance of success. Authorisation is given for a particular class or type of business. A company that then wants to write different business requires further authorisation.

ii. Financial Supervision: detailed, comprehensive returns are required on an annual basis by the Insurance Companies (Accounts and Statements) Regulations 1983, which are subjected to computer based solvency tests. These are in addition to and are considerably more detailed than the normal shareholder accounts which insurance companies have to file with the Registrar of Companies under general company law. They are audited. Insurance companies are also required to observe a series of financial requirements set out in the Insurance Companies Regulations 1994. In particular they are required to maintain, at all times, assets not just up to the amount of liabilities but to provide a safety margin (called a "solvency margin") so that they could suffer a certain degree of losses but still be able to meet their commitments in full. Asset Valuation rules ensure that companies maintain a sensible spread of assets, and value them conservatively. We expect non-life insurers normally to maintain a solvency margin of at least twice the statutory minimum. When examining returns, we consider such things as assets, liabilities, reinsurance protection, profitability, quality of management and future trends. We do not rely exclusively on the annual returns but have an active visit programme and monitor other sources of information to seek to ensure that our supervision is forward rather than backward looking.

iii. Sound and Prudent Management: under the terms of the Insurance Companies Act 1982, the Department has the statutory responsibility to ensure that key positions in authorised insurance companies (eg controllers, directors, managers) are not occupied by people who appear to be not "fit and proper". Additionally, since the implementation of the 3rd EC Directives in July this year, the concept of sound and prudent management has been introduced. This enables us to take a view as to whether the management of the company as a whole has the right balance of skills and experience not just the fitness of separately notified individuals. It also allows us to take action in a wider set of circumstances where we believe that the company is not acting in a prudent way. The criteria of sound and prudent management are explained in the attached Schedule to the 1994 Regulations. The Regulations permit use of all our existing powers of intervention in the event of failure to comply with the criteria of sound and prudent management. This has considerably strengthened our supervisory powers.

POWERS OF INTERVENTION

6 The Department has a number of intervention powers available if insurance companies appear to be in financial trouble. Probably the most common is to require companies to submit a plan for the restoration of a sound financial position in cases where the minimum solvency margin has been breached. Specific powers also exist whereby we can limit premium income, suspend underwriting, take custody of assets, accelerate accounting information required, call for actuarial reports, appoint inspectors and, ultimately, withdraw authorisation.

7 As explained above we are now able to intervene more easily where we have concerns that the company is acting in an imprudent manner, ie is failing to comply with the criteria of sound and prudent management. In the past, there have been occasions where supervisors have regarded intervention as desirable but have either had no specific power to do so, or considered that the power was not clearly enough defined to allow it to be used. These augmented powers are not intended to increase the overall level of supervision of soundly run insurance companies.. They are designed to enable us to intervene in cases where previous legislation proved to be inadequate. It remains the case that the main grounds for intervention are the protection of policyholders or breach of an obligation under the legislation.

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8 The first example of the robust use of our new powers has been the case of Dominion Insurance Co, which has been the subject of separate ministerial submissions. Action has been initiated under the sound and prudent management criteria to withdraw the company's authorisation to write new business because of the considerable uncertainties over the level of reserves for paying long tail asbestos and pollution claims, highlighted in an independent actuary's report. We took the view that the uncertainties over solvency were too great to permit continued writing. This was in spite of the company showing a reasonable margin of solvency according to its December 1993 DTI return (but on the basis of low reserves for asbestos etc).

9 Clearly, there are difficult judgements to be made as to when these powers should be invoked and to what extent. The overriding consideration must be the degree of risk that the company will be unable to meet its liabilities to policyholders. In the majority of cases, the Department is able to rely on its informal powers of persuasion to ensure that companies take appropriate action before serious problems arise, with the threat of formal sanctions in the background.

SUPERVISION OF LIFE AND NON-LIFE BUSINESS

10 The principles of our supervision of life and non life business are similar (freedom with disclosure) and our intervention powers are broadly the same, but there are some differences in the organisation of our supervisory work resulting from differences in the nature of the business.

11 All life companies are required to appoint an Actuary who has a professional duty to satisfy himself that the funds held by the company are at all times sufficient to meet its obligations to policyholders. The appointed Actuary also has a duty to report to the Department if he is not so satisfied (or if he is prevented from carrying out his responsibilities), and is subject to extensive professional guidance by the Institute and Faculty of Actuaries. Whilst the Department has responsibility for supervision of life companies and for decisions on the use of the intervention powers, we rely heavily on advice from the Government Actuary's Department (GAD) for detailed analysis of the financial returns.

12 There is at present no equivalent requirement for actuarial involvement in non-life insurance. The Department consults the GAD in cases where actuarial advice is appropriate. Over the past few years

considerable efforts have been made to upgrade the quality and technical competence of staff in the division, and to reinforce GAD's capability in this area, to ensure that they are adequately equipped to carry out their supervisory responsibilities.

IMPACT OF COMPANY INSOLVENCIES

13 Despite the supervisory activities described above, insurance company insolvency cannot be always prevented. Unlike some other countries which have imposed much more onerous regulation eg of policy conditions and premiums and have made prevention of failure an overriding objective, the UK system has always acknowledged the possibility of failure in a competitive market.

14 The benefits of competition feed through to the consumer in terms of more efficient and innovative companies. They can however also lead to under pricing of risks, over ambitious expansion plans or inadequate reserving. In addition sudden changes in external circumstances (a spate of catastrophes; developments in judicial awards) can catch companies unawares.

15 The consequences of company failure, whether or not the failure could have been prevented, are potentially traumatic. Following the collapse of the Vehicle and General Insurance Co in 1972 a protection scheme for policyholders (individuals and partnerships) was introduced as a back stop safety net. Under the Policyholders Protection Act (PPA) 1975 private policyholders affected by an insurance insolvency receive 90% of the value of claims for non-compulsory insurance and 100% for compulsory insurance. The PPB is also required to arrange the continuity of unexpired life policies to protect 90% of the future benefit. Funds are generated by a levy on the industry of up to 1% of annual net premium income.

16 Levies are only made when there is a specific need. Until recently calls on the PPA levy were relatively light. However, following the failure of a number of companies providing liability insurance in the US, notably the insurance subsidiaries of London United Investments, which collapsed in 1990 with liabilities of some £5 bn, the PPA levy has become a significant drain on the industry . Four of the five levies under the PPA have been made since 1989. This has focused interest within the industry on the coverage of the PPA (which currently includes overseas business when it is written in the UK but not incorporated entities) and the importance of effective supervision by the Department. You have separately received an initial brief on the review of the PPA.

The Government Actuary's Dear Appointed Actuary letters

DAA1 (13 November 1985)

MEMORANDUM TO APPOINTED ACTUARIES FROM THE GOVERNMENT ACTUARY

VALUATION RETURNS IN RELATION TO SOLVENCY MARGINS

1. It is apparent from my Department's scrutiny of companies' 1984 returns that many actuaries have not appreciated the full impact of the changes in the Accounts and Statements Regulations which came into force in March 1984 to give effect to the solvency margin requirements. Many companies have received letters drawing attention to aspects of their 1984 returns which do not appear to meet the new requirements, and the DTI with GAD is considering these on a company by company basis. Many of the points which are causing difficulty are in fact mentioned in the guidance notes on the preparation of annual returns issued by DTI in September 1984. My purpose in writing to you, in common with all other Appointed Actuaries to UK authorised companies, is to draw your attention to these guidance notes and also to explain rather more fully the background to and the nature of the changes in the regulations. I hope that any misunderstandings can be cleared up in time for the preparation of the next set of returns, which for most companies will be as at 31 December 1985.

2. The problems seem to arise from the interaction of several factors:

(i) The solvency margin requirement itself which means that a clear distinction must be drawn between the actuary's reserves and any free reserves in the life fund available for solvency margin.

(ii) The market value basis laid down for the valuation of assets. The balance sheet and statement of solvency in the Accounts and Statements Regulations are constructed around this concept.

(iii) Many companies prefer to maintain their life assurance funds at book value, rather than writing the fund up or down to market value each year. It is not intended to whittle away this facility, but there is no doubt that it adds to the complications.

The Government Actuary's Dear Appointed Actuary letters

DAA1 (13 November 1985)

3. The valuation regulations require actuarial reserves to be calculated on a prudent basis. Regulation 55 covers mismatching reserves, which ensure that the company can continue to maintain reserves meeting the minimum criteria in the face of changing investment conditions.

4. Although, in Schedule 4, an actuary may set his reserves in the context of the book value of the life assurance fund, for the purposes of the balance sheet and the statement of solvency (Forms 9, 10 and 14) the reserves have to be set in the context of the assets broadly at market value, as required by the asset valuation regulations. In other words the Schedule 4 valuation has to be justifiable by reference to market values, or additional reserves will need to be set up. In concept there are two sets of mathematical reserves, relating to book and market values respectively. Only the excess over the total "market" reserves, which have to be sufficient to cover all foreseeable liabilities including contingencies arising from mismatching, can be counted towards the solvency margin. In practice the main elements of a 'book' valuation basis, such as interest and mortality, are likely to be appropriate for both valuations, but additional provision may be needed for, eg, mismatching or capital gains tax liabilities, in order to move from a 'book' to a 'market' basis. If any of these items have been set against the margin between market and book values of assets, it is necessary to know how much of this margin has been so used, as only the remainder can count towards the solvency margin. This addition to the Schedule 4 mathematical reserves has to be mentioned in the Actuary's Certificate and shown in a note to Form 14.

5. Thus, in order that GAD can examine valuations in the usual way, the nature and extent of the provision for mismatching and CGT liabilities needs to be stated in the Fourth Schedule. Only then can a view be taken about the cover for the solvency margin shown in the returns. This is the background to paragraphs 7.7.6 - 7.7.7 and 12.6 - 12.8 of the DTI guidance notes.

6. Neither the valuation regulations nor the Institute and Faculty guidance notes lay down a specific basis for the calculation of mismatching reserves, so this is left to the professional judgement of the actuary. GAD's function is to advise the DTI how each company

The Government Actuary's Dear Appointed Actuary letters

DAA1 (13 November 1985)

stands having regard to the DTI's responsibilities under the Act. While GAD applies its professional judgement in formulating such advice, we need some rule against which to assess the adequacy of mismatching reserves. Obviously this becomes more crucial the smaller is the excess of free assets over the required solvency margin, but it would be untenable for DTI to operate the regulations on the basis that specific mismatching reserves need be set up only where the cover for the solvency margin is low, but that stronger companies need not bother and may thus overstate the cover for their solvency margins.

7. In general it is GAD's longstanding practice to formulate its own internal working rules after looking at the way in which established companies have treated the question, which thus needs to be set out in their Fourth Schedules, and after considering any Institute, Faculty or other papers on the subject and discussions thereon.

8. As regards mismatching reserves, the present working rule has regard to current investment conditions and to the tempo and scale of past changes. The present rule was stated at the Birmingham Convention; very briefly we would compare the company's reserves with the ability to meet the requirements of the Regulations (other than Regulation 55) given an immediate rise or fall of 3% in the rate of interest and fall of 25% in equity prices.

9. Naturally companies should also look at their mismatching provisions on the basis of cash flow matching, over a wide range of investment conditions, but this would be in the context of a gross premium valuation rather than the net premium valuation required by the regulations. These tests need not be fully described in the Fourth Schedule as a matter of routine, the amount of information to be shown would depend on their significance for the company concerned.

10. The essential point, however, is that Fourth Schedule returns will in future need to give greater detail as to the manner of assessment of mismatching reserves and provision for Capital Gains Tax.

The Government Actuary's Dear Appointed Actuary letters

DAA1 (13 November 1985)

11. Before the valuation regulations and guidance notes were written, there were extensive discussions in the Joint Actuarial Working Party comprising representatives of DTI, GAD and the Institute and Faculty. It is now intended to reconvene the Group to consider problems arising. This note is not intended to pre-empt the Joint Working Party in any way. I am writing to you now because it seems necessary to clarify as soon as possible what we will be looking for in the forthcoming returns. I hope this will be helpful.

13 November 1985

The Government Actuary's Dear Appointed Actuary letters

DAA4 (31 July 1992)

[redacted]

Government Actuary's Department

22 Kingsway, London WC2B 6LE
Telephone: 071-242 6828 ext.
Fax: 071-831 6653

31st July 1992

Dear Appointed Actuary,

Earlier this month, you will have received a copy of the revised version of Guidance Notes GN1 and GN8, issued by the Institute and Faculty of Actuaries. They update the previous versions of these Guidance Notes, and GN8 in particular now incorporates the main content of Temporary Practice Note No. 2 (TPN2), which dealt with resilience testing.

TPN2 referred to and effectively endorsed the specific parameters included in my predecessor's letter to Appointed Actuaries of 13 November 1985, against which it was recommended that an appointed actuary should in normal economic circumstances test the resilience of the valuation basis, namely, an immediate fall of 25% in the value of equities and property, and an immediate rise or fall in the yield on fixed interest securities of 3 percentage points.

The new GN8 does not specifically refer to these parameters. Instead it requires the appointed actuary to use professional judgement to determine an appropriate range of changes in financial conditions over which to test the resilience of the valuation basis. Since the actuary will soon have to sign a statutory certificate to indicate that the Guidance Notes have been complied with, great care had to be taken with the wording. It was considered inappropriate to include a fixed set of parameters in a Guidance Note which has to cover all possible financial conditions.

It remains the position of the DTI and GAD that, in most financial conditions, the parameters included in TPN2 will be taken as the benchmark against which an actuary's valuation basis will be tested, though higher parameters might be appropriate in certain financial conditions.

However, in more extreme circumstances the parameters outlined in Paragraph 2 above could lead to reserving standards which might be unreasonably strong for offices to have to maintain, given the margins built into the reserving standards elsewhere by the Determination of Liabilities Regulations.

DAA4 (31 July 1992)

Accordingly, I am writing to let you know that (unless there are particular circumstances which make the continuing use of the normal parameters appropriate) DTI and GAD consider that it would be reasonable for appointed actuaries whose companies' equity portfolios correspond broadly to the Financial Times All-Share Index to review the parameters which they incorporate in the resilience test when the dividend yield on that index exceeds 5.25%. A gradual tapering of the 25% parameter would be envisaged, but it would not be considered advisable to assume that there would be a maximum dividend yield at which no further fall in market values would be assumed. If, at any time when you are continuously monitoring the financial position of the long term fund, you consider it would be appropriate to introduce a tapering of the 25% parameter, or weaken any of the other parameters referred to in this letter, you should contact my Department straightaway to discuss your proposed basis.

With regard to investments held in land and property in more extreme financial conditions, appointed actuaries will need to test the resilience of their offices to meet falls in the value of those investments on a prudent basis, taking into account the specific properties held and the factors to which the company may be particularly vulnerable which could lead to further changes in the values of those assets. Property portfolios vary to such an extent between companies that it is not possible to give a more precise view of the standards which supervisors will apply when considering the appropriateness of an actuary's valuation basis.

When considering hypothetical changes in yields under the resilience test, the limitation on the dividend yield on an equity (and the rental yield on a property) - to the yield on Consols - might be a material factor, even though an adjustment may have already been made for the risk that the aggregate income from equity shares and land might not be maintained (Regulation 59(6)(b)). In circumstances where this is a material factor, my Department would be willing to discuss with you the practical application of this aspect of your proposed resilience test, having regard to the specific assets held by your company.

With regard to fixed interest yields and the resilience test, the absolute level of interest rates is a relevant criterion. It would be reasonable to assume that it is more likely that there could be an immediate fall of three percentage points if current rates were 15% than if they were 6%, say. At the present time, appointed actuaries will need to consider the high real interest rates currently prevailing, and the possibility of the UK experiencing higher rates of interest through forces which may be in part outside its control.

The Government Actuary's Dear Appointed Actuary letters

DAA4 (31 July 1992)

Appointed Actuaries should also consider the possibility of more extreme financial conditions in the future, and the extent to which the technical reserves held by the office, together with its solvency margin, will be sufficient to enable it to meet its liabilities in such circumstances.

Full details of the assumptions used should be provided in Schedule 4 of the Returns.

Appointed Actuaries should, of course, continue to carry out cash-flow analyses on prudent assumptions to determine whether additional reserves need to be established to ensure that liabilities can be met as they fall due in future, even under unfavourable investment conditions.

Officials at DTI and GAD would be happy to discuss and to clarify the implications of this letter with individual companies and their appointed actuaries.

Yours sincerely

[redacted]

The Government Actuary's Dear Appointed Actuary letters

DAA6 (30 September 1993)

[redacted]

Government Actuary's Department

22 Kingsway, London WC2B 6LE
Telephone: 071-242 6828 ext.
Fax: 071-831 6653

DAA6

30 September 1993

Dear Appointed Actuary

RESILIENCE TEST

Since my letter to all Appointed Actuaries of 31 July 1992(DAA4), the investment outlook has changed considerably, in particular as a result of the United Kingdom's departure from the Exchange Rate Mechanism. Long term investment yields on gilts have reduced from over 9% at that time to around 7¼% now, while the FT All Share Index has risen from about 1150 to around 1500 now, a rise of about 30 percent. Over the same period, the dividend yield on the FT All Share Index has reduced from 5.2% to 3.75%.

My letter of 31 July 1992 was triggered by the publication by the Institute and the Faculty of Actuaries of the revised versions of Guidance Notes GN1 and GN8. The latter does not now refer specifically to the parameters for the resilience test, unlike the old TPN2, which had effectively endorsed the parameters included in my predecessor's letter of 13 November 1985. In my letter last July, I stated that, notwithstanding the withdrawal of TPN2, it remained the position of the DTI and GAD that, in most financial conditions, these parameters would continue to be taken as the benchmark against which an actuary's valuation basis would be tested.

However, I referred in my letter to financial conditions in which the use of those fixed parameters could lead to reserving standards which might be unreasonably strong for offices to have to maintain; in particular, I referred to dividend yields on equities rising above 5.25% and to fixed interest yields falling.

With gross redemption yields on gilts having fallen by nearly 2 percentage points since just over a year ago, it is now appropriate to reconsider the parameters for the resilience test, especially in the context of an outlook for low inflation in the immediate future, and low short-term interest rates.

Document Number:20558 Page 1

DAA6 (30 September 1993)

In considering the formulation of the resilience test, it needs to be borne in mind that the valuation of liabilities regulations will need to be revised as a result of the Third Life Framework Directive, and so at the moment it is appropriate to consider the structure of the test in the context of the valuations at 31 December 1993 (and other valuation dates in the next 12 months). Further guidance may be expected when these amended regulations have been issued, but these will not affect valuations prepared for years ending before 1 July 1994 at the earliest.

With that in mind, the DTI and GAD consider that for companies which do not write with-profits business, i.e. those which might be expected to hold only fixed-interest securities to cover their non-linked liabilities, our benchmark for an appropriate range of yields at the present time would be an increase in current yields of 3 percentage points; and a fall of 20% from present levels, i.e. a fall of about 1.5 percentage points at the time of writing.

For with-profit offices, we consider that the valuation should be tested for three different scenarios. Our benchmark at the present time would be (1) a reduction in fixed-interest yields by 20% combined with a fall in value of equities of 10%. (2) a reduction in fixed-interest yields by 10% combined with a fall in equity values of 25%, and (3) a rise in fixed-interest yields of 3 percentage points combined with a fall in equity values of 25%.

As I indicated in my last letter, property portfolios vary to a considerable extent between offices and it is not possible to give a precise view of the tests which supervisors will expect to see applied to a particular portfolio. However, provided the current value given to properties is realistic and, where appropriate, reductions in values have already been adequately brought into account, an assumption of a further fall in property values above 20% is unlikely to be required.

In determining the valuation rate of interest, Regulation 59(6)(b) requires a prudent approach to be taken to the assessment of future equity share dividends and rental income from land, with a further overriding limitation that the yield assumed on an asset should not exceed the yield on 2½% Consols. Only the first of these limitations need be applied to the hypothetical yields which arise in the resilience test. You should bear in mind, however, the possible need to fund future reserve strengthening to enable the Consols test to be satisfied at the next valuation, should these scenarios occur in practice.

2

Document Number:20558 Page 2

The Government Actuary's Dear Appointed Actuary letters

DAA6 (30 September 1993)

As mentioned in my last letter on this subject, appointed actuaries should also consider the possibility of more extreme financial conditions in the future, and the extent to which the solvency margin would be sufficient to enable the office to meet its liabilities in such circumstances. Cash flow analyses should also be carried out on prudent assumptions.

The main assumptions used in the resilience tests should continue to be stated in Schedule 4 of the DTI Returns.

In the longer term, it is being considered whether further refinement to the concept of resilience testing should be applied along the lines proposed in other countries such as Australia, US and Canada. It is hoped that the Joint Actuarial Working Party (JAWP) will take forward some of this work and further discussion with the actuarial profession can be expected.

Officials at DTI and GAD will be happy to discuss any aspects of this letter with individual companies and their appointed actuaries.

Yours sincerely,

[redacted]

3

Document Number:20558 Page 3

The Government Actuary's Dear Appointed Actuary letters

DAA7 (31 March 1994)

[redacted]

Government Actuary's Department

22 Kingsway, London WC2B 6LE
Telephone: 071-242 6828 ext.
Fax: 071-831 6653

DAA7

31 March 1994

Dear Appointed Actuary

APPOINTED ACTUARY'S CERTIFICATE: COMPLIANCE WITH GUIDANCE NOTES 1 AND 8.

As you are aware, appointed actuaries are now required to sign a certificate, to be incorporated in the DTI returns, stating (if such be the case) that Guidance Notes 1 and 8, issued by the Institute and Faculty of Actuaries, have been complied with. I want to draw one aspect of those Guidance Notes to your attention, and to suggest a form of certificate (which is acceptable to the Department of Trade and Industry) for your consideration should the point be of relevance to your valuation.

In paragraph 3.2.3 of GN8, it is stated that "The company's reserves (including any resilience reserve) should be sufficient to absorb the effect of immediate changes in interest rates and asset values, on a suitably prudent basis without prejudicing the company's ability to hold reserves which satisfy the regulations for valuing liabilities (other than Regulation 55)".

Regulation 55 states - "The determination of the amount of long term liabilities shall take into account the nature and term of the assets representing the long term fund and the value placed upon them and shall include appropriate provision against the effects of possible future changes in the value of the assets on their adequacy to meet the liabilities".

Regulation 59(6)(b) states - "In calculating the yield on an asset under this regulation for assets which are equity shares or land, adjustments to yields shall be made as appropriate to exclude that part, if any, of the total yield from those assets, taken together, that is needed to compensate for the risk that the aggregate income from those assets taking one year with another might not be maintained, so however that the yield assumed on an asset shall not be greater than that on British Government 2½ per cent Consolidated Stock on the valuation date".

DAA7 (31 March 1994)

The so-called Consols test was devised before the concept of resilience testing was established in 1985, and is too stringent in certain scenarios tested by actuaries. (The Consultative Document on the implementation of the Third Directives suggested its deletion from the regulations.) Accordingly, the Government Actuary's letter of 30th September included the following paragraph:-

"In determining the valuation rate of interest, Regulation 59(6)(b) requires a prudent approach to be taken to the assessment of future equity share dividends and rental income from land, with a further overriding limitation that the yield assumed on an asset should not exceed the yield on 2½% Consols. Only the first of these limitations need be applied to the hypothetical yields which arise in the resilience test. You should bear in mind, however, the possible need to fund future reserve strengthening to enable the Consols test to be satisfied at the next valuation, should these scenarios occur in practice".

However, the effect of appointed actuaries not applying the limitation of the Consols test in their resilience scenarios is that they will need to say so in their certificates under the new regulation as the Guidance Note requires the test to be included. We consider that an appropriate certificate would be:-

The guidance notes "Actuaries and Long-Term Insurance Business (GN1)" and "Additional Guidance for Appointed Actuaries (GN8)" issued by the Institute of Actuaries and the Faculty of Actuaries dated July 1992 have been complied with, subject to the modification to the Consols test as set out in the Government Actuary's letter of 30th September, 1993.

[redacted]

c:\0394-023

The Government Actuary's Dear Appointed Actuary letters

DAA10 (24 November 1998)

GOVERNMENT ACTUARY'S DEPARTMENT

PLEASE NOTE
NEW EMAIL ADDRESS
[redacted]

22 KINGSWAY
LONDON WC2B 6LE

FAX (GTN) +44 (0) 171 211 2650
SWITCHBOARD +44 (0) 171 211 2600
[redacted]

24 November 1998

DAA10

Dear Appointed Actuary

RESILIENCE TEST

I am writing to you in connection with the advice given to appointed actuaries by GAD, with the agreement of HMT, on the application of the so-called 'resilience test' for life insurers. As you may know, I previously wrote to you on 30 September 1993 setting out three separate benchmark scenarios that were considered to be appropriate to examine for with-profit offices.

Recent increased volatility in the equity markets has produced extreme daily movements in the indices, both the FTSE100 and the FTSE All Share. Whilst this is a phenomenon which life offices should and must learn to live with, the interaction of such rapid movements with the type of resilience test which this department has applied for a number of years can produce unreasonable results.

At the same time, we have seen a significant fall in the yields on gilts, so that the benchmark 15 year yield is now only about 5%. Although it would not be appropriate to draw too many conclusions about the interactions between markets, there are economic arguments which make it unlikely that markets will sustain simultaneously lower gilt yields and very much lower equity levels than prevail at the time of writing (when the FTSE100 is at about 5500).

We are also aware that there is a working party of the Faculty and Institute of Actuaries looking at possible revisions to the resilience test for the future, but this is unlikely to come forward with proposals for some months. Furthermore, the Treasury is consulting the industry on changes to regulations, and in particular to regulation 69, which will require the resilience test to be revisited if implemented. It is in this context that we have decided to amend the resilience test on a temporary basis for the immediate future.

The proposal affects only the test numbered (2) in my 1993 letter: a 10% fall in fixed interest yields combined with a fall in equity values of 25%. The revised test is necessarily more complex, but will avoid the unreasonable stringency which might apply if equity markets fall significantly below their current levels.

The Government Actuary's Dear Appointed Actuary letters

DAA10 (24 November 1998)

Provided the benchmark 15 year gilt yield remains at or below 6% p.a.,

(i) if the FTSE100 index is above 4500 on the valuation date, the test (2) will remain as at present;

(ii) if the FTSE100 index is below 4500, but has not closed at a level below 3750 on any day in the previous 12 months, the equity component of test (2) will be replaced by test of a fall to a market level equivalent to a FTSE100 index of 3375;

(iii) if the FTSE100 has closed below 3750 on at least one day in the 12 months ended on the valuation date, then the equity component of test (2) will be replaced by a test of a fall to 10% below the lowest closing value in that 12 month period;

although in no case will it be necessary to test a fall of more than 25% from the level on the valuation date.

By way of illustration, if the FTSE100 is 4000 on the valuation date, and has remained above 3750, the fall to be tested would be 15.625%(=625/4000). If FTSE100 were at 4400, similarly with no previous fall below 3750, the fall would be 23.295%(=1025/4400).

In all three cases described above, Appointed Actuaries should apply the same fall of 20% as at present to property values, as these do not exhibit such high daily volatility.

If the benchmark yield rises above 6%, we will review the test again, but would intend to apply a similar approach, albeit perhaps at different levels.

I would like to stress that this revision only applies to test (2), and not to test (3). If there were a marked rise in gilt yields, back to the levels of only a relatively short time ago, there would be no justification for a relaxation of this type.

On a final point, where Appointed Actuaries extend the resilience tests to other types of business such as unit linked business, I do not consider it is appropriate to include in the test any component which, taken overall, serves to reduce the prudential effect of the test. For example, an office which has only unit linked business, some of which carries a guaranteed annuity rate, should not necessarily assume equity values fall in applying tests for lower interest rates.

Yours sincerely

[redacted]

The Government Actuary's Dear Appointed Actuary letters

DAA12 (30 September 1999)

GOVERNMENT ACTUARY'S DEPARTMENT

30 September 1999

Our Ref: DAA12

[redacted]

22 KINGSWAY
LONDON WC2B 6LE

FAX (GTN) +44 (0) 171 211 2650
SWITCHBOARD +44 (0) 171 211 2600

[redacted]

Dear Appointed Actuary,

RESILIENCE TEST

As you may recall, I wrote to you in November last year explaining that we were modifying on a temporary basis the guidance given to appointed actuaries on the fall in equity values that should be assumed in certain investment scenarios. We have now considered this guidance further in the context of the possible interrelationship that may exist between gilt yields and movements in the value of equities in some investment conditions.

I am therefore writing to you, with the agreement of FSA, to set out a revision to last year's guidance which should, we believe, be appropriate to apply now when assessing the ongoing financial condition of life insurers, and in particular for the production of the next set of financial returns.

As with last year's guidance, this change only affects the test numbered (2) in my 1993 letter; namely a 10% fall in fixed interest yields combined with a fall in equity values of 25%. In place of the formula set out in my letter last year, we propose that the test should comprise a combination of

(i) a 10% fall in fixed interest yields, and

(ii) a fall in the value of equities of the greater of

  (a) 25%, subject to the fall being restricted to such as would not produce a P/E ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long term gilt yield (as defined in regulation 69(9)) before the assumed fall in paragraph (i), and

  (b) 10%.

DAA12 (30 September 1999)

As mentioned in my 1993 letter, appointed actuaries should also consider the possibility of more extreme financial conditions in the future, and the extent to which the solvency margin would be sufficient to enable the office to meet its liabilities in such circumstances. Cash flow analyses should also be carried out on prudent assumptions.

The tests can be appropriately modified for other situations, in a similar way to that in my 1993 letter. As I indicated in my letter of last November, I do not consider it is appropriate to include in the test any component which, taken overall, serves to reduce the prudential effect of the test. For example, an office which has only unit linked business, some of which carries a guaranteed annuity rate, should not necessarily assume that equity values fall in applying tests for lower interest rates.

In arriving at the above benchmark, we have been mindful of the existence of the current professional working party, and have endeavoured not to anticipate their possible recommendations.

Yours sincerely

[redacted]

The Government Actuary's Dear Appointed Actuary letters

DAA14 (15 May 2000)

Our reference: DAA14

15 May 2000

[redacted]

Dear Appointed Actuary

RESILIENCE TEST

The revisions to the Insurance Companies Regulations 1994 made by HM Treasury recently include a revised formula for determining the yield on investment made more than three years in the future, with consequent effects on shorter term assumptions. This reintroduces a prudent margin on future investment assumptions, but has the effect of making the linkage of the future investment assumption to current yields more dynamic than applied in the past. Three scenarios were originally promulgated in my letter of 30 September 1993 and were amended most recently in DAA12 dated 30 September 1999. Two of these, in the context of the new regulation, now appear unnecessarily severe in their effects, given that the new regulations do allow for the effect of a sustained reduction in long-term interest rates.

I have, therefore, discussed with the Financial Services Authority revisions to the resilience test which FSA and GAD consider appropriate for current conditions. These revisions will apply from the date of coming into force of the amendment regulations.

For with profits offices, and others where it might be appropriate to do so, we consider the three scenarios which should constitute our benchmark to be:

(1) a combination of

- (i) a fall in the value of equities of 10%;
- (ii) for fixed interest securities
  - (a) of less than five years outstanding term to redemption, and for short term deposits, a fall in the risk free yield of 20%
  - (b) for fixed interest securities of fifteen or more years outstanding term to redemption, a fall in the risk free yield of 10%
  - (c) for fixed interest securities of more than five but less than fifteen years outstanding term to redemption, a fall in the risk free yield of (25-{outstanding term in years and part years})%
- (iii) a fall in property values of 10%

(iv) a fall in the real yields on indexed gilts of 25% (e.g. from 2% to 1.5%)

(2) a combination of

(i) a fall in the value of equities of the greater of

(a) 25%, subject to the fall being restricted to such as would not produce a P/E ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long term gilt yield (as defined in regulation 69(9)) before the assumed fall in paragraph (ii), and

(b) 10%

(ii) for fixed interest securities

(a) a fall in the yields on risk free securities of less than five years outstanding term to redemption and on short-term deposits to the level which is calculated under regulation 69(9) for future investments (or remain constant if already at or below this level),

(b) the yields on risk free securities of at least fifteen years duration remaining constant,

(c) a fall in the yields on risk free securities of more than five but less than fifteen years outstanding term to redemption to levels obtained by interpolating between the figures given by (a) above and the 15 year gilt index yield (or remain constant if already at or below this level),

(iii) a fall in property values of 20%, and

(iv) a rise in the real yields on indexed gilts of 10% (e.g. from 2% to 2.2%)

(3) a combination of

(i) a fall in the value of equities of 25%,

(ii) a rise in the risk free fixed interest yields of 3 percentage points,

(iii) a fall in property values of 20%, and

(iv) a rise in the real yields on indexed gilts of 1 percentage point.

For those fixed interest securities which are not risk free, we would expect actuaries to assume the yield differential to risk free does not reduce in a resilience test.

As mentioned in my 1993 letter, appointed actuaries should also consider the possibility of more extreme financial conditions in the future, and the extent to which the solvency margin would be sufficient to enable the office to meet its liabilities in such circumstances. Cash flow analyses should also be carried out on prudent assumptions.

The tests can be appropriately modified for other situations, in a similar way to that in my 1993 letter. As I indicated in my letters of November 1998 and September 1999, I do not consider it is appropriate to include in the test any component which, taken overall, serves to reduce the prudential effect of the test. For example, the actuary to an office which has only unit linked business, some of which carries a guaranteed annuity rate, should not necessarily assume equity values fall in applying tests for lower interest rates. Indeed actuaries to such offices should consider their resilience to a rise in equity values combined with falling interest rates.

DAA14 (15 May 2000)

In arriving at these benchmarks, we have been mindful of the existence of the current professional working party, and have endeavoured not to anticipate their possible recommendations. This has led us to maintain for the time being the core features of the previous tests, whilst introducing appropriate modifications in the context of the revised regulation.

Yours sincerely

[redacted]

DAA11 (13 January 1999)

Your reference :
Our reference : DAA 11

GOVERNMENT ACTUARY'S DEPARTMENT

The Appointed Actuary
All insurance companies authorised to carry on long-term business

22 KINGSWAY
LONDON WC2B 6LE

FAX (GTN) +44 (0) 171 211 2650
SWITCHBOARD +44 (0) 171 211 2600

[redacted]

13 January, 1999

Dear Appointed Actuary

RESERVING FOR GUARANTEED ANNUITY OPTIONS

Further to [redacted] letter of 18 December regarding the costs of guaranteed annuity options in the context of policyholders' reasonable expectations, he has agreed that it would be helpful if I were to provide some guidance to Appointed Actuaries of companies on the advice I have given him on the application of the existing reserving requirements in respect of contracts containing a guaranteed annuity.

2. I consider that Part IX of the Insurance Companies Regulations 1994 (ICR 1994) requires a life office to calculate its liabilities (and hence to reserve) on the basis of all the benefits offered under the contract. Regulation 64 of the Regulations requires long-term liabilities to be determined "on actuarial principles", and to "make proper provision for all liabilities on prudent assumptions". Regulation 64(2) makes clear that the determination must "take account of all prospective liabilities as determined by the policy conditions".

3. Contracts providing for a guaranteed annuity typically take two main forms-either:

- a contract to provide an annuity with an option to secure a cash fund; or
- a contract to provide a cash fund with the option to convert the benefits into an annuity at a guaranteed rate.

4. I would expect the reserving requirements to be very similar (if not identical) irrespective of whether the guaranteed annuity is the principal benefit under the contract or only an option. This is on the basis that in substance a policyholder will be entitled to the same choice of benefits irrespective of which is the principal benefit and which is the option.

Document Number: 00182 Page 1

DAA11 (13 January 1999)

5. In my view it is clear that, where a contract provides for a guaranteed level of annuity, then the effect of Part IX of the ICR 1994 is to require the company to reserve fully for its liabilities to provide annuity benefits to the value guaranteed under the contract. In addition it will be necessary to reserve fully in respect of any facility for policyholders to select an alternative form of benefits.

6. In assessing the extent of these liabilities, the company will need to make a prudent assessment of the extent to which any options are likely to be exercised. In this context I consider that, where the cost of meeting the guaranteed annuity benefits at maturity is significantly greater than the value of any alternative benefits, prudence will require the company to reserve for the contract at a level close to the full value of the guaranteed annuity. In general it would not in my view be prudent to assume that policyholders will choose a benefit form that is of significantly lower nominal value to them, although some limited allowance (of a few percentage points of the reserve) could in some cases be made for a reduction in the liability on the grounds of the additional flexibility or other perceived advantages to policyholders of any alternative benefits.

7. Where the levels of terminal bonus are to be adjusted with the aim of bringing the value of the guaranteed annuity option closer to the value of the alternative benefits, there might at first sight appear to be some room for argument that it was not necessary to reserve on the assumption that almost all policyholders will take the guaranteed annuity benefit. However, it needs to be remembered that, although the benefits formally "guaranteed" under the alternative form of benefit may be lower than those under the guaranteed annuity option, the company's discretion in setting the value of terminal bonus applied to the alternative benefit is limited as a result of the existence of the guaranteed annuity. It is likely that close to 100% of policyholders will exercise the annuity guarantee unless the company maintains terminal bonus at a level which ensures that the value to the policyholder of the alternative benefit is at least equal to the value of the guaranteed annuity. Accordingly, this constraint will need to be reflected in the valuation assumptions made about either the proportion of policyholders opting for the alternative benefit or the value of that alternative benefit. Consequently any reduction in the reserves held by the insurer by more than a few percentage points below the full value of the guaranteed annuity for this reason would require very careful justification by the actuary.

8. I am aware that many policyholders have in the past exercised their right to take up to 25% of the benefits of their pension policy in the form of a tax free lump sum. However, I would not consider it prudent to use past experience alone in this regard as a basis for reducing the percentage of benefits assumed to be taken in guaranteed annuity form. In my view there is a significant risk that there may be a marked change in policyholder practice if policyholders and their advisers view annuity guarantees as valuable and something that should be utilised to the full. For instance, there is the possibility that in future individuals with more than one pension policy will seek to maximise their benefits by exercising in full any guaranteed annuity option and only taking cash from those policies that do not carry a guarantee. In addition any further increase in the value of the annuity benefits relative to cash has the potential to lead to a significantly greater take up of annuity guarantees. As a result I would only consider it prudent to make significant allowance for a proportion

Document Number: 00182 Page 2

DAA11 (13 January 1999)

of available policy proceeds to be taken as cash, to the extent that policyholders are obliged to take some of the benefits as cash. Where policyholders are not obliged to take some benefits in cash, then the principles described in the above two paragraphs of this letter would apply.

9. In addition to holding mathematical reserves to cover their liabilities for annuity guarantees, companies will need to assess the extent to which a resilience reserve is required. I expect companies to apply the recommended resilience tests and other general advice in my letter (DAA6) of 30 September 1993 (as amended slightly in my letter of 24 November 1998 - DAA10) in determining the need for a resilience reserve. The need to hold substantial mathematical reserves to cover guaranteed annuity options would not in my view be a sound argument for reducing the stringency of the resilience test applied.

10. The level of reserves established for guaranteed annuity options is likely to be one of the features of companies' 1998 annual returns which FSA and GAD will want to review particularly closely. It should be remembered that Schedule 4 of the Insurance Companies (Accounts and Statements) Regulations 1996 requires the actuary's report in the annual returns to include detailed information about the contracts written.

11. In particular, paragraphs 4(1) and 5(1) of the Schedule require the provision of a description of the benefits of the contracts written, including any material options. I would expect such a description to provide an indication of the form of any annuity guarantee offered. In addition, in accordance with paragraph 6(1)(h), actuaries should provide a description of the way in which reserves for any annuity guarantees and options have been determined (including an indication of the interest rate and mortality assumptions used). I would also expect that, in accordance with Instruction 9 to forms 51-54, categories of contracts containing annuity guarantees would be shown separately in those forms.

12. The annual returns should include sufficient information for the FSA and GAD to make an assessment of the extent of the guarantees offered, the reserving basis adopted by the company and hence the scope for guaranteed annuity options to impact on the financial position of the company.

13. The above is my considered view and is without prejudice to any decision of the courts which may affect it.

Yours sincerely

[redacted]

Government Actuary

The Government Actuary's Dear Appointed Actuary letters

DAA13 (22 December 1999)

DAA13

22 December 1999

GOVERNMENT
ACTUARY'S
DEPARTMENT

NEW KING'S BEAM HOUSE
22 UPPER GROUND
LONDON SE1 9RJ

FAX (GTN) +44 (0)20 7211 2650
SWITCHBOARD +44 (0)20 7211 2600

[redacted]

Dear Appointed Actuary

RESERVING FOR GUARANTEED ANNUITY OPTIONS

As you will recall, I wrote to you and other Appointed Actuaries on 13January this year regarding the application of the reserving requirements in Part IX of the Insurance Companies Regulations 1994 in respect of contracts containing a guaranteed deferred annuity and a cash or other alternative.

Having now reviewed, at least provisionally, the majority of companies' 1998 annual returns, it is apparent that some aspects of this guidance have been interpreted in a variety of ways. It is clearly important that there should be consistency in the approach taken, and therefore the FSA has concluded that it would be helpful if I were to provide some further clarification on the reserving standards that would normally be expected to be seen in future HMT/FSA returns.

In my view, in determining the reserve for a contract containing a guaranteed annuity it would not generally be prudent to assume that policyholders will choose a benefit form that is of significantly lower nominal value to them than the guaranteed annuity. I indicated previously that I would expect any allowance for the reduction in the liability on the basis of policyholders making such choices to be limited to "a few percentage points" of the reserve. I would like to clarify that I was referring here to the total aggregate allowance that might prudently be made for all other benefit forms (whether cash or other forms of annuity) and that in my view an allowance in excess of 5% would not be considered to represent "a few percentage points".

Document Number: 00358 Page 1

DAA13 (22 December 1999)

There may be considered to be a stronger case for making an allowance for policyholders choosing to take a proportion of their benefits in the form of a tax free cash lump sum. However, I would not consider it prudent to assume that more than 20% of policyholders exercised the option to take the maximum cash lump sum permitted under the terms of the contract. In the case of most pension contracts, such an assumption would equate with a 5% reduction in reserve, the maximum aggregate allowance indicated above as likely to be accepted as prudent.

I am also reviewing the level of disclosure made by each company in their 1998 annual returns regarding the assumptions made to determine the level of reserve for contracts containing a guaranteed annuity. For the avoidance of any doubt, we would expect to see full disclosure of the proportions of policyholders assumed to take any available guaranteed annuity, along with the underlying mortality and interest rate assumptions. I should also add in this context that we would expect to see prudent allowance made for future mortality improvement both before and after the assumed retirement date, taking proper account of the recommendations in the latest CMI reports.

Yours sincerely

[redacted]

Document Number: 00358 Page 2

Section 6

Primary documents – the scrutiny of The Equitable Life Assurance Society's (Equitable's) returns

GAD's general scrutiny proforma reports

For companies' 1995 returns

SCRUTINY STRATEGY WORKING PARTY

PROFORMA SCRUTINY REPORT,
WITH NOTES ON CONTENT

LIFE ASSURANCE COMPANY

RETURNS AS AT 31 DECEMBER 1995

DETAILED SCRUTINY REPORT

The following pages list the 'standard' section and subsection headings. Notes of likely items to be covered are given in italics. It is suggested that the Sections should remain unchanged from one company report to another, to facilitate finding the desired part of any report, even if an occasional 'not applicable' entry is called for. Subsections should remain in the order shown where possible, but may be amended or omitted more freely.

1. SUMMARY

1.1 Key Features

Key features arising from the scrutiny should be presented, perhaps in the form of 'bullet points'. A possible approach is to extract one item from most Sections of the report. An example list of topics is shown below, but it should not be adhered to rigidly.

In addition to the specific key points arising from the scrutiny, we should express a view as to the soundness of the company in the short and longer term. Reference to the cover for the solvency margin (8.4 below) should be made, as this is a key DTI supervisory responsibility. The priority rating of the company should be clearly stated. Where there is any doubt as to whether the valuation basis used is in accordance with the Regulations (8.1 below), this should be also be clearly stated.

- *Size and type of office (e.g. medium-sized with profits mutual), and primary source of business (e.g. IFAs).*
- *Ownership issues.*
- *Our view as to its soundness.*
- *Most important types of business, and recent new business trends.*
- *Expense control.*
- *Recent trends in financial results, especially if adverse.*
- *Asset allocation for with profits business, and changes therein.*
- *Approach to valuation, and a general view as to its strength.*

- *Supportability of bonuses, and recent trends in bonus declarations.*
- *Likely impact of the SIB compensation requirements for mis-selling of personal pensions.*

1.2 Action Points

The list of Action Points should include items of as many of the following types as apply:

(a) Points needing immediate action by DTI;

(b) Points raised by GAD with the actuary in a letter (which should be enclosed);

(c) Points to be recorded for raising at a suitable opportunity, e.g. the next company visit.

2. BACKGROUND

This should be a 'potted history' of the company, covering such things as its size and ownership, and the type(s) of business it writes. Comments on the corporate structure, and particularly of any insurance subsidiaries, should be made. A brief note of the senior management, and particularly the chief executive and the Appointed Actuary, should be given, with information on their experience, recent changes, etc. Any Section 68 Orders in force should be recorded.

The background should also cover significant *developments during the year, e.g. acquisitions, disposals, S49 transfers, changes of ownership, and also such things as new types of business or distribution channels, new admin./computer systems, and LAUTRO/PIA regulatory problems, as recorded in the Chairman's statement, for example.*

Reference should be made to any recent company visit, including a brief description of its outcome. If there are any issues outstanding with the company they should be mentioned.

[It is intended that the 'Background' section should be in essay form rather than as bullet points; it will form an important part of any briefing note on the company. However, most of it should be self-standing, and may well therefore be carried forward from year to year largely unaltered.]

BUSINESS DEVELOPMENTS DURING THE YEAR

3. NEW BUSINESS

3.1 New products

Any significant new products introduced during the year should be described.

3.2 Source(s) of new business

The proportion coming from IFAs, direct sales forces, tied agents etc. (and if relevant the amount from overseas), and any significant changes during the year. [If not available from

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internal information such as the Report & Accounts, this may be obtained from surveys such as that in Planned Savings.]

3.3 Recent history:

Regular premiums

Class	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
Total					
Year on year % increase					

Single premiums

Class	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
Total					
Year on year % increase					

New Business Index (Regular premiums plus 10% of single premiums)

New Business Index (£000s)					
Year on year % increase					

Note that the classes to be shown in the new business tables must be selected individually to be appropriate to the company concerned. Some examples of likely categories are shown in the list below. One or more rows for overseas business should be shown if appropriate, and if such business is of sufficient significance it should be split by major territories too. There will normally be a row called 'Other' so that the totals reflect the Form 44 totals. Figures should be shown gross of reinsurance but a footnote may be added if, for example, some classes are (almost) wholly reinsured.

Life with profits | *Pensions with profits* | *Critical illness*
Life non profit | *Pensions non profit* | *Permanent Health*

Page 3

Unit linked life *Unit linked pensions*
Immediate Annuities *Group pensions*

For large companies all the above figures, and the expense figures below, may be shown in £millions if this is more appropriate.

4. CHANGES IN BUSINESS IN FORCE

4.1 Recent history of regular premiums

Class	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
Total gross regular premiums					
Less reinsurance premiums					
Total net regular premiums					
Year on year % increase					

4.2 Claims experience

Recent history of mortality rates

Class	1990	1991	1992	1993	**1994**

The mortality rates are:

Form 43, UK business, premiums, line 5 / (½ lines 1 + 12 + 5)*

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4.3 Persistency experience

Recent history of lapse rates

Class	1990	1991	1992	1993	**1994**

The lapse rates are:

*Form 43, UK business, premiums, line 8 / (½ * [½ * E(t-2) + E(t-1) + ½ * E(t)]), where*

E(t) = lines 2 + 3 in year t

Recent history of combined surrender, lapse & paid-up conversion rates

Class	1990	1991	1992	1993	**1994**

The combined surrender, lapse and paid-up conversion rates are:

Form 43, UK business, premiums, (lines 7 + 8 + 9) / (½ lines 1 + 12 + 7 + 8 + 9)*

Make reference to any features identified from these Form 43 figures, e.g. large increases in surrenders. Supplement this information with PIA data when this becomes available.

5. EXPENSES

5.1 Recent history of expenses:

Expense	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
Initial commission					
Acquisition expenses					
Renewal commission					
Renewal expenses					
Total expenses					
Year on year % increase					

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Expense ratios:	1990	1991	1992	1993	**1994**
Acquisition					
Renewal					

Expenses should be shown gross of reinsurance. The expense ratios are:

Acquisition (IC + AE) / New Business Index

Renewal (RC + RE) / Regular premium income in force [from Form 41, col. 1, lines 2 + 4 + 6 + 7 + 8]

The definitions of these ratios should be explicitly stated in the text of the report.

5.2 Commentary

To include comment on the trends in the expense ratios.

5.3 Exceptional items

Refer to any exceptional items of expenditure, e.g. fines and compensation payments. Also comment on any references in the Report & Accounts to DP or sales distribution developments.

SITUATION AT THE YEAR END

6. NON-LINKED ASSETS

6.1 Changes in portfolio

Recent history of asset mix

Type of asset	1990	1991	1992	1993	**1994**
Land					
Govt fixed interest					
Other fixed interest					
Govt index linked					
Equity shares					
Debts sec'd on land					
Other - producing income					
Other - not producing income					

Recent history of yields

Type of asset	1993	**1994**
Land		
Govt fixed interest		
Other fixed interest		
Govt index linked		
Equity shares		
Debts sec'd on land		
Other - producing income		
Other - not producing income		

Include comment on any significant changes in mix, redirection of investment of new moneys, or use of derivatives.

6.2 Investment performance

Use With-profit Guide information to identify performance of WP Fund.

7. UNIT-LINKED FUNDS

7.1 New funds introduced

7.2 Investment performance

Of the most important funds only (e.g. the managed fund).

7.3 Fund Management Charges to policyholders

With particular reference to any changes.

8. VALUATION & SOLVENCY

8.1 Strengths and/or weaknesses

An explicit statement as to whether the basis is, or might not be, in accordance with the Regulations must be made. Include a general statement about the relative strength or weakness of the basis overall compared with that used by other similar companies. Add comment to highlight the types of risk to which the company is particularly vulnerable.

8.2 Changes since previous year

8.3 Summary of results for main classes

Liabilities for non-linked business

Class	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
Total non-linked liability (Form 55)					

Liabilities for linked business

Class	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
Total linked liability (Form 56)					

Note that, as with the new business tables, the entries for classes should be adjusted to suit the particular company. If Unitised With Profits business is significant it should be shown separately from conventional with profits. Where there are additional reserves (e.g. mismatching or contingency) then these should be identified in the tables or in a note thereto.

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Valuation summary

		1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
1	Non-linked liability					
2	Linked liability					
3	Bonus reserves					
4	Total math. reserves					
5	Additional reserves					
6	Other liabilities					
7	Total long-term liabilities					
8	Long-term assets					
9	Shareholders' assets allocated to RMM					
10	Assets available to meet RMM (8+9-7)					
11	Implicit items					
12	Total amount available (10+11)					
13	RMM					
14	Cover (12/13)					
15	Free assets ratio ((10-13)/8)					

8.4 Cover for the solvency margin

Comment on recent trends, and any implicit items.

9. FINANCIAL RESULTS

9.1 Surplus emerging

	1990	1991	1992	1993	**1994**
Surplus emerging (£000s)					

9.2 Transfer to (or from) P&L Account

	1990	1991	1992	1993	**1994**
Transfer to/(from) P&L account (£000s)					

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9.3 Dividend declared

	1990	1991	1992	1993	**1994**
Dividend declared (£000s)					

10. BONUSES

10.1 Cost of bonuses declared

10.2 Key rates of bonus

10.3 Changes to bonus rates

Perhaps including a table giving a five-year history of the most important bonus rates only.

10.4 Distribution policy

Draw attention to the split between reversionary and terminal bonuses, and also (where relevant) between policyholders and shareholders. Make particular reference to any changes of practice, and any PRE implications.

11. REINSURANCE

11.1 Overview of treaties

11.2 Changes during the year

11.3 'Financing reinsurance'

OTHER ISSUES

12. COMPLIANCE

12.1 DTI compliance problems

12.2 PIA and other compliance problems

13. MISCELLANEOUS

Possible topics for inclusion here might include press comment about the company, changes in senior staff or directors, etc.

APPENDIX

In certain circumstances, it may not be appropriate to complete a full detailed scrutiny report for each member of a group of companies, although it is usually sensible to consider all the member companies of a group at the same time. Where a full report is not called for, the subsidiary company may be dealt with in an abbreviated report forming an appendix to the parent company report. Examples of where this might be appropriate include pensions management subsidiaries, captive reinsurers and closed fund subsidiaries.

A. N. Actuary
25/06/2008

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GAD's general scrutiny proforma reports

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SCRUTINY STRATEGY WORKING PARTY

PROFORMA SCRUTINY REPORT,
WITH NOTES ON CONTENT

LIFE ASSURANCE COMPANY

RETURNS AS AT 31 DECEMBER 1996

DETAILED SCRUTINY REPORT

The following pages list the 'standard' section and subsection headings. Notes of likely items to be covered are given in italics. It is suggested that the Sections should remain unchanged from one company report to another, to facilitate finding the desired part of any report, even if an occasional 'not applicable' entry is called for. Subsections should remain in the order shown where possible, but may be amended or omitted more freely.

1. SUMMARY

1.1 Key Features

Key features arising from the scrutiny should be presented, perhaps in the form of 'bullet points'. A possible approach is to extract one item from most Sections of the report. An example list of topics is shown below, but it should not be adhered to rigidly.

In addition to the specific key points arising from the scrutiny, we should express a view as to the soundness of the company in the short and longer term. Reference to the cover for the solvency margin (9.4 below) should be made, as this is a key DTI supervisory responsibility. The priority rating of the company should be clearly stated. Where there is any doubt as to whether the valuation basis used is in accordance with the Regulations (9.1 below), this should be also be clearly stated.

- *Size and type of office (e.g. medium-sized with profits mutual), and primary source of business (e.g. IFAs).*
- *Ownership issues.*
- *Our view as to its soundness.*
- *Most important types of business, and recent new business trends.*
- *Expense control.*
- *Recent trends in financial results, especially if adverse.*
- *Asset allocation for with profits business, and changes therein.*
- *Approach to valuation, and a general view as to its strength.*

- *Supportability of bonuses, and recent trends in bonus declarations.*
- *Likely impact of the SIB compensation requirements for mis-selling of personal pensions.*

1.2 Action Points

The list of Action Points should include items of as many of the following types as apply:

(a) *Points needing immediate action by DTI;*

(b) *Points raised by GAD with the actuary in a letter (which should be enclosed);*

(c) *Points to be recorded for raising at a suitable opportunity, e.g. the next company visit.*

2. BACKGROUND

This should be a 'potted history' of the company, covering such things as its size and ownership, and the type(s) of business it writes. Comments on the corporate structure, and particularly of any insurance subsidiaries, should be made. A brief note of the senior management, and particularly the chief executive and the Appointed Actuary, should be given, with information on their experience, recent changes, etc. Any Section 68 Orders in force should be recorded.

The background should also cover significant *developments during the year, e.g. acquisitions, disposals, S49 transfers, changes of ownership, and also such things as new types of business or distribution channels, new admin./computer systems, and LAUTRO/PIA regulatory problems, as recorded in the Chairman's statement, for example.*

Reference should be made to any recent company visit, including a brief description of its outcome. If there are any issues outstanding with the company they should be mentioned.

[It is intended that the 'Background' section should be in essay form rather than as bullet points; it will form an important part of any briefing note on the company. However, most of it should be self-standing, and may well therefore be carried forward from year to year largely unaltered.]

BUSINESS DEVELOPMENTS DURING THE YEAR

3. NEW BUSINESS

3.1 New products

Any significant new products introduced during the year should be described.

3.2 Source(s) of new business

The proportion coming from IFAs, direct sales forces, tied agents etc. (and if relevant the amount from overseas), and any significant changes during the year. [If not available from *internal information such as the Report & Accounts, this may be obtained from surveys such as that in Planned Savings.]*

3.3 Recent history:

Regular premiums

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Total					
Year on year % increase					

Single premiums

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Total					
Year on year % increase					

New Business Index (Regular premiums plus 10% of single premiums)

New Business Index (£000s)					
Year on year % increase					

Note that the classes to be shown in the new business tables must be selected individually to be appropriate to the company concerned. Some examples of likely categories are shown in the list below. One or more rows for overseas business should be shown if appropriate, and if such business is of sufficient significance it should be split by major territories too. There will normally be a row called 'Other' so that the totals reflect the Form 44 totals. Figures should be shown gross of reinsurance but a footnote may be added if, for example, some classes are (almost) wholly reinsured.

Life with profits | *Pensions with profits* | *Critical illness*
Life non profit | *Pensions non profit* | *Permanent Health*

Page 3

Unit linked life *Unit linked pensions*
Immediate Annuities *Group pensions*

For large companies all the above figures, and the expense figures below, may be shown in £millions if this is more appropriate.

4. CHANGES IN BUSINESS IN FORCE

4.1 Recent history of regular premiums

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life and General Annuity					
Pensions					
Permanent Health					
Others					
Total gross regular premiums					
Less reinsurance premiums					
Total net regular premiums					
Year on year % increase					

Claims experience

Note : Life and General Annuity to be combined from 1996

Recent history of mortality rates

Class	1992	1993	1994	1995	**1996**

The mortality rates are:

Form 46, UK business, premiums, line 21 / (½ lines 11 + 39 + 21)*

4.2 Persistency experience

Note : Life and General Annuity to be combined from 1996

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Recent history of lapse rates

Class	1992	1993	1994	1995	**1996**

The lapse rates are:

*Form 46, UK business, premiums, line 25 / (½ * [½ * E(t-2) + E(t-1) + ½ * E(t)]), where*

E(t) = lines 12 + 13 in year t

Note : Life and General Annuity to be combined from 1996

Recent history of combined surrender, lapse & paid-up conversion rates

Class	1992	1993	1994	1995	**1996**

The combined surrender, lapse and paid-up conversion rates are:

Form 46, UK business, premiums, (lines 24 + 25 + 26) / (½ lines 11+39+24+25+26)*

Make reference to any features identified from these Form 46 figures, e.g. large increases in surrenders. Supplement this information with PIA data when this becomes available.

5. EXPENSES

Note : Life and General Annuity to be combined from 1996

Page 5

5.1 Recent history of expenses:

Expense	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Initial commission					
Acquisition expenses					
Renewal commission					
Renewal expenses					
Other management expenses					
Total expenses					
Year on year % increase					

Expense ratios:	1992	1993	1994	1995	**1996**
Acquisition					
Renewal					

Expenses should be shown gross of reinsurance. The expense ratios are:

Acquisition *(IC + AE) / New Business Index*

Renewal *(RC + RE) / Regular premium income in force*
[from Form 41, col. 1, lines 12 + 14 + 16 + 18]

The definitions of these ratios should be explicitly stated in the text of the report.

5.2 Commentary

To include comment on the trends in the expense ratios.

5.3 Exceptional items

Refer to any exceptional items of expenditure, e.g. fines and compensation payments. Also comment on any references in the Report & Accounts to DP or sales distribution developments.

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SITUATION AT THE YEAR END

6. NON-LINKED ASSETS

6.1 Changes in portfolio

Recent history of asset mix

Type of asset	1992	1993	1994	1995	**1996**
Land					
Govt fixed interest					
Other fixed interest					
Govt index linked					
Equity shares					
Debts sec'd on land					
Other - producing income					
Other - not producing income					

Recent history of yields

Type of asset	1995	**1996**
Land		
Govt fixed interest		
Other fixed interest		
Govt index linked		
Equity shares		
Debts sec'd on land		
Other - producing income		
Other - not producing income		

Include comment on any significant changes in mix, redirection of investment of new moneys, or use of derivatives.

6.2 Investment performance

Use With-profit Guide information to identify performance of WP Fund.

	£000s	£000s
1. Investment Income per Form 40		
less Investment Income of Internal Funds (F44)		
less estimated Investment Income of other linked assets		
Non linked investment income		
Increase in non linked assets brought into account (F40)		
Investment Reserve carried forward		
Investment Reserve brought down		
Increase in investment reserve		
Investment Return		
Opening non linked assets		
Closing non linked assets		
Mean fund excluding investment return [=½×(10+11-9)]		
Rate of return from investment [= 9÷12]		

<u>This table will make use of information gathered from forms 55 & 56 during the post initial - pre detailed scrutiny process.</u>

6.3 <u>Analysis of Derivative Contracts</u>

Derivative Contracts	1995		**1996**	
	Assets	Liabilities	**Assets**	**Liabilities**
Futures				
Options				
Differences				
Adjustments				
Total				

7. UNIT-LINKED FUNDS

7.1 <u>New funds introduced</u>

7.2 <u>Investment performance</u>

Of the most important funds only (e.g. the managed fund).

7.3 <u>Fund Management Charges to policyholders</u>

With particular reference to any changes.

8. MATCHING RECTANGLES

Implement information gathered during post initial - pre detailed scrutiny process

Value of assets notionally allocated (by asset type and interest rate)

Land						
Govt fixed interest						
Other fixed interest						
Govt index linked						
Equity shares						
Debts sec'd on land						
Other - producing income						
Other - not producing income						
Total						
Total - under resilience scenario						

Value of assets notionally allocated (by asset and business types)

	L&GA WP	L&GA NP	Pens WP	Pens NP	Other WP	Other NP
Land						
Govt fixed interest						
Other fixed interest						
Govt index linked						
Equity shares						
Debts sec'd on land						
Other - producing income						
Other - not producing income						
Total						
Total - under resilience scenario						

Value of assets notionally allocated (by business type and interest rate)

Page 9

Life & GA - with profits						
Life & GA - Non profit						
Pensions - with profits						
Pensions - non profit						
Other - with profits						
Other - non profit						
Total						
Total - under resilience scenario						

Balance of remaining long term liabilities not required for matching

9. VALUATION & SOLVENCY

9.1 Strengths and/or weaknesses

An explicit statement as to whether the basis is, or might not be, in accordance with the Regulations must be made. Include a general statement about the relative strength or weakness of the basis overall compared with that used by other similar companies. Add comment to highlight the types of risk to which the company is particularly vulnerable.

9.2 Changes since previous year

9.3 Summary of results for main classes

Liabilities for non-linked business

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Total non-linked liability (Forms 51 & 52)					

Note: Forms 51 & 52 will be combined together. The entries should be adjusted to suit the particular company.

-

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Liabilities for linked business

Class	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
Total linked liability (Forms 53 & 54)					

Note: Forms 53 & 54 will be combined together. The entries should be adjusted to suit the particular company.

Valuation summary

		1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
1	Non-linked liability					
2	Linked liability					
3	Bonus reserves					
4	Total math. reserves					
5	Additional reserves					
6	Other liabilities					
7	Total long-term liabilities					
8	Long-term assets					
9	Shareholders' assets allocated to RMM					
10	Assets available to meet RMM (8+9-7)					
11	Implicit items					
12	Total amount available (10+11)					
13	RMM					
14	Cover (12/13)					
15	Free assets ratio ((10-13)/8)					

9.4 Cover for the solvency margin

Comment on recent trends, and any implicit items.

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10. FINANCIAL RESULTS

10.1 Surplus emerging

	1992	1993	1994	1995	**1996**
Surplus emerging (£000s)					

10.2 Transfer to (or from) P&L Account

	1992	1993	1994	1995	**1996**
Transfer to/(from) P&L account (£000s)					

10.3 Dividend declared

	1992	1993	1994	1995	**1996**
Dividend declared (£000s)					

11. BONUSES

Create automated tables of bonuses declared

11.1 Cost of bonuses declared

11.2 Key rates of bonus

11.3 Changes to bonus rates

Perhaps including a table giving a five-year history of the most important bonus rates only.

11.4 Distribution policy

Draw attention to the split between reversionary and terminal bonuses, and also (where relevant) between policyholders and shareholders. Make particular reference to any changes of practice, and any PRE implications.

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12. REINSURANCE

12.1 Overview of treaties

12.2 Changes during the year

12.3 'Financing reinsurance'

OTHER ISSUES

13. COMPLIANCE

13.1 DTI compliance problems

13.2 PIA and other compliance problems

14. MISCELLANEOUS

Possible topics for inclusion here might include press comment about the company, changes in senior staff or directors, etc.

APPENDIX

In certain circumstances, it may not be appropriate to complete a full detailed scrutiny report for each member of a group of companies, although it is usually sensible to consider all the member companies of a group at the same time. Where a full report is not called for, the subsidiary company may be dealt with in an abbreviated report forming an appendix to the parent company report. Examples of where this might be appropriate include pensions management subsidiaries, captive reinsurers and closed fund subsidiaries.

A. N. Actuary
25/06/2008

GAD's general scrutiny proforma reports

For companies' 1997 returns

XYZ LIFE ASSURANCE COMPANY

RETURNS AS AT 31 DECEMBER 1997

DETAILED SCRUTINY REPORT

GAD PRIORITY RATING:

GOVERNMENT ACTUARY'S DEPARTMENT

To: **[HMT Supervisor], Her Majesty's Treasury**

From: **[GAD Actuary], Government Actuary's Department**

This report conforms fully with the professional requirements of the Institute and Faculty of Actuaries, details of which are set out in section [16] of this report.

[The following pages list the 'standard' section and subsection headings. Edit the items in square brackets in the opening sentence above and in the final section (Professional Requirements), but otherwise these must be left unchanged. Notes of likely items to be covered in other sections are given in italics. It is suggested that these <u>sections</u> should remain unchanged from one company report to another, to facilitate finding the desired part of any report, even if an occasional 'not applicable' entry is called for. <u>Subsections</u> should remain in the order shown where possible, but may be amended or omitted more freely. It is essential that the whole of sections 1 and 2 fit onto just page 1 of the report.]

1. KEY FEATURES

Type of company:	*(mutual/proprietary, UK/overseas owned, etc)*	
Type of business:	*(with-profit, credit life, unit-linked, etc)*	
Last visit date:		
Key Financial Statistics:	1995	**1996**
New Business Index:		
Long Term Assets:		
Assets Available:		
RMM		

[The key statistics table must be completed for all companies, and its format and position in the report left unaltered. HMT have requested this specifically. If company has any implicit items and/or subordinated loans, then these will be shown in an extra line in the table.

-

2. ACTION POINTS

[This should (a) clearly identify any points needing immediate action by HMT; (b) give a very brief summary of the most important points raised by GAD with the company and/or Appointed Actuary in a letter (stating that this letter can be found in the Appendix); (c) identify any points to be recorded for raising at a suitable opportunity, e.g. the next company

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visit. It is essential that all points requiring action by HMT are highlighted clearly in this section of the report, and an indication given as to their relative importance/priority.

When there are no points for immediate action, this fact should be highlighted in bold-face.]

3. EXECUTIVE SUMMARY

[This section should be kept fairly concise but still draw out all salient features on a company. It should express a view as to the soundness of the company in the short and longer term, comment on its general competitive position and likely long term viability, and indicate whether it presents any particular difficulties for HMT. Where there is any doubt as to whether the valuation basis used is in accordance with the regulations (section 10 below), this should be clearly stated. Summaries on companies with no concerns will be more concise than those on rogue ones. The features drawn out in this part of the report should link to the action points.]

Topics from which these might be drawn include:

- *significant changes in types of business written*
- *recent trends in new business and/or sources of business*
- *ownership issues (e.g. changes of control)*
- *recent trends in expenses*
- *recent trends in financial results, especially if adverse*
- *likely impact of compensation for pensions mis-selling*
- *reinsurance treaties or other financing.]*

4. BACKGROUND

[This should be a 'potted history' of the company, covering such things as its size and ownership, and the type(s) of business it writes. Comments should be made on the corporate structure, and particularly any insurance subsidiaries, all past Sch 2C transfers, and any history of significant HMT or PIA regulatory problems. A brief note of the senior management, and particularly the Chief Executive and the Appointed Actuary, should be given, with information on their experience, recent changes, etc. Any section 68 orders in force should be recorded.

This section should also cover any significant developments during the year, e.g. acquisitions, disposals, Sch 2C transfers in that year, changes of ownership, and also such things as new types of business or distribution channels, new admin/computer systems and PIA regulatory problems, as recorded in the Chairman's statement, for example.

Reference should be made to any recent company visit, including a brief description of its outcome. If there are any issues outstanding with the company they, should be mentioned.

It is intended that this section should be in essay form; it will form an important part of any briefing note on the company. Most of it should be self-standing, and may well therefore be carried forward from year to year largely unaltered, but items which are no longer of interest should be deleted. It would be helpful in this regard if items which are of short term interest are separately identified from those of more enduring interest.

Particular care should be taken to ensure that this section is historically sound and as complete as possible.]

BUSINESS DEVELOPMENTS DURING THE YEAR

5. NEW BUSINESS

5.1 <u>New and altered products</u>

[Any significant new products introduced during the year should be described. Reference should also be made in this subsection to any significant changes in existing product terms, such as increases in policy charges.]

5.2 <u>Source(s) of new business</u>

[Give the proportion of new business coming from IFAs, direct sales forces, tied agents etc. and, where relevant, from the UK and overseas. If not available from internal documents such as the Report & Accounts, this information should be obtained from surveys such as those in Money Management and Planned Savings. Highlight any significant recent trends or other changes in sales direction, presenting the data in a table where possible.]

5.3 Recent history:

New regular premiums

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life and general annuity: - accumulating with-profit					
- other with-profit					
- non-profit					
- property-linked					
- index-linked					
Pensions: - accumulating with-profit					
- other with-profit					
- non-profit					
- property-linked					
- index-linked					
Permanent health					
Overseas (all classes)					
Other					
Total					
Year on year % increase					

Source: Form 47, column 6

proforma 1997.doc August 3, 1998

Page 4

New single premiums

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life and general annuity: - accumulating with-profit					
- other with-profit					
- non-profit					
- property-linked					
- index-linked					
Pensions: - accumulating with-profit					
- other with-profit					
- non-profit					
- property-linked					
- index-linked					
Permanent health					
Overseas (all classes)					
Other					
Total					
Year on year % increase					

Source: Form 47, Column 3

New Business Index (regular premiums plus 10% of single premiums)

New Business Index (£000s)					
Year on year % increase					
ABI comparisons (UK business): ***- Life***	*4%*	*1%*	*(11%)*	*(9%)*	***22%***
- Pensions	*9%*	*(5%)*	*(11%)*	*(11%)*	***16%***
- Overall	*6%*	*(2%)*	*(11%)*	*(10%)*	***20%***

Source: ABI Insurance Statistics Yearbook 1996

[Note that the classes to be shown in the new business tables should be selected individually to be appropriate to the company concerned. One or more rows for overseas business should be shown if appropriate, and if such business is of sufficient significance, it should be split by major territories too. Where the 'Other' rows contain only rounding entries, absorb these appropriately but ensure that the totals reflect the Form 47 totals.

Figures should be shown gross of reinsurance but a footnote may be added if, for example, some classes are (almost) wholly reinsured. Directly written business and reinsurance accepted should be separately identified, where both are material. For large companies, all the above figures, and the expense figures below, may be shown in £m if this is more appropriate.

For companies writing new industrial business, separate tables should be produced for OB and IB, with separate NBI figures being shown for these two classes, clearly labelled.

5.4 Commentary

Comment on any atypical features and on recent new business trends. Retain the ABI comparatives in the NBI table in subsection 5.3 above, but comment additionally in this subsection on the company's relative new business performance compared with its peer group of companies (chosen appropriately), using data from the annual report or elsewhere.

Make specific reference to any material discontinuities or distortions in the figures caused by changes in the way in which recurrent single premium contracts are reported, or due to the inclusion of increases to premiums on existing contracts in new business figures from 1996.]

6. CHANGES IN BUSINESS IN FORCE

6.1 Recent history of regular premiums received

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life & general annuity					
Pensions					
Permanent health					
Other contracts					
Total gross regular premiums					
Less reinsurance premiums					
Total net regular premiums					
Year on year % increase					

Source: Form 41

6.2 Claims experience

Recent history of claim amounts

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life assurance deaths					
Life assurance maturities					
Annuity payments					
Surrenders					
Pension lump sums					
Pension annuity payments					
Pension surrenders					
PHI lump sums					
PHI regular payments					
Other lump sums					
Other regular payments					

Source: Form 42

[Immaterial lines should be deleted/combined as appropriate.]

6.3 Persistency experience

Latest PIA persistency statistics (represented as % of policies written in year no longer in force at end of term)

	Endowments					
Business Year:	1993	1994	1995	1993	1994	1993
Persistency Term:	1yr	1yr	1yr	2yr	2yr	3yr
Regular Premium:						
Company Reps						
Industry ave company reps	*8.2*	*8.1*	*7.7*	*13.9*	*13.2*	*19.0*
IFAs						
Industry ave IFAs	*5.8*	*5.5*	*4.7*	*9.6*	*8.4*	*12.5*
Direct Adverts.						
Industry ave direct adverts.	*5.8*	*6.0*	*4.9*	*10.4*	*10.4*	*14.5*
Single Premium:						
Company Reps						
Industry ave company reps	*1.2*	*1.4*	*1.6*	*4.6*	*3.6*	*6.8*

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	Other Life					
Business Year:	1993	1994	1995	1993	1994	1993
Persistency Term:	1yr	1yr	1yr	2yr	2yr	3yr
Regular Premium:						
Company Reps						
Industry ave company reps	*14.9*	*13.8*	*12.2*	*25.5*	*23.7*	*34.0*
IFAs						
Industry ave IFAs	*8.0*	*7.1*	*6.7*	*13.8*	*13.5*	*20.5*
Direct Adverts.						
Industry ave direct adverts.	*10.5*	*11.7*	*11.5*	*14.8*	*16.8*	*17.4*
Single Premium:						
Company Reps						
Industry ave company reps	*3.2*	*3.4*	*1.9*	*9.4*	*7.3*	*14.7*
IFAs						
Industry ave IFAs	*2.7*	*2.6*	*1.5*	*6.6*	*6.9*	*11.4*

	Pensions					
Business Year:	1993	1994	1995	1993	1994	1993
Persistency Term:	1yr	1yr	1yr	2yr	2yr	3yr
Regular Premium:						
Company Reps						
Industry ave company reps	*14.5*	*14.8*	*13.5*	*25.4*	*25.1*	*33.7*
IFAs						
Industry ave IFAs	*7.6*	*7.9*	*8.6*	*15.2*	*16.4*	*11.6*
Single Premium:						
Company Reps						
Industry ave company reps	*0.5*	*0.8*	*1.1*	*1.0*	*1.5*	*1.7*
IFAs						
Industry ave IFAs	*1.1*	*1.3*	*1.7*	*2.3*	*2.8*	*3.5*

Source: PIA: Third Survey of the Persistency of Life and Pensions Policies (Nov 1997)

Note: Data not available for SP via direct adverts (all classes) and SP via IFAs (endowments).

[Delete inappropriate or unusable sections and add appropriate commentary.]

Recent history of combined surrender, lapse & paid-up conversion rates

Class	1992	1993	1994	1995	**1996**
Life non-linked					
Life linked					
Pensions non-linked					
Pensions linked					

Note: The combined surrender, lapse and paid-up conversion rates are:
Form 46, UK business, annual premiums, lines (24+25+26) / [½*lines (11+39+24+25+26)]

[Make reference to any features identified from these figures, e.g. large increases in surrenders. Where it is felt necessary, draw attention to the differences between these two sets of persistency rates, in particular that the PIA statistics are based on policy not

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accounting year and are to some extent out of date, and that the Form 46 figures relate to the company's total portfolio.]

7. EXPENSES

7.1 Recent history of expenses:

Expense	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Initial commission					
Acquisition expenses					
Renewal commission					
Maintenance expenses					
Other management expenses					
Total expenses					
Year on year % increase					

Source: Form 41

Expense ratios:	1992	1993	1994	1995	**1996**
Acquisition					
[Sector] average acquisition					
Renewal					
[Sector] average renewal					
Renewal as % of total fund					
[Sector] average renewal as % of total fund					

Notes: 1. The expense ratios are:
Acquisition: (IC + AE + OME) / New Business Index
Renewal: (RC + ME) / Gross earned regular premiums [F41.29.1]
Renewal as % of total fund: (RC + ME) / Average total fund [½*(F40.49 + F14.51.1 + F40.59 + F14.51.2)]

2. The trend in the acquisition expense ratio is subject to distortion from the reclassification of recurrent single premiums as regular premiums from 1996, and also from the inclusion of other management expenses in this ratio.

[Expenses should be shown gross of reinsurance, but a footnote may be added if these are substantially reinsured. Only the version of the renewal expense ratio most appropriate to the company should be retained, the other and its accompanying note being deleted.

For making comparisons, choose the sector appropriate to the company, and enter its name in the tables, extracting the data from the annual report.

Where there is industrial business, separate tables of expenses should be created for OB and IB, and the above table of expense ratios substituted with the following table:

Expense ratios:	*1992*	*1993*	*1994*	*1995*	***1996***
OB acquisition					
[Sector] average OB acquisition					
OB renewal					
[Sector] average OB renewal					
IB combined					
Industry average IB combined					

Notes: 1. *The expense ratios are:*

OB Acquisition: *OB (IC + AE + OME) / OB New Business Index*

OB Renewal: *OB (RC + ME) / OB Gross earned regular premiums [OB F41.29.1]*

IB combined: *IB (Total expenses) / IB Gross earned total premiums [IB (F41.19.1 + F41.29.1)]*

2. *The acquisition expense ratio is subject to distortion from the reclassification of recurrent single premiums as regular premiums from 1996, and also from the inclusion of other management expenses in this ratio.*

Separate tables and appropriately modified expense ratios should also be created where there is any other major and continuing subdivision of the fund - such as between with-profit and non-profit business.

Mention should be made of discontinuities arising from the 1996 A&S Regulations, expanding in particular on the fact that recurrent single premium business is now treated as regular, with a knock-on effect to the acquisition (and, to a lesser extent renewal) expense ratio, and also that other management expenses, which are treated as wholly acquisition expenses above, may also in fact include some renewal expenses.]

7.2 Commentary

[To include comment on the trends in the expense ratios, and their relative level compared with the relevant sector average, where appropriate.

The service company arrangements disclosed under note 5 on page 96 of the A&S Regulations (note to the returns coded 4008) should be mentioned and, if known, a statement as to whether expense charges from the service company are at cost should be made.

Note any sub-fund divisions where expenses are determined specially, e.g. under a Sch 2C scheme, and comment with cross reference to the controlling document. Comment also where expenses are shared with other companies within the same group.

Comment on where investment expenses are shown - in expenses or as an offset to investment income]

7.3 Exceptional items

[Refer to any exceptional items of expenditure, e.g. fines and compensation payments. Also comment on any references in the Report & Accounts to sales distribution developments and/or computer upgrades to illuminate the progression of expenses and in particular those shown as other management expenses..]

SITUATION AT THE YEAR END

8. NON-LINKED ASSETS

8.1 Make-up of portfolio

Recent history of asset mix

Type of asset	1992 %	1993 %	1994 %	1995 %	**1996 %**
Land					
Approved fixed interest					
Other fixed interest					
Approved variable yield					
Other variable yield					
Equity shares					
Debts sec'd by mortgages					
Other - producing income					
Other - not producing income					

Source: Form 48

[Figures to be shown without % signs, and to the nearest whole number.]

Movement in asset values during the year

Type of asset	1995		**1996**		
	£000s	Yield %	£000s	Yield %	***Mkt yld %***
Land					
Approved fixed interest					
Other fixed interest					
Approved variable yield					
Other variable yield					
Equity shares					
Debts sec'd by mortgages					
Other - producing income					
Other - not producing income					
Total					

Source: Form 48

[Yields to be shown without % signs, and to 1 d.p.

Comment on any significant changes in asset mix and redirection of investment of new moneys.

Make reference as to whether Form 49 reveals any significant spread of yields (columns 3 and 6), i.e. if a typical average yield above hides some very low and some high yielders.

Make specific reference to any discontinuities or distortions caused by the change in definition of the assets included in Form 48 from 1996 compared to those included in the old Form 45, in particular that excess linked assets are now included, and that assets matching index-linked liabilities (many of which may be derivatives) are now definitely excluded.

Make reference to any material holdings of inadmissible assets, and any significant reconciliation items to the Companies Act assets as per lines 94 and 95 of Form 13.

Comment on the balance between non-income producing assets above and the non-interest demanding other insurance liabilities, and whether the yield on net assets would be markedly different to the above yield on gross assets due to high other insurance liabilities, including loans. Comment if a separate investment house exists rather than an in-house team, and whether any performance bonus arrangements or penalties apply to our knowledge.

Make reference to any significant debts/loans or contingent liabilities relating to connected companies (see line 100 of Form 13 and note to the returns coded1404 respectively).

Comment also on any material counterparty exposures disclosed under paragraph 11 of Schedule 1 (note to the returns coded 1306)

For making comparisons, compare with data from Annual Report.]

8.2 Derivatives

[Include this subsection only for companies with a material exposure to derivatives.

Comment on any significant amendment to the asset distribution shown in section 8.1 from the impact of derivatives (see Regulation 23(1)(d) statement), and whether such usage is long-standing or new. Comment on margining arrangements in force.]

8.3 Investment performance

[Estimate the investment return on the total non-linked assets from Form 40 and the template below. The result of the calculation should be quoted, but the actual table may be hidden in the report after it has been reviewed by the chief actuary (but preferably not deleted), unless desired to be shown.

	£000s	£000s
1. Total investment income (F 40.12)		
2. *less* estimated investment income on assets matching property linked liabilities *		
3. *less* estimated investment income on non-linked assets matching index-linked liabilities ‡		
4. Investment income on Form 48 assets		
5. Increase in non-linked assets brought into account (F 40.13)		
6. *less* increase in non-linked assets matching index-linked liabilities brought into account ‡		
7. Increase in Form 48 assets brought into account		
8. Investment reserve carried forward (F 14.51.1)		
9. Investment reserve brought forward (F 14.51.2)		
10. Increase in investment reserve		
11. Investment return		
12. Opening Form 48 assets		
13. Closing Form 48 assets		
14. Mean fund excluding investment return [=½×(12+13-11)]		
15. Rate of return from investment [= 11/14]		%
16. Expected investment return†		

* calculated as F44.12 / average F55 internal linked col 7 * average F55 total cols (8 - 9)
‡ estimated figures based on Form 56
† based on overall market performance applied to asset mix shown in section 8.1

Given the problems of subdividing the index-linked assets and the resulting approximations above, it is recognised that the estimated investment return is subject to distortion. Clear health warnings should therefore be included where the volume of index-linked business is significant.

Where there is a separate with-profit sub-fund, the investment return should be calculated for this separately, where possible (i.e. when the split of the total investment reserve is known). Supplementary information on the with-profit sub-fund should be obtained from the with-profit guide, which will be requested for all major with-profit companies as a matter of course at the end of August each year.

Where there is a marked disparity between the crude actual investment return calculated above and that shown in line 16 expected from the mix of assets held and market performance during the reporting period, this should be commented upon. Where there is no such disparity, and the table is being retained, the line 16 figure may be deleted.

Draw attention also to any marked disparity between the crude actual investment return calculated above and that seen for a typical office (again separately for the with-profit fund where possible). Indicate whether this appears to be driven purely from differences in asset mix and comment on its possible implications for the company's long term competitiveness.]

9. ASSETS HELD TO MATCH LINKED LIABILITIES

9.1 Internal linked funds

9.1.1 New and altered funds

[Give details of any new funds introduced during the year, and of any fund mergers or rationalisations, including the terms on which these were made.]

9.1.2 Investment performance

[Comment on the relative investment performance of the most important funds only (e.g. the managed fund) compared both with the performance expected given the stated investment objectives of the funds and overall market performance during the reporting period, and with the performance of funds with similar investment objectives operated by other companies in the industry based on the results of magazine surveys.]

9.1.3 Fund Management Charges to policyholders

[Make reference to any changes in particular.]

9.1.4 Principles of unit pricing

[Give a brief description of the basis on which assets are valued and how this is selected, including the timing of the asset valuation used in respect of unit creations and cancellations in relation to the time at which both the operation is decided upon and effected. If there is any evidence that the procedures adopted may result in incoming, outgoing and continuing policyholders being treated inequitably, a specific statement to this effect should be included. Where unit trust principles are adopted, this may be stated in lieu of a description. Reference should also be made to the allowance made for CGT (see paragraph 5(5) of Schedule 4). Draw attention to any apparent inconsistencies between this information and the accounting data shown in Form 45.]

9.1.5 Liquidity and gearing

[Include this subsection only where there are any liquidity or gearing issues arising from Forms 43 and 45, adding appropriate commentary.]

9.2 Other assets matching property-linked liabilities

[Include brief details of any directly held assets shown in Form 55, where relevant.]

9.3 Mismatching to property-linked liabilities

[Indicate the degree to which linked assets (be they in internal linked funds or directly held) exceed or fall short of the corresponding property-linked liabilities they are held to match. Emphasise that such surplus or shortfall is included in section 8.1 above.]

9.4 Assets matching index-linked liabilities

[Include brief details of these assets, with particular reference to derivatives, and of the liabilities they are matching. If there is a material mismatch, this fact should be specifically noted. Comment also on counterparty exposure and margining arrangements in force in respect of such derivatives.]

9.5 PRE (issues on linked funds)

[Include reference in this subsection to any possible implications for PRE not covered in earlier subsections, for example arising from internal linked fund mergers/rationalisations, lacklustre investment performance or increases in fund management charges or any other policy fees. Comment also on rebates from unit trusts, and in particular the extent to which policyholders benefit from such rebates.]

10. VALUATION BASIS

[An explicit statement as to whether each element of the basis (interest, mortality, morbidity (if relevant), expenses and any other relevant factors) is, or might not be, in accordance with the Regulations should be made, together with a comment on the company's matching position, under the separate headings set out below. Changes since the previous year should be clearly described within each relevant section. Specific reference should be made both to trends in the basis caused by successive small changes over recent years, and to any apparently arbitrary changes.]

10.1 Overall strength

[Include here a general statement about the relative strength or weakness of the basis overall compared with that used by other similar companies. Add comment to highlight the types of risk to which the company is particularly vulnerable.]

10.2 Interest

[Comment on the supportability of, and the degree of margin apparent in, the interest rate used for each group of liabilities shown in Form 57. Check that allowance has been made for the change to asset classes brought about by derivatives (Regulation 23(d) statement and paragraph 6(1)(a) of Schedule 4). Comment on whether the with-profit interest rates appear to make adequate provision for PRE. The method by which regard has been given to PRE, and account taken of the custom and practice of the company in the manner and timing of the distribution of profits or the grant of discretionary additions over the duration of the policy should be described briefly.]

10.3 Mortality

[Make specific reference to any concerns over the mortality assumptions used, including in particular the allowance made for future improvements in annuitant mortality. Consider also the reasonableness of any other adjustments made to the assumptions, for example for changes in incidence of disease, medical developments and the State of the commitment, and of the allowance for AIDS.

Provide a commentary on the recent history of the mortality assumptions used for the most important liability classes, perhaps by means of a table if desired.

10.4 Morbidity

[Include this subsection only for companies for which morbidity is material, making specific reference to any concerns over the assumptions used.]

10.5 Expenses

[Comment on the amount and adequacy of the aggregate allowance made in the valuation for expenses in the year following the valuation date (paragraph 10(2) of Schedule 4) compared with the level of expenses in connection with maintenance of business shown in Form 41, qualifying these remarks appropriately if there are material other management expenses shown in Form 41 with the possibility that these may in fact more properly be classified as in connection with maintenance of business.

Comment also on the information provided in paragraphs 10(1), (3) and (4) of Schedule 4 on the assumed level of expense inflation and the bases used to allow for such inflation, the reserve for expenses of continuing to transact new business during the 12 months following the valuation date, and the subsequent close-down reserve.

It is recommended that a 5-year history of the per policy expense assumptions used for the most important linked liability classes is given in a table.]

10.6 Mismatching and Resilience

Comment on the suitability of the assets hypothecated to each group of liabilities shown in Form 57, and whether these still look reasonable after the change to asset classes brought about by derivatives (see Regulation 23(d) statement). Comment on the size and method of calculation of the Regulation 75(b) resilience reserve, and also on any material mismatching by currency. Highlight any apparent inconsistencies between the information given in the Schedule 4 narrative on either of these two issues and the data on these shown in Form 57. Comment also on the size and method of calculation of any Regulation 75(a) reserve required in respect of cashflow mismatching.]

10.7 Other factors

[Comment on the adequacy of aspects of the valuation basis adopted for linked contracts not already covered in earlier subsections, including in particular the differential between the rate of unit growth, gross of tax and management charges, and expense inflation, and the extent to which account has been taken of any increases in management charges which are allowed under policy terms.

Highlight any concerns over the allowance made for tax, where relevant, including in particular the adjustments made to the gross interest rates in Form 57, and the aggregate provision made for CGT.

Where additional reserves are held, these should normally be described.

Make specific reference where relevant to the provision made for pensions mis-selling, including a comment as to its likely adequacy and whether it has been increased since last year.]

10.8 Options and Guarantees

[Include details only if material, making particular reference to annuity guarantees, including information on reserving and implications.]

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11. FINANCIAL RESULTS

11.1 Overview

[Comment on recent trends in the level of cover for the RMM and any implicit items. Where shareholders' assets are allocated to the RMM, comment on the quality and suitability of the assets held for this purpose.

Reference should be made as to where any mismatching reserves, CGT reserves or pensions mis-selling reserves are located in the returns, and in the tables in sections 11.2 and 11.3 below.

Include comments on subordinated loans, where applicable.

Provide, if possible, a brief history of policyholders' shares shown in section 11.4 below over a long period to enable the 5 years shown to be judged in context.]

Include also a general comment on the apparent current and future financial viability of the company.]

11.2 Summary of results for main classes

11.2.1 Liabilities for non-linked business

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life & general annuity: - accumulating with-profit					
- other with-profit					
- non-profit					
Pensions: - accumulating with-profit					
- other with-profit					
- non-profit					
Permanent health					
Additional reserves					
Overseas (all classes)					
Other					
Total non-linked liability					

Source: Forms 51 & 52

11.2.2 Liabilities for linked business

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life & general annuity - property-linked					
- index-linked					
Pensions: - property-linked					
- index-linked					
Permanent health					
Additional reserves					
Overseas (all classes)					
Other					
Total linked liability					

Source: Forms 53 & 54

[As with the new business tables, the entries for classes should be adjusted to suit the particular company.]

11.3 Valuation summary

		1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
1	Non-linked liability					
2	Linked liability					
3	Bonus reserves					
4	Total math. reserves					
5	Additional reserves					
6	Other liabilities					
7	Total LT liabilities					
8	Total LT assets					
9	Excess of LT assets over LT liabilities (8-7)					
10	Shareholders' assets allocated to RMM					
11	Assets available (9+10)					
12	Implicit items					
13	Total amount available					
14	RMM					
15	Cover (13/14)					
16	Free assets ratio ((11-14)/8)					

11.4 Composition and distribution of surplus

£000s	1992	1993	1994	1995	**1996**
Surplus brought forward					
Transfer from P/L account					
Surplus emerging in year					
Total available					
Allocated to policyholders					
Transfer to P/L account					
Surplus carried forward					
% of distributed surplus allocated to policyholders					

Investment Reserves: *[Include in this memo item the amount of the investment reserves]*

Source: Form 58

[Subdivide for separate sub-funds with differing policyholders' shares.]

11.5 Movement in shareholders' assets allocated to RMM

£000s	1992	1993	1994	1995	**1996**
Brought forward					
Transfer from (to) LT fund					
Other net income after tax					
less dividends paid					
Total brought forward plus retained profit/loss					
New capital injected					
Change in inadmissible assets					
Other movements					
Carried forward					

[Delete this subsection for mutuals and (genuine) composites. Where total brought forward plus retained profit/loss equals carried forward, the former and intermediate lines should be deleted. Where the balancing item other net income after tax is material, it should be subdivided as appropriate, identifying in particular dividends received from subsidiary companies.]

12. BONUSES

12.1 Cost of bonuses declared

£000s	1992	1993	1994	1995	**1996**
Bonus payments made in anticipation of a surplus					
Reversionary bonuses					
Other bonuses					
Total					

Source: Form58

[Subdivide for the separate sub-funds shown in section 11.4 above. Note any valuation basis changes or cuts in bonus rates that have driven any significant changes in the table.]

12.2 Recent history of key bonus rates

	1992	1993	1994	1995	**1996**
Life: - accumulating with-profit					
- other (specify)					
Pension: - accumulating with-profit					
- other (specify)					

Source: Schedule 4, Paragraph 15

[Note any initial guaranteed rates on accumulating with-profit contracts from with-profit bond launches etc. Ensure that any guarantees are included in the bonus rates shown where the company quotes a minimum guaranteed bonus or increases benefits automatically and quotes bonuses on top. Comment should be made where accumulating with-profit bonus rates look difficult to sustain, and in particular where these exceed the tax adjusted yield on gilts.]

12.3 PRE (issues on with-profit business)

[Include details of the principles on which the distribution of profits among policyholders and shareholders (where relevant) is based, the company's aims in relation to the distribution of profits among policyholders, and of the methods used in order to ensure that these aims are achieved. Make particular reference to any changes of practice.

Note how rights are specified, by sub-fund if necessary, by Sch 2C transfer scheme, Articles, etc., as described in paragraph 14(1) of Schedule 4. Cross reference to documents held on file and any commitments given to HMT in addition to published documents.

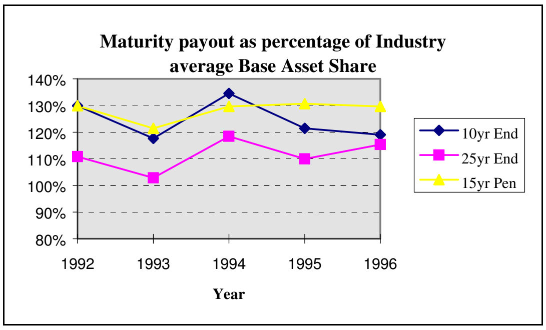
Draw attention to the split between reversionary and terminal bonuses, including where possible a brief history of the percentage of total payout for key contracts represented by terminal bonus. Highlight any significant trends in this percentage and/or marked differences with the industry average.

Comment on other bonus or quasi bonus series such as deposit administration business.]

12.4 Recent history of maturity payouts

£000s	1992	1993	1994	1995	**1996**
25 yr endowment					
Industry average 25 yr endowment					
10 yr endowment					
Industry average 10 yr endowment					
15 yr pension					
Industry average 15 yr pension					
10 yr SV on 25 yr endowment					
Industry average 10 yr SV on 25 yr endowment					

Note: Endowments: £50p.m., maturing 1 Feb. in next year Source: Money Management 4/97
Pensions: £200p.m., maturing 1 Jul. in year Source: Money Management 10/96



[Comment on the company's relative competitive position, the significance of individual maturity years, etc.

Warnings should be included if the method of calculation is over or under estimating the actual amount of the base asset share.]

13. REASSURANCE AND FINANCING

13.1 Overview of reassurance treaties

[Highlight in particular deals with associated companies, looking at the total risk involved overall and any other implications; significant exposures to individual reinsurers, especially ones not authorised in the UK; and new (for that company) and imaginative uses of reinsurance. The names of significant individual reinsurers should be stated, and any changes in the company's reinsurance arrangements since the previous year should be highlighted. Make reference to any deposit back arrangements in force, and comment on the issue of tax deductibility of interest payments under such arrangements, where relevant.]

13.2 Financing arrangements

[Include details of the nature of, and risks involved for the company in, any financing arrangements, apart from subordinated loans entered into, including in particular the

amounts of any undischarged obligations of the company, the conditions for their discharge, and how these have been taken into account in the valuation.]

OTHER ISSUES

14. COMPLIANCE

14.1 <u>HMT compliance problems</u>

[Watch in particular for likely errors in completing Forms 55-57, the assets which have been included in Form 48, the treatment of recurrent single premium contracts, the possible misclassification as non-linked of certain contracts which are now classified as linked, and Section 35A issues.

Also comment on Form 48/57 comparisons, if problems arise.]

14.2 <u>PIA and other compliance problems</u>

15. MISCELLANEOUS

[Possible topics for inclusion here might include press comment about the company, changes in senior staff or directors, etc. Delete this section if not applicable.]

16. PROFESSIONAL REQUIREMENTS

This report conforms fully with the requirements of the Institute and Faculty of Actuaries as set out in their Memorandum of Professional Conduct and Advice on Professional Conduct.

This report had been prepared under the terms of the Agreement between Insurance Directorate of the Her Majesty's Treasury (HMT) and the Government Actuary's Department (GAD) dated March 1995 ("the service agreement") setting out the level of service to be provided by GAD in respect of the supervision of companies authorised, or seeking authorisation, under the Insurance Companies Act 1982 to carry on long term business.

The purpose of this report is to enable HMT to fulfil its duties under the Third Life Directive and the Insurance Companies Act 1982.

The scope of this report is:

- to advise on the statutory solvency position of the company;
- to identify any issues relevant to the duties of HMT;
- to describe the development of the company over the previous 12 months;
- to provide historical background to the company.

[This report is limited to a minor degree because certain questions need to be put to the company and/or the Appointed Actuary. Under the service agreement, GAD has written to the company directly on these. A copy of our letter is included in Appendix [B] to this report.]

The advice and information contained in this report are solely for the use of HMT in fulfilling its statutory duties and should not be transmitted to third parties, including the company concerned, without the prior consent of GAD.

[GAD Actuary], [FIA/FFA]
Government Actuary's Department
[DD] [Month] 199[Y]

proforma 1997.doc August 3, 1998 Page 22

APPENDIX A

[In certain circumstances, it may not be appropriate to complete a full detailed scrutiny report for each member of a group of companies, although it is usually sensible to consider all the member companies of a group at the same time. Where a full report is not called for, the subsidiary company may be dealt with in an abbreviated report forming an appendix to the parent company report. Examples of where this might be appropriate include pensions management subsidiaries, captive reinsurers and small closed fund subsidiaries.]

APPENDIX B

[Include here a copy of the letter (if any) sent to the company and/or Appointed Actuary on the returns.]

GAD's detailed scrutiny reports in respect of Equitable

1989 returns

Reference : 7000 - 103A

[redacted]

THE EQUITABLE LIFE ASSURANCE SOCIETY
****

DTI ANNUAL RETURNS to 31st DECEMBER 1989

We have completed the scrutiny of this Society's 1989 returns. 1989 was an exceptional year for the company because during this year the new business growth set a record. The annual report and accounts show that the new regular premiums amounted to £234m (1988 - £190m) and single premiums amounted to £408m (1988 -£132m). The main contributor to this growth was the Society's personal pension plan.

The long term business admissible assets at the end of the year amounted to £5,805m (1988 - £4,215m). Two-thirds of the non-linked assets were invested in low yielding equities and properties. The Society declared unchanged bonus rates and 94% of the total cost of the bonus was financed by a transfer from the investment reserves. If the property values remain depressed and the equity market does not show any bullish tendencies in the 1990 and beyond; we think that the Society may have problems in maintaining the current bonus rates on its with-profit life and pensions contracts.

The 1989 valuation basis was satisfactory. There was a significant margin in the published mathematical reserves. We have raised a few queries with the company (see attached copy letter), and we do not anticipate that the replies will affect our view of the solvency position.

The following table shows the solvency situation at the end of last two years ;

	End of 1989	End of 1988
Total Available assets	£974m	£618m
Required Minimum Margin	£204m	£161m
Cover	4.77x	3.84x

[redacted]

GAD's detailed scrutiny reports in respect of Equitable's returns

1990 returns

11

[redacted]
DTI

EQUITABLE LIFE - 1990 RETURNS

We have completed a detailed scrutiny of this Company's 1990 returns and enclose a copy of our letter addressed to the appointed actuary.

Our comments are as follows:

1. Growth of business: The Company continued to expand rapidly. The annual accounts show that total new premium income increased 30% to £836m. New regular premiums, at £258m, were up 10% on the previous year and single premiums increased 42% to £578m. This increase in single premiums is due partly to the continuing success of the Society's with-profits bond. The revenue account (Form 40) shows total premiums receivable during 1990 to be £1345m (1989 - £1040m).

2. The Society has produced separate Forms 40, 41, and 42 for its ordinary life, general annuity and pension business this year. We are asking the appointed actuary to explain the reasons for this split.

3. During 1990, in common with other life companies, the Society experienced falls in the market values of equities and other assets. As a result the actuary has decided to weaken the valuation basis of the with-profits business. The rates of interest he has used are within the limits laid down in the regulations and could be supported by the yields shown in Form 45 although the margin is small. We

Document Number:01692 Page 1

are asking a few questions about the valuation basis and we will comment in detail after the replies from the Society.

4. The cover for the required minimum margin is reduced from 477% (1989) to 177% of this year. The main reason for this is the fall in value of the assets (referred to in paragraph (3) above). Part of the fall has been covered by a release of £214m from the mathematical reserves arising from the weakening in the valuation basis. Other reasons for the reduction in cover for the RMM are (a) growth of new business and (b) maintenance of unchanged bonus rates on with profit policies.

5. Equitable Life is a major player in the repeated single premium personal pensions market. It has been successful in obtaining the additional voluntary contributions (AVC) contract of National Health Service in 1990.

[redacted]

Government Actuary's Department
20 November 1991

[redacted]

Document Number:01692 Page 2

GAD's detailed scrutiny reports in respect of Equitable's returns

1991 returns

13

Asked [redacted] if a reply had been received yet to [redacted] letter of 29/10 — he'll look into this + chivvy if no reply has been received.

[redacted]

14/1.

[redacted] said a reply had been received — would send us a copy.

To: [redacted]
Department of Trade and Industry

From: [redacted]
Government Actuary's Department

Copies: [redacted]

Date: 29 October 1992

Subject: **Equitable Life - 1991 Returns**

Note: copy with [redacted] comments on general file.

We have completed our scrutiny of this company's 1991 returns and attach a copy of a letter to the company's actuary raising a few points.

2. The company continued to expand rapidly in 1991. Total premiums received amounted to £1715M [against £1345M in 1990 and £1040M in 1989]. Most of these premiums are either single premiums or renewable single premiums on pension schemes. Contractual annual premiums in force at the end of 1991 amounted to only £75M.

3. The total assets of the company were £7452M at the end of 1991. It is difficult to give a picture of growth of the company in terms of total assets as there have been fairly large changes in the market values of assets in the past 2 years. However if we exclude transfers from investment reserve. Form 40 shows an increase in the fund of £953M in 1990 and £1208M in 1991.

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4. Total available assets shown at Form 9.34 were £488M to cover a RMM of £293M [1.67 x cover]. In 1990 these figures were £413M and £233M [1.77 x cover]. In 1989 the available assets were £974M to cover a RMM of £204M.

5. This is one of the companies which we have seen recently in connection with their low cover for the RMM in 1991 and future prospects. Our present comments relate to their 1991 returns. The company publishes its valuation results using a bonus reserve basis. However it shows the alternative net premium reserves in order to comply with the regulations. Our comments on the valuation relate to the net premium figures.

6. At the end of 1991 the U.K. equity market was at about the same level as that at the end of 1989. Also some gilt prices were at a higher level in 1991. It is therefore reasonable to compare these two year ends rather than the 1990 position when markets were very depressed.

7. Total available assets in 1991 were £488M compared with £974M in 1989. The net transfer from investment reserve in non-linked funds in the two years was £185M. Hence total non-linked assets must have fallen in value by £301M.

Big difference!

8. A comparison of the net premium valuation bases used at the end of each year shows a weakening in the 1991 bases as compared with 1989. This is true of a number of companies. What we have compared here is the average valuation rate of interest employed by the actuary with the average rate of interest earned on the corresponding hypothecated assets (using the highest yielding assets first). There appears to be little or no margin in the interest rates used in the 1991 valuation and we have asked the actuary a question relevant to this point.

2

Document Number:01736 Page 2

1991 returns

9. Why has this situation arisen? We know from our recent talks with [redacted] that the with profit assets earned -11.3% in 1990 and +14.0% in 1991. These rates take into account both capital changes and interest earnings, so the return on with profit assets was only about +3% for the two years. This is after making allowance for the high rates of interest that the company needs to earn on its non-profit contract (up to 10%) and the 3½% p.a. guarantees given on with profit contracts.

10. Total bonuses paid to policyholders cost £423M in 1989 and £456M in 1991. The actual net transfer from investment reserve to the fund on non-linked assets in the two years was £185M.

11. In order to pay the bonuses in the two years the company needed to earn 11¼% per annum on the assets backing the with profit contracts. The amount earned would include interest income and capital gains. In fact the company earned about +3% over the two years instead of the required +23%, and this is the main reason why the available assets have been reduced and the valuation basis has been weakened. A major part of the bonuses have been paid out of (i) a weakening of the valuation basis and (ii) transfers from investment reserve.

12. It is perhaps worth noting that despite the lower cover for the RMM, the company still had, over 60% of its non-linked assets invested in equities and property. We understand from recent discussions with [redacted] that they are now investing more in gilts.

3

Document Number:01736 Page 3

13. The company's new business figures have increased in the past few years and we wonder whether this has given rise to any significant strains on the fund. We have asked a question about this in our letter to the company.

[redacted]

C:\1092-021

4

Document Number:01736 Page 4

GAD's detailed scrutiny reports in respect of Equitable's returns

1992 returns

[redacted] PA copies on: [redacted] 26
93 returns
general file.
[redacted] 11/4.

(8)

To: [redacted]
Department of Trade & Industry

28 March 1994

Copy to: [redacted]

From: [redacted]
Government Actuary's Department

Subject: **EQUITABLE LIFE ASSURANCE SOCIETY**
ANNUAL RETURNS AS AT 31 DECEMBER 1992

RcuA: 24/3/94

We have now carried out a detailed scrutiny of the above returns. Equitable has again had a successful year overall, with an increase in funds (ignoring investment appreciation) of £1,370m (compared with £1,208m and £953m in the two previous years), and total funds at the year end of £8,562m.

As you know, the Equitable publish, rather unusually, a Bonus Reserve Valuation (BRV) and then, as an Appendix to Schedule 4, a Net Premium Valuation (NPV) in accordance with the Regulations. The reserves on the BRV are always demonstrated to be higher than those required using the NPV; on this occasion the former were £8,259m and the latter £7,809m. Thus, in Form 9 they show a cover for the RMM of 2.36x (which compares with 1.67x in 1991). The (more conventional) NPV seems to demonstrate cover of about 3.9x; however we do have one or two questions about the NPV basis. We are however satisfied that the BRV (and hence the overall returns as formally deposited) is, in aggregate, adequate according to the Regulations. As at the end of 1992 it was on a similar basis to 1991 but with some minor strengthening, amounting to some £100m overall.

The company's business is very largely with profits and nearly all single premium (or recurrent single premium) - out of total premiums received in 1992 of £1,877m, the regular premiums in force, as shown in Forms 55 and 56, amounted to only about £80m. As we have discussed before - see in particular my minute of 3 March 1992 - this makes it difficult to compare Equitable with other with profits companies. We have been concerned in the past that they have overdistributed and weakened their reserves. More recently matters seem to have been brought under better control. The situation as at 31 December 1992 is more satisfactory than the previous year, and as you will know from recent reports (e.g. the notes of the meeting held on 30 November last) we expect the position as at the end of 1993 to have improved still further. Reversionary and terminal bonus rates were reduced at the end of 1992 and it has just been confirmed that reversionary bonuses have been reduced again from the end of 1993.

Business for this company continues to do well despite the difficult economic circumstances. The tables on the next page give a recent history of new business (in the UK - the overseas business, in Guernsey and Ireland, is not of great significance), as reported in Form 44:

EQUIT02.DOC: 28 Mar 94

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1992 returns

Single premiums

Class	1989 £k.	1990 £k.	1991 £k.	1992 £k.
Life, non-linked (mainly WP)	37,126	85,437	150,027	**128,977**
Life, linked	2,060	1,969	3,628	**1,513**
Annuity	14,667	15,646	21,704	**29,327**
Pensions, non-linked WP	32,336	27,955	68,029	**131,319**
Pensions, non-linked NP	29,256	49,109	109,410	**151,729**
Pensions, linked	917	283	735	**1,269**
Total	116,362	180,399	353,533	**444,134**

Annual premiums

Life	4,512	5,249	7,291	**9,390**
Annuity	6,395	5,669	8,447	**1,286**
Pensions, non-linked WP	145,419	186,470	202,014	**221,541**
Pensions, non-linked NP	2,662	2,285	4,607	**1,965**
Pensions, linked	28,151	32,809	17,565	**31,763**
Total	187,139	232,482	239,924	**265,945**

(The apparent anomaly between the annual premium business shown here, and that mentioned earlier, is explained because recurrent single premium business is treated as regular premium business in the year of issue for Form 44 purposes.)

The next table shows a recent history of expenses in the same format as the new business. The Equitable, of course, is well known as the leading non-commission-paying office and so I have not shown any figures for commission. The ratio of management expenses to total premium income was reduced again in 1992, from 7.2% to 6.6%, which is by industry standards very low. OK

Expense	1989 £k.	1990 £k.	1991 £k.	1992 £k.
Acquisition expenses	56,633	60,381	72,576	**75,678**
Renewal expenses	29,097	37,561	47,950	**41,048**
Total expenses	85,730	97,942	120,526	**116,726**

The Equitable has responded to the letters regarding potential liability for mis-selling of personal pensions indicating that they expect any such liability to be negligible; from our knowledge of the company we would have no reason to doubt this.

Although there was some useful information supplied for the meeting held last November (already referred to), we still have a few further questions to ask on the 1992 returns, relating to particular features of the NPV basis which might appear somewhat weak. We have also asked the actuary for some formal information about bonuses, and also for his indication of the position as at the end of 1993. A copy of our letter is enclosed for your information.

OK

[redacted]

EQUIT02.DOC: 28 Mar 94 2

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GAD's detailed scrutiny reports in respect of Equitable's returns

1993 returns

[redacted] PA copies on Equit. + Univ. 93 + 94 returns. Equitable general.

cc [redacted].

To:	[redacted] 16/11 Department of Trade & Industry	15 November, 1994
Copy to:	[redacted]	
From:	[redacted] Government Actuary's Department	
Subject:	EQUITABLE LIFE ASSURANCE SOCIETY UNIVERSITY LIFE ASSURANCE SOCIETY RETURNS AS AT 31 DECEMBER 1993	

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1 SUMMARY

1.1 Key Features

The cover for solvency for both companies remains healthy at 3.75× and 15.7× for Equitable and University respectively on the published basis.

This report deals with both companies, but as the Equitable is very much larger and more significant, the focus is deliberately slanted towards that society. Most figures for University are given in the Appendix, and not in the main report.

The expenses of Equitable remain low, with comfortably the best ratios in the industry. It is apparent that expense control is still tight.

The new business continues to grow, with the emphasis remaining on pensions business

A new branch was added in Germany in 1993, adding to existing Guernsey and Republic of Ireland branches.

Equitable, no doubt influenced by the favourable figures they can properly demonstrate, voluntarily introduced the disclosure regime early in July 1994.

1.2 Action Points

We have raised a number of questions on Equitable's returns, and a smaller number on University's.

Equitable:

1. There is a surprising sum due from a dependant insurance company not authorised in the UK, which we are not aware of. Reinsurance?
2. The treatment of single premiums in the returns appears inconsistent.
3. The note required to form 40 regarding the agreement with University is missing.

EQU93REP.DOC 15 Nov 94

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4. A contract has disappeared. We are seeking confirmation that it has ceased.
5. There appears to have been an error in describing a link.
6. A contract is now described as like a different plan to that which it was likened to in 1992.
7. Interest rates used in the valuation look high. We are seeking clarification.
8. A mortality table looks light.
9. An annuity table looks too heavy.
10. The expense reserves are determined on a somewhat optimistic basis. This has been true before, and we are trying to determine how great the society's exposure is.
11. The amount of resilience reserve required is not given, but only that it can be met.

University:

1. The new large linked contract is described as not being linked to an internal fund, and therefore forms 49-51 are not completed. This appears wrong.
2. As with Equitable, the interest rates used in the valuation are high compared with the yield on assets.

2 BACKGROUND

Equitable is very proud to be the oldest mutual life assurance society in the world, dating from 1762. It was the first to develop policies based on scientific principles as used today.

Equitable has never paid commission to third parties, a further matter of much trumpeting.

There is a background of their own somewhat unusual approach to bonuses, unit linked products (which often have discretionary surrender values) and valuation using a gross premium bonus reserve method. The DTI returns also show the results of applying a net premium basis with assumptions close to the minimum permitted by the regulations.

Although Equitable applies for a section 68 order for an implicit item each year, it has never used this order, it being a precaution only. It does however also enjoy an order ? exempting full description of its personalised funds in the return. There is also an order in relation to call option for FTSE links on some policies.

University is also an old institution, which is now a subsidiary of Equitable, having been acquired in 1919. Equitable provides management services to University under an agreement dating from 1919, which caps University's expenses.

Equitable also has a unit trust and PEP subsidiary.Equitable Unit Trust Managers Ltd, which has over £1bn under management.

The Appointed Actuary and Managing Director posts are both held by [redacted]

1993 returns

BUSINESS DEVELOPMENTS DURING THE YEAR

3 NEW BUSINESS

3.1 New products

3.1.1 With profits and unit linked Major Medical Cash Plan, carries guaranteed insurability option.

3.1.2 With profits and unit linked Critical Illness Plan...carries RPI guaranteed insurability option.

3.1.3 With profits and unit linked Managed Annuity. There are problems with this product with the Inland Revenue, who have not approved it as a valid annuity under the Taxes Acts.

3.1.4 Branch Operations:
These offer similar products to the UK, but on a more limited scale.

3.2 Source(s) of new business

Equitable pays no commissions. They run a sales force, but a lot of their business comes from direct approaches from prospective policyholders.

3.3 Recent history:

Note: University Life is closed to new business, but in 1993 a restructuring of the contracts with the Universities Superannuation Scheme took place, and this led to a large item of new business being reported. This all arose from a surrender, and might just as easily have been reported as an alteration or transfer. It has not been included in the following tables. There are also a very small number of policies (2 in 1993) arising from options in University, but these have also been omitted on the grounds of materiality.

1993 returns

Regular premiums

Class	1989 £000s	1990 £000s	1991 £000s	1992 £000s	**1993 £000s**
UK with profits life	2645	2984	5412	7518	**7235**
UK non profits life	1587	1844	1750	1743	**1761**
UK linked life	280	421	129	129	**404**
UK general annuity with profits	6049	5496	8323	1222	**0**
UK general annuity non profits	18	12	34	10	**13**
UK general annuity linked	328	161	90	54	**0**
UK with profits pensions	145419	186470	202014	221541	**180159**
UK non profits pensions	2662	2285	4607	1965	**1910**
UK linked pensions	28151	32809	17565	31763	**43818**
Overseas with profits life	0	0	1003	4073	**4742**
Overseas non profits life	0	0	0	4	**12**
Overseas linked life	0	0	251	343	**2477**
Overseas general annuity	0	21	3007	0	**11**
Overseas with profits pensions	0	0	466	2643	**6333**
Overseas non profits pensions	0	0	3	9	**21**
Overseas linked pensions	0	0	156	276	**818**
Total	187139	232503	244810	273293	**249714**
Year on year percentage increase		55.0	5.3	11.6	**(8.6)**

EQU93REP.DOC 15 Nov 94

Page 4

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GAD's detailed scrutiny reports in respect of Equitable's returns

1993 returns

Single premiums

Class	1989 £000s	1990 £000s	1991 £000s	1992 £000s	**1993 £000s**
UK with profits life	37094	85414	149999	128609	**137585**
UK non profits life	32	23	28	368	**198**
UK linked life	2060	1969	3628	1513	**6369**
UK general annuity with profits	8786	7337	11484	14896	**20385**
UK general annuity non profits	5755	8157	10086	14402	**17655**
UK general annuity linked	126	152	134	29	**9**
UK with profits pensions	32336	27955	68029	131319	**200751**
UK non profits pensions	29256	49109	109410	151729	**244819**
UK linked pensions	917	283	735	1269	**14742**
Overseas with profits life	0	0	509	457	**2249**
Overseas non profits life	0	0	0	0	**1029**
Overseas linked life	0	0	0	0	**32**
Overseas general annuity	0	0	0	36	**694**
Overseas with profits pensions	0	0	156	343	**882**
Overseas non profits pensions	0	0	156	8946	**23302**
Total	116362	180399	354354	453916	**670701**
Year on year percentage increase		55.0	96.4	28.1	**47.8**

New Business Index (Regular premiums plus 10% of single premiums)

New Business Index (£000)	198775	250543	280245	318685	**316784**
Year on year percentage increase		26.0	11.9	13.7	**(0.6)**

3.4 Commentary

These figures are somewhat strange, however, in that a great volume of pension business is regarded as recurrent single premium. This is reported in the year of issue as regular premium,

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in accordance with the guidance notes, but it does not appear in form 43 as regular premium. In 1993 the effect was for £225.887m new regular premium to appear in form 44 but not in form 43. It is also therefore impossible to reconcile form 41 and form 43.

Should we ask for revised forms?

GAD doesn't mention F.43 in letter to co — query this with GAD.

4 EXPENSES

4.1 Recent history of expenses:

Expense	1989 £000s	1990 £000s	1991 £000s	1992 £000s	**1993 £000s**
Initial commission	0	0	0	0	**0**
Acquisition expenses	56633	60381	72576	75678	**76538**
Renewal commission	0	0	0	0	**0**
Renewal expenses	29097	37561	47950	41048	**41773**
Total expenses	85730	97942	120526	116726	**118311**
Year on year percentage increase		14.2	23.1	(3.2)	**1.4**

Expense ratios: Acquisition	28.5	24.1	25.9	23.7	**24.2**
Renewal (Equitable)	3.5	3.6	4.0	3.2	**3.2**

4.2 Commentary

Equitable is well known as a non-commission paying office, and prides itself in it low expense ratio.

The Equitable publish in their Report and Accounts figures for total expenses divided by total premium income for the society and industry average. The figures are illuminating and the point is valid. Equitable's expenses are indeed low.

Year	1985	1986	1987	1988	1989	1990	1991	1992	1993
Industry	21.7	20.6	20.3	23.4	20.3	21.0	19.3	18.5	not yet available
Equitable	9.6	8.4	8.5	9.1	8.5	7.6	7.2	6.6	5.8

The expenses of University are met by Equitable, and a formula basis is used to charge University. It is not therefore necessary to consider the expense history of University, as the residual effect appears as an expense in Equitable.

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1993 returns

4.3 Exceptional items

None known. There is no provision for mis-selling of personal pensions. This is due to the selling methods which are based upon largely approaches from prospective policyholders. It remains to be seen whether this is correct, but it is true that their exposure is likely to be very much lower than typical in the industry. OK

5 CLAIMS AND WITHDRAWALS

5.1 Claims experience

There has been an increase in the level of death claims, but this does not necessarily indicate any particular problem, as the amount of claim for linked business is very clearly impacted by unit prices.

5.2 Persistency experience

The persistency rates are generally quite good, particularly on the non-linked side. The prevalence of recurrent single premium contracts prevents proper analysis, however. The linked business is generally newer, and shows higher off rates.

6 FINANCIAL RESULTS

6.1 Surplus emerging

On the bonus reserve basis a surplus of £481m arose (1992 £331m). The corresponding figures for University was £100m for the triennium. There is little point in comparing triennia, as these periods are so long and with such varied investment condition and valuation bases up to six years apart.

6.2 Transfer to (or from) P&L Account

This is only applicable to University, where a transfer of £9.979m was made. The transfer is always the 10% share of distributed surplus to within a very small margin. Small transfers can be made in other years depending on terminal bonuses.

6.3 Dividend declared

Equitable is a mutual. University declared a dividend covering the triennium of £9.985m, though small amounts are paid annually, reflecting terminal bonus shares.

1993 returns

SITUATION AT THE YEAR END

7 (NON-LINKED) ASSETS

7.1 Mix of assets at year end (Equitable)

% held	1993	1992	1993 New Money (£1.5bn)
Land	7	8	4
Gilts	28	26	54
Other Fixed Interest	13	12	16
Indexed Gilts	3	2	6
Equities	43	43	30
Other	6	9	-10*

* : representing a decrease in net current assets and cash.

A table in the With Profits Guide shows the assets attributed to with profits business.

UK with profits business	1989 %	1990 %	1991 %	1992 %	1993 %
Fixed Interest	15	17	18	27	31
Property	14	15	12	9	8
UK Equities	46	44	43	41	41
Non-UK Equities	17	12	14	11	12
Unlisted Equities	1	1	2	2	2
Other	7	11	11	10	6
Total	*100*	*100*	*100*	*100*	*100*

The most noteworthy feature of this table is the shift towards a higher fixed interest component. Over five years the fixed interest has risen by 16 points to more than twice the previous level. Equally, the property component has fallen by six points to just over half previously and equity holdings in both the UK and overseas have fallen by five points each, which in the case of overseas equities represents some thirty per cent.

7.2 Investment performance (Equitable)

Investment Income, £665m (1992 £568m)

Capital Gains (non-linked), brought into account £1,180m (1992 £140m)
change in investment reserve £ 875m (£491m)
Totals £2,055m (£631m)

The total return for 1993 was 28.3% (per company's own figures).

1993 returns

8 VALUATION & SOLVENCY

8.1 Strengths and/or weaknesses

The bases used for the gross premium valuation are primarily a tool to support the method of determining distributions. They are not particularly relevant to supervision. The adequacy of the valuation is demonstrated by publishing a net premium valuation on the minimum basis necessary to meet the regulations and except where explicitly stated otherwise comments and figures in this report are based upon this alternative basis.

Q The net premium bases have a number of apparent weaknesses, though in the light of the cover for the required minimum margin there is little concern as to the solvency. If, however, the reserves are too thin, it may lead to inappropriate conclusions being drawn by policyholders and prospective policyholders as to the financial strength of the society. We are therefore seeking confirmation of the prudence of certain of the assumptions.

The rates of interest used are somewhat high in comparison with form 45. As this form does not provide sufficient information to draw a firm conclusion, we are seeking further information.

Some mortality tables look a little on the optimistic side, and again further information on their justification is required.

There is a somewhat weak reserving basis for unit linked expenses, which does not meet the standards this department normally expects. We normally expect the differential between the rate of growth of unit linked assets, and hence the prices, before all charges and taxation to be no more than 2% higher than the rate of inflation of renewal expenses. For this company the difference is about 3.7%. We are trying to determine the extent of exposure here to an adverse experience in costs.

8.2 Changes since previous year

Expense allowances on linked business have been increased, no doubt based upon the experience shown in the table in section 4.1 above, but costs are increasing only very slowly (just over 1%), despite a substantial (over 6%) increase in contracts in force. Expense allowances on unitised with profits have been increased.

Some mortality tables have been strengthened.

The revised resilience test has been incorporated.

Interest rates have been reduced, but not generally by quite as much as the fall in asset yields.

8.3 Summary of results for main classes

Liabilities for non-linked business - Equitable:

Class	*1991 BRV £m*	*1992 BRV £m*	***1993 BRV £m***	1991 NPV £m	1992 NPV £m	**1993 NPV £m**
Life with profits	*560.8*	*712.9*	***846.8***	516.0	664.4	**796.0**
Gen Annuity with profits	*118.7*	*134.5*	***163.1***	104.7	120.5	**157.3**
Pensions with profits	*4,538.1*	*5,581.2*	***7,391.4***	4,181.6	5,148.9	**7,123.6**
Life non profit	*31.7*	*34.3*	***36.8***	34.9	36.6	**40.1**
Gen Annuity non profits	*81.7*	*91.1*	***106.4***	81.8	91.1	**106.4**
Pensions non profits	*663.8*	*955.0*	***1,496.5***	668.0	958.7	**1,499.7**
Overseas Business	*5.2*	*22.5*	***74.5***	4.7	20.0	**71.3**
Additional reserves UK‡	*44.6*	*34.8*	***33.5***	80.1	76.4	**49.4**
Total non-linked liability (Form 55)	*6,044.6*	*7,566.3*	***10,149.0***	5,671.8	7,116.6	**9,843.8**

‡ includes group post-renewal movements reserve and (NPV only) AIDS reserve

Liabilities for linked business - Equitable:

Class	1991 £m	1992 £m	**1993 £m**
Life regular premium	40.7	45.7	**53.7**
Life single premium	44.0	47.5	**61.4**
Gen Annuity single prem†	6.5	7.4	**9.3**
Pensions single premium†	412.3	591.1	**851.3**
Overseas Business	0.4	0.9	**5.4**
Additional reserves common to both bases	(1.0)	(0.3)	**0.1**
Total linked liability for BRV (Form 56)	502.9	692.3	**981.2**
Reduced Miscellaneous Pensions Reserve	(0.4)		
Total linked liability for NPV (Form 56)	502.5	692.3	**981.2**

† Includes recurrent single premium business

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1993 returns

Valuation summary - Equitable:

Bonus Reserve Valuation?

Net premium valuation

	1991 BRV £m	*1992 BRV £m*	***1993 BRV £m***	1991 NPV £m	1992 NPV £m	**1993 NPV £m**
Non-linked liability	*6,349.1*	*7864.9*	***10,466.5***	5,950.1	7,388.8	**10,144.3**
Linked liability	*502.9*	*692.3*	***981.2***	502.5	692.3	**981.2**
Total liability	*6,852.0*	*8557.2*	***11,447.7***	6,452.6	8,081.1	**11,125.5**
Long term assets ...(net of other liabs)	*7,340.2*	*9,400.6*	***13,164.2***	7,340.2	9,400.3	**13,164.2**
Available assets	*488.2*	*843.3*	***1,716.5***	887.6	1,319.4	**2,038.8**
(% of liability)	*7.0*	*9.7*	***14.7***	13.5	16.0	**18.0**
Implicit items	*0**	*0**	***0****	0*	0*	**0***
Total amount available	*488.2*	*843.3*	***1,716.5***	887.6	1,319.4	**2,038.8**
Required Minimum Margin	*292.8*	*356.6*	***458.0***	276.8†	337.6†	**445.1†**
Cover	*1.67*	*2.36*	***3.75***	3.2†	3.9†	**4.6†**

* Section 68 order (for £420m in 1993) not used as per on form 9

† Estimated figure. The cover makes no allowance for the absence of a reserve to meet the resilience test. The amount required in 1992 was £462m, which wipes out the difference between the BRV and NPV and reduces the surplus under the NPV to only some £18m without recourse to the investment reserve which was £839m. As a result the cover for required minimum margin would only have been about the 2.4× shown under the BRV.

8.4 Cover for the solvency margin — Why does Equitable have to do things different from everyone else? !

For both societies the cover for the required minimum margin remains substantial, and gives no cause for concern in itself. The only issues therefore revolve around whether the valuation basis itself is of sufficient strength. This is covered in 8.1 above, but particular care is needed in reviewing the figures for the NPV, as the resilience reserve is omitted, and the figure is not known. ?

9 **BONUSES**

9.1 Cost of bonuses declared

The figure varies by valuation basis and method. The figures for the net premium basis are:

Equitable	£300.4
University	£ 4.3m

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1993 returns

9.2 Key rates of bonus

The Equitable has a large range of bonus series, and a system of final bonuses which is somewhat different to the normal terminal bonus. Specimens are given below in the table.

The system of final bonus is a little unusual. It consists of a declaration of bonus which is not reversionary, in that it may be withdrawn, and/or reduced in future. However it has a lot of features in common with reversionary bonuses. It is declared in a similar way as a percentage of benefit, and the amount paid at the end of the policy's normal span is the sum of the annual "declarations", subject to the proviso that a previously granted bonus can be withdrawn. The wording used by the Society in the WITH PROFITS GUIDE is:

"Final bonuses are also determined and applied retrospectively. The final bonus is calculated so as to top up the growth arising from the policy guarantees and the declared bonus rate for the year to the overall rate of return announced for the year. Final bonuses do not add a guaranteed element to the contract, and the final bonus element of a policy can be varied up or down in future."

The same guide includes a table of investment returns gross on market value and the rate applied in fixing bonuses.

	1989	1990	1991	1992	1993
Actual	24.1%	-8.3%	13.5%	17.1%	28.8%
Allocated	20%	12%	12%	10%*	13%

* : 12% on new benefits secured during the year

Equitable Life	1993				1992			
Bonuses	Reversionary ‰		Final %		Reversionary ‰		Final %	
	On SA.	On Bonus	At 31.12.	Interim	On SA.	On Bonus	At 31.12.	Interim
Endowment Ass.	35.00	22.50	Varies	Varies	40.00	22.50	Varies	Varies
Unitised	52.50	52.50	10.25	8.0	60.00	60.00	8.0	8.0
Deferred Annuity	37.50	37.50	Varies	Varies	45.00	45.00	Varies	Varies
Rec. SP Def Ann	40.00	40.00	13.0	10.0	50.00	50.00	10.0	10.0
Annuity in paymt	40.00	40.00	13.0	10.0	50.00	50.00	10.5	10.0
Pensions	40.00	40.00	13.0	10.0	45.00	45.00	10.0	10.0
Guernsey Life	75.00	75.00	13.0	10.0	85.00	85.00	10.0	10.0
Irish Life	52.50	52.50	12.0	9.0	52.50	52.50	11.0	9.0
Irish Pension	40.00	40.00	13.0	10.0	50.00	50.00	10.0	10.0

The whole life bonus is £37.50‰ + £3‰×(years in force in excess of 11)
(previous year £42.50‰ + £4‰×(ditto))

1993 returns

The final bonuses for traditional life are a table depending on duration in force and this gives the full final bonus, which is in this case therefore a terminal bonus. Specimen values are:

Complete Years In Force	% of SA and Bonus 1994	% of SA and Bonus 1993
1	8.5	7.5
2	11.0	10.0
3	13.0	12.5
4	15.5	15.0
5	18.0	17.5
10	40.5	46.0
15	81.0	81.0
20	102.5	99.0
25	117.5	113.0
30	120.0	113.0

The final bonuses for deferred annuities are a similar table. Specimen values are:

Complete Years In Force	% of SA and Bonus 1994	% of SA and Bonus 1993
1	10.0	7.5
2	12.5	10.0
3	14.0	11.0
4	15.5	13.5
5	17.5	14.5
10	31.0	35.0
15	72.0	71.0
20	94.5	89.0
25	106.0	101.0
30	110.0	101.0

9.3 Changes to bonus rates

Covered above.

9.4 Distribution policy

Both societies follow a stated policy of full distributions, with a basis designed to make up the implied guaranteed rate to a total earned rate. Part is in the form of the non-cancellable reversionary bonus and the rest in the form of final bonus.

The policy is to link declared reversionary bonus rates to the redemption yields on fixed interest stock. This has produced a series of reductions in recent years as yields have fallen, but the system of final bonus effectively balances this in total returns. Policyholders' reasonable expectations are therefore influenced downwards in line with yields.

10 UNIT-LINKED FUNDS

10.1 New funds introduced

Indexed Gilt (life and pensions versions) fund
Global Bond (life and pensions versions) fund — a US dollar Guernsey fund.
Global Equity (life and pensions versions) fund — a US dollar Guernsey fund.
Irish Managed (life) fund

A new arrangement now exists in University as a result of the restructuring of the University Superannuation Scheme policies.

10.2 Investment performance

By far the largest fund is the Pensions Managed, which showed an increase in valuation price of 34% which is respectable. The largest life fund is the Managed which increased by 24%, which is not as good, though still satisfactory.

10.3 Fund Management Charges to policyholders

These are unchanged at either 0.6875% p.a. (for UK and Irish life funds) or 0.75% p.a. (for all other funds).

11 REINSURANCE

11.1 Overview of treaties

Little use is made of reassurance by Equitable, other than for very large sums assured (retention being £400K for life risks and £50K for critical illness risks), income bonds, German business, and facultative cover in some cases.

11.2 Changes during the year

New treaties were put in place for 50% quota share reassurance of major medical cash benefits, and for the excess over retention for critical illness benefits..

Extensive reassurance is also now in place for German business.

11.3 'Financing reinsurance'

None

OTHER ISSUES

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12 COMPLIANCE

12.1 Significant compliance problems

None known

13 MISCELLANEOUS

No provision is made for mis-selling of pensions.

[redacted]

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Appendix

University Life Assurance Society Ltd.

7.1 Mix of assets at year end

University	Land	11%	(1992 4%)
	Gilts	37%	(19%)
	Other FI	18%	(6%)
	Equities	27%	(57%)
	Other	7%	(14%)

8.3 Summary of results for main classes

Liabilities for non-linked business - University:

Class	*1991 BRV £m*	1991 NPV £m	*1992 BRV £m*	1992 NPV £m	***1993 BRV £m***	**1993 NPV £m**
Life with profits			*8.6*	8.5	***8.2***	**7.4**
Gen Annuity with profits			*7.5*	7.5	***6.8***	**6.4**
Pensions with profits			*75.3*	71.6	***8.4***	**7.1**
Life non profit			*1.6*	1.7	***1.5***	**1.5**
Gen Annuity non profits			*4.8*	4.8	***3.9***	**3.9**
Pensions non profits			*2.5*	2.6	***2.3***	**2.3**
Additional reserves			*0.3*	0.7	***0.8***	**0.1**
Total non-linked liability (Form 55)			*100.6*	97.4	***31.9***	**28.7**

Liabilities for linked business - University:

Class	1991 £m	1992 £m	**1993 £m**
Life regular premium		.240	**.271**
Life single premium		.046	**.039**
Gen Annuity single prem†		.013	**.015**
Pensions single premium†		0	**129.561**
Additional reserves		0	**0**
Total linked liability for both bases (Form 56)		0.299	**129.886**

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1993 returns

Valuation summary - University:

	1991 BRV £m	1992 BRV £m	1993 BRV £m	1991 NPV £m	1992 NPV £m	1993 NPV £m
Non-linked liability		100.6	35.6		98.1	33.0
Linked liability		0.3	129.9		0.3	129.9
Total liability		100.9	165.5		98.4	162.9
Long term assets ...(net of other liabs)		193.2	188.9		193.2	188.9
Available assets		92.3	23.5		94.8	26.0
(% of liability)		75.8	12.4		77.3	15.7
Implicit items		0	0		0	0
Total amount available		92.3	23.5		94.8	26.0
Required Minimum Margin		4.3	1.5		4.2	1.4†
Cover		21.39	15.70		22.6	18.7

OK !

† Estimated figure

9.2 Key rates of bonus

For University the bonuses are declared triennially. 1993 was the end of the triennium and bonuses were therefore declared as follows:

University Bonuses %	1993 Declaration		1990 Declaration	
Compound	Declared	Interim	Declared	Interim
Whole Life	5.00	4.50	7.00	5.00
Endowment	4.75	4.25	6.75	4.75
Annuities	7.50	5.00	9.00 10.00 on bonus	7.50
Pensions (except Part 14)	8.00	5.50	10.00 11.50 on bonus	8.00
Pens Part 14 deferred	9.00	6.00	13.00	9.00

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GAD's detailed scrutiny reports in respect of Equitable's returns

1993 returns

Terminal Bonuses were set as follows:

University Rates %	1993		1990	
	Life & Annuity	Pension	Life & Annuity	Pension
up to 5 years	0	0	0	0
5	12.50	12.50	7.00	7.00
10	25.00	25.00	35.00	35.00
15	43.75	43.75	55.00	55.00
20	68.75	68.75	80.00	80.00
25	93.75	78.125	95.00	95.00
30 or more	100.00	87.50	95.00	95.00

Linear interpolation applies.

[redacted]

GAD's detailed scrutiny reports in respect of Equitable's returns

1994 returns

24/1/96 cc. [redacted]

cc. [illegible] + 95 returns.
EL general file.

EQUITABLE LIFE ASSURANCE SOCIETY

RETURNS AS AT 31 DECEMBER 1994

DETAILED SCRUTINY REPORT

1. SUMMARY

1.1 Key Features

- This is a large old-established mutual life insurer with total long term assets of £13½bn. This makes it the seventh largest company measured in terms of long term business assets.
- This company is classified as priority 3.
- Rather unusually, especially since the recent disappearance of Provident Mutual, the company publishes a gross premium bonus reserve valuation, and a net premium comparison.
- For the first time, Equitable has used a small implicit item in form 9, amounting to about £250m.
- The main line of business is pensions, which is somewhat unusually structured in that it is almost all on a recurrent single premium basis.
- Branches are operated in Guernsey, Ireland and Germany. These are producing ever more business - 8% of new business in 1994.
- Expenses remain the lowest in the industry, and the ratios continue to fall.
- Reserving bases are weak, by design, to maximise the free asset ratio. Nonetheless, this has fallen in 1994.

1.2 Action Points

Much useful information was derived last year from the With Profit Guide, but we have only an edition dating from 1 May 1994. We have requested a later version in our letter.

We have also raised a number of areas of greater or lesser concern, pre-eminent amongst which are mortality bases for annuitants and interest rates used in the valuation.

2. BACKGROUND

Equitable is very proud to be the oldest mutual life assurance society in the world, dating from 1762. It was the first to develop policies based on scientific principles as used today.

Equitable has never paid commission to third parties, a further matter of much trumpeting.

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There is a background typified by their own somewhat unusual approach to bonuses, unit linked products (which often have discretionary surrender values) and valuation using a gross premium bonus reserve method. The DTI returns also show the results of applying a net premium basis with assumptions close to the minimum permitted by the regulations.

Although Equitable applies for a section 68 order for an implicit item each year, it has used this order (in part, being £250m on an order permitting £500m) for the first time in 1994, it having being a precaution only hitherto. The implicit item is not strictly necessary for the statutory purpose, it forming part of the excess assets in Form 9. A similar order in the sum of £500m was granted for 31 December 1995. It also enjoys an order exempting full description of its personalised funds in the return.

University Life is also an old institution, which is now a subsidiary of Equitable, having been acquired in 1919. Equitable provides management services to University under an agreement dating from 1919, which caps University's expenses.

Equitable also has a unit trust and PEP subsidiary Equitable Unit Trust Managers Ltd, which has over £1bn under management.

In 1995 Equitable purchased a majority interest in [redacted], the PHI specialist, from the mutual Medical Sickness. This does not feature in this scrutiny, in view of the purchase post-dating the valuation, but will feature in future scrutinies. There are indications from scrutiny work on Permanent that the price paid may have been quite a full one.

Equitable has been active overseas in recent years, and has branches in Guernsey (sometimes called its International Branch), Ireland and Germany. These branches have been set up on a low cost base, but are developing steadily and are producing ever increasing amounts of new business. The impression we have been given is that the Equitable regard this as an exercise in extending the numbers of people who can benefit from the Society as an institution. It is almost like missionary work, rather than a purely commercial move in the interests of UK policyholders, for example. The mutual concept is extended to all policyholders, and indeed is even part of Equitable's dealing with UK non profit policyholders.

The Appointed Actuary and Managing Director posts are both held by [redacted] who is due to retire within a few years (though it is dangerous to speculate exactly when!).

A visit to the company by DTI and GAD officials was made in December 1994.

BUSINESS DEVELOPMENTS DURING THE YEAR

3. NEW BUSINESS

3.1 New products

UK

No new contracts

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Guernsey

1. International Flexible Protection Plan - a unit linked renewable endowment with selectable sum assured.
2. Unit linked Guernsey and International Group Pension Plans

Ireland

1. With profits Major Medical Cash Plan - a PHI type product, about which there has been correspondence as to its proper classification.
2. Irish Flexible Protection Plan - a unit linked renewable endowment with selectable sum assured.

Germany

1. Term assurance non profit.
2. Whole life unitised with profit "Investment Plan" - a long term savings vehicle with trivial life assurance, the difference between the death benefit and surrender value being only that the latter is discretionary and will, in particular, suffer a market value adjustment.
3. Unitised with profit endowment "Flexible Savings Plan" with life cover selected at outset.
4. With profits immediate annuities.
5. Unit linked German Investment Plan - a unit linked version of 2 above.
6. Unit linked German Flexible Savings Plan - a unit linked version of 3 above.

In addition various contracts have been revised, particularly in the European branches.

3.2 Source(s) of new business

Equitable pays no commissions. They run a sales force, but a lot of their business comes from direct approaches from prospective policyholders. There is also a significant volume of quasi-institutional business, both from pension schemes themselves and from AVC schemes run for pension schemes.

1994 returns

3.3 Recent history:

Regular premiums

Class	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
Life with-profit	2,984	5,412	7,518	7,235	**8,632**
Life non-profit	1,844	1,750	1,743	1,761	**1,840**
Life linked	421	129	129	404	**822**
General annuity with-profit	5,496	8,323	1,222	0	**0**
General annuity non-profit	12	34	10	13	**4**
General annuity linked	161	90	54	0	**0**
Pensions with-profit	186,470	202,014	221,541	180,159	**263,347**
Pensions non-profit	2,285	4,607	1,965	1,910	**1,585**
Pensions linked	32,809	17,565	31,763	43,818	**66,026**
Overseas	21	4,886	7,389	14,414	**33,116**
Total	232,503	244,810	273,334	249,714	**375,372**
Year on year % increase	24.2%	5.3%	11.7%	-8.6%	**50.3%**

Single premiums

Class	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
Life with-profit	85,414	149,999	128,609	137,585	**128,152**
Life non-profit	23	28	368	198	**379**
Life linked	1,969	3,628	1,513	6,369	**6,802**
General annuity with-profit	7,337	11,484	14,896	20,385	**19,575**
General annuity non-profit	8,157	10,086	14,402	17,655	**13,727**
General annuity linked	152	134	29	9	**123**
Pensions with-profit	27,955	68,029	131,319	200,751	**226,163**
Pensions non-profit	49,109	109,410	151,729	244,819	**136,735**
Pensions linked	283	735	1,269	14,742	**14,153**
Overseas	0	821	9,782	28,188	**22,426**
Total	180,399	354,354	453,916	670,701	**568,235**
Year on year % increase	55.0%	96.4%	28.1%	47.8%	**-15.3%**

New Business Index (Regular premiums plus 10% of single premiums)

New Business Index (£000s)	250,543	280,245	318,726	316,784	**432,196**
Year on year % increase	26.0%	11.9%	13.7%	-0.6%	**36.4%**

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1994 returns

3.4 Commentary

The new business results for Equitable are once again strong, after a temporary reduction in 1993. There will have been a material strain in 1994 associated with the new business, especially in a year of declining market values of assets. The lower single premium sales do follow a good result in 1993, and are still well ahead of the previous levels and represent 25% higher sales than 1992.

These figures are somewhat strange, however, in that a great volume of pension business is regarded as recurrent single premium. This is reported in the year of issue as regular premium, in accordance with the guidance notes, but it does not appear in form 43 as regular premium.

The strong presence the Society has built in the upper echelons of the pensions market continues to underpin the business performance. The level of life sales lags somewhat, though there are signs of improvement. Single premium life with profit business is strong, of course, on the back of the low expense base and absence of commission.

The annual report on the industry showed Equitable as one of the success stories of 1994. It was ranked only 27th for new life business, but was 1st in pensions and 3rd in the combined table. In terms of growth, it ranked 8th, and was the top mutual office. It held the same place over the period 1989 to 1994, though the [redacted] was the top mutual from a low base.

Overseas business now accounts for an impressive 8% of NBI, driven primarily by regular premium sales, particularly from the Guernsey branch.

4. CHANGES IN BUSINESS IN FORCE

4.1 Recent history of regular premiums

Class	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
Life	49,468	49,911	63,303	64,806	**77,399**
General annuity	18,288	19,417	8,291	7,399	**5,833**
Pensions	974,051	1,123,234	1,201,594	1,241,058	**1,307,015**
Total gross regular premiums	1,041,807	1,192,562	1,273,188	1,313,263	**1,390,247**
Less reinsurance premiums	2,231	2,186	2,332	1,463	**1,440**
Total net regular premiums	1,039,576	1,190,376	1,270,856	1,311,800	**1,388,807**
Year on year % increase	24.6%	14.5%	6.8%	3.2%	**5.9%**

There is a continued rise in regular premiums with pensions the prime source, but life premiums are rising also. All this is helpful in keeping the low expense ratio which drives the business. This is clearly a virtuous circle.

4.2 Claims experience

Recent history of mortality rates *(based upon regular premium exiting through death)*

Class	1990	1991	1992	1993	1994
Life non-linked	0.35%	0.30%	0.37%	0.28%	**0.37%**
Life linked	0.68%	0.20%	0.11%	0.20%	**0.10%**
Pensions non-linked	0.23%	0.14%	0.19%	0.07%	**0.26%**

There is no pensions linked regular premium business reported in form 43, as the business is all recurrent single premium. There is nothing remarkable in this table.

It is not possible from the DTI return to form any view on the mortality experience of annuitants. This was the subject of correspondence with the company in recent times, partly prompted by an enquiry from the BAV on the business being written in Germany. We are returning to this issue again in the light of recently published data.

4.3 Persistency experience

Recent history of lapse rates *(forfeitures as prop'n of reg. prem NB in force < 2 years)*.

Class	1990	1991	1992	1993	1994
Life non-linked	17.48%	20.31%	17.39%	10.17%	**7.34%**
Life linked	0.00%	4.45%	0.97%	0.45%	**0.82%**
Pensions non-linked	30.72%	36.36%	37.33%	44.77%	**64.45%**

There is no pensions linked regular premium business reported in form 43, as the business is all recurrent single premium. The lapse rates are distorted for pensions as nearly all the business is term assurance type without surrender values. The life non-linked figure is falling satisfactorily, though the rising new business may explain this.

Recent history of surrender & paid-up conversion rates

Class	1990	1991	1992	1993	1994
Life non-linked	1.05%	1.24%	1.53%	2.34%	**2.62%**
Life linked	4.50%	5.06%	6.76%	10.25%	**12.56%**
Pensions non-linked	3.38%	1.43%	1.46%	1.16%	**1.11%**

There is no pensions linked regular premium business reported in form 43, as the business is all recurrent single premium. Most non-linked pensions business cannot surrender, and this ratio is therefore distorted.

5. EXPENSES

5.1 Recent history of expenses:

Expense	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
Initial commission	0	0	0	0	0
Acquisition expenses	60,381	72,576	75,678	76,538	**78,136**
Renewal commission	0	0	0	0	0
Renewal expenses	37,561	47,950	41,048	41,773	**32,941**
Total expenses	97,942	120,526	116,726	118,311	**111,077**
Year on year % increase	14.2%	23.1%	-3.2%	1.4%	**-6.1%**

Expense ratios:	1990	1991	1992	1993	**1994**
Acquisition	24.1%	25.9%	23.7%	24.2%	**18.1%**
Renewal	3.6%	4.0%	3.2%	3.2%	**2.4%**

Note: The expense ratios are:
Acquisition (IC + AE) / New Business Index
Renewal (RC + RE) / Regular gross premium income in force
[from Form 41, Col 1, lines 2 + 4 + 6 + 7 + 8]

5.2 Commentary

Can these ratios keep improving? They really have reached astonishingly low levels now, and it is difficult to see them falling very much lower. However, the ever increasing sales seem to be taking up slack in the administration systems, and whilst this continues there will be improvements. The problem might come where a significant jump in capacity is required to support the levels of administration demanded by adding large quantities of new business.

Equitable is well known as a non-commission paying office, and prides itself in its low expense ratio. It is a very positive marketing message, and a key attraction of the Society with its customers. It helps explain the positive sales figures in a poor time for most of its competitors, and it part of a virtuous circle.

The Equitable publish in their Report and Accounts figures for total expenses divided by total premium income for the society and industry average. The figures are illuminating and the point is valid. Equitable's expenses are indeed low.

Year	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Industry	21.7	20.6	20.3	23.4	20.3	21.0	19.3	18.5	17.7	"not yet available"
Equitable	9.6	8.4	8.5	9.1	8.5	7.6	7.2	6.6	5.8	5.5

The annual report on the industry in 1994 showed that Equitable was the most efficient office on acquisition expenses covered, though some small specialist companies with

1994 returns

unusual factors did have lower figures. For renewal expenses the position is again 1st, but here no company at all beats Equitable.

The comparison of the expense ratios used by GAD between the Equitable and the industry are as follows:

Ratio	Equitable	Top 50 average	Industry Average
Acquisition	18.1%	92.5%	106.0%
Renewal	2.4%	13.0%	14.9%

(The industry comparatives are based upon the annual report on the life insurance industry for the year ending 31 December 1994 issued in October 1995)

SITUATION AT THE YEAR END

6. NON-LINKED ASSETS

6.1 Changes in portfolio

Recent history of asset mix

Type of asset	1990	1991	1992	1993	**1994**
Land	12.7%	10.7%	7.8%	6.9%	**8.1%**
Govt fixed interest	17.1%	15.8%	26.3%	28.1%	**27.1%**
Other fixed interest	8.1%	10.3%	11.8%	12.5%	**10.5%**
Govt index linked	2.2%	1.2%	1.9%	2.7%	**2.4%**
Equity shares	47.1%	50.7%	42.9%	43.2%	**46.8%**
Debts sec'd on land	0.4%	0.3%	0.2%	0.1%	**0.1%**
Other - producing income	8.2%	7.7%	5.8%	4.1%	**2.1%**
Other - not producing income	4.1%	3.3%	3.3%	2.4%	**2.8%**

Recent history of allocation of new money (Equitable's own figures)

Type of asset	1993	**1994**
Land	4%	**8%**
Govt fixed interest	54%	**23%**
Other fixed interest	16%	**2%**
Govt index linked	6%	**0%**
Equity shares	30%	**79%**
Other	*-10%	***-12%**

* : representing a decrease in net current assets and cash.

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Recent history of yields

Type of asset	1993	1994
Land	7.33%	**6.82%**
Govt fixed interest	6.46%	**8.92%**
Other fixed interest	6.75%	**7.51%**
Govt index linked	2.66%	***2.76%**
Equity shares	2.91%	**3.34%**
Debts sec'd on land	6.58%	**7.70%**
Other - producing income	5.25%	**5.06%**
Total	4.71%	**5.51%**

* 4.24% under regulation 69

The investment mix is not of particularly unusual shape. The proportion of non profit and with profit business is critical in assessing this mix, and the apparent mix does not always reveal everything. It is more useful to look at the mix hypothecated to the types of business. The decisions on where to allocate new money are always of interest, and it is a useful piece of information which Equitable provide. Interestingly, only 43% of new money was directed at UK equities, though 12% was in undescribed in-house unit trusts.

A table in the latest available With Profits Guide shows the assets attributed to with profits business up to 1993.

UK with profits business	1989 %	1990 %	1991 %	1992 %	1993 %
Fixed Interest	15	17	18	27	31
Property	14	15	12	9	8
UK Equities	46	44	43	41	41
Non-UK Equities	17	12	14	11	12
Unlisted Equities	1	1	2	2	2
Other	7	11	11	10	6

The most noteworthy feature of this table is the shift towards a higher fixed interest component. Over the five years the fixed interest has risen by 16 points to more than twice the previous level. Equally, the property component has fallen by six points to just over half previously and equity holdings in both the UK and overseas have fallen by five points each, which in the case of overseas equities represents some thirty per cent.

6.2 Investment performance

	£m	£m
1. Investment Income per form 40	732.2	
2. less Investment Income of Internal Funds (F51)	(34.2)	
3. less estimated Investment Income of other linked assets	(1.5)	
4. Non linked investment income		696.5
5. Increase in non linked assets brought into account (F40)		(538.5)
6. Investment Reserve carried forward	917.5	
7. Investment Reserve brought down	1,713.3	
8. Increase in investment reserve		(795.8)
9. Investment Return		(637.8)
10. Opening non linked assets	12,383.9	
11. Closing non linked assets	12,466.8	
12. Mean fund excluding investment return [=½×(10+11-9)]		12,744.3
13. Rate of return from investment [= 9÷12]		**-5.0%**

The Equitable's own figure for the with profits fund was a fall of 4.2%.

7. UNIT-LINKED FUNDS

7.1 New funds introduced

Ethical Fund - no description provided.

7.2 Investment performance

The annual report claims second quartile performance for the managed fund. The actual returns on the most important fund, the Pensions Managed, was -4.5%, which is reasonable. This fund is over 30% of unit linked business.

7.3 Fund Management Charges to policyholders

¾% per annum except for UK and Irish Life Assurance funds, for which the charge is $^{11}/_{16}$% per annum

8. VALUATION & SOLVENCY

8.1 Strengths and/or weaknesses

8.1.1 Overview

It is known from the company visit at the end of 1994 that Equitable's Actuary has decided that the interests of the Society are best served by using a weak valuation basis

1994 returns

to show as strong a free asset position as is possible. This means that the valuation basis is selected at the limits of the regulations. This requires us to exercise particular vigilance in ensuring that users of the returns are not misled. Additionally, the Equitable has a full distribution policy. Although one should not, perhaps, be critical of this per se, it does mean that the Society is more vulnerable than many to adverse conditions. The low free asset ratio means that there is comparatively little to spare if the reserves do prove inadequate.

There are, however, a number of hidden strengths in the valuation. Principal amongst these is the treatment of recurrent single premium pensions business. This is assumed to pay no more premiums, and this is an extremely strong basis, though arguably only in line with the best practice. If the business were treated as regular premium, margins in future premiums and charges on the funds built up might allow some lower reserves. It is likely that some credit is being taken implicitly for this in the expense reserves (see §8.1.4)

8.1.2 Mortality

Assurances

The bases used for assurances are generally fairly reasonable. In one or two cases a more aggressive line is taken, but within the bounds of recent data, and these have been raised with the Appointed Actuary before, and he has had little trouble in justifying them.

Annuities - general

The vast majority of UK annuities are valued on the a(90) table with a one year down rating. This is well in excess of recent industry experience, and although the Appointed Actuary claimed to be able to justify this last year, we are pressing him quite vigorously on this point this year.

Annuities - pension

The basis here is still out of date ,being PA(90)-4. This is, however, close to the effect of using the more recent table with a fair adjustment for improving mortality. We are not therefore concerned at this table. It is not a strong basis, however, but rather an adequate one.

German business

The basis here for assurances is a German table, except for term business where a heavy UK table is used. For annuities, one policy is valued on a German table, and four on a UK table. The table chosen is that for pensioners above, and is probably adequate in a UK context. In the light of the small volumes, it is unnecessary to enquire further, as the problem, if any, is too insignificant.

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8.1.3 Interest Rates

The following table summarises the interest rates used, in general terms, for major classes (with liabilities in excess of £50m).

Classes	Net Interest Rate	Gross Interest Rate *	Approximate Liability (£m)
UK with profit assurances	3.25%	4.06%	270
UK unitised with profit assurances	4.25%	5.31%	633
UK with profit general annuities in payment	5.75%	5.75%	155
UK non profit general annuities in payment	8.50%	8.50%	90
UK pensions with profit - regular premium	5.00%	5.00%	208
UK pensions unitised with profit style	5.75%	5.75%	7,499
UK pensions non profit - main classes	8.50%	8.50%	1,481

* grossed up at 20% tax for with profit assurances and 25% for non profit assurances.

Comparing this table with the assets and yields as below, gives rise to some doubt as to the sufficiency of higher yielding assets, particularly one a yield differential for risk is included.

Category of Assets	Value of Admissible Assets (£m)	Yield
Land	1,014	6.82%
Gilts etc	3,380	8.92%
Other fixed interest	1,313	7.51%
Indexed Gilts	300	4.24%
Other variable interest	12	5.34%
Equities	5,834	3.34%
Debts secured on land	16	7.70%
Other	253	4.78%

It is far from clear how this asset yield pattern will allow such a high rate of interest for the with profits business, if the non profit business takes the highest yielding assets to support its valuation rate. We are therefore seeking a thorough matching rectangle in the format under the proposed new Accounts and Statements regulations.

8.1.4 Expenses

The expenses of Equitable are well controlled, and are falling in relation to business in force and indeed in cash terms as well. There is little reason to question the low expense allowances in the valuation, therefore. A substantial hidden margin in respect of the pensions recurrent single premium business covers any apparent shortfall.

8.1.5 Resilience and special reserves

The Equitable takes advantage of its use of a bonus reserve gross premium valuation to hide its resilience reserve. The difference between the net premium valuation and the gross premium valuation results is its resilience reserve (or at least a substantial part of that difference). They do not disclose how much. This will be asked for yet again. Other reserves seem to be on a reasonable basis.

8.2 Changes since previous year

Small amendments were made to the reserves for future bonuses under the net premium basis, and a number of other small changes were made. Some minor classes were valued under revised parameters.

Interest rate bases were revised to absorb some of the effect of rising interest rates and falling asset values.

Pension annuitant mortality was strengthened from a very weak basis to an acceptable one. The old basis would not, given recent publications, have continued to be defensible.

8.3 Summary of results for main classes

Liabilities for non-linked business

Class	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**	**1994 NPV £000s**
Life with-profit	386,004	561,514	718,200	856,490	**1,001,606**	**908,633**
Life non-profit	27,224	31,684	34,237	36,777	**45,328**	**49,793**
General annuity with-profit	97,579	121,867	137,060	166,184	**181,175**	**168,427**
General annuity non-profit	81,343	81,772	91,108	106,451	**105,047**	**103,656**
Pensions with-profit	3,533,969	4,538,652	5,583,654	7,399,654	**7,930,355**	**7,691,802**
Pensions non-profit	520,095	663,966	961,301	1,504,671	**1,598,887**	**1,595,659**
Pensions add. reserves	45,553	44,603	34,833	33,482	**0**	0
Republic of Ireland Business	2	523	5,919	45,050	**68,101**	**63,877**
All other overseas business	0	0	0	211	**1,625**	**51,019**
Additional Reserves (AIDS)	0	0	0	0	**0**	**18,378**
Total non-linked liability (Form 55)	4,691,769	6,044,581	7,566,312	10,148,970	**10,932,124**	**10,651,244**

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Liabilities for linked business

Class	1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**	**1994 NPV £000s**
Life	77,771	83,921	93,526	118,565	**109,984**	**109,993**
General annuity	5,827	6,533	7,368	9,348	**8,674**	**8,674**
Pensions	317,870	412,465	591,415	852,975	**964,898**	**964,898**
Republic of Ireland business	0	0	20	315	**1,209**	**1,209**
All other overseas business	0	0	0	0	**10,978**	**10,978**
Total linked liability (Form 56) BRV	401,468	502,919	692,329	981,203	**1,095,743**	**1,095,752**

The difference in the two bases is an AIDS reserve.

Valuation summary

		1990 £000s	1991 £000s	1992 £000s	1993 £000s	**1994 £000s**
1	Non-linked liability	4,691,769	6,044,581	7,566,312	10,148,970	**10,932,124**
2	Linked liability	401,468	502,919	692,329	981,203	**1,095,743**
3	Bonus reserves	268,540	304,459	298,582	317,509	**349,647**
4	Total math. reserves	5,361,777	6,851,959	8,557,223	11,447,682	**12,377,514**
5	Additional reserves	0	0	0	0	**0**
6	Other liabilities	157,748	112,063	164,195	218,184	**256,265**
7	Total long-term liabilities	5,519,525	6,964,022	8,721,418	11,665,866	**12,633,779**
8	Long-term assets	5,932,451	7,452,253	9,564,764	13,382,406	**13,551,281**
9	Shareholders' assets allocated to RMM	0	0	0	0	0
10	Assets available to meet RMM (8+9-7)	412,926	488,231	843,346	1,716,540	**917,502**
11	Implicit items	0	0	0	0	**249,985**
12	Total amount available (10+11)	412,926	488,231	843,346	1,716,540	**1,167,487**
13	RMM	233,182	292,829	356,625	458,014	**494,616**
14	Cover (12/13)	1.77	1.67	2.36	3.75	**2.36**
15	Free assets ratio ((10-13)/8)	3.03%	2.62%	5.09%	9.40%	**3.12%**

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		1992 BRV £m	*1993 BRV £m*	***1994 BRV £m***	1992 NPV £m	1993 NPV £m	**1994 NPV £m**
1.	Non-linked liability	*7,566.3*	*10,149.0*	***10,932.1***	7,116.6	9,843.8	**10,651.2**
2.	Linked liability	*692.3*	*981.2*	***1,095.7***	692.3	981.2	**1,095.8**
3.	Bonus Reserves	*298.6*	*317.5*	***349.6***	272.2	300.4	**330.2**
4.	Total math. reserves	*8,557.2*	*11,447.7*	***12,377.5***	8,081.1	11,125.4	**12,077.2**
5.	Additional Reserves	*0*	*0*	***0***	462.0	236.0	**????‡**
6.	Other liabilities	*164.2*	*218.2*	***256.3***	164.2	218.2	**256.3**
7.	Total liability	*8,721.4*	*11,665.9*	***12,633.8***	8,707.3	11,579.6	**????‡**
8.	Long term assets	*9,564.7*	*13,382.4*	***13,551.3***	9,564.7	13,382.4	**13,551.3**
9.	Shareholders' assets	*0*	*0*	***0***	0	0	**0**
10	Available assets	*843.3*	*1,716.5*	***917.5***	857.4	1,802.8	**????‡**
11	Implicit items	*0**	*0**	***250.0***	0*	0*	**250.0**
12	Total amount available	*843.3*	*1,716.5*	***1,167.5***	857.4	1,802.8	**????‡**
13	Required Minimum Margin	*356.6*	*458.0*	***494.6***	356†	455†	**????‡**
14	Cover	*2.36×*	*3.75×*	***2.36×***	2.41×	3.96×	**????‡**
15	Free asset ratio	*5.1%*	*9.4%*	***3.1%***	5.2%	10.1%	**????‡**

* Section 68 order not used until 1994.
† Estimated figure.
‡ The amount of resilience reserve is not known for 1994. It is possibly sufficient to make the difference between the BRV and NPV zero, but we have no way of telling until the answer to our enquiry is received.

8.4 Cover for the solvency margin

It is not possible at present to calculate the net premium basis cover for the required minimum margin, but the gross premium cover is stated as higher. The cover with the implicit item included amounts to 2.36×, and if the implicit item had not been included it would have been 1.85×. The market reaction to the free assets falling to the level shown in our table (3.12%) as opposed to the free asset ratio often used including the implicit item (4.97%) might have been similar to that when [redacted] revealed a low figure. Note that the section 68 order actually allowed an item up to £500m.

The cover may not be huge, but it is adequate, provided the Appointed Actuary can satisfactorily defend his basis from the questions we have raised.

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9. FINANCIAL RESULTS

9.1 Surplus emerging

Gross Premium Basis	1990	1991	1992	1993	**1994**
Surplus emerging (£000s)	422,489	596,501	330,523	480,935	**519,981**

10. BONUSES

10.1 Cost of bonuses declared

Cost in £000's (on Gross Premium Valuation)	1990	1991	1992	1993	**1994**
Reversionary Bonus	268,534	304,459	298,582	317,509	**349,647**
Terminal and other bonuses in anticipation of a surplus	154,725	151,565	167,898	165,053	**173,541**
Total Distributed	425,249	458,015	468,472	484,555	**525,182**

10.2 Key rates of bonus

The Equitable has a large range of bonus series, and a system of final bonuses which is somewhat different to the normal terminal bonus. Specimens are given below in the table.

The system of final bonus is a little unusual. It consists of a declaration of bonus which is not reversionary, in that it may be withdrawn, and/or reduced in future. However it has a lot of features in common with reversionary bonuses. It is declared in a similar way as a percentage of benefit, and the amount paid at the end of the policy's normal span is the sum of the annual "declarations", subject to the proviso that a previously granted bonus can be withdrawn. The wording used by the Society in the With Profits Guide is:

"Final bonuses are also determined and applied retrospectively. The final bonus is calculated so as to top up the growth arising from the policy guarantees and the declared bonus rate for the year to the overall rate of return announced for the year. Final bonuses do not add a guaranteed element to the contract, and the final bonus element of a policy can be varied up or down in future."

The same guide includes a table of investment returns gross on market value and the rate applied in fixing bonuses.

	1990	1991	1992	1993	1994
Actual	-8.3%	13.5%	17.1%	28.8%	-4.2%†
Allocated	12%	12%	10%*	13%	10%†

* : 12% on new benefits secured during the year
† : figures from annual report, not with profits guide

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1994 returns

Equitable Life	1993				1994			
Bonuses	Reversionary ‰		Final (total return)%		**Reversionary ‰**		**Final (total return)%**	
UK style policies	On SA.	On Bonus	At 31.12.	Interim	**On SA.**	**On Bonus**	**At 31.12.**	**Interim**
Endowment Ass.	35.00	22.50	Varies	Varies	**35.00**	**22.50**	**Varies**	**Varies**
Unitised	52.50	52.50	10.25	8.0	**52.50**	**52.50**	**8.0**	**8.0**
Deferred Annuity	37.50	37.50	Varies	Varies	**37.50**	**37.50**	**Varies**	**Varies**
Rec. SP Def Ann	40.00	40.00	13.0	10.0	**40.00**	**40.00**	**10.0**	**10.0**
Annuity in paymt	40.00	40.00	13.0	10.0	**40.00**	**40.00**	**10.0**	**10.0**
Pensions	40.00	40.00	13.0	10.0	**40.00**	**40.00**	**10.0**	**10.0**
Guernsey Life	75.00	75.00	13.0	10.0	**75.00**	**75.00**	**10.0**	**10.0**
Irish Life	52.50	52.50	12.0	9.0	**52.50**	**52.50**	**9.0**	**9.0**
Irish Pension	40.00	40.00	13.0	10.0	**40.00**	**40.00**	**10.0**	**10.0**
German Life	N/A	N/A	N/A	N/A	**52.50**	**52.50**	**8.5**	**8.5**
German Annuity	N/A	N/A	N/A	N/A	**52.50**	**52.50**	**8.5**	**8.5**

The whole life bonus is £37.50‰ + £3‰×(years in force in excess of 11)
(previous year - same)

There are also a small number of policies with German style bonuses, but these are too small a class to cover here.

The final bonuses for traditional life are a table depending on duration in force and this gives the full final bonus, which is in this case therefore a terminal bonus. Specimen values are:

Complete Years In Force	% of SA and Bonus 1994	**% of SA and Bonus 1995**
1	8.5	**6.0**
2	11.0	**9.0**
3	13.0	**11.5**
4	15.5	**13.5**
5	18.0	**16.0**
10	40.5	**34.5**
15	81.0	**76.0**
20	102.5	**101.0**
25	117.5	**118.5**
30	120.0	**122.5**

The final bonuses for deferred annuities are a similar table. Specimen values are:

Complete Years In Force	% of SA and Bonus 1994	**% of SA and Bonus 1995**
1	10.0	**7.5**
2	12.5	**11.0**
3	14.0	**13.5**
4	15.5	**15.5**
5	17.5	**16.5**
10	31.0	**28.0**
15	72.0	**68.5**
20	94.5	**92.5**
25	106.0	**107.5**
30	110.0	**115.0**

10.3 Changes to bonus rates

Reversionary bonuses were, as can be seen, unchanged.

10.4 Distribution policy

The society follows a stated policy of full distributions, with a basis designed to make up the implied guaranteed rate to a total earned rate. Part is in the form of the non-cancellable reversionary bonus and the rest in the form of final bonus.

The policy is to link declared reversionary bonus rates to the redemption yields on fixed interest stock. This has produced a series of reductions in recent years as yields have fallen, but the system of final bonus effectively balances this in total returns. Policyholders' reasonable expectations are therefore influenced downwards in line with yields.

11. REINSURANCE

11.1 Overview of treaties

Little use is made of reassurance by Equitable, other than for very large sums assured (retention being £400K for life risks and £50K for critical illness risks), income bonds, German business, and facultative cover in some cases.

11.2 Changes during the year

Nothing significant.

11.3 'Financing reinsurance'

Not used.

OTHER ISSUES

12. COMPLIANCE

12.1 DTI compliance problems

Although the Equitable take a highly esoteric line on a number of issues, and are inclined to argue their case rather longer than most, they have a culture which would not permit the continuation of a compliance breach.

There are some small omissions from Schedule 4 relating to a new fund and question 4(2)(c). These are not all mentioned in our letter, and we do not feel they are of sufficient significance for DTI action, especially as elsewhere the actuary does provide the information on derivatives (under 4(2)(a)).

They are reporting business believed by us and DTI to be class IV as class III, but have undertaken to revise this in future. This will have trivially understated the required minimum margin.

12.2 PIA and other compliance problems

Although they have had a few issues, we understand, they are not significant.

13. MISCELLANEOUS

13.1 Mis-selling of personal pensions liabilities

It looks from the outside as if it is almost impossible for Equitable to conceive that any of their salesmen could have mis-sold anything - or at least they could not publicly acknowledge it! There is no explicit provision, but we understand from Equitable's reply to [redacted] letter that £50m has been set aside by an "over-estimation" of the liabilities, and this has been accepted under the "true and fair view" accounts sign-off, despite the lack of any sophisticated supporting calculations.

13.2 Derivatives

We have separately enquired of the company on their use of derivatives ([redacted] letter of 8th December 1995 refers). We would otherwise have made enquiries as part of the scrutiny process, as the usage is quite high.

13.3 Deferred Acquisition Costs and the Accounts Directive Format Accounts

Equitable was probably the first insurance company to publish accounts in the new statutory form. Although much more detailed than previously, especially on the actuarial side, and, as they are mutual, of considerably less significance than for, say, a quoted company, it is an interesting opportunity to obtain a taster of the new format.

1994 returns

Deferred acquisition costs of £219.1m are shown in the accounts. These are not, of course, admissible in the DTI return. It is a matter of debate how meaningful these deferred acquisition costs are in any life assurer, and here less than 60% of acquisition costs are deferred. The total figure represents almost 19% of the "Fund for Future Appropriations" in Equitable Life.

[redacted]

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GAD's detailed scrutiny reports in respect of Equitable's returns

1995 returns

Rec'd 5/11. XAD 238/96 cc. [redacted]

THE EQUITABLE LIFE ASSURANCE SOCIETY

[redacted]

RETURNS AS AT 31 DECEMBER 1995

PA copies on '95 + 96 returns + general.

[redacted] 5/11.

DETAILED SCRUTINY REPORT

1. SUMMARY

1.1 Key Features

- This large, old-established mutual life insurer has total long term assets of £16½bn. This makes it the seventh largest company in terms of long term business assets.
- This company was classified as priority 4 for this scrutiny.
- Unusually, the company publishes a gross premium bonus reserve valuation - and a net premium comparison. For the second year, Equitable has used an implicit profits item in Form 9, amounting to about £264m. For '96, we've approved £600m. we approved £500m.
- In a year when the industry generally struggled for new business, the Society achieved record sales. Personal marketing is focused on high net worth individuals, while the company also has considerable presence in the AVC pensions market. Its main line of business is pensions - somewhat unusually structured, with almost all on a recurrent single premium basis.
- In 1995, the Society acquired a controlling interest in the [redacted], and thus became able to offer permanent health and business expense protection insurances. Branches are operated in Germany and the Republic of Ireland, and an International Branch is operated from Guernsey. These produced continued good growth in 1995.
- Expenses remain the lowest in the industry, and the ratios continue to fall. It reduced the annual fund charge on its internal linked funds to just ½% (from 11/16% for UK and Irish life funds and ¾% for pension and non-UK and Irish life funds).
- Reserving bases are fairly weak, by design, to maximise the disclosed free asset ratio, while permitting fair bonus distributions to the current generation of policyholders. The RMM was shown as comfortably covered by a factor of 2.89 at the end of 1995 (cf. 2.36 at end 1994) - the factor would be 2.44 without crediting the implicit future profits item.

1.2 Action Points

No matters have been raised directly with the company, but at the planned visit it would be interesting to discuss -

1. Details of the continued fall in its actual overhead expense levels, and its potential ability to continue on this creditable path.
2. How the company views the sustainability of its present contract structures - largely based on accumulating funds to which regular bonuses are added. What scenario tests has it performed in relation to possible falls in asset values, and how would it react to sustained unfavourable market movements ?
3. The increased investment in non-insurance companies - £75.4m shares and £18.7m in debt (previously, £49.3m and £2.8m respectively).

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1995 returns

2. BACKGROUND

Equitable is proud to be the oldest mutual life assurance society in the world, dating from 1762. It was the first to develop policies based on scientific principles as used today.

Equitable has never paid commission to third parties - another strong marketing point.

This background is typified by a determination to provide fair bonuses to policyholders, with no deliberate holding back of profits from one generation to another, by unit linked products which often have discretionary surrender values, and by using a gross premium bonus reserve valuation method. (The DTI returns also show the results of applying a net premium basis with assumptions close to the minimum permitted by the regulations.)

Equitable applies for a Section 68 Order for an implicit profits item each year, but used this Order to demonstrate solvency cover for the first time in 1994 - it having been only a precaution previously. The implicit item is not strictly necessary for statutory purposes, it forming part of the excess assets in Form 9. An Order allowing £500m was granted for 31 December 1995 - of which £264m was used. The Society also enjoys an Order exempting full description of its personalised funds in the return.

In 1995, Equitable purchased a controlling interest in Permanent Insurance, the PHI specialist, from the mutual Medical Sickness.

University Life, which is also an old institution, has been a subsidiary of Equitable since 1919. Equitable provides management services to University, under an agreement which caps University's expenses.

Equitable has been active overseas in recent years, with branches in Ireland and Germany and an International Branch operated from Guernsey. These branches have been set up on a low cost base, are developing steadily and are producing ever increasing amounts of new business. Equitable regard this as an exercise in extending the numbers of people who can benefit from the Society as an institution. It is almost like missionary work, rather than a purely commercial move in the interests of UK policyholders. The mutual concept is extended to all policyholders, and is even part of Equitable's dealing with UK non profit policyholders.

Equitable also has a unit trust and PEP subsidiary, Equitable Unit Trust Managers Ltd, which has over £1bn under management. Its highly developed systems department has set up a subsidiary, Equitable Services and Consultancy Limited, which obtained a major contract with [redacted] in 1995.

The Appointed Actuary and Managing Director posts are both held by [redacted] but the Board is chaired by a non-executive, [redacted], and the total Board of 13 includes 8 non-executives.

A visit to the company by DTI and GAD officials was made in December 1994, and a further visit is planned for 8 November 1996. ✓

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BUSINESS DEVELOPMENTS DURING THE YEAR

3. NEW BUSINESS

3.1 New products

UK

A new with profits or unit linked Managed Pension policy allows the taking of an income by way of withdrawals pending the use of the remainder to purchase a pension annuity on or before the policyholder's 75th birthday. Upper and lower limits are imposed on withdrawals.

From 17 April 1995, premiums payable for new Temporary Assurance contracts reverted to a guaranteed basis rather than being subject to a rebate (as operated from June 1988).

Germany

A UK-style with profits or unit linked Deferred Annuity contract with premiums of the recurrent single premium type, payable on either a regular or a variable basis. Premiums, less a deduction for expenses, are accumulated to buy an annuity - which can be fully commuted for cash on maturity.

Guernsey

No new contracts, but the premiums payable for Temporary Assurance contracts written after 29 May 1995 are guaranteed rather than subject to a rebate.

Republic of Ireland

The new Personal Retirement Bond is a single premium policy with segments providing with profits or unit linked retirement benefits as an accumulated cash fund.

After 8 June 1995, the premiums payable for new Temporary Assurance contracts are guaranteed rather than subject to a rebate.

3.2 Source(s) of new business

Equitable pays no commission. It runs a sales force and also conducts direct response advertising, targeted at high net worth individuals, but a lot of business comes from its reputation and direct approaches from prospective policyholders. It also has a significant volume of quasi-institutional business, from actual pension schemes and from AVCs.

1995 returns

3.3 Recent history:

Regular premiums -

Class	1991 £000s	1992 £000s	1993 £000s	1994 £000s	**1995 £000s**
Life with-profit	5,412	7,518	7,235	8,632	**11,465**
Life non-profit	1,750	1,743	1,761	1,840	**2,199**
Life linked	129	129	404	822	**560**
General annuity with-profit	8,323	1,222	0	0	**0**
General annuity non-profit	34	10	13	4	**20**
General annuity linked	90	54	0	0	**0**
Pensions with-profit	202,014	221,541	180,159	263,347	**327,693**
Pensions non-profit	4,607	1,965	1,910	1,585	**1,517**
Pensions linked	17,565	31,763	43,818	66,026	**43,591**
Permanent health	0	0	0	0	**0**
Overseas	4,886	7,389	14,414	33,116	**27,657**
Total	244,810	273,334	249,714	375,372	**414,702**
Year on year % increase	5.3%	11.7%	-8.6%	50.3%	**10.5%**

Single premiums -

Class	1991 £000s	1992 £000s	1993 £000s	1994 £000s	**1995 £000s**
Life with-profit	149,999	128,609	137,585	128,152	**123,759**
Life non-profit	28	368	198	379	**102**
Life linked	3,628	1,513	6,369	6,802	**4,063**
General annuity with-profit	11,484	14,896	20,385	19,575	**19,959**
General annuity non-profit	10,086	14,402	17,655	13,727	**18,156**
General annuity linked	134	29	9	123	**67**
Pensions with-profit	68,029	131,319	200,751	226,163	**419,724**
Pensions non-profit	109,410	151,729	244,819	136,735	**114,994**
Pensions linked	735	1,269	14,742	14,153	**11,658**
Permanent health	0	0	0	0	**0**
Overseas	821	9,782	28,188	22,426	**28,419**
Total	354,354	453,916	670,701	568,235	**740,901**
Year on year % increase	96.4%	28.1%	47.8%	-15.3%	**30.4%**

New Business Index (Regular premiums plus 10% of single premiums)

Index (£000s)	280,245	318,726	316,784	432,196	**488,792**
Year on year % increase	11.9%	13.7%	-0.6%	36.4%	**13.1%**

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4. CHANGES IN BUSINESS IN FORCE

4.1 Recent history of regular premiums

Class	1991 £000s	1992 £000s	1993 £000s	1994 £000s	1995 £000s
Life	49,911	63,303	64,806	77,399	**87,209**
General annuity	19,417	8,291	7,399	5,833	**7,497**
Pensions	1,123,234	1,201,594	1,241,058	1,307,015	**1,421,752**
Permanent health	0	0	0	0	**291**
Capital redemption	0	0	0	0	**0**
Total gross regular premiums	1,192,562	1,273,188	1,313,263	1,390,247	**1,516,749**
Less reinsurance premiums	2,186	2,332	1,463	1,440	**1,877**
Total net regular premiums	1,190,376	1,270,856	1,311,800	1,388,807	**1,514,872**
Year on year % increase	14.5%	6.8%	3.2%	5.9%	**9.1%**

This data understates the true position, since a considerable amount of business is written as subject to recurrent single premiums - which are, in practice, paid regularly.

4.2 Claims experience

Recent history of mortality rates *(based upon regular premium exiting through death)* -

Class	1991	1992	1993	1994	1995
Life non-linked	0.30%	0.37%	0.28%	0.37%	**0.35%**
Life linked	0.20%	0.11%	0.20%	0.10%	**0.40%**
Pensions non-linked	0.14%	0.19%	0.07%	0.26%	**0.29%**

There is no pensions linked regular premium business reported in Form 43, as pension business is all recurrent single premium. There is nothing remarkable in this table.

4.3 Persistency experience

Recent history of lapse rates *(forfeitures as prop'n of reg. prem NB in force < 2 years)* -

Class	1991	1992	1993	1994	1995
Life non-linked	20.31%	17.39%	10.17%	7.34%	**6.84%**
Life linked	4.45%	0.97%	0.45%	0.82%	**0.00%**
Pensions non-linked	36.36%	37.33%	44.77%	64.45%	**61.33%**

1. The life non-linked figure is falling satisfactorily.
2. The pensions non-linked lapse rates are distorted because nearly all such business is term assurance type without surrender values, so the denominator should relate to all business in force.
3. There is no pensions linked regular premium business reported in Form 43, as pension business is all recurrent single premium.

1995 returns

Recent history of combined surrender, lapse & paid-up conversion rates -

Class	1991	1992	1993	1994	1995
Life non-linked	3.52%	3.94%	3.96%	3.85%	**3.80%**
Life linked	5.29%	6.79%	10.27%	12.64%	**8.49%**
Pensions non-linked	6.16%	6.74%	6.56%	7.76%	**7.40%**

There is no pensions linked regular premium business reported in Form 43, as pension business is all recurrent single premium.

5. EXPENSES

5.1 Recent history of expenses:

Expense	1991 £000s	1992 £000s	1993 £000s	1994 £000s	1995 £000s
Initial commission	0	0	0	0	**0**
Acquisition expenses	72,576	75,678	76,538	78,136	**82,376**
Renewal commission	0	0	0	0	**0**
Renewal expenses	47,950	41,048	41,773	32,941	**30,222**
Total expenses	120,526	116,726	118,311	111,077	**112,598**
Year on year % increase	23.1%	-3.2%	1.4%	-6.1%	**1.4%**

Expense ratios:

	1991	1992	1993	1994	1995
Acquisition	25.9%	23.7%	24.2%	18.1%	**16.9%**
Renewal	4.0%	3.2%	3.2%	2.4%	**2.0%**

Note: *The expense ratios are:*

Acquisition - *(IC + AE) / New Business Index*
Renewal - *(RC + RE) / Regular gross premium income in force*
[from Form 41, Col 1, lines 2 + 4 + 6 + 7 + 8]

5.2 Commentary

Expense ratios of the Society keep improving. !

They have reached astonishingly low levels, with ever increasing sales taking up slack in the administration systems and overhead costs apparently falling.

Equitable is well known as a non-commission paying office, and prides itself on its low expense ratio. It is a very positive marketing message, and a key attraction of the Society with its customers. It helps explain the positive sales figures achieved in a poor time for most of its competitors, and is part of a virtuous circle.

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In their Report and Accounts, the Equitable publish figures for total expenses divided by total premium income. For the Society the figure reduced to just 4.8% in 1995, from 5.5% in 1994, and continues a steady fall from 9.6% in 1985.

These ratios are the lowest in the industry, being well less than half the industry average.

5.3 Exceptional items

The revealed total of "other management expenses" continued its amazing fall, actually reducing by £2.7m to £30.2m, from £32.9m in 1994 (and from £47.9m in 1991!).

It would be interesting to determine at the next visit exactly how this has been achieved.

SITUATION AT THE YEAR END

6. NON-LINKED ASSETS

6.1 Changes in portfolio

Recent history of asset mix -

Type of asset	1991	1992	1993	1994	1995
Land	10.7%	7.8%	6.9%	8.1%	**6.7%**
Govt fixed interest	15.8%	26.3%	28.1%	27.1%	**26.5%**
Other fixed interest	10.3%	11.8%	12.5%	10.5%	**8.9%**
Govt index linked	1.2%	1.9%	2.7%	2.4%	**2.5%**
Equity shares	50.7%	42.9%	43.2%	46.8%	**49.6%**
Debts sec'd on land	0.3%	0.2%	0.1%	0.1%	**0.1%**
Other - producing income	7.7%	5.8%	4.1%	2.1%	**3.6%**
Other - not producing income	3.3%	3.3%	2.4%	2.8%	**2.1%**

Part of the reduction in the "other fixed interest" percentage in 1995 is due to the revised designation of convertible loan stocks as derivative contracts - that have now been included under "other - producing income".

Increased investment in non-insurance companies has been noted - £75.4m shares and £18.7m in debt at the end of 1995 (previously, £49.3m and £2.8m respectively), and it would be interesting to receive details of these holdings.

GAD's detailed scrutiny reports in respect of Equitable's returns

1995 returns

Change in portfolio over the last year -

Type of asset	1994 £000s	1994 Yield	1995 £000s	1995 Yield
Land	1,014,404	6.82%	**1,016,553**	**7.10%**
Govt fixed interest	3,379,851	8.92%	**4,019,565**	**7.70%**
Other fixed interest	1,312,968	7.51%	**1,342,329**	**8.54%**
Govt index linked	299,970	2.76%	**383,329**	**2.86%**
Equity shares	5,834,307	3.34%	**7,520,468**	**3.26%**
Debts sec'd on land	15,908	7.70%	**13,706**	**7.94%**
Other - producing income	266,092	4.82%	**543,152**	**4.96%**
Other - not producing income	343,315	0.00%	**312,225**	**0.00%**
Total	12,466,815	5.51%	**15,151,327**	**5.15%**

1. The rise in the figure for "other producing income" in 1995 appears to be largely due to changed reporting practice, whereby convertible loan stocks (£185,275K), warrants (£22,345K) and partly paid securities (£4,964K) are all now being treated as "derivative contracts" and have been included in this line.
2. Most other changes reflect market movements, with new money being broadly invested to maintain existing allocations, except for a small movement to overseas equities from fixed interest holdings in relation to with-profit funds.

6.2 Investment performance

	£m	£m
1. Investment Income per form 40	833.6	
2. less Investment Income of Internal Funds (F51)	(44.5)	
3. less estimated Investment Income of other linked assets	(1.5)	
4. Non linked investment income		787.6
5. Increase in non linked assets brought into account (F40)		798.1
6. Investment Reserve carried forward	1,433.4	
7. Investment Reserve brought down	917.5	
8. Increase in investment reserve		515.9
9. Investment Return		2,101.6
10. Opening non linked assets	12,466.8	
11. Closing non linked assets	15,151.3	
12. Mean fund excluding investment return [=½×(10+11-9)]		12,758.3
13. Rate of return from investment [= 9÷12]		**16.5%**

1. The Equitable's own figure for its *with profits fund* was a rise of 16.6%.
2. The overall result is close to expectations, based on known market movements and after allowing for investment expenses having absorbed about ½%.
3. A slightly higher figure might have been hoped for in relation to a with profits fund, but it may be that the expanded overseas equity portfolios (referred to in the 1996 With-Profits Guide) were biased towards far eastern markets that performed poorly in 1995.

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7. UNIT-LINKED FUNDS

7.1 New funds introduced

In Ireland, new Far Eastern, International Growth and Money Funds were introduced for both Life and Pensions business.

In relation to the UK, assets backing the Guaranteed Equity Funds that were previously shown in Form 48 are now included as Linked Funds in Forms 49, 50 and 51.

7.2 Investment performance

The Pension Managed Fund produced growth of 14.4%, while the Life Managed Fund showed growth of 13.1%. These figures would seem to be somewhat disappointing in the light of known market movements.

The Pelican and North American Funds appear to have produced performances that are relatively good compared with the markets, but most other Funds show results 1% to 2% below what might have been hoped for.

7.3 Fund Management Charges to policyholders

The annual charge on its internal linked funds was reduced to just ½% (from $^{11}/_{16}$% for UK and Irish life funds and ¾% for pension and non-UK and Irish life funds).

This charge is waived where a fund invests in an Equitable Unit Trust, and charges are also adjusted where a fund invests in units of another fund to ensure that only one levy is made.

8. VALUATION & SOLVENCY

8.1 Strengths and/or weaknesses

8.1.1 Overview

The company produces its published Return on the basis of a gross premium valuation, with some allowance for future bonuses, but the results of a net premium valuation are also shown in the Returns. It is known from the company visit at the end of 1994 that Equitable's Actuary has decided that the interests of the Society are best served by using a weak valuation basis to show as strong a free asset position as is possible. This means that interest bases are selected near the limits of the regulations. Detailed matching rectangle data was sought in relation to the 1994 Returns and was found acceptable.

Additionally, the Equitable tries to provide a fair bonus allocation to each generation of policyholders - without holding back an excessive estate. The result is that lower free asset margins are revealed than might have been expected for such a well thought of institution. It may be noted that the Society has, for the last two years, found it desirable to utilise a future profits implicit item to improve the disclosed free assets position - although at nowhere near the maximum that could be justified under the guidelines.

There is one obvious hidden strength in the valuation - the treatment of recurrent single premium pensions business, under which it is assumed that no more premiums will be received. Although arguably only in line with the best practice, this is an extremely strong basis. If the business were treated as regular premium, margins in future premiums and charges on the funds built up might allow lower reserves. It is likely that some credit is being taken implicitly for this in the expense reserves (see §8.1.4)

8.1.2 Mortality

Assurances

Bases used for assurances are reasonable - particularly taking account of the market sector in which the Society operates.

Annuities - general

UK annuities have this year been valued on the a(90) table with a two year down rating. This follows discussions last year with the Appointed Actuary about the inadequacy of a one year down rating, which he claimed to be able to justify last year. It would seem desirable to keep pressing him quite vigorously on this point - as longevity improves.

Annuities - pension

The table used here is out of date, being PA(90)-4. However, this is close to the effect of using the more recent table with a fair adjustment for improving mortality, and we are not currently minded to press the Actuary regarding use of this table.

German business

Mostly German tables are used, although some annuities are valued on the same UK table as used for UK pensioners. The level of business in force, while growing fast, is still modest, and it seems unnecessary to examine these bases further at the present time.

8.1.3 Interest Rates

The table below summarises the interest rates used for major UK classes of non-linked business (with liabilities in excess of £50m).

Classes	Net Interest Rate (1994 Rate)	Gross Interest Rate *	Liability Approx. (£m)
life assurances with profit	3.25% (3.25)	4.33%	286
pensions with profit - regular premium	5.00% (5.00)	5.00%	200
general annuities in payment with profit	5.25% (5.75)	5.25%	165
pensions with profit imm. annuities	5.25% (5.75)	5.25%	1,218
pensions unitised with profit	5.25% (5.75)	5.25%	7,851
life assurances unitised with profit	4.00% (4.25)	5.33%	776
general annuities in payment non profit	7.75% (8.50)	7.75%	98
pensions non profit - main classes	8.00% (8.50)	8.00%	1,647

* grossed up at 25% tax

These major liability categories total £12,241m. Comparing this table with the assets and yields as shown on Page 8, it would seem that the assumptions made are acceptable.

8.1.4 Expenses

The expenses of Equitable are well controlled, and continue to fall in relation to business in force and, indeed, in cash terms as well. There is little reason to question the low expense allowances in the valuation. Increased provision has been made this year for the cost of paying annuities. A substantial hidden margin in respect of the pensions recurrent single premium business could cover any apparent shortfall elsewhere.

8.1.5 Resilience and special reserves

The Actuary indicates that the resilience reserve required in relation to his net premium valuation would be covered by the difference between the bonus reserve gross premium valuation liability and the net premium valuation liability.
This difference is revealed as £436m, and we have no reason to doubt its adequacy - although managing the distribution of bonuses and consequent growth in guaranteed liabilities in respect of the very substantial (over £8.6bn) portfolio of unitised with profit type business is a potential problem to be monitored.
(The actual resilience reserve that would have been required at the end of 1994 was disclosed in correspondence with the Actuary as £171m.)

Other reserves seem to be on a reasonable basis, although the failure to set up a specific reserve in relation to the contingent liability for tax on capital gains of £37.4m is dubious - relying on other margins in the valuation basis.

8.2 Changes since previous year

Interest rate bases were revised to reflect falling interest rates and rising asset values.

Annuitant mortality and expense reserves were strengthened following correspondence last year.

8.3 Summary of results for main classes

Liabilities for non-linked business -

	Published Bonus Reserve Gross Premium Valuation					**NPV**
Class	1991 £000s	1992 £000s	1993 £000s	1994 £000s	**1995 £000s**	**1995 £000s**
Life with-profit	561,514	718,200	856,490	1,001,606	**1,169,416**	**1,063,870**
Life non-profit	31,684	34,237	36,777	45,328	**49,284**	**54,163**
Gen. annuity with-profit	121,867	137,060	166,184	181,175	**190,734**	**178,967**
Gen. annuity non-profit	81,772	91,108	106,451	105,047	**120,652**	**118,524**
Pensions with-profit	4,538,652	5,583,654	7,399,654	7,930,355	**9,646,509**	**9,268,743**
Pensions non-profit	663,966	961,301	1,504,671	1,598,887	**1,835,318**	**1,830,634**
Pensions add. reserves	44,603	34,833	33,482	0	**0**	**0**
Rep. of Ireland business	523	5,919	45,050	68,101	**109,558**	**103,892**
Other overseas business	0	0	211	1,625	**11,916**	**86,481**
Additional AIDS reserve	0	0	0	0	**0**	**17,840**
Total non-linked liability (Form 55)	6,044,581	7,566,312	10,148,970	10,932,124	**13,133,387**	**12,723,114**

1. It should be noted that in the Bonus Reserve Gross Premium valuation, the Guernsey business is included with UK, so that the "other overseas business" represents only German business.
2. Also, in the Bonus Reserve Gross Premium valuation any additional reserve required for AIDS is presumed covered by the bonus margin.
3. Most of the margin between the total BRV and NPV liabilities would be needed to cover resilience.

Liabilities for linked business -

Class	1991 £000s	1992 £000s	1993 £000s	1994 £000s	1995 £000s
Life	83,921	93,526	118,565	117,342	**131,095**
General annuity	6,533	7,368	9,348	8,674	**5,785**
Pensions	412,465	591,415	852,975	968,489	**1,224,477**
Republic of Ireland	0	20	315	1,209	**2,942**
Other overseas	0	0	0	29	**141**
Total linked liability (F. 56)	502,919	692,329	981,203	1,095,743	**1,364,440**

The Net Premium Valuation included an additional AIDS reserve of just £11,000.

Valuation summary

Published Bonus Reserve Gross Premium Valuation

		1991 £000s	1992 £000s	1993 £000s	1994 £000s	1995 £000s
1	Non-linked liability	6,044,581	7,566,312	10,148,970	10,932,124	**13,133,387**
2	Linked liability	502,919	692,329	981,203	1,095,743	**1,364,440**
3	Bonus reserves	304,459	298,582	317,509	349,647	**417,361**
4	Total math. reserves	6,851,959	8,557,223	11,447,682	12,377,514	**14,915,188**
5	Additional reserves	0	0	0	0	0
6	Other liabilities	112,063	164,195	218,184	256,265	**153,980**
7	Total long-term liabilities	6,964,022	8,721,418	11,665,866	12,633,779	**15,069,168**
8	Long-term assets	7,452,253	9,564,764	13,382,406	13,551,281	**16,502,548**
9	Shareholders' assets	0	0	0	0	0
10	Available to meet RMM	488,231	843,346	1,716,540	917,502	**1,433,380**
11	Implicit items	0	0	0	249,985	**263,731**
12	Total available (10+11)	488,231	843,346	1,716,540	1,167,487	**1,697,111**
13	RMM	292,829	356,625	458,014	494,616	**586,275**
14	Cover (12/13)	1.67	2.36	3.75	2.36	**2.89**
15	Free assets ratio ((10-13)/8)	2.62%	5.09%	9.40%	3.12%	**5.13%**

8.4 Cover for the solvency margin

It should be appreciated that this bonus reserve valuation includes only an allowance for modest levels of future bonuses, with the result that the disclosed liability is actually very similar to that that would be derived from an acceptable net premium valuation with due allowance for resilience reserves.

Thus, the picture shown above may reasonably be compared directly with other offices who prepare Returns on standard net premium valuation bases. Without the implicit future profits item, cover for the RMM would be by a factor of 2.44. This is satisfactory.

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9. FINANCIAL RESULTS

(£000s)	1991	1992	1993	1994	1995
Surplus emerging (Form 58)	596,501	330,523	480,935	519,981	**662,848**

10. BONUSES

10.1 Cost of bonuses declared

£000's	1991	1992	1993	1994	1995
Reversionary Bonus	304,459	298,582	317,509	349,647	**417,361**
Terminal and other bonuses in anticipation of a surplus	151,565	167,898	165,053	173,541	**245,487**
Total Distributed	456,024	466,480	482;562	523,188	**662,848**

10.2 Key rates of bonus

The Equitable has a large range of bonus series.

Specimens are given below in the table -

	1994				1995			
Bonuses on UK style policies	Reversionary ‰		Final (total return)%		**Reversionary ‰**		**Final (total return)%**	
	On SA.	On Bonus	At 31.12.	Interim	**On SA.**	**On Bonus**	**At 31.12.**	**Interim**
Endowment Ass.	35.00	22.50	Varies	Varies	**35.00**	**22.50**	**Varies**	**Varies**
Unitised	52.50	52.50	8.0	8.0	**52.50**	**52.50**	**8.0**	**8.0**
Deferred Annuity	37.50	37.50	Varies	Varies	**37.50**	**37.50**	**Varies**	**Varies**
Rec. SP Def Ann	40.00	40.00	10.0	10.0	**40.00**	**40.00**	**10.0**	**10.0**
Annuity in paymt	40.00	40.00	10.0	10.0	**40.00**	**40.00**	**10.0**	**10.0**
Pensions	40.00	40.00	10.0	10.0	**40.00**	**40.00**	**10.0**	**10.0**
Guernsey Int. £	75.00	75.00	10.0	10.0	**75.00**	**75.00**	**10.0**	**10.0**
Guernsey Int. $	N/A	N/A	N/A	N/A	**52.50**	**52.50**	**10.0**	**7.5**
Irish Life	52.50	52.50	9.0	9.0	**52.50**	**52.50**	**8.0**	**7.5**
Irish Pension	40.00	40.00	10.0	10.0	**40.00**	**40.00**	**10.0**	**10.0**
German Life	52.50	52.50	8.5	8.5	**52.50**	**52.50**	**8.5**	**8.0**
German Annuity	52.50	52.50	8.5	8.5	**52.50**	**52.50**	**8.5**	**8.0**

The Whole Life bonus is £37.50‰ + £3‰×(years in force in excess of 11) [unchanged from 1994]

There are also a small number of policies with German style bonuses, but these are too small a class to cover here.

1995 returns

The system of **final bonus applied to unitised type contracts** is a little unusual. As well as any guaranteed and declared annual bonuses, a further annual bonus is declared which is not reversionary - in that it may be withdrawn, and/or reduced in future. However, it has a lot of features in common with reversionary bonuses. It is declared in a similar way as a percentage of benefit, and the amount paid at the end of the policy's normal span is the sum of these annual "declarations", subject to the proviso that a previously granted bonus can be withdrawn. The wording used by the Society in its With Profits Guide is:

"Final bonuses are also determined and applied retrospectively. Final bonus is calculated so as to top up the growth arising from the policy guarantees and the declared bonus rate for the year to the overall rate of return announced for the year. Final bonuses do not add a guaranteed element to the contract, and the final bonus element of a policy can be varied up or down in future."

The same guide includes a table of gross investment returns achieved on market value of assets of the Society in recent years (from 1993 - as attributable to with-profits business) and the smoothed rate that was applied in fixing bonuses for policyholders -

	1990	1991	1992	1993	1994	1995
Earned	-8.3%	13.5%	17.1%	28.8%	-4.2%	16.6%
Allocated	12%	12%	10%*	13%	10%	10%

* 12% was applied to new benefits secured during the year

Final bonuses for traditional life contracts are according to a table based on duration in force. This gives a standard terminal bonus.

Specimen values as a % of SA and Bonus are:

Complete Years In Force	1994	1995	**1996**
1	8.5	6.0	**6.0**
2	11.0	9.0	**8.0**
3	13.0	11.5	**10.0**
4	15.5	13.5	**12.5**
5	18.0	16.0	**15.0**
10	40.5	34.5	**30.5**
15	81.0	76.0	**66.5**
20	102.5	101.0	**99.0**
25	117.5	118.5	**118.5**
30	120.0	122.5	**125.0**

Final bonuses for deferred annuities are derived from a similar table.

Specimen values as a % of SA and Bonus are:

Complete Years In Force	1994	1995	1996
1	10.0	7.5	**7.5**
2	12.5	11.0	**10.0**
3	14.0	13.5	**12.5**
4	15.5	15.5	**15.0**
5	17.5	16.5	**16.5**
10	31.0	28.0	**26.0**
15	72.0	68.5	**58.5**
20	94.5	92.5	**90.5**
25	106.0	107.5	**108.0**
30	110.0	115.0	**117.5**

10.3 Changes to bonus rates

Reversionary bonus rates were maintained unchanged, but some adjustments were made to final bonus scales.

10.4 Distribution policy

The society follows a policy aimed at providing each generation of policyholders with a return that reflects earnings on assets during his or her membership of the fund, whilst avoiding short term fluctuations. Thus, total bonuses are intended to reflect a smoothed total earned rate. Part is allocated in the form of non-cancellable reversionary bonuses and the rest is in the form of final bonus.

11. REINSURANCE

11.1 Overview of treaties

Little use is made of reassurance by Equitable, other than for very large sums assured (retention being £400K for life risks and £100K for critical illness risks), income bonds, German business, and facultative cover in some cases.

Major Medical Cash Plans are fully reassured - 50% quota share to two reassurers.

Total reassurance premiums paid in 1995 were less than £2 million.

11.2 Changes during the year

A new treaty was introduced to cover Major Medical Cash and Critical Illness Plans - we presume with its new subsidiary, [redacted]

11.3 'Financing reinsurance'

None used.

1995 returns

OTHER ISSUES

12. COMPLIANCE

12.1 DTI compliance problems

The Equitable is a highly ethical institution and likes to think of itself as being beyond reproach, although it has recently given ground in relation to mortality assumptions in relation to annuity liabilities.

I am unconvinced of the value of its gross premium bonus reserve valuation, and would be happier to see a clearer exposition of its ability to react to possible falls in the value of assets - bearing in mind its exceptionally large exposure to unitised with profit type liabilities. It would be helpful to learn what scenario testing it undertakes.

No serious reporting omissions are noted, although the Actuary continues to rely on the comments made about derivatives under 4(2)(a) rather than include a specific response to 4(2)(c). (Usage of real derivatives is minimal, with the majority of entries in Form 13A relating to quasi-derivatives, i.e. convertible bonds, warrants and partly paid shares.)

12.2 PIA and other compliance problems

Although the Equitable might be expected to be beyond reproach, we understand that an over-estimation of pension liabilities of £50m has been incorporated into its reserves as a provision against possible costs arising from pensions mis-selling.

No other problems are known.

[redacted]

[redacted]
1 November, 1996

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GAD's detailed scrutiny reports in respect of Equitable's returns

1996 returns

cc [redacted]

Rec'd 18/12

GOVERNMENT ACTUARY'S DEPARTMENT

EQUITABLE LIFE ASSURANCE SOCIETY

RETURNS AS AT 31 DECEMBER 1996

DETAILED SCRUTINY REPORT

copies to: EL general, 96, '97 Returns.

To: [redacted] **Department of Trade & Industry**

From: [redacted] **Government Actuary's Department**

I have completed my detailed scrutiny of the 1996 returns of Equitable Life and submit my report. I have raised a number of questions on these returns with the Appointed Actuary, and a copy of my letter is included as an Appendix of this report.

This report conforms fully with the professional requirements of the Institute and Faculty of Actuaries, details of which are set out in section 15 of this report.

1. EXECUTIVE SUMMARY

1. This highly regarded, oldest mutual life assurance society in the world pays no commission to intermediaries, but achieves outstanding new business growth - based largely on its reputation for low expenses.
2. About 65% of its liabilities relate to unitised with-profits business, for which it endeavours to show competitive annual accumulations of benefits reflecting the total investment returns achieved, but, because guaranteed bonuses include credit for a measure of asset appreciation, future bonus declarations of the Society would seem to be vulnerable to any sustained stockmarket downturn. It has a modest free estate.
3. Some questions have been raised about the strength of the reserves established.

2. KEY FEATURES

- Key statistics:

Type of company:	*Mutual*
Type of business:	Largely pensions, esp. AVCs. Substantial accumulating with profits
Long term assets (£000s):	19,131,286
Cover for RMM:	2.53
GAD priority rating:	3

- New business has more than doubled over the last five years.
- Expense ratios are the lowest in the business and persistency experience is good.
- The Society achieved a mediocre investment return of 10.3% in 1996.
- The gross premium bonus reserve valuation published does not appear to be any stronger than its permissible net premium valuation.

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1996 returns

3. ACTION POINTS

Questions have been asked of the Actuary about the provisions made: (1) for resilience, (2) for possible CGT, and (3) for pensions mis-selling in the net premium valuation.

He has also been asked to supply data comparing total accumulated assets shares for contracts in force with the total assets available.

4. BACKGROUND

Equitable is the oldest mutual life assurance society in the world, dating from 1762. It was the first to develop policies based on scientific principles as used today.

Equitable has never paid commission to third parties - another strong marketing point.

This background is typified by a determination to provide fair bonuses to policyholders, with no deliberate holding back of profits from one generation to another, by unit linked products which often have discretionary surrender values, and by using a gross premium bonus reserve valuation method. (The DTI returns also show the results of applying a net premium basis with assumptions close to the minimum permitted by regulations.)

Equitable applies for a Section 68 Order for an implicit profits item each year, but used this Order to demonstrate solvency cover for the first time in 1994. The implicit item is not necessary to cover its RMM, but forms part of the excess assets shown in Form 9. An Order allowing £600m was granted for 31.12.96 - of which £312,794,000 was used. The Society also enjoys an Order allowing the presentation of aggregated data for its "personalised funds" in the return.

In 1995 the Equitable purchased a controlling interest in [redacted], the PHI specialist, from Medical Sickness - and bought out the minority in June 1997.

University Life, another old institution, has been a subsidiary of Equitable since 1919. Equitable provides management services under an agreement with capped charges.

Equitable has increased activity overseas in recent years, with branches in Ireland and Germany and an International Branch operated from Guernsey. These branches have been set up on a low cost base and produce ever increasing amounts of new business. Equitable regard this as an exercise in extending the numbers of people who can benefit from the Society as an institution. It is almost like missionary work, rather than a purely commercial move in the interests of UK policyholders. [However, the company has expressed dissatisfaction with the cost effectiveness of the German branch.] The mutual concept is extended to all policyholders, and is even part of Equitable's dealing with UK non profit policyholders.

Equitable has a unit trust and PEP subsidiary, Equitable Unit Trust Managers Ltd, with nearly £1.6bn under management. Its strong systems department has set up a subsidiary, Equitable Services and Consultancy Limited, which obtained a contract with [redacted] in 1995 and, in 1996, entered an agreement to provide systems support to the group pension operations of [redacted]

The Appointed Actuary and Managing Director posts were both held by [redacted] at the valuation date, but the Board is chaired by a non-executive, [redacted] retired at the end of July 1997, being succeeded as Managing Director by [redacted] and as Appointed Actuary by [redacted]. At 31.12.1996, the total Board of 14 included 9 non-executives.

The last visit to the company by DTI and GAD officials was made in November 1996.

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In 1997, a £350m subordinated loan has been taken from a specially created subsidiary, Equitable Life Finance plc, which floated corresponding Bonds on the market.

BUSINESS DEVELOPMENTS DURING THE YEAR

5. NEW BUSINESS

5.1 New and altered products

The only new products observed are -

1. a unit linked deposit plan: a single premium whole life contract utilising the maturity proceeds of other contracts;
2. a new unit linked Jersey based personal pension plan: that accepts recurrent single premiums on either a unit linked or accumulating with profits basis;
3. life or pensions annuities in payment offered on a RPI linked basis.

5.2 Source(s) of new business

Equitable pays no commission. It runs a sales force and also conducts direct response advertising, targeted at high net worth individuals, but a lot of business comes from its reputation and direct approaches from prospective policyholders.

It also has a significant volume of quasi-institutional business, from actual pension schemes and from AVCs. More than 200 new AVC schemes started in 1996, together with many Grouped Personal Pension and Group Money Purchase arrangements.

5.3 Recent history:

New Regular premiums -

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life and general annuity: - accumulating with-profit	0	0	0	0	**19,925**
- other with profit	8,740	7,235	8,632	11,465	**4,315**
- non-profit	1,753	1,774	1,844	2,219	**3,307**
- property-linked	183	404	822	560	**3,362**
- index-linked	0	0	0	0	**0**
Pensions: - accumulating with profit	0	0	0	0	**300,067**
- other with-profit	221,541	180,159	263,347	327,693	**6**
- non-profit	1,965	1,910	1,585	1,517	**2,311**
- property-linked	31,763	43,818	66,026	43,591	**67,993**
- index-linked	0	0	0	0	**0**
Permanent health	0	0	0	0	**0**
Overseas (all classes)	7,389	14,414	33,116	27,657	**12,878**
Total	273,334	249,714	375,372	414,702	**414,164**
Year on year % increase	12%	(9%)	50%	10%	**(0%)**

1996 returns

New Single premiums -

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life and general annuity: - accumulating with-profit	0	0	0	0	**199,881**
- other with profit	143,505	157,970	147,727	143,718	**16,366**
- non-profit	14,770	17,853	14,106	18,258	**22,437**
- property-linked	1,542	6,378	6,925	4,130	**15,239**
- index-linked	0	0	0	0	**2,063**
Pensions: - accumulating with profit	0	0	0	0	**897,272**
- other with-profit	131,319	200,751	226,163	419,724	**178,390**
- non-profit	151,729	244,819	136,735	114,994	**63,227**
- property-linked	1,269	14,742	14,153	11,658	**77,125**
- index-linked	0	0	0	0	**25,558**
Permanent health	0	0	0	0	**0**
Overseas (all classes)	9,782	28,188	22,426	28,419	**92,636**
Total	453,916	670,701	568,235	740,901	**1,590,195**
Year on year % increase	28%	48%	(15%)	30%	**115%**

New Business Index (Regular premiums plus 10% of single premiums)

Index (£000s)	318,726	316,784	432,196	488,792	**573,184**
Year on year % increase	14%	(1%)	36%	13%	**17%**
ABI comparisons (UK business): - Life	*4%*	*1%*	*(11%)*	*(9%)*	*22%*
- Pensions	*9%*	*(5%)*	*(11%)*	*(11%)*	*16%*
- Overall	*6%*	*(2%)*	*(11%)*	*(10%)*	*20%*

5.4 Commentary

The Society continues to produce exceptionally strong new business figures, particularly for pensions business.

A very large proportion of the business is of the "accumulating with profit" type, which is newly identified in the 1996 Returns.

The single premiums shown in the Tables above correspond with the amounts shown in Form 41 of the Returns, and the regular premiums shown in these Tables are in line with the way that the Society credits the renewable single premium business sold (and the basis on which it rewards its sales operation). [However, since it is not able to produce meaningful in-force premium figures for renewable single premium business, with the agreement of the DTI, the annual premiums recorded in Forms 46 ignore this business.]

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6. CHANGES IN BUSINESS IN FORCE

6.1 Recent history of regular premiums received

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life & General Annuity	71,594	72,205	83,232	94,706	**116,541**
Pensions	1,201,594	1,241,058	1,307,015	1,421,752	***1,125,149**
Permanent health	0	0	0	291	**484**
Other contracts	0	0	0	0	**0**
Total gross regular premiums	1,273,188	1,313,263	1,390,247	1,516,749	**1,242,174**
Less reinsurance premiums	2,332	1,463	1,440	1,877	**2,106**
Total net regular premiums	1,270,856	1,311,800	1,388,807	1,514,872	**1,240,068**
Year on year % increase	7%	3%	6%	9%	**(18%)**

* 1996 saw a change in presentation. While the revised Regulations were intended to help give appropriate recognition to renewable single premium business and classify it as regular premium business, the flexible nature of Equitable's products has made it difficult for them to quote a basic regular premium payment. As a somewhat perverse result, for 1996 the Returns of Equitable actually show lower regular pension premiums and higher single premiums.

Total gross pensions premiums received rose from £2,257,650 in 1995 to £2,832,369 in 1996, an increase of 25.5%.

6.2 Claims experience

Recent history of claim amounts -

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life assurance deaths	9,242	12,253	15,248	17,023	**21,613**
Life assurance maturities	56,951	80,061	64,275	42,068	**57,497**
Annuity payments	33,066	37,293	41,053	46,359	**51,515**
Surrenders	40,310	48,805	55,050	63,768	**80,160**
Pension lump sums	280,467	469,203	494,912	724,791	**881,593**
Pension annuity payments	144,678	194,608	238,774	295,383	**359,724**
Pension surrenders	382,130	279,858	201,190	239,205	**284,052**
PHI lump sums	0	0	0	64	**119**
PHI regular payments	0	0	0	0	**0**
Other lump sums	2	0	0	0	**0**
TOTAL	946,846	1,122081	1,110,502	1,428,661	**1,735,274**

1996 returns

6.3 Persistency experience

Latest PIA persistency statistics (represented as % of policies written in year no longer in force at end of term) -

Year	1995	1994		1993			1995	1994		1993		
Term	1yr	1yr	2yr	1yr	2yr	3yr	1yr	1yr	2yr	1yr	2yr	3yr
Regular Premium:	Endowments						Other Life					
Company Reps	3.4	2.3	4.7	4.0	5.0	6.5	6.9	5.2	10.4	6.6	9.5	15.8
Industry ave	*7.7*	*8.1*	*13.2*	*8.2*	*13.9*	*19.0*	*13.2*	*13.8*	*23.7*	*14.9*	*25.5*	*34.0*
Single Premium:	Endowments						Other Life					
Company Reps							0.7	1.1	3.1	1.1	2.3	4.8
Industry ave							*1.9*	*3.4*	*7.3*	*3.2*	*9.4*	*14.7*

Note: In spite of Pensions being the major class of business conducted by the Society, data is not available for persistency, due to the flexible nature of the contracts written.

Recent history of combined surrender, lapse & paid-up conversion rates -

Class	1992	1993	1994	1995	**1996**
Life non-linked	3.91%	4.02%	3.89%	3.85%	**5.54%**
Life linked	6.79%	10.27%	12.64%	8.49%	**9.96%**
Pensions non-linked	6.74%	6.56%	7.76%	7.40%	**7.50%**

Note: The combined surrender, lapse and paid-up conversion rates are:
Form 46, UK business, annual premiums, lines (24+25+26) / [½*lines (11+39+24+25+26)]

7. EXPENSES

7.1 Recent history of expenses:

Expense	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Initial commission	0	0	0	0	**0**
Acquisition expenses	75,678	76,538	78,136	82,376	**88,457**
Renewal commission	0	0	0	0	**0**
Maintenance expenses	41,048	41,773	32,941	30,222	**30,208**
Other management expenses	0	0	0	0	**2,514**
Total expenses	116,726	118,311	111,077	112,598	**121,179**
Year on year % increase	(3%)	1%	(6%)	1%	**8%**

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Expense ratios:	1992	1993	1994	1995	1996
Acquisition	23.7%	24.2%	18.1%	16.9%	**15.9%**
Mutual average	*79.0%*	*76.9%*	*81.3%*	*75.7%*	*N/A*
Renewal	3.2%	3.2%	2.4%	2.0%	**2.4%**
Mutual average	*10.1%*	*9.7%*	*9.7%*	*10.3%*	*N/A*

Notes:
1. The expense ratios are:
   Acquisition: (IC + AE + OME) / New Business Index
   Renewal: (RC + ME) / Gross earned regular premiums [F41.29.1]
2. The trend in the acquisition expense ratio is subject to distortion from 1996 from reclassification of recurrent single premiums as regular premiums, and also from the inclusion of "other management expenses" in this ratio.

7.2 Commentary

Even though difficult to assess on a totally comparable basis with other offices, because of the substantial pensions business conducted on a variable contribution basis, expense ratios of the Society keep improving. They have reached astonishingly low levels, with increasing sales taking up slack in the administration systems and overhead costs being kept under tight control. Total staff numbers fell by 20 in 1996 to 1,911.

Reported expense ratios are the lowest in the industry, being only about half those of its nearest competitor. Amazing!

Equitable is well known as a non-commission paying office, and prides itself on its low expense ratio. It is a very positive marketing message and a key attraction of the Society with its customers. It helps explain the strong sales figures achieved and is part of a virtuous circle.

In their Report and Accounts, the Equitable publish figures for total expenses divided by total premium income. For 1996 the figure reduced still further to just 4.3%, compared with 4.8% in 1995 and 5.5% in 1994, and continues a steady fall from 9.1% in 1988.

7.3 Exceptional items

The Society claims to have invested some £50m in the complete redevelopment of all operating systems over recent years, but no exceptional costs are observed in 1996.

SITUATION AT THE YEAR END

8. NON-LINKED ASSETS

8.1 Changes in portfolio

A. Recent history of asset mix (%) [from the Returns] -

Type of asset	1992	1993	1994	1995	1996
Land	8	7	8	7	**6**
Approved fixed interest	26	28	27	27	**27**
Other fixed interest	12	12	11	9	**9**
Approved variable yield	2	3	2	3	**1**
Other variable yield	0	0	0	0	**0**
Equity shares	43	43	47	50	**52**
Debts sec'd by mortgages	0	0	0	0	**0**
Other - producing income	6	4	2	3	**3**
Other - not producing income	3	2	3	2	**1**

B. Recent history of asset mix **attributable to UK with-profits business** (%) -
[Taken from the Society's 1997 With-Profits Guide]

Type of asset	1992	1993	1994	1995	1996
Land	9	8	10	8	**7**
Fixed interest	27	31	27	28	**27**
Equity shares ;					
(i) UK shares	41	41	42	41	**46**
(ii) non-UK shares	11	12	15	15	**14**
(iii) unlisted shares	2	2	2	3	**2**
Other investments	10	6	4	5	**4**

C. Movement in asset values during the year -

Type of asset	1995		**1996**		
	£000s	Yield %	**£000s**	**Yield %**	*Mkt yld %*
Land	1,016,553	7.1	**1,078,897**	**7.3**	*7.0*
Approved fixed interest	4,019,565	7.7	**4,711,620**	**7.7**	*7.4*
Other fixed interest	1,342,329	8.5	**1,588,073**	**7.3**	*7.9*
Approved variable yield	383,329	2.9	**207,080**	**3.8**	*3.6*
Other variable yield	15,476	5.3	**15,206**	**5.3**	*5.5*
Equity shares	7,520,468	3.3	**8,967,387**	**3.2**	*3.5*
Debts sec'd by mortgages	13,706	7.9	**12,296**	**7.3**	*8.0*
Other - producing income	527,676	5.0	**539,387**	**4.7**	*5.5*
Other - not producing income	312,225		**107,488**		
Total	15,151,327	5.2	**17,227,434**	**5.1**	

8.2 Derivatives

Guidelines in force are fairly tight, and the only derivative asset held at the end of the year (other than matching linked liabilities) was £314,000 in "other" futures contracts. A liability of £1,399,000 in equity options is also observed.

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1996 returns

8.3 Investment performance

	£000s	£000s
1. Total Investment Income	988,396	
2. less estimated investment income on assets matching property linked liabilities *	53,000	
3. less estimated investment income on non-linked assets matching index-linked liabilities ‡	10,000	
4. Investment income on Form 48 assets		925,396
5. Increase in non-linked assets brought into account	669,016	
6. less increase in non-linked assets matching index-linked liabilities brought into account ‡	10,000	
7. Increase in Form 48 assets brought into account		659,016
8. Investment reserve carried forward	1,420,178	
9. Investment reserve brought forward	1,433,380	
10. Increase in investment reserve		(13,202)
11. Investment return		1,571,210
12. Opening form 48 assets	14,895,931	
13. Closing Form 48 assets	17,227,435	
14. Mean fund excluding investment return [=½*(12+13-11)]		15,276,127
15. Rate of return from investment [=11/14]		10.3%

* calculated as F44.12 / average F55 internal linked col 7 * average F55 total cols (8 - 9)
‡ estimated figures based on Form 56

This return is slightly disappointing for the portfolio held, but includes a write-down in the value of investments in dependants. However, the return claimed in the Society's accounts for assets matching with-profit liabilities of 10.7% is competitive.

9. ASSETS HELD TO MATCH LINKED LIABILITIES

9.1 Internal linked funds

9.1.1 New and altered funds

The Society has introduced FTSE Index Tracker Funds for Life, Annuity, Pensions and International business as well as now offering an Annuity Smaller Companies Fund.

9.1.2 Investment performance

Units in the Pension Managed Fund showed growth of 10.7%, while the Life Managed Fund produced growth of 9.7%. These figures would seem to be broadly in line with expectations based on known market movements, bearing in mind that all units are of the accumulation type and management charges are just ½% per annum.

The Pelican Funds appear to have again produced exceptionally good performances (with Pension units up 18.0% and Life units up 14.9%), but most other Funds show results no better than might have been hoped for from market movements.

9.1.3 Fund Management Charges to policyholders

The annual charge on internal linked funds, other than personalised funds, is just ½% (believed to be the lowest in the market).

1996 returns

9.1.4 Principles of unit pricing

Most of the internal funds are invested in units of trusts managed by Equitable Trust Managers. Those trusts operate on a forward pricing basis, with a 4 p.m. valuation point. When expanding a offer price is used, but when contracting the Society might exercise its discretion to move to a full bid basis - although such a change would normally await the emergence of a sustained trend. Creation or cancellation of units by the manager is based on overall liability data and then actioned on the basis of prices established on the previous day.

9.1.5 Liquidity and gearing

No problems are observed.

9.2 Other assets matching property-linked liabilities

£51,970,000 is held directly in the Pelican Unit Trust, which showed a return of 13.2% over the year, and just £152,000 is on deposit with [redacted] Building Society.

9.3 Mismatching to property-linked liabilities

No serious mismatching is observed. Only small surpluses of units exist for most funds.

9.4 Assets matching index-linked liabilities

Total RPI linked liabilities of £295,762,000 are matched by holdings of £278,406,000 in Government Index Linked Securities and £17,356,000 in deposits and other short term assets. Partial FTSE 100 linked liabilities of just £2,427,000 are covered by holdings of £246,000 in FTSE call options and £2,704,000 in deposits and other short term assets.

9.5 PRE

Where a fund invests in an Equitable Unit Trust, the annual management charge is reduced by ½%, and charges are also adjusted where a fund invests in units of another fund to ensure that only one levy is made.

10. VALUATION BASIS

The company produces its published Return on the basis of a gross premium valuation for non linked business, with some allowance for future bonuses, but the results of a net premium valuation are also shown in the Returns - with a negligible liability difference,

The Equitable tries to provide a fair bonus allocation to each generation of policyholders - without holding back an excessive estate. The result is that lower free asset margins exist than might have been expected for such a well thought of institution. It may be noted that the Society has, for the last three years, found it desirable to utilise a future profits implicit item to improve the disclosed free assets position - although at nowhere near the maximum that could be justified under the guidelines.

There is one hidden strength in the valuation - the treatment of recurrent single premium pensions business, under which it is assumed that no more premiums will be received. Although in line with the best practice, this is a strong basis - particularly for property linked contracts. If such business were treated as regular premium, margins in future premiums and charges on the funds built up might allow somewhat lower reserves.

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10.1 Interest

The table below sets out **interest rates used in the net premium valuation** for major classes of non-linked business (with liabilities in excess of £100m) from Forms 57.

Classes	Net Interest Rate (1995 Rate)	Gross Interest Rate *	Liability Approx. (£m)
life assurances with profit	3.25% (3.25)	4.06%	305
pensions with profit - regular premium	5.00% (5.00)	5.00%	198
pensions with profit - special classes?	3.00%(??)	3.00%	178
annuities in payment with profit	5.00% (5.25)	5.00%	168
pensions with profit imm. annuities	5.25% (5.75)	5.25%	1,218
pensions **accumulating** with profit	5.00% (5.25)	5.00%	10,414
life **accumulating** with profit	2.50% (4.00)	3.13%	1,071
annuities in payment non profit	7.25% (7.75)	7.75%	115
pensions annuities	7.75% (8.00)	7.75%	1,524

* grossed up at 20% tax

These major liability categories total £15,191m. Forms 57 show that matching assets are available.

10.2 Mortality

The bases used for assurances appear reasonably conservative, being largely based on AM80 and AF80 with varying adjustments for some classes of business - particularly taking account of the market sector in which the Society operates.

UK annuities have this year been valued using the IM80 and IF80 (C=2010) tables, compared with the use last year of the a(90) table with a two year down rating, while pensions annuities are reserved for using PMA80 (C=2010) ult -1 (broadly equivalent to the use last time of PA(90) -4). The Appointed Actuary insists in his report that these tables contain sufficient allowance for future reductions in rates of mortality.

10.3 Morbidity

Not material.

10.4 Expenses

The aggregate expense allowance for the next twelve months revealed in 10(2) of the report is £56m. This compares with actual F41 maintenance expenses of £30.2m in 1996 and just £2.5m of "other expenses" shown. The total provisions would thus seem to be more than adequate, and the Actuary contends that no additional provisions are needed to cover the continued sale of new business or to cover closure. This seems acceptable.

10.5 Resilience

A resilience reserve requirement is reported of £501m, but this has not been allowed for in Line 29 of Form 57 and bearing in mind that this must be largely covered by equity assets, it is thought that a grossed up figure of £668m should have been provided for.

This is being queried. OK Q. 1.

1996 returns

10.6 Other factors

The parameters used for establishing sterling reserves for unit linked products seem to be rather weak, assuming a gross 8½% annual unit price growth before charges (up from 8% last year) - while only allowing for 5% annual inflation of expenses. However, potential expense strains are not thought to be great for this company and the standard annual expense inflation rate assumption they use is only 4%, so no question has been raised on this occasion. OK

The failure to set up a specific reserve in relation to the contingent liability of £47.7m for tax on capital gains on non-linked assets is dubious - relying on other margins in the valuation basis. *This is being queried.* Q. 2.

A pensions mis-selling reserve of £50m was included within the future bonus provision in the bonus reserve valuation, but it is not clear that any such provision was established in the net premium valuation. *This is also being queried.* [Recent correspondence suggests that the required provision had risen to £85m by 30 September 1997.] Q. 3

10.7 Overall strength

The Society informs its holders of accumulating with profit contracts of the amount of their accumulating final bonus (although clearly stating that it is not guaranteed), but only holds reserves for a discounted sum compared with the current guaranteed value.

It is stated in the return that final bonus additions (the accumulated amount of which are not revealed) are implicitly covered by the amount of excess admissible assets over the mathematical reserves - shown in the 1996 Return as being about £1.4bn. (including the RMM). However, since the reserves already value current guaranteed benefit values at a combined discount of some £1.3bn, it seems likely that the total current "asset shares" (including final bonuses indicated to members) exceed total current admissible assets. *The Actuary is being asked to clarify his view of the situation!* Q. 4.

11. FINANCIAL RESULTS

11.1 Overview

The Bonus Reserve Gross Premium valuation shows available assets covering the RMM by a factor of 2.53, and the net premium valuation would show a similar picture.

Without the implicit future profits item of about £312.8m, cover for the RMM would be reduced to a factor of 2.07. Further, we are not clear that provisions made against the market value of assets for resilience and prospective capital gains tax are as strong as they should be.

Because of the large proportion of business written on a participating basis and the high level of annual emerging surplus, there are not considered to be any actual potential solvency problems for the Society, but it does seem that, in the event of a marked fall in asset values, the Society might find itself in a position where it had to cut back severely the level of payout to members.

GAD queried this in letter re asset shares

It would seem desirable for the Society to hold back more of its emerging surplus by declaring lower guaranteed bonuses - although it could still attempt to pay out generous final bonuses to members (preferably without raising expectations too much in advance with its declarations of "non-guaranteed final bonuses").

policyholders must find this confusing!

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11.2 Summary of results for main classes

11.2.1 Liabilities for non-linked business -

	Published Bonus Reserve Gross Premium Valuation					NPV
Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**	**1996 £000s**
Life and general annuity: - accumulating with-profit	0	0	0	0	**1,149,366**	**1,099,731**
- other with profit	855,261	1,022,674	1,182,781	1,360,150	**409,655**	**394,980**
- non-profit	125,345	143,228	150,375	169,935	**158,831**	**166,900**
Pensions: - accumulating with profit	0	0	0	0	**9,900,538**	**9,592,573**
- other with-profit	5,583,654	7,399,654	7,930,355	9,646,509	**1,576,576**	**1,473,577**
- non-profit	961,301	1,504,671	1,598,887	1,835,318	**1,658,705**	**1,665,516**
Permanent health	0	0	0	0	**0**	**0**
Additional reserves	34,833	33,482	0	0	**0**	
Rep. of Ireland (all classes)	5,918	45,050	68,101	109,558	**152,822**	**144,794**
Other overseas (all classes)	0	211	1,625	11,917	**145,195**	**137,138**
Total non-linked liability (Forms 51+52)	7,566,312	10,148,970	10,932,124	13,133,387	**15,151,688**	**14,675,209**

NOTE Prior to 1996, Guernsey business was included with the UK - so that "other overseas business" was only German business.
For 1996, the other overseas BRGP liability is divided: £21,961,000 for Germany and £123,234,000 for Guernsey. (£19,237K and £117,901K, respectively, for the NPV.)

11.2.2 Liabilities for linked business -

Class	1992 £000s	1993 £000s	1994 £000s	1995 £000s	**1996 £000s**
Life and general annuity: - property-linked	100,895	127,912	126,016	136,880	**145,096**
- index-linked	0	0	0	0	**9,301**
Pensions: - property-linked	591,415	852,975	968,489	1,224,477	**1,443,311**
- index-linked	0	0	0	0	**290,753**
Additional reserves	0	0	0	0	**0**
Rep. of Ireland (all classes)	19	316	1,209	2,942	**4,512**
Other overseas (all classes)	0	0	29	141	**23,845**
Total linked liability (Forms 53+54)	692,329	981,203	1,095,743	1,364,440	**1,916,818**

See Note above. For 1996, overseas linked liability is split: £427,000 for Germany and £23,418,000 for Guernsey.

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11.3 Valuation summary

		1992 £000s	1993 £000s	1994 £000s	1995 £000s	1996 £000s
1	Non-linked liability	7,566,312	10,148,970	10,932,124	13,133,387	**15,151,688**
2	Linked liability	692,329	981,203	1,095,743	1,364,440	**1,916,818**
3	Bonus reserves	298,582	317,509	349,647	417,361	**503,622**
4	Total math. reserves	8,557,223	11,447,682	12,377,514	14,915,188	**17,572,128**
5	Additional reserves	0	0	0	0	**0**
6	Other liabilities	164,195	218,184	256,265	153,980	**138,980**
7	Total long-term liabilities	8,721,418	11,665,866	12,633,779	15,069,168	**17,711,108**
8	Total long-term assets	9,564,764	13,382,406	13,551,281	16,502,548	**19,131,286**
9	Excess assets (8-7)	843,346	1,716,540	917,502	1,433,380	**1,420,178**
10	Shareholders' assets	0	0	0	0	**0**
11	Assets available	843,346	1,716,540	917,502	1,433,380	**1,420,178**
12	Implicit items	0	0	249,985	263,731	**312,794**
13	Total amount available	843,346	1,716,540	1,167,487	1,697,111	**1,732,972**
14	RMM	356,625	458,014	494,616	586,275	**685,282**
15	Cover (13/14)	2.36	3.75	2.36	2.89	**2.53**
16	Free assets ratio ((11-14)/8)	5.09%	9.40%	3.12%	5.13%	**3.84%**

The Net Premium Valuation generated a lower non-linked liability of £14,675,209,000 and a lower reserve for declared bonuses of £474,207,000 but was shown to require a resilience reserve of £501m.

Thus, the total Long Term liabilities for Line 9 for the NPV would be £17,705,214,000 i.e. most of the apparent margin between the BRV and NPV policy liabilities is needed to cover resilience, and the BRV does not produce any material extra margins.

11.4 Composition and distribution of surplus

£000s	1992	1993	1994	1995	1996
Surplus brought forward	140,790	4,833	3,207	0	**0**
Surplus emerging in year	330,523	480,935	519,981	662,848	**802,539**
Total available	471,313	485,768	523,188	662,848	**802,539**
Allocated to policyholders	466,480	482,561	523,188	662,848	**802,539**
Surplus carried forward	4,833	3,207	0	0	**0**
% of distributed surplus allocated to policyholders	100.0%	100.0%	100.0%	100.0%	**100.0%**

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12. BONUSES

12.1 Cost of bonuses declared

£000s	1992	1993	1994	1995	1996
Bonus payments made in anticipation of a surplus	167,898	165,053	173,541	245,486	**298,917**
Reversionary bonuses	298,582	317,509	349,647	417,361	**503,622**
Other bonuses	0	0	0	0	**0**
Total	466,480	482,562	523,188	662,847	**802,539**

12.2 Recent history of key bonus rates

The Equitable has a large range of bonus series.
Specimens are given below in the table -

	1995				**1996**			
Bonuses on UK style policies	Reversionary ‰		Final (total return)%		**Reversionary ‰**		**Final (total return)%**	
	On SA.	On Bonus	At 31.12.	Interim	**On SA.**	**On Bonus**	**At 31.12.**	**Interim**
Endowment Ass.	35.00	22.50	Varies	Varies	**35.00**	**22.50**	**Varies**	**Varies**
Unitised	52.50	52.50	8.0	8.0	**52.50**	**52.50**	***8.0**	***7.25**
Deferred Annuity	37.50	37.50	Varies	Varies	**37.50**	**37.50**	**Varies**	**Varies**
Rec. SP Def Ann	40.00	40.00	10.0	10.0	**40.00**	**40.00**	**10.0**	**9.0**
pre 1.7.96 annuity	40.00	40.00	10.0	10.0	**40.00**	**40.00**	**10.0**	**9.0**
post 1.7 annuities	N/A	N/A	N/A	N/A	**75.00**	**75.00**	**10.0**	**9.0**
pre 1.7.96 pension	40.00	40.00	10.0	10.0	**40.00**	**40.00**	**10.0**	**9.0**
post 1.7 pension	N/A	N/A	N/A	N/A	**75.00**	**75.00**	**10.0**	**9.0**
Guernsey Int. £	75.00	75.00	10.0	10.0	**75.00**	**75.00**	**10.0**	**9.0**
Guernsey Int. $	52.50	52.50	10.0	7.5	**52.50**	**52.50**	**15.0**	**9.0**
Irish Life	52.50	52.50	8.0	7.5	**52.50**	**52.50**	**9.0**	**6.75**
Irish Pension	40.00	40.00	10.0	10.0	**40.00**	**40.00**	**12.0**	**9.0**
German Life	52.50	52.50	8.5	8.0	**52.50**	**52.50**	**9.0**	**8.0**
German Annuity	52.50	52.50	8.5	8.0	**52.50**	**52.50**	**9.0**	**8.0**

* 0.25% higher for SP Bonds
The Whole Life bonus is £37.50‰ + £3‰×(years in force in excess of 11)
[unchanged from 1995]

There are also a small number of policies with German style bonuses, but these are too small a class to cover here.

1996 returns

The system of **final bonus that is granted to unitised type contracts** is unusual. As well as declared guaranteed annual bonuses, based on all income and a proportion of capital appreciation, a further annual bonus is declared which is not reversionary - in that it may be withdrawn, and/or reduced in future.

However, it has a lot of features in common with reversionary bonuses. It is declared in a similar way as a percentage of benefit, and the amount paid at the end of the policy's normal span is the sum of these total annual "declarations", subject to the proviso that the final non-guaranteed bonus can be withdrawn. The wording used by the Society in its Bonus Declaration to describe this third element of distributing a smoothed return to policyholders is:

perhaps this confuses p. holders?

"By passing on the balance of the overall rate of return through final bonus, which does not add to the guarantees under the contract. The amount of final bonus is only finally determined when a claim becomes contractually payable."

The Society's With-Profits Guide includes a table of gross investment returns achieved on market value of assets of the Society in recent years (from 1993 - as attributable to with-profits business) and the smoothed rate that was applied in allocating bonuses for policyholders -

	1990	1991	1992	1993	1994	1995	1996
Earned	-8.3%	13.5%	17.1%	28.8%	-4.2%	16.6%	10.7%
Allocated	12%	12%	10%*	13%	10%	10%	10%

* 12% was applied to new benefits secured during the year

Final bonuses for traditional life contracts are according to a table based on duration in force. This gives a standard terminal bonus.

Specimen values as a % of SA and Bonus are:

Complete Years In Force	1994	1995	1996	**1997**
1	8.5	6.0	6.0	**6.0**
2	11.0	9.0	8.0	**8.0**
3	13.0	11.5	10.0	**10.0**
4	15.5	13.5	12.5	**12,0**
5	18.0	16.0	15.0	**14.0**
10	40.5	34.5	30.5	**27.0**
15	81.0	76.0	66.5	**57.5**
20	102.5	101.0	99.0	**96.0**
25	117.5	118.5	118.5	**122.5**
30	120.0	122.5	125.0	**130.0**

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- **Final bonuses for deferred annuities** are derived from a similar table.

Specimen values as a % of SA and Bonus are:

Complete Years In Force	1994	1995	1996	**1997**
1	10.0	7.5	7.5	**7.5**
2	12.5	11.0	10.0	**10.0**
3	14.0	13.5	12.5	**12.5**
4	15.5	15.5	15.0	**15.0**
5	17.5	16.5	16.5	**16.5**
10	31.0	28.0	26.0	**24.0**
15	72.0	68.5	58.5	**50.0**
20	94.5	92.5	90.5	**88.0**
25	106.0	107.5	108.0	**110.0**
30	110.0	115.0	117.5	**120.0**

12.3 PRE

The Society tries very hard to achieve an equitable distribution to each generation of its policyholders, whilst avoiding short term fluctuations in benefits - with the result that it has not accumulated any material unallocated estate compared with accumulated asset shares (if any - see Section 10.7).

However, it reserves the right to penalise early surrenders, even in relation to guaranteed bonuses added under unitised contracts, and it might be desirable for this possibility to receive greater prominence in the literature distributed. Further, with such a large proportion of unitised business and with the level of guaranteed bonuses declared taking account of some asset appreciation, it would seem to be desirable that policyholders were given some greater warning about the possible implications for future bonuses of a substantial market setback. Take up with company? I discussed this briefly with [redacted] – concern is that co. has no estate – no cushion. Should not perhaps be giving bonuses to new p. holders. But the markets are up at present.

12.4 Recent history of maturity payouts

£	1993	1994	1995	1996	**1997**
25 yr endowment (£50pm)	87,681	88,971	87,887	86,739	**84,025**
Industry average	*91,924*	*94,499*	*94,356*	*94,908*	*96,767*
10 yr endowment (£50pm)	12,203	11,494	10,575	10,211	**9,879**
Industry average	*11,067*	*10,711*	*10,331*	*9,926*	*9,784*
15 yr pension (£200pm)	148,969	145,338	131,239	120,078	**109,211**
Industry average	*137,356*	*133,094*	*125,766*	*117,754*	*113,379*
10yr SV on 25 yr endowment	11,819	10,854	10,070	9,073	**8,427**
Industry average	*7,914*	*7,707*	*7,616*	*7,638*	*7,446*

The comparative generosity of surrender payments contrasts with a rather disappointing position for maturity payouts.

Re my notes above: see [redacted] reply – of 16/1/98 – para. 4 at 'X'.

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13. REINSURANCE

13.1 Overview of treaties

Little use is made of reassurance by Equitable, other than for very large sums assured (retention being £400K for life risks and £100K for critical illness risks), income bonds, German business, and facultative cover in some cases.

Major Medical Cash Plans are fully reassured - 50% quota share to two reassurers.

Total reassurance premiums paid in 1996 were about £2.2 million.

13.2 Financing arrangements

None exist.

OTHER ISSUES

14. COMPLIANCE

14.1 DTI compliance problems ← I wouldn't call this a compliance problem.

The Society is not able to produce meaningful in-force premium figures for renewable single premium business, and a Section 68 Order has been given on a temporary basis (up to the end of 1998) allowing the Society to exclude recurrent single premiums from the annual premiums recorded in Forms 46. ✓ Order given for 96, 97, 98 returns.

14.2 PIA and other compliance problems

A pensions mis-selling reserve of £50m was included within the future bonus provision in the bonus reserve valuation, *although it is not clear that any such provision was established in the net premium valuation and this is being queried.* Q.3

Recent correspondence suggests the required provision had risen to £85m by 30.9.1997.

15. PROFESSIONAL REQUIREMENTS

This report conforms fully with the requirements of the Institute and Faculty of Actuaries as set out in their Memorandum of Professional Conduct and Advice on Professional Conduct.

This report had been prepared under the terms of the Agreement between Insurance Division (I Division) of the Department of Trade & Industry (DTI) and the Government Actuary's Department (GAD) dated March 1995 ("the service agreement") setting out the level of service to be provided by GAD in respect of the supervision of companies authorised, or seeking authorisation, under the Insurance Companies Act 1982 to carry on long term business.

The purpose of this report is to enable DTI to fulfil its duties under the Third Life Directive and the Insurance Companies Act 1982.

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GAD's detailed scrutiny reports in respect of Equitable's returns

1996 returns

The scope of this report is:

- to advise on the statutory solvency position of the company;
- to identify any issues relevant to the duties of DTI;
- to describe the development of the company over the previous 12 months;
- to provide historical background to the company.

This report is limited to a minor degree because certain questions need to be put to the Appointed Actuary. Under the service agreement, GAD has written to the company directly on these. A copy of our letter is included as an Appendix to this report.

The advice and information contained in this report are solely for the use of DTI in fulfilling its statutory duties and should not be transmitted to third parties, including the company concerned, without the prior consent of GAD.

[redacted]

[redacted]
Government Actuary's Department
16 December 1997

GAD's detailed scrutiny reports in respect of Equitable's returns

1997 and 1998 returns

EQUITABLE LIFE ASSURANCE SOCIETY

RETURNS AS AT 31 DECEMBER, 1998

DETAILED SCRUTINY REPORT

GAD PRIORITY RATING: 2

GOVERNMENT ACTUARY'S DEPARTMENT

To: [redacted] **Financial Services Authority**

From: [redacted] **Government Actuary's Department**

This report conforms fully with the professional requirements of the Institute and Faculty of Actuaries, details of which are set out in section 15 of this report, and combines comment on activity in both 1997 and 1998.

1. KEY FEATURES

Type of company:	Mutual	
Type of business:	Largely pensions: esp. group personal pensions and AVCs. Substantial accumulating with profits	
Last visit date:	November 1996	
Key Financial Statistics:	1997 (£000s)	**1998 (£000s)**
New Business Index:	689,332	**636,984**
Long Term Assets:	23,827,839	**28,238,041**
Assets Available:	2,122,633	**2,523,931**
Implicit Items	371,083	**850,000**
Sub-ordinated loans	346,362	**346,204**
RMM	845,457	**1,007,534**

2. ACTION POINTS

No points have been raised with the Society as a result of this scrutiny. However,

- there remains a need for FSA and GAD to consider the final terms of the reinsurance treaty agreed with Irish European Reinsurance Company Limited that limits the reserves carried by the Society to cover its liability for guaranteed annuity options.
- Further, a policy decision needs to be taken about whether to challenge some of the assumptions made by the Actuary in setting the level of his provisions for these options. [See Section 10.8.]

3. EXECUTIVE SUMMARY

The Equitable tries to provide fair benefits to each generation of its policyholders, on maturity or surrender - without holding back any excessive estate. The result is that

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1997 and 1998 returns

lower free asset margins exist than might have been expected for such a well thought of institution. It may be noted that the Society has, for the last five years, found it desirable to utilise a future profits implicit item to improve the disclosed free assets position, and also took out a subordinated loan in 1997.

The solvency position of the Society is complicated on this occasion by a need to carry reserves appropriate to the extent of guaranteed annuity options attaching to a large percentage of existing pensions liabilities. The basis for these provisions has been the subject of extensive discussions between GAD and the Appointed Actuary, and an attempt has been made to mitigate the strain by taking out a special reinsurance contract with Irish European Reinsurance Company Limited. [See Section 13.2.]

The valuation shows available assets covering the RMM by a factor of 2.51, unchanged from end 1997. Without the implicit future profits item of £850m, cover for the RMM would be reduced to a factor of 1.66. (Liability for a subordinated loan of £340m is also disregarded in this result – as permitted by a Section 68 Order.)

New business in 1998 fell back a little from the exceptional level reached in 1997, but total premiums received exceeded £3.7bn (after £3.45bn in 1997). Gross claims paid out in 1998 exceeded £2.5bn. Expense ratios remain the lowest in the industry.

Asset performance is a little disappointing, although most linked funds perform broadly in line with expectations, and maturity benefits actually fall below those of competitors who tend to pay out much less to their policyholders who surrender early.

4. BACKGROUND

Equitable is the oldest mutual life assurance society in the world, dating from 1762. It was the first to develop policies based on scientific principles as used today.
Equitable has never paid commission to third parties - another strong marketing point.

This background is typified by a determination to provide fair bonuses to policyholders, with no deliberate holding back of profits from one generation to another, by unit linked products which often have discretionary surrender values, and by using a gross premium bonus reserve valuation method. (However, the returns also show the results of a net premium valuation on a minimum basis – and the free asset position shown is identical.)

In 1995 the Equitable purchased a controlling interest in [redacted], the PHI specialist, from Medical Sickness - and bought out the minority in June 1997.

University Life, another old institution, has been a subsidiary of Equitable since 1919. Equitable provides management services under an agreement with capped charges.

Equitable has increased activity overseas in recent years, with branches in Ireland and Germany and an International Branch operated from Guernsey. These branches have been set up on a low cost base and produce ever increasing amounts of new business. The company also began providing insurance from 3 August 1998 on a services basis into Greece. Equitable regards these activities as an exercise in extending the numbers of people who can benefit from the Society as an institution. It is almost like missionary work, rather than a purely commercial move in the interests of UK policyholders. [However, the company has expressed dissatisfaction with the cost effectiveness of the German branch.] The mutual concept is extended to all policyholders, and is even part of Equitable's dealing with UK non profit policyholders.

1997 and 1998 returns

Equitable has a unit trust and PEP subsidiary, Equitable Unit Trust Managers Ltd, with over £2.4bn under management (largely units bought by the Society to back unit-linked policies?). Its strong systems department established a subsidiary, Equitable Services and Consultancy Limited, that has run a contract with [redacted] Limited since 1995 and, in 1996, agreed to provide systems support to group pension operations of [redacted] In 1997 it took on the processing of policy records for a Zimbabwe company, and in 1998 commenced a three year project to provide administration services to [redacted]

In July 1997, a £350m subordinated loan was taken from a specially created subsidiary, Equitable Life Finance plc, which floated corresponding Bonds on the market. This liability is shown in Form 15, despite having no "other than long term business" assets, thus producing a negative value in Line 23 of Form 10 – offset by an entry in Line 26. As a result of this reporting, the capital raised is not shown as an asset in Line 22 of Form 9. [This is different from the convention used by [redacted] and [redacted], who include the loan as a liability in Form 14, but we are happy to live with the presentation adopted by the Society.]

Equitable Life has been heavily criticised in the press, of late, for the approach that it is taking of reducing terminal bonuses to meet the costs of guaranteed annuity options attaching to some of its pension contracts. A test case to be brought before the Courts in July 1999 will try to obtain legal clearance for the practice.

There were four Section 68 Orders in force at the 31 December 1997 valuation date:

- an order dated 14 October 1997, allowing the Society to take into account a future profits implicit item, with a value not exceeding £700 million. The Society included an implicit item in the 31.12.97 returns of £371.1 million, for the purpose of achieving equity between the total net value of policyholders' assets, and the corresponding total net asset value shown in the Society's Companies Act accounts.
- an order dated 13 June 1997, to the effect that figures in Form 46 exclude recurrent single premiums from the annual premium figures as the Society cannot at present calculate a meaningful figure.
- an order dated 31 January 1997, directing that the Society may include aggregate details for total "Personalised Funds" in Forms 43, 45 and 55, instead of providing separate details for each fund.
- an order dated 19 August 1997, enabling the Society to disregard, for the purposes of Regulation 60 of ICR94, amounts owing to Equitable Life Finance PLC under a (Subordinated) loan agreement dated 4 August 1997 up to an amount not exceeding 50% of the company's required margin of solvency.

For the 1998 valuation the implicit item order above had been revoked. It was replaced by a similar order dated 30 December 1998, which allowed the Society to take into account a future profits implicit item of up to £1,900m. The actual amount that the Society took into account was £850m.

[redacted] is Appointed Actuary and the Managing Director is [redacted] They replaced [redacted], who held both posts until his retirement at the end of July 1997. A non-executive, [redacted] chairs the Board. At 31.12.1997, the total Board of 11 included 9 non-executives.

The last visit by DTI and GAD officials was made in November 1996.

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BUSINESS DEVELOPMENTS DURING THE YEAR

5. NEW BUSINESS

5.1 New and altered products

There was only one new product introduced in 1997 –

A **Guaranteed Equity Fund Annuity:** a single premium product, which provides a guaranteed basic level annuity together with an additional level of income in the years where the FTSE 100 index rises. This increase is measured by the movement in the unit price of the appropriate Guaranteed Equity sub-fund.

During 1998, 7 new products were introduced -

Three accumulating with-profit contracts, namely the UK Personal Investment Plan and the Services Investment Plan, which are both life products, together with a UK Money Purchase Transfer Plan pension policy.

Four unit-linked variants: the Personal Investment Plan Benefit, the Grouped Personal Pension Plan Retirement Benefit, the Services Investment Plan and the Money Purchase Transfer Plan Retirement Benefit.

5.2 Source(s) of new business

Equitable pays no commission. It runs a sales force and also conducts direct response advertising, targeted at high net worth individuals, but a lot of business comes from its reputation and direct approaches from prospective policyholders. The last two years saw the further development of Equitable Direct, which has been established to complement the branch-based direct sales force, with staff numbers rising to 90 at the end of 1998. [The Society's internet site was enhanced in 1998, but is a source of information and data for policyholders in relation to policy servicing and is not a direct sales tool.]

The Society also has significant volumes of quasi-institutional pensions business, from actual pension schemes and from AVCs - with more than 300 of the UK's 500 largest companies having pension arrangements with Equitable. 230 employers set up new Grouped Personal Pension plans in 1997, and this number increased by 10% in 1998, so that over 2,000 such plans are now operating. The Society operates AVC schemes for both the Civil Service and the NHS.

5.3 Recent history:

New regular premiums -

Class	1994 £000s	1995 £000s	1996 £000s	1997 £000s	**1998 £000s**
Life and general annuity: - accumulating with-profit	0	0	19,925	20,910	**17,300**
- other with profit	8,632	11,465	4,315	5,673	**3,500**
- non-profit	1,844	2,219	3,307	4,327	**4,535**
- property-linked	822	560	3,362	10,020	**13,351**
Pensions: - accumulating with profit	0	0	300,067	348,515	**267,390**
- other with-profit	263,347	327,693	6	27	**17**
- non-profit	1,585	1,517	2,311	2,583	**2,524**
- property-linked	66,026	43,591	67,993	89,076	**91,308**
Overseas (all classes)	33,116	27,657	12,878	13,214	**19,368**
Total	375,372	414,702	414,164	494,345	**419,293**
Year on year % increase	50%	10%	(0%)	19%	**(15%)**

Source: Form 47, column 6

New single premiums -

Class	1994 £000s	1995 £000s	1996 £000s	1997 £000s	**1998 £000s**
Life and general annuity: - accumulating with-profit	0	0	199,881	205,403	**256,866**
- other with profit	147,727	143,718	16,366	17,830	**10,709**
- non-profit	14,106	18,258	22,437	30,973	**17,008**
- property-linked	6,925	4,130	15,239	10,887	**30,123**
- index-linked	0	0	2,063	969	**2,996**
Pensions: - accumulating with profit	0	0	897,272	1,059,306	**777,151**
- other with-profit	226,163	419,724	178,390	233,230	**517,518**
- non-profit	136,735	114,994	63,227	84,826	**186,786**
- property-linked	14,153	11,658	77,125	138,294	**142,897**
- index-linked	0	0	25,558	54,386	**82,848**
Overseas (all classes)	22,426	28,419	92,636	113,765	**152,011**
Total	568,235	740,901	1,590,195	1,949,869	**2,176,913**
Year on year % increase	(15%)	30%	115%	23%	**12%**

Source: Form 47, column 3

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New Business Index (Regular premiums plus 10% of single premiums)

Index (£000s)	432,196	488,792	573,184	689,332	**636,984**
Year on year % increase	36%	13%	17%	20%	**(8%)**
ABI comparisons (UK business):					
- Life	*(11%)*	*(9%)*	*22%*	*5%*	***Not Available***
- Pensions	*(11%)*	*(11%)*	*16%*	*22%*	***Not Available***
- Overall	*(11%)*	*(10%)*	*20%*	*11%*	***Not Available***

Source of comparisons: ABI Insurance Statistics Yearbook 1997

A very large proportion of the business is of the "accumulating with profit" type, which was first separately identified in the 1996 Returns.

5.4 Commentary

Single premiums in the Tables above correspond with amounts shown in Form 41 of the Returns, and the regular premiums shown in these Tables are in line with the way that the Society credits the renewable single premium business sold (and the basis on which it rewards its sales operation). [However, since it is not able to produce meaningful in-force premium figures for renewable single premium business, with the agreement of a Section 68 Order, the annual premiums recorded in Forms 46 ignore this business.]

Although formal comparisons are not available at present, it does appear from recently published ABI data that Equitable may have underperformed the industry average in 1998 in terms of increases in new business. This could, though, be put down to the Society's starting position - having achieved excellent growth in 1997.

In 1997, the Equitable was reported as the largest writer of pensions business in the UK.

6. CHANGES IN BUSINESS IN FORCE

6.1 Recent history of regular premiums received

Class	1994 £000s	1995 £000s	1996 £000s	1997 £000s	**1998 £000s**
Life & General Annuity	83,232	94,706	116,541	145,586	**175,465**
Pensions	1,307,015	1,421,752	1,125,149*	1,358,484*	**1,379,753***
Permanent health	0	291	484	641	**801**
Total gross regular premiums	1,390,247	1,516,749	1,242,174	1,504,711	**1,556,019**
Less reinsurance premiums	1,440	1,877	2,106	2,451	**3,455**
Total net regular premiums	1,388,807	1,514,872	1,240,068	1,502,260	**1,522,564**
Year on year % increase	6%	9%	(18%)	21%	**1%**

Source: Form 41

* 1996 saw a change in presentation. While the revised Regulations were intended to help give appropriate recognition to renewable single premium business and classify it as regular premium business, the flexible nature of Equitable's products has made it difficult for them to quote a basic regular premium payment. As a somewhat perverse result, from 1996 onwards the Returns of Equitable actually show lower regular pension premiums and higher single premiums.

Total gross pensions premiums received rose from £2.832bn in 1996 to £3.454bn in 1997, an increase of 22.0% (after a 25.5% rise in 1996). There was a further increase of 8.1% to £3.732bn in 1998.

6.2 Claims experience

Recent history of claim amounts (*gross of reinsurance*) -

Class	1994 £000s	1995 £000s	1996 £000s	1997 £000s	**1998 £000s**
Life assurance deaths	15,248	17,023	21,613	20,402	**22,788**
Life assurance maturities	64,275	42,068	57,497	51,387	**75,634**
Annuity payments	41,053	46,359	51,515	54,446	**58,434**
Surrenders	55,050	63,768	80,160	106,379	**140,426**
Pension lump sums/deaths	494,912	724,791	881,593	1,147,729	**1,191,703**
Pension annuity payments	238,774	295,383	359,724	425,252	**515,676**
Pension surrenders	201,190	239,205	284,052	416,723	**536,538**
PHI lump sums	0	64	119	320	**239**
Total	1,110,502	1,428,661	1,735,274	2,222,637	**2,541,438**

Source: Form 42

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6.3 Persistency experience

Latest PIA persistency statistics (*represented as % of policies written in year no longer in force at end of term*) -

	Endowments									
Business Year:	1993	1994	1995	1996	1993	1994	1995	1993	1994	1993
Persistency Term:	1yr	1yr	1yr	1yr	2yr	2yr	2yr	3yr	3yr	4yr
Regular Premium:										
Company Reps	4.0	2.3	3.4	2.3	5.0	4.7	4.6	6.5	5.4	6.8
Industry ave company reps	*8.3*	*8.1*	*7.7*	*6.5*	*14.0*	*13.3*	*12.9*	*19.1*	*18.3*	*23.3*

	Other life									
Business Year:	1993	1994	1995	1996	1993	1994	1995	1993	1994	1993
Persistency Term:	1yr	1yr	1yr	1yr	2yr	2yr	2yr	3yr	3yr	4yr
Regular Premium:										
Company Reps	6.6	5.2	6.9	4.6	9.5	10.4	10.3	15.8	14.5	19.5
Industry ave company reps	*14.9*	*13.6*	*12.0*	*10.3*	*25.3*	*23.4*	*21.4*	*33.9*	*31.7*	*40.9*
Single Premium:										
Company Reps	1.1	1.1	0.7	1.2	2.3	3.1	2.7	4.8	5.1	6.6
Industry ave company reps	*3.3*	*3.5*	*1.9*	*1.7*	*9.6*	*7.8*	*4.7*	*15.0*	*12.4*	*20.5*

Source: PIA: Fourth Survey of the Persistency of Life and Pensions Policies (Oct 1998)
Note: Data not available for SP via direct adverts (all classes)

NOTE In spite of Pensions being the major class of business conducted by the Society, data is not available for persistency, due to the flexible nature of the contracts written.

Recent history of combined surrender, lapse & paid-up conversion rates -

Class	1994	1995	1996	1997	**1998**
Life non-linked	3.89%	3.85%	5.54%	3.81%	**4.10%**
Life linked	12.64%	8.49%	9.96%	6.11%	**4.98%**
Pensions non-linked	7.76%	7.40%	7.50%	7.54%	**6.46%**

Note: The combined surrender, lapse and paid-up conversion rates are:
Form 46, UK business, annual premiums, lines (24+25+26) / [½*lines (11+39+24+25+26)]

These are excellent results, reflecting the fact that business is largely bought rather than sold !

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7. EXPENSES

7.1 Recent history of expenses:

Expense	1994 £000s	1995 £000s	1996 £000s	1997 £000s	**1998 £000s**
Initial commission	0	0	0	0	**0**
Acquisition expenses	78,136	82,376	88,457	99,143	**106,552**
Renewal commission	0	0	0	0	**0**
Maintenance expenses	32,941	30,222	30,208	33,303	**34,243**
Other management expenses	0	0	2,514	7,279	**8,475**
Total expenses	111,077	112,598	121,179	139,725	**149,270**
Year on year % increase	(6.1%)	1.4%	7.6%	15.3%	**6.8%**

Source: Form 41

Expense ratios:	1994	1995	1996	1997	**1998**
Acquisition	18.1%	16.9%	15.9%	15.4%	**18.1%**
Mutual average	*80.7%*	*93.6%*	*71.1%*	*75.2%*	***Not Available***
Renewal	2.4%	2.0%	2.4%	2.2%	**2.2%**
Mutual average	*11.9%*	*11.7%*	*10.3%*	*12.4%*	***Not Available***

Notes: 1. These expense ratios are:
Acquisition: (IC + AE + OME) / New Business Index
Renewal: (RC + ME) / Gross earned regular premiums [F41.29.1]
Renewal as % of total fund: (RC + ME) / Average total fund [½*(F40.49 + F14.51.1 + F40.59 + F14.51.2)]

2. The trend in the acquisition expense ratio is subject to distortion from the inclusion of other management expenses in this ratio.

7.2 Commentary

Reported expense ratios are the lowest in the industry, being only about half those of its nearest competitor. They have reached astonishingly low levels, with increasing sales taking up slack in the administration systems and overhead costs being kept under tight control. However, total staff numbers increased in 1997 by 53 to 1,991, and in 1998 by a further 109 to 2,110 – largely accounted for by the expansion of Equitable Direct.

Equitable is well known as a non-commission paying office, and prides itself on its low expense ratio. It is a very positive marketing message and a key attraction of the Society with its customers. It helps explain the strong sales figures achieved and is part of a virtuous circle.

In its Report and Accounts, Equitable publishes figures for total expenses divided by total premium income. For 1998 the figure fell to 4.0%, after being 4.1% in 1997, 4.3% in 1996 and 4.8% in 1995, and continues a steady fall from 9.1% in 1988.

7.3 Exceptional items

The Society claims to have invested some £70m in the complete redevelopment of all its operating systems over recent years.

SITUATION AT THE YEAR END

8. NON-LINKED ASSETS

8.1 Changes in portfolio

Recent history of asset mix (%) -

Type of asset	1994	1995	1996	1997	**1998**
Land	8	7	6	6	**6**
Approved fixed interest	27	27	27	24	**23**
Other fixed interest	11	9	9	9	**11**
Approved variable yield	2	3	1	1	**1**
Other variable yield	0	0	0	0	**0**
Equity shares	47	50	52	53	**51**
Debts sec'd by mortgages	0	0	0	0	**0**
Other – producing income	2	3	3	6	**7**
Other - not producing income	3	2	1	1	**1**

Source: Form 48

Recent history of asset mix **attributable to UK with-profits business** (%) -
[Taken from the Society's 1998 With-Profits Guide]

Type of asset	1994	1995	1996	**1997**
Land	10	8	7	7
Fixed interest	27	28	27	24
Equity shares:				
(i) UK shares	42	41	46	49
(ii) non-UK shares	15	15	14	11
(iii) unlisted shares	2	3	2	3
Other investments	4	5	4	6

Movement in asset values over the last year -

Type of asset	1997		**1998**		
	£000s	Yield %	**£000s**	**Yield %**	*Mkt yld %*
Land	1,223,249	6.8	**1,462,406**	**7.2**	*6.5*
Approved fixed interest	5,078,648	6.6	**5,856,252**	**4.7**	*4.5*
Other fixed interest	2,026,852	6.6	**2,889,359**	**5.5**	*5.5*
Approved variable yield	306,908	3.3	**178,431**	**4.3**	*2.0*
Other variable yield	16,769	4.5	**18,565**	**3.6**	*6.0*
Equity shares	11,402,970	2.8	**12,774,363**	**2.7**	*2.7*
Debts sec'd by mortgages	10,251	8.2	**9,393**	**8.4**	*7.0*
Other – producing income	1,193,391	6.3	**1,770,908**	**6.0**	*6.0*
Other - not producing income	147,096		**165,001**		
Total	21,406,134	4.5	**25,124,678**	**4.0**	

Source: Form 48

8.2 Derivatives

Guidelines in force are fairly tight, and the only derivative asset held at the end of 1998 (other than matching index-linked liabilities) was £355,000 in "other" futures contracts. A liability of £6,102,000 in currency futures is also observed.

8.3 Investment performance in 1998

	£000s	£000s
1. Net investment income (F 40.12 – F 40.23)	1,139,053	
2. *less* estimated investment income on assets matching property linked liabilities *	78,481	
3. *less* estimated investment income on non-linked assets matching index-linked liabilities ‡	17,500	
4. Investment income on Form 48 assets		1,043,072
5. Increase in non-linked assets brought into account (F 40.13)	1,806,498	
6. *less* increase in non-linked assets matching index-linked liabilities brought into account ‡	71,498	
7. Increase in Form 48 assets brought into account		1,735,000
8. Investment reserve carried forward (F 14.51.1)	2,373,931	
9. Investment reserve brought forward (F 14.51.2)	2,151,550	
10. Increase in investment reserve		222,381
11. Investment return		**3,000,453**
12. Opening Form 48 assets	21,406,135	
13. Closing Form 48 assets	25,124,678	
14. Mean fund excluding investment return [=½×(12+13-11)]		21,765,180
15. Rate of return from investment [= 11/14]		**13.8%**

* calculated as F44.12 / average F55 internal linked col 7 * average F55 total cols (8 - 9)
‡ estimated figures based on Form 56

This return slightly underperforms what might have been hoped for in 1998 - but is probably in line with returns generally achieved. The correspondingly calculated 1997 figure of around 19.1% was somewhat higher than the average return achieved by with-profit offices in that year, of 18.5%. [However, it may be noted that in the Society's accounts the return claimed for assets matching with-profit liabilities is lower than the figures generated by us: it was only 17.2% in 1997, and was just 13.3% in 1998.]

9. ASSETS HELD TO MATCH LINKED LIABILITIES

9.1 Internal linked funds

9.1.1 New and altered funds

In 1997, three new overseas global funds were introduced: the Far Eastern, International Growth and North American funds.
There were no new funds in 1998.

9.1.2 Investment performance

Units in the Pension Managed Fund showed growth of 16.6% and 11.6% in 1997 and 1998 respectively, while the Life Managed Fund produced corresponding growth of 15.5% and 12.5%. The Pelican Funds appear to have again produced good performances (with Pension units up 25.7% and 13.9% and Life units up 22.0% and 12.2%).

A table displaying investment growth and performance compared with the rest of the industry, for the major unit funds, is shown in the table below -

	1997	1998	
	Investment Growth	**Investment Growth**	**Market Quartile**
Life Funds: Managed	15.9%	**12.5%**	**1**
Pelican (Equity)	22.0%	**12.2%**	**1**
High Income	22.9%	**9.4%**	**2**
European	26.3%	**28.9%**	**1**
Far Eastern	-18.3%	**6.8%**	**1**
Pension Funds: Managed	16.6%	**11.6%**	**3**
Pelican (Equity)	25.7%	**13.9%**	**1**
High Income	26.7%	**10.0%**	**2**
European	31.3%	**34.9%**	**1**
Far Eastern	-23.5%	**7.2%**	**1**

Source: Planned Savings, February 1999

9.1.3 Fund Management Charges to policyholders

The annual charge levied on the internal linked funds, other than personalised funds, remains at just ½% (believed to be the lowest level in the market, apart from tracker funds).

9.1.4 Principles of unit pricing

Most of the internal funds are invested in units of trusts managed by Equitable Trust Managers. Those trusts operate on a forward pricing basis, with a 4 p.m. valuation point. When expanding an offer price is used, but when contracting the Society might exercise its discretion to move to a full bid basis - although such a change would normally await the emergence of a sustained trend. Creation or cancellation of units by the manager is based on overall liability data and then actioned on the basis of prices established on the previous day.

9.1.5 Liquidity and gearing

There were no liquidity issues in 1997.

In 1998, the aggregate Pension Personalised Funds data showed a negative liquidity percentage of 0.43%.

9.2 Other assets matching property-linked liabilities

At end 1998 £60,784,000 (1997: £58,053,000) is held directly in the Pelican Unit Trust, which showed a return of 11.4% over 1998 (20.9% in 1997); and just £146,000 (£139,000 at end 1997) is on deposit with the [redacted] Building Society.

9.3 Mismatching to property-linked liabilities

No serious mismatching is observed. Only small surpluses of units exist for most funds.

9.4 Assets matching index-linked liabilities

Total RPI linked liabilities of £560,390,000 (£385,553,000 at end 1997) are matched by holdings of £492,197,000 in Government Index Linked Securities and £68,193,000 held in deposits and other short-term assets.

Partial FTSE 100 linked liabilities of £5,082,000 (£3,950,000 at end 1997) are covered by holdings of £275,000 in FTSE call options and £4,807,000 held in deposits and other short-term assets.

9.5 PRE (issues on linked funds)

Where a fund invests in an Equitable Unit Trust, the annual management charge is reduced by ½%, and charges are also adjusted where a fund invests in units of another fund to ensure that only one levy is made.

10. VALUATION BASIS

10.1 Overall strength

The Society produces its published Return on the basis of a gross premium valuation for non linked business, with some modest allowance for future bonuses, but the resilience reserve included is determined such that the total liability is identical with the results of a net premium valuation - that is shown as an Appendix to the Returns, and is largely the basis on which the strength of the reserves is monitored by GAD.

The bases used in the net premium valuation are generally considered to be acceptable, subject to the point raised in Section 10.8.

The Society informs its holders of accumulating with profit contracts of the amount of their accumulating final bonus (although clearly stating that it is not guaranteed), but only holds reserves for a discounted sum compared with the current guaranteed value.

It is known, having been acknowledged by the Society, that total current "asset shares" (indicated to members as their policy value) exceed total current admissible assets.

The solvency position of the Society is complicated on this occasion by a need to carry reserves appropriate to the extent of guaranteed annuity options attaching to a large percentage of existing pensions liabilities. The basis for these provisions has been the subject of extensive discussions between GAD and the Appointed Actuary, and an attempt has been made to mitigate the strain by taking out a special reinsurance contract with Irish European Reinsurance Company Limited. [See Section 13.2.]

10.2 Interest

The table below sets out **interest rates used in the net premium valuation** for major classes of non-linked business (with liabilities in excess of £100m) from Forms 57.

Classes	Net Interest Rate (1997 Rate)	Gross Interest Rate *	Liability Approx. (£m)
life assurances with profit	2.75% (3.25%)	3.44%	320
Pensions with profit - regular premium	3.25% (3.75%)	3.50%	197
Pensions with profit - various	2.50% (2.50%)	2.69%	1,329
ann. In payment with profit (Series I)	4.00% (4.25%)	4.30%	137
ann. In payment with profit (Series II)	2.50% (2.50%)	2.69%	102
Pensions **accumulating** with profit	4.00% (4.25%)	4.30%	12,667
life **accumulating** with profit	2.25% (2.25%)	2.81%	1,587
Annuities in payment non profit	4.50% (6.25%)	5.00%	151
Pensions annuities	5.00% (6.75%)	5.18%	2,310

* grossed up at 20% tax

These liability categories total £18.8bn. Forms 57 show matching assets are available.

10.3 Mortality

The bases used for assurances appear reasonably conservative, being largely based on AM80 and AF80 with varying adjustments for some classes of business - particularly taking account of the market sector in which the Society operates.

UK annuities have been valued using the IM80 and IF80 (C=2010) tables, unchanged since 1996; while pensions annuities are reserved for using PMA80 (C=2010) ult -2, unchanged from 1997 (in 1996 an age rating of only one year was used). The Appointed Actuary states in his report that these tables contain sufficient allowance for future reductions in rates of mortality.

10.4 Morbidity

Not material – permanent health business is written in Permanent Insurance.

10.5 Expenses

The aggregate expense allowance for the next twelve months, as revealed in paragraph 10(2) of the 1998 net premium valuation report, is £69m. This compares with actual F41 maintenance expenses of £34.2m in 1998 and just £8.5m of "other expenses" reported. The total of provisions made would thus seem to be more than adequate, and the Actuary contends that no additional provisions are needed to cover the continued sale of new business or to cover closure.

10.6 Resilience

A resilience reserve requirement under the net premium valuation method is reported as £1,236m in 1998 (£1,022m in 1997). Whereas, for the gross premium bonus reserve (GPBR) valuation a resilience reserve is shown of £600m (£325m). **The modified resilience reserve figures shown in the published GPBR valuation are designed to ensure that the amount of free assets disclosed is the same as would be shown by the Net Premium Valuation!**

It may be noted that the most adverse scenario at the end of 1998 involved a reduction

1997 and 1998 returns

of 10% in fixed interest yields combined with a 25% fall in equity values, whereas at end 1997 it had been the combination of a 3% rise in fixed interest yields with a 25% fall in equity values.

10.7 Other factors

For UK and Guernsey linked business, it was assumed at the end of 1998 that both unit prices and "FTSE 100" linked benefits would grow at 6.0% gross p.a. (5.0% net) before charges and that expenses would inflate at 4.0% p.a., while cash flows were discounted at an interest rate of 4.5% gross (3.5% net). [For Irish business, all these assumed rates were reduced by 0.75%.]

A pensions mis-selling reserve of £70m is included in Form 52 (£75m at end 1997).

A CGT reserve of £75m was established at end 1997, and has been increased to £100m at end 1998 (reducing to £20m in the most onerous resilience scenario).

10.8 Options and Guarantees

For UK many retirement annuities, AVCs and individual pensions contracts sold up to 1988, the option to purchase an annuity on minimum guaranteed rates at retirement can be exercised at any age between 60 and 75. These minimum guaranteed rates are largely based on a(55) ult mortality and 7% interest. As a result of current economic conditions, these options are proving extremely onerous, although the Society attempts to restrict the ultimate value given to those policyholders exercising the option to their appropriate accumulated asset share - by reducing the terminal bonus granted to such cases.

The Society has been heavily criticised in the press, of late, for taking this approach. A test case is being brought before the Courts in July 1999 to try to obtain legal clearance for the practice. [Loss of the case would result in a need for the Society to reduce its level of terminal bonus additions to a wider group of policyholders – maybe all!]

Notwithstanding the Society's method of reducing the ultimate strain on the maturity of such contracts, it has been determined by the Government Actuary that there is a need in the statutory valuation to recognise the accumulated option liability attaching to the minimum level of benefits already guaranteed – without taking credit for any possible future emerging surplus offset.

The Appointed Actuary has therefore set up a reserve in the Net Premium Valuation of £1,556m to allow for this, with £793m of this being ceded to an overseas reinsurer. [Shown as £1,593m gross, with £809M ceded, in the GPBR valuation.]

In deriving the level of the required reserves, the Actuary has made assumptions about the maximum percentage of maturity benefits that would be taken in guaranteed annuity form, and in doing so has somewhat stretched the concessions offered by the GA in his guidance letter of 13 January 1999 –

Type of contract:	Proportion taken in guaranteed annuity form
UK retirement annuities	70.0%
UK individual pensions (1st series)	82.5%
UK transfer plans (1st series)	82.5%
UK group pensions (1st series)	82.5%

It is necessary to consider whether the Actuary's reserving assumptions for annuity

guarantees should be challenged -

1. Considering the proportions indicated in the above table, it is disclosed in the Return:

(1) that allowance of a few percentage points has been made for the additional flexibility and other perceived advantages of alternative forms of benefit available and for the bonus system that the Society operates in relation to these contracts;

(2) that a modest allowance has also been made for the availability of cash commutation options, and

(3) where it would be advantageous for higher rate tax-payers to commute for cash and buy a purchased life annuity, then a further allowance of a few percentage points has been made.

These proportions of benefits assumed to be taken in guaranteed annuity form are then discounted to allow for mortality in deferment based on AM80 ult –5 years. Reasonably prudent assumptions appear to have been made in relation to mortality in payment.

It is noted that the proportions of benefits assumed to be taken in guaranteed annuity form are somewhat higher than were used in a January Board paper, and which were discussed with the Actuary by GAD on the 29th of that month, but they might still be thought to stretch the guidance given by The Government Actuary.

2. No information has been supplied about the reinsurance offset has been determined and, in particular, about what allowance has been made for the premiums payable.

There are no other guarantees or options deemed to require explicit reserves.

11. FINANCIAL RESULTS

11.1 Overview

The valuation shows available assets covering the RMM by a factor of 2.51, unchanged from end 1997.

The Equitable tries to provide fair benefits to each generation of its policyholders, on maturity or surrender - without holding back any excessive estate. The result is that lower free asset margins exist than might have been expected for such a well thought of institution. It may be noted that the Society has, for the last five years, found it desirable to utilise a future profits implicit item to improve the disclosed free assets position.

Without the implicit future profits item of £850m, cover for the RMM would be reduced to a factor of 1.66. Further, we are still not entirely clear that provisions made to cover the currently guaranteed level of annuity liabilities are as strong as they should be.

A large proportion of business is written on a participating basis, so that, provided the currently high level of annual emerging surplus continues, the Society should be able to work its way out of its current solvency margin problems. However, it does seem highly desirable for the Society to mitigate the risks posed by a possible downturn in asset values, by holding back more emerging surplus by declaring lower guaranteed bonuses - although it can still pay out appropriate final benefits to its members with declarations of "non-guaranteed final bonuses".

To be fair, the Society appears to be proceeding down this path - although mindful of the need to sustain a competitive position in the marketplace. [See the latest declarations in Section 12.2.]

11.2 Summary of results for main classes

11.2.1 Liabilities for non-linked business

	Published Bonus Reserve Gross Premium Valuation					NPV
Class	1994 £000s	1995 £000s	1996 £000s	1997 £000s	**1998 £000s**	**1998 £000s**
Life and general annuity: - accumulating with-profit	0	0	1,149,366	1,382,703	**1,675,340**	**1,596,920**
- other with profit	1,182,781	1,360,150	409,655	421,630	**435,489**	**420,083**
- non-profit	150,375	169,935	158,831	186,513	**200,954**	**217,539**
Pensions: - accumulating with profit	0	0	9,900,538	12,320,623	**14,398,745**	**14,093,456**
- other with-profit	7,930,355	9,646,509	1,576,576	1,862,135	**2,324,320**	**2,112,336**
- non-profit	1,598,887	1,835,318	1,658,705	1,958,592	**2,502,860**	**2,515,098**
Permanent health	0	0	0	0	**0**	**0**
Additional reserves	0	0	0	0	**0**	**0**
Rep. of Ireland (all classes)	68,101	109,558	152,822	177,443	**274,710**	**265,598**
Other overseas (all classes)	1,625	11,917	145,195	248,434	**340,591**	**318,677**
Total non-linked liability	10,932,124	13,133,387	15,151,688	18,558,073	**22,153,009**	**21,539,707**

Source: Forms 51 & 52

11.2.2 Liabilities for linked business

Class	1994 £000s	1995 £000s	1996 £000s	1997 £000s	**1998 £000s**
Life and general annuity: - property-linked	126,016	136,880	145,096	169,154	**200,319**
- index-linked	0	0	9,301	10,441	**14,512**
Pensions: - property-linked	968,489	1,224,477	1,443,311	1,833,853	**2,293,943**
- index-linked	0	0	290,753	381,520	**555,158**
Rep. of Ireland (all classes)	1,209	2,942	4,512	6,343	**10,880**
Other overseas (all classes)	29	141	23,845	32,610	**46,925**
Total linked liability	1,095,743	1,364,440	1,916,818	2,433,921	**3,121,737**

Source: Forms 53 & 54

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11.3 Valuation summary for Gross Premium Valuation

		1994 £000s	1995 £000s	1996 £000s	1997 £000s	**1998 £000s**
1	Non-linked liability	10,932,124	13,133,387	15,151,688	18,558,073	**22,153,009**
2	Linked liability	1,095,743	1,364,440	1,916,818	2,433,921	**3,121,737**
3	Bonus reserves	349,647	417,361	503,622	508,097	**363,378**
4	Total math. reserves	12,377,514	14,915,189	17,572,128	21,500,091	**25,638,124**
5	Additional reserves	0	0	0	400,000	**700,000**
6	Other liabilities	256,265	153,979	138,980	176,198	**225,986**
7	Total long-term liabilities	12,633,779	15,069,168	17,711,108	22,076,289	**26,564,110**
8	Total long-term assets	13,551,281	16,502,548	19,131,286	23,827,839	**28,238,041**
9	Excess of LT assets over LT liabilities (8-7)	917,502	1,433,380	1,420,178	1,751,550	**1,673,931**
10	Shareholders' assets	0	0	0	0	**0**
11	Assets available	917,502	1,433,380	1,420,178	1,751,550	**1,673,931**
12	Implicit items	249,985	263,731	312,794	371,083	**850,000**
13	Total amount available	1,167,487	1,697,111	1,732,972	2,122,633	**2,523,931**
14	RMM	494,616	586,275	685,282	845,457	**1,007,534**
15	Cover (13/14)	2.36	2.89	2.53	2.51	**2.51**
16	Free asset ratio ((11-14)/8)	3.12%	5.13%	3.84%	3.80%	**5.37%**

NOTE. Although the Net Premium Valuation showed a lower non-linked liability of £21,539,707k and a lower reserve for declared bonuses of £340,547k, it was shown to require a resilience reserve £636m higher than the GBPR valuation. Thus, as intended, the total of Long Term liabilities (shown in Line 7) for the NPV is identical with the result shown above.

11.4 Composition and distribution of surplus

£000s	1994	1995	1996	1997	**1998**
Surplus brought forward	3,207	0	0	0	**0**
Surplus emerging in year	519,981	662,848	802,539	895,553	**838,365**
Total available	523,188	662,848	802,539	895,553	**838,365**
Allocated to policyholders	523,188	662,848	802,539	895,553	**838,365**
Surplus carried forward	0	0	0	0	**0**
% dist. to policyholders	100.0%	100.0%	100.0%	100.0%	**100.0%**

Source: Form 58

Investment Reserves carried in Form 14:
£2,374m at end 1998 and £2,152m at end 1997. (£1,420m at end 1996)

12. BONUSES

12.1 Cost of bonuses declared

£000s	1994	1995	1996	1997	1998
Bonus payments made in anticipation of a surplus	173,541	245,486	298,917	387,455	**474,987**
Reversionary bonuses	349,647	417,361	503,622	508,098	**363,379**
Total	523,188	662,848	802,539	895,553	**838,365**

Source: Form58

12.2 Recent history of key bonus rates

	1997				**1998**			
Bonuses on UK style policies	Reversionary ‰		Final (total return)%		**Reversionary ‰**		**Final (total return)%**	
	On SA.	On Bonus	At 31.12.	Interim	**On SA.**	**On Bonus**	**At 31.12.**	**Interim**
Endowment Ass.	30.00	17.50	Varies	Varies	**22.50**	**10.00**	**Varies**	**Varies**
Unitised Life	47.50	47.50	*10.75	*7.50	**35.00**	**35.00**	**8.50**	**7.75**
Deferred Annuity	30.00	30.00	Varies	Varies	**22.50**	**22.50**	**Varies**	**Varies**
Recur. SP D. Ann	30.00	30.00	13.0	9.0	**15.00**	**15.00**	**10.0**	**9.0**
pre 7.96 annuity	30.00	30.00	13.0	9.0	**15.00**	**15.00**	**10.0**	**9.0**
post 6.96 annuity	65.00	65.00	13.0	9.0	**50.00**	**50.00**	**10.0**	**9.0**
pre 7.96 pension	30.00	30.00	13.0	9.0	**15.00**	**15.00**	**10.0**	**9.0**
post 6.96 pension	65.00	65.00	13.0	9.0	**50.00**	**50.00**	**10.0**	**9.0**
Gnsy Overseas £	65.00	65.00	13.0	9.0	**50.00**	**50.00**	**10.0**	**9.0**
Gnsy Overseas $	47.50	47.50	12.0	9.0	**37.50**	**37.50**	**9.0**	**9.0**
R. o I. Life	45.00	45.00	15.0	9.25	**32.50**	**32.50**	**10.5**	**10.5**
RoI pre 7.96 Ann	30.00	30.00	20.0	12.0	**15.00**	**15.00**	**13.0**	**13.0**
RoI post 6.96 An.	65.00	65.00	20.0	12.0	**50.00**	**50.00**	**13.0**	**13.0**
German Life	45.00	45.00	12.0	9.0	**37.50**	**37.50**	**11.0**	**9.0**
German Annuity	45.00	45.00	12.0	9.0	**37.50**	**37.50**	**11.0**	**9.0**

Source: Schedule 4, Paragraph 15   * 0.25% higher for SP Bonds

The Whole Life bonus at end 1998 was £25.00‰ + £1.50‰×(years in force over 11). [£32.50‰ + £2.50‰×(years in force over 11) at end 1997.]

There are also a small number of policies with revalorization style German bonuses.

The method of annual bonus declarations for unitised type contracts is unusual. As well as a declared guaranteed annual bonus, based on a proportion of accrued income and capital appreciation, a further annual bonus is quoted, which is not guaranteed (in that it may be withdrawn and/or reduced in future), but which makes up the total quoted accrued policy value at the valuation date. This non-guaranteed final bonus is declared in a similar way to reversionary bonuses, as a percentage of benefit, and the amount payable at maturity is the sum of these total annual "declarations", *subject to the proviso that the final non-guaranteed bonus can be withdrawn.*

The Society's With-Profits Guide includes a table of gross investment returns achieved on the funds of the Society at market value in recent years (from 1993 - as attributable to with-profits business), quoting the smoothed rate that was applied in allocating bonuses for policyholders in each year and the "guaranteed rate", being the rate at which guaranteed benefits were built up in each year -

	1994	1995	1996	1997	**1998**
Earned	-4.2%	16.6%	10.7%	17.2%	**13.3%**
Allocated	10.0%	10.0%	10.0%	13.0%	**10.0%**
Guaranteed	7.5%	7.5%	7.5%	6.5%	**5.0%**

Final bonuses for traditional life contracts are according to a table based on duration in force. Specimen values as a % of SA and existing declared Bonus are:

Complete Years In Force	1995	1996	1997	1998	**1999**
1	6.0	6.0	6.0	9.0	**7.0**
2	9.0	8.0	8.0	11.0	**11.0**
3	11.5	10.0	10.0	13.0	**14.0**
4	13.5	12.5	12,0	15.0	**16.0**
5	16.0	15.0	14.0	17.0	**18.0**
10	34.5	30.5	27.0	30.0	**31.0**
15	76.0	66.5	57.5	54.0	**51.0**
20	101.0	99.0	96.0	98.0	**97.0**
25	118.5	118.5	122.5	128.0	**132.0**
30	122.5	125.0	130.0	140.0	**150.0**
35	122.5	125.0	130.0	140.0	**155.0**

Final bonuses for deferred annuities are derived from a similar table.

Specimen values as a % of SA and existing declared Bonus are:

Complete Years In Force	1995	1996	1997	1998	**1999**
1	7.5	7.5	7.5	11.0	**8.0**
2	11.0	10.0	10.0	13.0	**13.0**
3	13.5	12.5	12.5	15.0	**17.0**
4	15.5	15.0	15.0	17.0	**20.0**
5	16.5	16.5	16.5	20.0	**22.0**
10	28.0	26.0	24.0	28.0	**30.0**
15	68.5	58.5	50.0	48.0	**44.0**
20	92.5	90.5	88.0	90.0	**89.0**
25	107.5	108.0	110.0	116.0	**121.0**
30	115.0	117.5	120.0	130.0	**139.0**
35	115.0	117.5	120.0	130.0	**145.0**

12.3 PRE (issues on with-profit business)

The Society tries very hard to achieve an equitable distribution to each generation of its policyholders, whilst avoiding short term fluctuations in benefits - with the result that it has not accumulated any material unallocated estate compared with accumulated asset shares (if any - see Section 10.7).

However, it reserves the right to penalise early surrenders, even in relation to guaranteed bonuses added under unitised contracts, and it might be desirable for this possibility to receive greater prominence in the literature distributed. Further, with such a large proportion of unitised business and with the level of guaranteed bonuses declared taking account of some asset appreciation, it would seem to be desirable that policyholders were given some greater warning about the possible implications for future bonuses of a substantial market setback.

Equitable Life has been heavily criticised in the press, of late, for the approach that it is taking of reducing terminal bonuses to meet the costs of guaranteed annuity options attaching to some of its pension contracts. A test case to be brought before the Courts in July 1999 will try to obtain legal clearance for the practice.

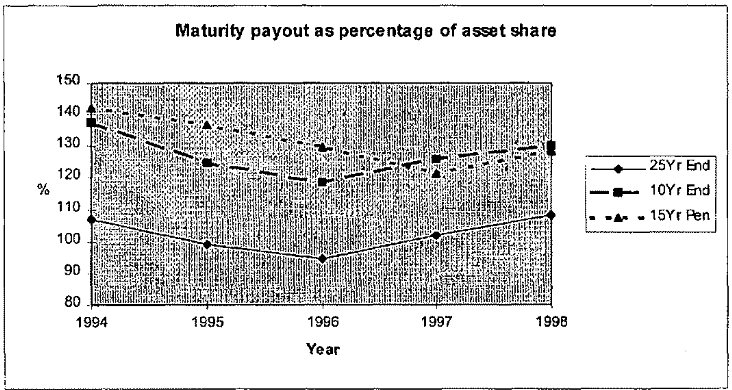
12.4 Recent history of maturity payouts

£	1994	1995	1996	1997	**1998**
25 yr endowment	87,887	86,739	84,025	86,355	**84,418**
Industry average	*94,068*	*94,503*	*96,319*	*102,150*	***102,893***
10 yr endowment	10,575	10,211	9,879	9,926	**9,681**
Industry average	*10,327*	*9,923*	*9,783*	*9,940*	***9,971***
15 yr pension	145,338	131,239	120,078	109,211	**102,970**
Industry average	*133,094*	*125,766*	*117,754*	*113,379*	***109,874***
10yr SV on 25 yr endowment	10,070	9,073	8,427	8,191	**8,057**
Industry average	*7,616*	*7,638*	*7,446*	*7,439*	***7,315***

Note: Endowments: £50p.m., maturing 1 Feb. in next year Source: Money Management 4/99
Pensions: £200p.m., maturing 1 Jul. in year Source: Money Management 10/98

It is clear that, while Equitable strives to be fair to all its policyholders, and pays much more generous surrender values than most other offices, its maturity payouts fall well short of the best in the market, particularly for conventional life contracts.

Nevertheless, the chart below shows that policyholders seem to be receiving quite fair returns – no doubt helped by the low expense charges levied by the Society.



Note: Asset shares used to calculate the percentages above are theoretical amounts based on GAD's estimate of industry experience for investment return and expenses. There is no allowance for distribution of miscellaneous profits or transfers to/from the estate. See section 12.6 of the GAD annual report for further commentary.

13. REASSURANCE AND FINANCING

13.1 Overview of conventional reassurance treaties

Little use is made of traditional reassurance by Equitable, other than for very large sums assured (retention being £400,000 for UK life risks and DM250,000 for German risks), and for supplementary disability and accident risks.

Major Medical Cash Plans and Critical Illness Plans are fully reassured, on a 50% quota share basis to two reassurers: [redacted] and [redacted], with the former taking all Critical Illness risks in excess of £100,000.
Total reassurance premiums paid in 1998 were about £3.3m (£2.4m in 1997).

13.2 Financing arrangements

A new treaty with Irish European Reinsurance Company Limited provides surplus cover for the costs arising from the exercise of guaranteed annuity options in respect of Retirement Annuity policies, Individual Pension Plans and Transfer Plans issued before 1 July 1988. If the proportion of retirement terminations where the option is exercised in any year exceeds 25% of the total, measured by the guaranteed funds for those policies, the reinsurer's gross liability is equal to the value of the guaranteed annuity in excess of the guaranteed policy fund for that proportion of retirements effecting the option which is in excess of 25%.

This treaty enables the Actuary to make a substantial offset to his guaranteed annuity option additional reserves (£793m off the gross £1,556m in the net premium valuation).

OTHER ISSUES

14. COMPLIANCE

14.1 HMT compliance problems

None observed.

14.2 PIA and other compliance problems

A pensions mis-selling reserve of £70m is included in Form 52 (£75m at end 1997).

15. PROFESSIONAL REQUIREMENTS

This report conforms fully with the requirements of the Institute and Faculty of Actuaries as set out in their Memorandum of Professional Conduct and Advice on Professional Conduct.

This report had been prepared under the terms of the Agreement between Insurance Directorate, Her Majesty's Treasury (HMT) and the Government Actuary's Department (GAD) dated November 1998 ("the service agreement"), as continued between the Financial Services Authority (FSA) and GAD under an exchange of letters in December 1998, setting out the level of service to be provided by GAD in respect of the supervision of companies authorised, or seeking authorisation, under the Insurance Companies Act 1982 to carry on long term business.

The purpose of this report is to enable FSA to fulfil its responsibilities under the Third Life Directive and the Insurance Companies Act 1982.

The scope of this report is:

- to advise on the statutory solvency position of the company;
- to identify any issues relevant to the responsibilities of FSA;
- to describe the development of the company over the previous 12 months;
- to provide historical background to the company.

The advice and information contained in this report are solely for the use of FSA in fulfilling its responsibilities and should not be transmitted to third parties, including the company concerned, without the prior consent of GAD.

[redacted]

[redacted]

Government Actuary's Department
20 May 1999

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1999 returns

EQUITABLE LIFE ASSURANCE SOCIETY

RETURNS AS AT 31 DECEMBER 1999

DETAILED SCRUTINY REPORT

GAD PRIORITY RATING: 2 Surely 1 !

GOVERNMENT ACTUARY'S DEPARTMENT

To: [redacted] **IFSD, Financial Services Authority,** [redacted]

From: [redacted] **Government Actuary's Department, ☎** [redacted]

This report conforms fully to the professional requirements of the Faculty and Institute of Actuaries, details of which are set out in Section 15 of this report.

1. KEY FEATURES

Type of company:	Mutual	
Type of business:	Largely pensions: esp. group personal pensions and AVCs. Substantial accumulating with profits	
Last visit date:	6th December 1999	
Key financial statistics:	1998 £000s	**1999 £000s**
New Business Index:	636,984	**539,766**
Long term assets:	28,238,041	**33,110,903**
Assets available:	2,523,931	**3,861,027**
Implicit items	850,000	**925,000**
Sub-ordinated loans	346,204	**346,204**
RMM	1,007,534	**1,114,310**

2. ACTION POINTS

There are no direct action points for FSA arising from the scrutiny, ***but GAD have written the Society to raise a number of questions as a result of the scrutiny and other recent discussions. A copy of our letter is attached.***

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GAD's detailed scrutiny reports in respect of Equitable's returns

1999 returns

3. EXECUTIVE SUMMARY

As is well known, the Society put itself up for sale following the House of Lords ruling in July 2000 that it was acting improperly in its then established practice of applying differential scales of terminal bonus according to whether or not policies contain Guaranteed Annuity Rates (GAR's) or according to the form in which benefits are taken. (In 1999 the Society had initiated and funded a Court case to seek a ruling on this point - in the first place the Society succeeded in the High Court; however, the case was then taken to the Court of Appeal, where only one of the three Judges agreed with the High Court, and the other two found against the Society. In order to obtain a definitive answer, the Society appealed to the House of Lords, and the Lords ruled 5 : 0 against the Society.)

In the light of this ruling, the Society were faced with the need to reduce the level of benefits to all policyholders and also of making substantial changes to their investment policy (essentially switching away from equities into fixed interest securities). The Board thus concluded that members' interests would be best served by selling the business to an organisation capable of providing capital support and therefore ensuring continued investment freedom. The press have reported a number of companies to be expressing interest in acquiring the Society, but there are just three companies expected to make final bids (which need to be lodged in November 2000). At the meeting at GAD on 03.11.2000 [redacted] explained that if the sale does not take place, the Society is likely to need to stop writing new business, and to re-arrange its investment portfolio to a more defensive position.

The Society is affected by many of the risks to which life offices are potentially exposed, as indicated below:

Capital risk :

1. At first sight the solvency position at 31.12.99 looks reasonable - available assets of £3,861m. cover the rmm. of £1,114m. by a factor of 3.46. However, these available assets include an implicit item for future profits worth £925m., they disregard the liability to repay the subordinated loan of £346m., and they benefit from a reduction of almost £1.1 bn. in the GAO reserves from the Society's reassurance arrangements. Without these items, the available assets would be just £1,511m., and the cover 1.36x : a less satisfactory picture for this large fund.

2. The aggregate asset shares are close to the value of the fund - i.e. there is no 'estate'. (The £1.5 bn. 'saved' from the cut in roll-up rates on UWP business since the House of Lords judgement has been re-allocated to finance future GAO support and the likely costs of the rectification scheme.)

3. This situation arises because the Equitable has traditionally operated with an underlying philosophy of providing fair benefits to each generation of its policyholders, on maturity or surrender - without holding back any excessive estate. The result is that lower free asset margins exist than might have been expected for such an institution.

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Reserve risk :

1. There appears to be a wide range of ages over which benefits can be taken on accumulating with profits pensions contracts at the option of the policyholder, without any market value adjustment being applied to the guaranteed benefits, and with the full value of any GAR (provided this attaches to their policy) being available. It is unclear whether the reserves are adequate to provide fully for this flexibility, and we have questioned this in our letter.

2. In the resilience scenario, the Society effectively takes credit for an additional ½% p.a. on the investment return. This appears to be justified as a 'Zillmer' adjustment to enable the Society to recoup unrelieved acquisition expenses. We are questioning this also.

3. Inter alia, the Insurance Companies (Amendment) Regulations 2000 are likely to lead to increased reserves on accumulating with profits business. We are asking the Appointed Actuary in our letter to confirm the impact on this Society, which we understand from our recent meeting to be much lower than is being suggested in the market.

4. The Society utilises a reassurance treaty with Irish European which provides protection to the Society should more than 60% (formerly 25%) of the benefits in any calendar year on the contracts which incorporate guaranteed annuity options be taken in guaranteed form. This is not wholly satisfactory from a regulatory perspective as it relies on regulatory arbitrage to achieve the desired result, and would not be available in the event of insolvency. It removes over £1bn. of liabilities from Equitable's balance sheet.

5. When setting GAO reserves, the Appointed Actuary assumes that 85% of benefits are taken in GAO form. This is a weaker assumption than that specified in the guidance of DAA13, although currently any assumption over 60% would be negated by the offset gained from the reassurance treaty above.

Asset risk : The Society is exposed to falls in the equity market. A sensitivity matrix supplied by the Society to FSA on 09.10.2000 shows the Society would be unable to cover its rmm. if the FTSE-100 Index fell to around 5750 (a fall of 15% from end-August levels), though they are not particularly sensitive to movements in fixed interest yields.

Strategy risk : Without capital support from a prospective purchaser, the Society will be unable to reinstate the 7 months bonus foregone this year on the accumulating with profits pensions business. There are PRE issues here for both GAR and non-GAR policyholders. Indeed, the related question of whether the Society should be continuing to sell non-GAR policies in the same fund as that where the GAR policies reside could be considered to be an ***environment risk.***

Control risk : We understand that PIA have been in correspondence with the Society over mis-selling of income drawdown schemes, and that enforcement action is under consideration.

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4. BACKGROUND

Equitable is the oldest mutual life assurance society in the world, dating from 1762. It was the first to develop policies based on scientific principles as used today.
Equitable has never paid commission to third parties.

This background is typified by a determination to provide fair bonuses to policyholders, with no deliberate holding back of profits from one generation to another, by unit linked products which often have discretionary surrender values, and by using a gross premium bonus reserve valuation method. (However, the returns also show the results of a net premium valuation on a minimum basis – and the free asset position shown is identical.)

In 1995 the Equitable purchased a controlling interest in [redacted], the PHI specialist, from Medical Sickness - and bought out the minority in June 1997.

University Life, another old institution, has been a subsidiary of Equitable since 1919. Equitable provides management services under an agreement with capped charges.

Equitable has increased activity overseas in recent years, with branches in Ireland and Germany and an International Branch operated from Guernsey. These branches have been set up on a low cost base and produce ever increasing amounts of new business. The company also began providing insurance from 3 August 1998 on a services basis into Greece. Equitable regards these activities as an exercise in extending the numbers of people who can benefit from the Society as an institution. It is almost like missionary work, rather than a purely commercial move in the interests of UK policyholders. [However, the company has expressed dissatisfaction with the cost effectiveness of the German branch.] The mutual concept is extended to all policyholders, and is even part of Equitable's dealing with UK non profit policyholders.

Equitable has a unit trust and PEP subsidiary, Equitable Unit Trust Managers Ltd, with over £2.4bn under management (possibly units bought by the Society to back unit-linked policies). Its strong systems department established a subsidiary, Equitable Services and Consultancy Limited, that has run a contract with [redacted] since 1995 and, in 1996, agreed to provide systems support to group pension operations of [redacted] In 1997 it took on the processing of policy records for a Zimbabwe company, and in 1998 commenced a three year project to provide administration services to [redacted]

In July 1997, a £350m subordinated loan was taken from a specially created subsidiary, Equitable Life Finance plc, which floated corresponding Bonds on the market. This liability is shown in Form 15, despite having no "other than long term business" assets, thus producing a negative value in Line 23 of Form 10 – offset by an entry in Line 26. As a result of this reporting, the capital raised is not shown as an asset in Line 22 of Form 9. [This is different from the convention used by [redacted] and [redacted], who include the loan as a liability in Form 14; FSA have recently been seeking to regularise these different methods of presentation.]

There were four Section 68 Orders in force at the 31 December 1997 valuation date:

- an order dated 14 October 1997, allowing the Society to take into account a future profits implicit item, with a value not exceeding £700 million. The Society included an implicit item in the 31.12.97 returns of £371.1 million, for the purpose of achieving equity between the total net value of policyholders' assets, and the corresponding total net asset value shown in the Society's Companies Act accounts.

- an order dated 13 June 1997, to the effect that figures in Form 46 exclude recurrent single premiums from the annual premium figures as the Society cannot at present calculate a meaningful figure. ***(See also §6.1 following.)***
- an order dated 31 January 1997, directing that the Society may include aggregate details for total "Personalised Funds" in Forms 43, 45 and 55, instead of providing separate details for each fund.
- an order dated 19 August 1997, enabling the Society to disregard, for the purposes of Regulation 60 of ICR94, amounts owing to Equitable Life Finance PLC under a (Subordinated) loan agreement dated 4 August 1997 up to an amount not exceeding 50% of the company's required margin of solvency.

For the 1998 valuation the implicit item order above had been revoked. It was replaced by a similar order dated 30 December 1998, which allowed the Society to take into account a future profits implicit item of up to £1,900m. The actual amount that the Society took into account was £850m. For the 1999 valuation there was a new order dated 09 November 1999, and the Society took into account an amount of £925 million, again within the maximum permitted.

[redacted] is Appointed Actuary and the Managing Director is [redacted]. They replaced [redacted], who held both posts until his retirement at the end of July 1997. A non-executive, [redacted], chairs the Board.

BUSINESS DEVELOPMENTS DURING THE YEAR

5. NEW BUSINESS

5.1 New and altered products

Within the 'family' of Life accumulating with profits Savings Plans, a German group savings plan and an Irish flexible income plan were introduced in 1999.

On the pensions accumulating with profits side, the UK personal pension trustee investment policy and UK personal pension trustee income drawdown policy are mentioned for the first time in the 1999 Returns. In Autumn 1999 / early 2000 there was some correspondence between GAD and the Society regarding the drawdown policy; a number of policyholders had found the maximum income they could withdraw each year had been cut considerably at the first three-yearly review. In response to our questions, the Society explained that this had been due to the investment performance of their mixed portfolio over the three year period falling short of the implied performance of a long term gilt over the period, given the yield shift experienced. Whilst this was obviously a disappointing outcome, GAD accepted the Society's explanation. ***We understand that PIA have had further dialogue with the Society on this subject, and that enforcement action is under consideration.***

Unit-linked versions of the above products were also introduced.

With profits annuities issued since 01 July 1996 are subject to a maximum permitted rate of decrease of 8.5% p.a. The actual maximum at 31.12.99 was 5.5% p.a., up from 5.0% at 31.12.98.

5.2 Source(s) of new business

Equitable pays no commission. It runs a sales force and also conducts direct response advertising, targeted at high net worth individuals, but a lot of business comes from its reputation and direct approaches from prospective policyholders. Another recent development is that of Equitable Direct, which has been established to complement the branch-based direct sales force, with staff numbers of 90 at the end of 1998.

The Society also has significant volumes of quasi-institutional pensions business, from actual pension schemes and from AVCs - with more than 300 of the UK's 500 largest companies having pension arrangements with Equitable. Over 2,000 such plans are now operating. The Society operates AVC schemes for both the Civil Service and the NHS.

5.3 Recent history:

New regular premiums

Class	1995 £000s	1996 £000s	1997 £000s	1998 £000s	**1999 £000s**
Life and general annuity:					
- accumulating with-profit		19,925	20,910	17,300	**19,770**
- other with profit	11,465	4,315	5,673	3,500	**2,823**
- non-profit	2,219	3,307	4,327	4,535	**4,071**
- property-linked	560	3,362	10,020	13,351	**11,558**
Pensions:					
- accumulating with profit		300,067	348,515	267,390	**203,937**
- other with-profit	327,693	6	27	17	**13**
- non-profit	1,517	2,311	2,583	2,524	**2,438**
- property-linked	43,591	67,993	89,076	91,308	**75,921**
Overseas (all classes)	27,657	12,878	13,214	19,368	**21,488**
Total	414,702	414,164	494,345	419,293	**342,018**
Year on year % increase	10%	(0%)	19%	(15%)	**(18%)**

Source: Form 47, column 6

New single premiums

Class	1995 £000s	1996 £000s	1997 £000s	1998 £000s	**1999 £000s**
Life and general annuity: - accumulating with-profit		199,881	205,403	256,866	**389,956**
- other with profit	143,718	16,366	17,830	10,709	**4,519**
- non-profit	18,258	22,437	30,973	17,008	**9,053**
- property-linked	4,130	15,239	10,887	30,123	**57,406**
- index-linked		2,063	969	2,996	**2,713**
Pensions: - accumulating with profit		897,272	1,059,306	777,151	**615,015**
- other with-profit	419,724	178,390	233,230	517,518	**369,131**
- non-profit	114,994	63,227	84,826	186,786	**103,195**
- property-linked	11,658	77,125	138,294	142,897	**170,660**
- index-linked		25,558	54,386	82,848	**32,200**
Overseas (all classes)	28,419	92,636	113,765	152,011	**223,630**
Total	740,901	1,590,195	1,949,869	2,176,913	**1,977,480**
Year on year % increase	30%	115%	23%	12%	**(9%)**

Source: Form 47, column 3

New Business Index (Regular premiums plus 10% of single premiums)

New Business Index (£000s)	488,792	573,184	689,332	636,984	539,766
Year on year % increase	13%	17%	20%	(8%)	**(15%)**
ABI comparisons (UK business): - Life	*(11%)*	*20%*	*10%*	*18%*	***Not available***
- Pensions	*(11%)*	*17%*	*22%*	*10%*	***Not available***
- Overall	*(11%)*	*20%*	*14%*	*15%*	***Not available***

Source of comparisons: ABI Insurance Statistics Yearbook 1998

5.4 Commentary

Single premiums in the Tables above correspond with amounts shown in Form 41 of the Returns.

A very large proportion of the business is of the "accumulating with profit" type (which was first separately identified in the 1996 Returns). In 1997, the Equitable was reported as the largest writer of pensions business in the UK.

6. CHANGES IN BUSINESS IN FORCE

6.1 Recent history of regular premiums received

Class	1995 £000s	1996 £000s	1997 £000s	1998 £000s	**1999 £000s**
Life & general annuity	94,706	116,541	145,586	175,465	**207,924**
Pensions	1,421,752	1,125,149	1,358,484	1,379,753	**1,301,634**
Permanent health	291	484	641	801	**965**
Total gross regular premiums	1,516,749	1,242,174	1,504,711	1,556,019	**1,510,523**
Less reinsurance premiums	1,877	2,106	2,451	3,455	**4,281**
Total net regular premiums	1,514,872	1,240,068	1,502,260	1,552,564	**1,506,242**
Year on year % increase	9%	(18%)	21%	3%	**(3%)**

Source: Form 41

The above figures are taken from ***Form 41***.

Note 4604 to the 1998 Returns describes the Section 68 Order dated 13 June 1997 which permitted the Society to exclude recurrent single premiums from the annual premium figures on ***Form 46*** since they were unable to calculate a meaningful figure for these. However, in the 1999 Returns Note 4604 has been revised. It now explains that most policyholders take advantage of the flexibility under recurrent single premium contracts to change / cease the level of premium, and consequently there is no precisely identifiable annual premium on these contracts. On Form 46 the annual premiums now include recurrent single premiums to the extent that they are not specifically identified as single premiums. Annual premiums brought forward from 1998 have been restated accordingly.

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6.2 Claims experience

Recent history of claim amounts (*gross of reinsurance*)

Class	1995 £000s	1996 £000s	1997 £000s	1998 £000s	**1999 £000s**
Life assurance deaths	17,023	21,613	20,402	22,788	**33,146**
Life assurance maturities	42,068	57,497	51,387	75,634	**47,703**
Annuity payments	46,359	51,515	54,446	58,434	**59,591**
Other insured events	0	0	0	0	**0**
Surrenders	63,768	80,160	106,379	140,426	**221,669**
Pension lump sums/deaths	724,791	881,593	1,147,729	1,191,703	**1,098,505**
Pension annuity payments	295,383	359,724	425,252	515,676	**605,213**
Pension surrenders	239,205	284,052	416,723	536,538	**621,831**
PHI lump sums	64	119	320	239	**750**
PHI regular payments	0	0	0	0	**0**
Total	1,428,661	1,736,273	2,222,638	2,541,438	**2,688,408**

Source: Form 42

6.3 Persistency experience

Latest PIA persistency statistics (*represented as % of policies written in year no longer in force at end of term*)

	Endowments									
Business Year:	1994	1995	1996	1997	1994	1995	1996	1994	1995	1994
Persistency Term:	1yr	1yr	1yr	1yr	2yr	2yr	2yr	3yr	3yr	4yr
Regular Premium:										
Company Reps	2.3	3.4	2.3	4.0	4.7	4.6	4.0	5.4	5.7	6.2
Industry average	*8.2*	*7.8*	*6.6*	*6.7*	*13.4*	*13.0*	*12.5*	*18.5*	*18.4*	*23.1*

	Other life									
Business Year:	1994	1995	1996	1997	1994	1995	1996	1994	1995	1994
Persistency Term:	1yr	1yr	1yr	1yr	2yr	2yr	2yr	3yr	3yr	4yr
Regular Premium:										
Company Reps	5.2	6.9	4.6	4.4	10.4	10.3	7.6	14.5	13.0	15.2
Industry average	*13.6*	*11.9*	*10.2*	*10.2*	*23.4*	*21.3*	*19.9*	*31.0*	*30.2*	*38.6*
Single Premium:										
Company Reps	1.1	0.7	1.2	0.8	3.1	2.7	2.4	5.1	4.8	6.9
Industry average	*3.3*	*1.9*	*1.9*	*1.8*	*7.4*	*4.8*	*4.7*	*12.3*	*8.3*	*17.1*

Source: PIA: Fifth Survey of the Persistency of Life and Pensions Policies (Oct 1999)
Note: Data not available for SP via direct adverts (all classes)

NOTE In spite of Pensions being the major class of business conducted by the Society, data is not available for persistency, due to the flexible nature of the contracts written.

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Recent history of combined surrender, lapse & paid-up conversion rates

Class	1995	1996	1997	1998	**1999**
Life non-linked	3.85%	5.54%	3.81%	4.10%	**5.06%**
Life linked	8.49%	9.96%	6.11%	4.98%	**5.18%**
Pensions non-linked	7.40%	7.50%	7.54%	6.46%	**2.13%**

Note: The combined surrender, lapse and paid-up conversion rates are:
Form 46, UK business, annual premiums, lines (24+25+26) / [½*lines (11+39+24+25+26)]

These are excellent results, reflecting the fact that business is largely bought rather than sold! The pensions annual premiums reported on Form 46 in the 1999 Returns are substantially higher than previously – see the comments following the table in §6.1 above - and the reduced ratio for pensions above is a reflection of this revised information.

7. EXPENSES

7.1 Recent history of expenses:

Expense	1995 £000s	1996 £000s	1997 £000s	1998 £000s	**1999 £000s**
Initial commission	0	0	0	0	**0**
Acquisition expenses	82,376	88,457	99,143	106,552	**96,677**
Renewal commission	0	0	0	0	**0**
Maintenance expenses	30,222	30,208	33,303	34,243	**35,796**
Other management expenses	0	2,514	7,279	8,475	**12,888**
Total expenses	112,598	121,179	139,725	149,270	**145,361**
Year on year % increase	1%	8%	15%	7%	**(3%)**

Expense ratios:	1995	1996	1997	1998	**1999**
Acquisition	16.9%	15.4%	14.4%	16.7%	**17.9%**
Mutual median	*93.6%*	*67.7%*	*72.6%*	*72.4%*	***Not available***
Renewal	2.0%	2.4%	2.2%	2.2%	**2.4%**
Mutual median	*12.4%*	*10.3%*	*12.1%*	*11.2%*	***Not available***
OME as % of total expenses	0.0%	2.1%	5.2%	5.7%	**8.9%**

Source: Form 41

Notes: 1. The expense ratios are:
Acquisition: (IC + AE) / New Business Index
Renewal: (RC + ME) / Gross earned regular premiums [F41.29.1]
OME as % of total expenses: OME / Total Expenses

2. The trend in the acquisition expense ratio is subject to distortion from the reclassification of recurrent single premiums as regular premiums from 1996.

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7.2 Commentary

Reported expense ratios are the lowest in the industry, being only about half those of its nearest competitor. They are astonishingly low. Over ***1998***, its nearest (mutual) competitor was the [redacted], with an Acquisition Expense ratio of 36.0%, and a Renewal ratio of 5.9%. However, Equitable's total staff numbers increased in 1998 by 92 from 2,091 to 2,183 - reflecting increases in both Administration and Marketing.

Equitable is well known as a non-commission paying office, and prides itself on its low expense ratio. It is a very positive marketing message and a key attraction of the Society with its customers. It helps explain the strong sales figures achieved and is part of a virtuous circle.

7.3 Exceptional items

The Society claims to have invested some £70m in the complete redevelopment of all its operating systems over recent years.

SITUATION AT THE YEAR END

8. NON-LINKED ASSETS

8.1 Changes in portfolio

Recent history of asset mix (%)

Type of asset	1995	1996	1997	1998	1999
Land	6.7	6.3	5.7	5.8	**7.1**
Approved fixed interest	26.5	27.3	23.7	23.3	**20.9**
Other fixed interest	8.9	9.2	9.5	11.5	**10.0**
Approved variable yield	2.5	1.2	1.4	0.7	**0.6**
Other variable yield	0.1	0.1	0.1	0.1	**0.1**
Equity shares	49.6	52.1	53.3	50.8	**57.6**
Debts sec'd by mortgages	0.1	0.1	0.0	0.0	**0.0**
Other - producing income	3.5	3.1	5.6	7.0	**3.0**
Other - not producing income	2.1	0.6	0.7	0.7	**0.7**

Source: Form 48

1999 returns

Recent history of asset mix **attributable to UK with-profits business** (%) -
[Taken from the Society's 1999 With-Profits Guide]

Type of asset	1995	1996	1997	1998
Land	8	7	7	7
Fixed interest	28	27	24	24
Equity shares:				
(i) UK shares	41	46	49	46
(ii) non-UK shares	15	14	11	12
(iii) unlisted shares	3	2	3	3
Other investments	5	4	6	8

Movement in asset values during the year

Type of asset	1998		1999		
	£000s	Yield %	**£000s**	**Yield %**	*Mkt yld %*
Land	1,462,406	7.2	**2,051,629**	**6.3**	*6.5*
Approved fixed interest	5,856,252	4.7	**6,040,885**	**5.5**	*5.3*
Other fixed interest	2,889,359	5.5	**2,903,516**	**6.6**	*6.3*
Approved variable yield	178,431	4.3	**180,804**	**4.5**	*2.0*
Other variable yield	18,565	3.6	**18,168**	**4.0**	*5.5*
Equity shares	12,774,363	2.7	**16,656,816**	**1.9**	*2.2*
Debts sec'd by mortgages	9,393	8.4	**8,280**	**6.8**	*6.5*
Other - producing income	1,770,908	6.0	**863,341**	**4.9**	*5.5*
Other - not producing income	165,001	[redacted]	**203,129**	[redacted]	[redacted]
Total	25,124,678	4.0	**28,926,568**	**3.5**	[redacted]

Source: Form 48

8.2 Derivatives

Guidelines in force are fairly tight, and no derivative assets were held at the end of 1999 (other than those matching index-linked liabilities). A liability of £726,000 in currency futures at 31.12.99 is also observed (although this is down from £6,102,000 at 31.12.98).

8.3 Investment performance

	£000s	£000s
1. Total investment income (F 40.12 – F40.23)	1,167,743	
2. *Less* estimated investment income on assets matching property linked liabilities *	78,901	
3. *Less* estimated investment income on non-linked assets matching index-linked liabilities ‡	18,000	
4. Investment income on Form 48 assets		1,070,842
5. Increase in non-linked assets brought into account (F 40.13)	407,156	
6. *Less* increase in non-linked assets matching index-linked liabilities brought into account ‡	63,700	
7. Increase in Form 48 assets brought into account		343,456
8. Investment reserve carried forward (F 14.51.1)	4,436,027	
9. Investment reserve brought forward (F 14.51.2)	2,373,931	
10. Increase in investment reserve		2,062,096
11. Inadmissibles carried forward (F 13.92)	58,413	
12. Inadmissibles brought forward (F 13.92)	0	
13. Increase in inadmissibles		58,413
14. Investment return		3,534,807
15. Opening Form 48 assets	25,124,678	
16. Closing Form 48 assets	28,926,568	
17. Mean fund excluding investment return [=½×(11+12+15+16-14)]		25,287,426
18. Rate of return from investment [= 14/17]		14.0%
19. Expected investment return †		*12.8%*

* calculated as F44.12 / average F55 internal linked col 7 * average F55 total cols (8 - 9)
‡ estimated figures based on Form 56
† based on overall market performance applied to asset mix shown in section 8.1

The achieved rate of return of 14.0% over 1999 is encouraging - exceeding an expected return for the year of 12.8%. This follows achieved returns of 13.8% in 1998 and 19.1% in 1997.

9. ASSETS HELD TO MATCH LINKED LIABILITIES

9.1 Internal linked funds

9.1.1 New and altered funds

The only new fund in 1999 was the Equitable Ethical Annuity Fund, which presumably mirrors the existing Ethical (Life) and Ethical Pension Funds. There was only £31,000 invested in this new fund at 31.12.99.

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9.1.2 Investment performance

In general, investment performance appears to have been good over 1999. The Life Managed Fund was up 18.7%, after growth of 12.5% in 1998, whilst the Pensions Managed Fund was up 22.8%, after 11.6% last time.

The Life Pelican (Equity) Fund was up 15.8% (after 12.2%), with the Pensions Pelican (Equity) Fund up 19.0%, after 13.9% last time.

9.1.3 Fund Management Charges to policyholders

The annual charge levied on the internal linked funds, other than personalised funds, remains at just ½% (believed to be the lowest level in the market, apart from tracker funds).

9.1.4 Principles of unit pricing

Most of the internal funds are invested in units of trusts managed by Equitable Trust Managers. Those trusts operate on a forward pricing basis, with a 4 p.m. valuation point. When expanding an offer price is used, but when contracting the Society might exercise its discretion to move to a full bid basis - although such a change would normally await the emergence of a sustained trend. Creation or cancellation of units by the manager is based on overall liability data and then actioned on the basis of prices established on the previous day.

9.1.5 Liquidity and gearing

At 31.12.99, the aggregate Pension Personalised Funds data showed a negative liquidity percentage of 1.06%, after a negative figure of 0.43% at 31.12.98.

9.2 Other assets matching property-linked liabilities

At end 1999 £67,407,000 (1998: £60,784,000) was held directly in the Pelican Unit Trust, which showed a return of 16.9% over 1999 (11.4% in 1998); and just £150,000 (£146,000 at end 1998) was on deposit with the [redacted].

9.3 Mismatching to property-linked liabilities

No serious mismatching is observed. Only small surpluses of units exist for most funds.

9.4 Assets matching index-linked liabilities

Total RPI linked liabilities of £599,164,000 (£560,390,000 at end 1998) are matched by holdings of £543,410,000 in Government Index Linked Securities and £55,754,000 held in deposits and other short-term assets.

Partial FTSE 100 linked liabilities of £7,297,000 (£5,082,000 at end 1998) are covered by holdings of £444,000 in FTSE call options and £6,853,000 held in deposits and other short-term assets.

9.5 PRE (issues on linked funds)

Where a fund invests in an Equitable Unit Trust, the annual management charge is reduced by ½%, and charges are also adjusted where a fund invests in units of another fund to ensure that only one levy is made.

10. VALUATION BASIS

10.1 Overall strength.

The Society produces its published Return on the basis of a gross premium valuation for non linked business, with some modest allowance for future bonuses, but the resilience reserve included is determined such that the total liability is identical with the results of a net premium valuation - that is shown as an Appendix to the Returns, and is largely the basis on which the strength of the reserves is monitored by GAD.

We have a number of concerns about the reserving bases used by the Society, which are documented in the Executive Summary of this Report (§3 above). These relate to whether the reserves are adequate to provide fully for the flexibility policyholders have to take benefits at a range of ages, the assumptions used by the Society in the resilience scenario, the impact of the '2000' Regulations on the Society's accumulating with profits business (see also §10.1 below), and the reserving for GAO liabilities.

10.2 Accumulating with profits business.

Reserves for this business are substantial, at £14.9 bn. net of reassurance on pensions business, with a further £1.9 bn. on the life side.

A recent press article had suggested that the industry would need to increase reserves on this business by 10% as a result of the introduction of the '2000' Regulations. GAD and the Society believe this article was mis-informed, and attempting inappropriately to extrapolate figures from one large company across the market. (On Equitable's current UWP reserves, an additional 10% would amount to £1.8 bn.)

At a meeting with GAD on 03.11.2000, the Appointed Actuary told us that he does not believe the '2000' Regulations would lead to any material increase in reserves on this business (other than a general increase of the order of £300m. resulting from the more stringent reinvestment assumption). The flexibility offered by the proposed revisions to GN8, e.g. on mass discontinuance, coupled with the Society's inherent facility to apply market / policy value adjusters, e.g. to recover DAC's, are seen as giving them the valuation 'freedom' they need. However, in our letter we have asked him to confirm the position.

Many of the Society's pensions contracts contain a guaranteed rate of accumulation of 3.5%. This business is in general valued at 4% in the NPV, which results in only modest discounting, and valuation reserves of the order of 95% of face value. Benefits are generally assumed to be taken at the earliest of, or close to the bottom of, a range of possible retirement dates (typically ages 55 or 60). We are asking the company to explain why age 55 is assumed for personal pensions business. In the BRV, the allowance for future bonuses is such that the valuation reserves are at, or slightly above, face value. (GAO reserves are held in addition.)

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10.3 Interest

The table below sets out **interest rates used in the net premium valuation** for major classes of non-linked business (figures mainly from Forms 57).

Classes	Valuation Interest Rate		1999 liability Approx. (£m)
	1999	1998	
Life assurances with profit	2.75%	2.75%	329
Pensions with profit - regular premium	3.25%	3.25%	181
Pensions with profit - various	2.50%	2.50%	1,889
ann. In payment with profit (Series I)	4.00%	4.00%	122
ann. In payment with profit (Series II)	2.50%	2.50%	138
Pensions **accumulating** with profit	4.00%	4.00%	12,379
	2.50%	2.50%	784
	0.00%	0.00%	1,736
life **accumulating** with profit	2.25%	2.25%	1,952
Annuities in payment non profit	5.25%	4.50%	137
Pensions annuities	5.75%	5.00%	2,334
TOTAL			**21,981**

In general, valuation interest rates are unchanged from 1998, although in response to the higher yields available from fixed interest securities, annuities have been valued at higher rates than in 1998.

Form 57 shows matching assets to be available. In the case of accumulating with profits business, however, a significant proportion of the backing assets are equities, and this contributes to our concern regarding whether the reserves are adequate to provide fully for the flexibility policyholders have to take benefits at a range of ages, as raised in our letter to the Society.

10.4 Mortality

The bases used for assurances appear reasonably conservative, being largely based on AM80 and AF80 with varying adjustments for some classes of business - particularly taking account of the market sector in which the Society operates.

Life Annuities have been valued using the IM80 and IF80 (C=2010) tables, unchanged since 1996. This appears a rather weak basis, although the Appointed Actuary states in his report that the mortality tables contain sufficient allowance for *future* reductions in rates of mortality. However the liabilities for this class are fairly minor, and so the point will not be pursued with the Society at this time.

Pensions annuities are reserved for using PMA/PFA 80 (C=2010) ult - 3 (in 1998 an age rating of - 2 was used). This looks satisfactory.

The mortality assumptions used to value the GAO's also look satisfactory, and incorporate additional allowance for mortality improvement before vesting.

10.5 Morbidity

Not material – permanent health business is written in Permanent Insurance.

10.6 Expenses

The aggregate expense allowance for the next twelve months, as revealed in paragraph 10(2) of the 1998 net premium valuation report, is £74m. (after £69m. at 31.12.98). This compares with actual F41 maintenance expenses of £35.8m in 1999 and £12.9m of "other expenses" reported. The total of provisions made would thus seem to be more than adequate.

The Actuary contends that no additional provisions are needed to cover the continued sale of new business or to cover closure. In reaching this conclusion he takes into account the results of internal management projections, the assumed future cash flows and assumed aggregate new business / closure costs. He also has regard to the level of the expense reserves already set up (see above). We see no reason to question his conclusions.

10.7 Mismatching & resilience

A resilience reserve requirement under the net premium valuation method is reported as £2,142m. in 1999 (£1,236m in 1998). For the gross premium bonus reserve (GPBR) valuation a resilience reserve in 1999 is shown of £1,350m (£600m. in 1998). **The modified resilience reserve figures shown in the published GPBR valuation are designed to ensure that the amount of free assets disclosed is the same as would be shown by the Net Premium Valuation!**

It may be noted that the most adverse scenario at the end of 1999 involved a 3% rise in fixed interest yields with a 25% fall in equity values, whereas at end 1998 it had been the combination of. a reduction of 10% in fixed interest yields combined with a 25% fall in equity values.

We presume that the GPBR resilience reserve is included in the Actuary's Certificate provision, and thus in the entry at Form 14, line 63 (£1,500m. at 31.12.99.)

In the Society's recent (post House of Lords judgement) demonstrations to FSA of their solvency position, they have continued to use the old Resilience Test 2, which they find less severe than its replacement (under which the yield curve 'flips' to the traditional rising curve, to the 15 year point). They are considering whether to justify formally the continued use of this (which may give rise to some adverse comment), or whether to seek a Section 68 Order to enable them to adopt a 'synthetic bond' concept (under which the valuation yield on the fixed interest assets would reflect both the amounts and durations of stocks held). A number of other insurers already do this. However, were they to do so, we would expect them to adopt a common approach in both the base and resilience scenarios, and to be consistent in approach as between one valuation and the next (i.e. not 'picking and choosing' according to which method was the more

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favourable at the time). We have asked in our letter for an update from the Society on this topic.

The Society also, in the resilience scenario, effectively takes credit for an additional ½% p.a. on the investment return. This appears to be justified as a 'Zillmer' adjustment to enable the Society to recoup unrelieved acquisition expenses. We are questioning this practice also.

10.8 Other factors

For UK and Guernsey linked business, it was assumed at the end of 1999 that both unit prices and "FTSE 100" linked benefits would grow at 6.0% gross p.a. (5.0% net) before charges and that expenses would inflate at 4.0% p.a., while cash flows were discounted at an interest rate of 4.5% gross (3.5% net). [For Irish business, all these assumed rates were reduced by 0.75%.]

A pensions mis-selling reserve of £132m. is included in Form 52 (£70m at end 1998).

The CGT reserve, of £100m at end 1998, increased to £150m. at end 1999; this reduces to £53m. in the most onerous resilience scenario. [Also reported at Form 14.63.]

10.9 Options and guarantees

As described in the Executive Summary (§3 of this Report), the Society's treatment of guaranteed annuity options on pensions contracts has come to the fore in recent months. The contracts with these options are UK retirement annuities, AVCs and individual pensions contracts sold up to 1988, where the option exists to purchase an annuity on minimum guaranteed rates at retirement at any age between 60 and 75 (for retirement annuities) and between 50 and 75 for personal pensions. The form of the annuity is restricted, e.g. for retirement annuities to a single life, level non-profit annuity with no guaranteed period paid quarterly in advance. The minimum guaranteed rates are largely based on a(55) ult mortality and 7% interest.

Paragraph 6.(1) (h) of the 1999 Returns describes the approach taken by the Society in reserving for these guarantees. In the ***1998*** Returns, the Society disclosed the proportion of benefits assumed to be taken in guaranteed form under these contracts - these amounts ranged from 70% (on UK retirement annuities) to 82.5% on the other lines of business. As explained by [redacted] to GAD in his letter of 25 June 1999 (following our questioning after the 1998 scrutiny), these percentages are the result of allowing for the bonus systems operated by the Society, the flexibility of alternative forms of benefit and the availability of cash commutation options (which can be especially attractive to higher rate tax payers). These percentages are not repeated in the ***1999*** Returns, but the ***1999*** Returns state that 'the combined effect of the allowances made is that of those policies which survive to retirement date the gross reserves are reduced by less than 5%'.

The Appointed Actuary has advised us separately that the underlying assumption in the 1999 valuation was that 85% of benefits were taken in GAO form. This is weaker than the guidance included in DAA13, and so ***this aspect has been raised with him in our letter (attached).***

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The Society has had a reassurance treaty with Irish European which provides protection to the Society should more than 25% of the benefits in any calendar year on the contracts which incorporate guaranteed annuity options be taken in guaranteed form. Following the House of Lords judgement in July 2000, this treaty became void, as it was contingent upon the Society maintaining its pre-judgement practice of reducing the terminal bonus entitlement of policyholders who exercised the GAO. However, a subsequent treaty with the same reassurer has since been negotiated, providing protection to the Society should more than 60% (instead of 25%) of benefits be taken in guaranteed form.

The treaty as it stood at 31.12.99 (and at 31.12.98) provided these reassurance offsets :

GAO liability :	1999 valuation		1998 valuation	
	NPV	BRV	NPV	BRV
Gross liability	£1,630m.	£1,663m.	£1,556m.	£1,593m.
Reassurance Offset	£1,079m.	£1,098m.	£793m.	£809m.
Net liability	£551m.	£565m.	£763m.	£784m.

The Reassurance offset at 12.99 was relatively greater than at 12.98 because of the inclusion in 1999 of Group Pensions business in the treaty (see §13.2 following). There still remain some categories of business excluded from the treaty.

About 3/4 of the GAO reserves relate to benefits already secured; the remaining 1/4 is in respect of benefits to be bought by future premiums. Given the uncertainty over future levels of premiums on recurrent SP contracts, the Society assume that current premium trends continue. However, the Actuary appears to have assumed that premiums reduce by 20% p.a. in assessing this reserve, which does not appear to be prudent. The Actuary has told us that in the worst case scenario (itself limited by premium maxima driven by net relevant earnings and associated Inland Revenue constraints), the GAO reserve in respect of future premiums would approximately double. ***We have asked in our letter for more details about the 'future premiums' part of the GAO reserve.***

The cost of the proposed rectification scheme, offering compensation to policyholders who have retired since 1994, could be up to £200m.

About 44% of currently retiring policyholders are exercising the GAR - restrictions on the mode of payment etc. (see above) act as a disincentive. The Society are introducing a '1/2 way house' to complement the GAO with a reversionary spouse's annuity on current rates to provide a JLLS annuity.

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11. FINANCIAL RESULTS

11.1 Overview

At first sight the solvency position at 31.12.99 looks reasonable - available assets of £3,861m. cover the rmm. of £1,114m. by a factor of 3.46. However, these available assets include the implicit item for future profits of £925m., disregard the liability to repay £346m. of subordinated loan, and benefit from the GAO reassurance offset of £1,079m. (in the NPV). Without these items, the available assets would be just £1,511m., and the cover 1.36x : a less satisfactory picture for this large fund.

At the meeting at GAD on 03.11.2000, [redacted] confirmed that the aggregate asset shares are close to the value of the fund (i.e. there is no 'estate'). The £1.5 bn. 'saved' from the cut in roll-up rates on UWP business since the HoL judgement has been re-allocated to finance future GAO support and the likely costs of the rectification scheme.

This situation arises because the Equitable has traditionally operated with an underlying philosophy of providing fair benefits to each generation of its policyholders, on maturity or surrender - without holding back any excessive estate. The result is that lower free asset margins exist than might have been expected for such an institution.

A sensitivity matrix supplied by the Society to FSA on 09.10.2000 shows the Society would be unable to cover its rmm. if the FTSE-100 Index fell to around 5750 (a fall of 15% from end-August levels), though they are not particularly sensitive to movements in fixed interest yields. At the meeting at GAD on 03.11.2000 [redacted] explained that the Society had little alternative other than to arrange a sale and demutualisation if they are to remain open to new business.

11.2 Summary of results for main classes

11.2.1 Liabilities for non-linked business

Class	Published Bonus Reserve Gross Premium Valuation 1995 £000s	1996 £000s	1997 £000s	1998 £000s	1999 £000s	NPV 1999 £000s
Life and general annuity: - accumulating with-profit	0	1,149,366	1,382,703	1,675,340	**2,075,683**	**1,944,388**
- other with profit	1,360,150	409,655	421,630	435,489	**423,984**	**411,040**
- non-profit	169,935	158,831	186,513	200,954	**190,098**	**207,485**
Pensions: - accumulating with profit	0	9,900,538	12,320,623	14,398,745	**15,224,684**	**14,899,234**
- other with-profit	9,646,509	1,576,576	1,862,135	2,324,320	**2,611,641**	**2,332,549**
- non-profit	1,835,318	1,658,705	1,958,592	2,502,860	**2,534,486**	**2,545,903**
Permanent health	0	0	0	0	**0**	**0**
Additional reserves	0	0	0	0	**0**	**0**
Rep. of Ireland (all classes)	109,558	152,822	177,443	274,710	**302,940**	**287,666**
Other overseas (all classes)	11,917	145,195	248,434	340,591	**454,950**	**429,060**
Total non-linked liability	13,133,387	15,151,688	18,558,073	22,153,009	**23,818,464**	**23,057,323**

Source: Forms 51 & 52

11.2.2 Liabilities for linked business

Class	1995 £000s	1996 £000s	1997 £000s	1998 £000s	1999 £000s
Life and general annuity: - property-linked	136,880	145,096	169,154	200,319	**291,321**
- index-linked	0	9,301	10,441	14,512	**16,245**
Pensions: - property-linked	1,224,477	1,443,311	1,833,853	2,293,943	**3,185,486**
- index-linked	0	290,753	381,520	555,158	**594,211**
Overseas (all classes)	3,083	28,357	38,953	57,805	**105,391**
Total linked liability	1,364,440	1,916,818	2,433,921	3,121,737	**4,192,654**

Source: Forms 53 & 54

11.3 Valuation summary for Gross Premium Valuation

		1995 £000s	1996 £000s	1997 £000s	1998 £000s	**1999 £000s**
1	Non-linked liability	13,133,387	15,151,688	18,558,073	22,153,007	**23,818,465**
2	Linked liability	1,364,440	1,916,818	2,433,921	3,121,737	**4,192,654**
3	Bonus reserves	417,361	503,622	508,098	363,379	**422,636**
4	Total math. reserves	14,915,189	17,572,128	21,500,092	25,638,123	**28,433,755**
5	Additional reserves	0	0	400,000	700,000	**1,500,000**
6	Other liabilities	153,979	138,980	176,198	225,986	**241,122**
7	Total long-term liabilities	15,069,168	17,711,108	22,076,289	26,564,110	**30,174,876**
8	Total long-term assets	16,502,548	19,131,286	23,827,839	28,238,041	**33,110,903**
9	Excess of LT assets over LT liabilities (8-7)	1,433,380	1,420,178	1,751,550	1,673,931	**2,936,027**
10	Shareholders' assets allocated to RMM	0	0	0	0	**0**
11	Assets available	1,433,380	1,420,178	1,751,550	1,673,931	**2,936,027**
12	Implicit items	263,731	312,794	371,083	850,000	**925,000**
13	Total amount available	1,697,111	1,732,972	2,122,633	2,523,931	**3,861,027**
14	RMM	586,275	685,282	845,457	1,007,534	**1,114,310**
15	Cover (13/14)	2.89	2.53	2.51	2.51	**3.46**
16	Free asset ratio ((11-14)/8)	5.13%	3.84%	3.80%	2.36%	**5.50%**

NOTE. Although the Net Premium Valuation showed a lower non-linked liability of £23,057m. (£761m. less than in the BRV) and a lower reserve for declared bonuses of £392m. (£31m. less than in the BRV), it was shown to require a resilience reserve £792m higher than the GBPR valuation. Thus, as intended, the total of Long Term liabilities (shown in Line 7) for the NPV is identical with the result shown above.

11.4 Composition and distribution of surplus

£000s	1995	1996	1997	1998	1999
Surplus brought forward	0	0	0	0	**0**
Surplus emerging in year	662,848	802,539	895,553	838,365	**931,271**
Total available	662,848	802,539	895,553	838,365	**931,271**
Allocated to policyholders	662,848	802,539	895,553	838,365	**931,271**
Surplus carried forward	0	0	0	0	**0**
% of distributed surplus allocated to policyholders	100.0%	100.0%	100.0%	100.0%	**100.0%**

Investment reserves (F14.51)	1,433,380	1,420,178	2,151,550	2,373,931	**4,436,027**
Addl math. Reserves (F14.63)	0	0	400,000	700,000	**1,500,000**
Net investment reserves	1,433,380	1,420,178	1,751,550	1,673,931	**2,936,027**

Source: Form 58

12. BONUSES

12.1 Cost of bonuses declared

£000s	1995	1996	1997	1998	1999
Bonus payments made in anticipation of a surplus	245,486	298,917	387,455	474,987	**508,635**
Reversionary bonuses	417,361	503,622	508,098	363,379	**422,636**
Other bonuses	0	0	0	0	**0**
Total	662,848	802,539	895,553	838,366	**931,271**

Source: Form58

12.2 Recent history of key bonus rates

	1998				**1999**			
Bonuses on UK style policies	Reversionary ‰		Final (total return)%		**Reversionary ‰**		**Final (total return)%**	
	On SA.	On Bonus	At 31.12.	Interim	**On SA.**	**On Bonus**	**At 31.12.**	**Interim**
Endowment Ass.	22.50	10.00	Varies	Varies	**22.50**	**10.00**	**Varies**	**Varies**
Unitised Life	35.00	35.00	8.50	7.75	**35.00**	**35.00**	**10.25**	**7.75**
Deferred Annuity	22.50	22.50	Varies	Varies	**22.50**	**22.50**	**Varies**	**Varies**
Recur. SP D. Ann	15.00	15.00	10.0	9.0	**15.00**	**15.00**	**12.0**	**9.0**
pre 7.96 annuity	15.00	15.00	10.0	9.0	**15.00**	**15.00**	**12.0**	**9.0**
post 6.96 annuity	50.00	50.00	10.0	9.0	**50.00**	**50.00**	**12.0**	**9.0**
pre 7.96 pension	15.00	15.00	10.0	9.0	**15.00**	**15.00**	**12.0**	**9.0**
post 6.96 pension	50.00	50.00	10.0	9.0	**50.00**	**50.00**	**12.0**	**9.0**
Gnsy Overseas £	50.00	50.00	10.0	9.0	**50.00**	**50.00**	**12.0**	**9.0**
Gnsy Overseas $	37.50	37.50	9.0	9.0	**37.50**	**37.50**	**10.5**	**9.0**
R. o I. Life	32.50	32.50	10.5	10.5	**32.50**	**32.50**	**11.0**	**10.75**
RoI pre 7.96 Ann	15.00	15.00	13.0	13.0	**15.00**	**15.00**	**13.5**	**13.0**
RoI post 6.96 An.	50.00	50.00	13.0	13.0	**50.00**	**50.00**	**13.5**	**13.0**
German Life	37.50	37.50	11.0	9.0	**37.50**	**37.50**	**13.0**	**10.0**
German Annuity	37.50	37.50	11.0	9.0	**37.50**	**37.50**	**13.0**	**10.0**

Source: Schedule 4, Paragraph 15

The Whole Life bonus at end 1999 was £25.00‰ + £1.50‰ × (years in force over 11). [unchanged from 1998.]

There are also a small number of policies with revalorization style German bonuses.

The method of annual bonus declarations for unitised type contracts is unusual. As well as a declared guaranteed annual bonus, based on a proportion of accrued income and

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capital appreciation, a further annual bonus is quoted, which is not guaranteed (in that it may be withdrawn and/or reduced in future), but which makes up the total quoted accrued policy value at the valuation date. This non-guaranteed final bonus is declared in a similar way to reversionary bonuses, as a percentage of benefit, and the amount payable at maturity is the sum of these total annual "declarations", *subject to the proviso that the final non-guaranteed bonus can be withdrawn.*

The Society's With-Profits Guide includes a table of gross investment returns achieved on the funds of the Society at market value in recent years (from 1993 - as attributable to with-profits business), quoting the smoothed rate that was applied in allocating bonuses for policyholders in each year and the "guaranteed rate", being the rate at which guaranteed benefits were built up in each year -

	1995	1996	1997	1998	**1999**
Earned	16.6%	10.7%	17.2%	13.3%	***16.0%****
Allocated	10.0%	10.0%	13.0%	10.0%	***12.0%****
Guaranteed	7.5%	7.5%	6.5%	5.0%	***5.0%****

* *taken from their 1999 Annual Report.*

Final bonuses for traditional life contracts are according to a table based on duration in force. Specimen values as a % of SA and existing declared Bonus are:

Complete Years In Force	1996	1997	1998	1999	**2000**
1	6.0	6.0	9.0	7.0	**8.0**
2	8.0	8.0	11.0	11.0	**11.0**
3	10.0	10.0	13.0	14.0	**14.0**
4	12.5	12,0	15.0	16.0	**18.0**
5	15.0	14.0	17.0	18.0	**21.0**
10	30.5	27.0	30.0	31.0	**34.0**
15	66.5	57.5	54.0	51.0	**51.0**
20	99.0	96.0	98.0	97.0	**97.0**
25	118.5	122.5	128.0	132.0	**137.0**
30	125.0	130.0	140.0	150.0	**162.0**
35>	125.0	130.0	140.0	155.0	**170.0**

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Final bonuses for deferred annuities are derived from a similar table.

Specimen values as a % of SA and existing declared Bonus are:

Complete Years In Force	1996	1997	1998	1999	**2000**
1	7.5	7.5	11.0	8.0	**9.0**
2	10.0	10.0	13.0	13.0	**13.0**
3	12.5	12.5	15.0	17.0	**18.0**
4	15.0	15.0	17.0	20.0	**22.0**
5	16.5	16.5	20.0	22.0	**25.0**
10	26.0	24.0	28.0	30.0	**36.0**
15	58.5	50.0	48.0	44.0	**46.0**
20	90.5	88.0	90.0	89.0	**90.0**
25	108.0	110.0	116.0	121.0	**126.0**
30	117.5	120.0	130.0	139.0	**149.0**
35>	117.5	120.0	130.0	145.0	**157.0**

12.3 PRE (issues on with-profit business)

The Society tries very hard to achieve an equitable distribution to each generation of its policyholders, whilst avoiding short term fluctuations in benefits - with the result that it has not accumulated any material unallocated estate compared with accumulated asset shares (if any).

However, it reserves the right to penalise early surrenders, even in relation to guaranteed bonuses added under unitised contracts, and it might be desirable for this possibility to receive greater prominence in the literature distributed. Further, with such a large proportion of unitised business and with the level of guaranteed bonuses declared taking account of some asset appreciation, it would seem to be desirable that policyholders were given some greater warning about the possible implications for future bonuses of a substantial market setback.

As previously described, the recent Court Case revolved around the Society's approach of reducing terminal bonuses to meet the costs of guaranteed annuity options attaching to some of the pension contracts. In current conditions, this has been negating the value of the guarantee, although in times of low terminal bonus scales (when the value of the terminal bonus is less than the value of the GAO) the policyholders with GAO's would benefit from the GAO 'underpin'. Unfortunately for the Society, the House of Lords ruled conclusively against their practice, with the consequences as set out in §3 of this Report above.

Also as noted in §3, accumulating with profits pensions policyholders have foregone 7 months bonus this year on their business following the House of Lords judgement. Whether this will be reinstated depends largely on the Society being successful in finding the 'right' purchaser.

12.4 Recent history of maturity payouts

£	1995	1996	1997	1998	1999
25 yr endowment	86,739	84,025	86,355	84,418	**84,047**
Industry average	*93,867*	*95,559*	*101,217*	*102,893*	*101,491*
10 yr endowment	10,211	9,879	9,926	9,681	**9,612**
Industry average	*9,947*	*9,813*	*9,970*	*9,971*	*9,860*
15 yr pension	126,785	114,126	104,626	98,303	**92,691**
Industry average	*122,328*	*116,309*	*107,947*	*104,937*	*98,722*
10yr SV on 25 yr endowment	9,073	8,427	8,191	8,057	**7,641**
Industry average	*7,638*	*7,446*	*7,439*	*7,315*	*7,375*

Note: Endowments: £50p.m., maturing 1 Feb. in next year Source: Money Management 4/2000
Pensions: £200p.m., maturing 1 Jan. in next year Source: Money Management 3/2000.

It is clear that, while Equitable strives to be fair to all its policyholders, and pays more generous surrender values than most other offices, its maturity payouts fall well short of the best in the market, particularly for conventional life contracts.

13. REASSURANCE AND FINANCING

13.1 Overview of reassurance treaties

Little use is made of traditional reassurance by Equitable, other than for very large sums assured (retention being £400,000 for UK life risks and DM250,000 for German risks), and for supplementary disability and accident risks.

Major Medical Cash Plans and Critical Illness Plans are fully reassured, on a 50% quota share basis to two reassurers: [redacted] and [redacted], with the former taking all Critical Illness risks in excess of £100,000.

Reassurance premiums paid in 1999 were about £3.4m (£3.3m.in 1998).

13.2 Financing arrangements

A treaty was set up on 31 December 1998 with Irish European Reinsurance Company Limited, which provides surplus cover for the costs arising from the exercise of guaranteed annuity options in respect of Retirement Annuity policies, Individual Pension Plans and Transfer Plans issued before 1 July 1988. If the proportion of retirement terminations where the option is exercised in any year exceeds 25% of the total, measured by the guaranteed funds for those policies, the reinsurer's gross liability is equal to the value of the guaranteed annuity in excess of the guaranteed policy fund for that proportion of retirements effecting the option which is in excess of 25%.

The scope of the treaty was extended in 1999 to include group pensions business effected before 01 July 1988.

Total premiums paid in 1999 were £875,000. This comprises the second instalment of £250,000 (which was due on 01 April 1999) of the £400,000 deposit premium for 1998/99, plus the first instalment of £625,000 (due on 31 December 1999) of the £700,000 deposit premium for 1999/2000. The higher premium for the second year reflects the now wider scope of the treaty.

As mentioned in Section 10.8 above, this treaty was renegotiated following the House of Lords judgement in July 2000, and provides protection to the Society should more than 60% (instead of 25%) of benefits be taken in guaranteed form.

This treaty enables the Actuary to make a substantial offset to his guaranteed annuity option additional reserves as shown in Section 10.8 above.

OTHER ISSUES

14. COMPLIANCE

14.1 IFSD compliance problems

None observed.

14.2 PIA and other compliance problems

We understand that PIA have been in correspondence with the Society over mis-selling of income drawdown schemes, and that enforcement action is under consideration.

A pensions mis-selling reserve of £132m. is included in Form 52 (after £70m at end 1998).

15. PROFESSIONAL REQUIREMENTS

This report conforms fully to the requirements of the Faculty and Institute of Actuaries as set out in their Professional Conduct Standards.

This report has been prepared under the terms of the Agreement between Insurance Directorate, Her Majesty's Treasury (HMT) and the Government Actuary's Department (GAD) dated November 1998 ("the service agreement"), as continued between the Financial Services Authority (FSA) and GAD under an exchange of letters in December 1998, setting out the level of service to be provided by GAD in respect of the supervision of companies authorised, or seeking authorisation, under the Insurance Companies Act 1982 to carry on long term business.

The purpose of this report is to enable FSA to fulfil its responsibilities under the Third Life Directive and the Insurance Companies Act 1982.

The scope of this report is:

- to advise on the statutory solvency position of the company;
- to identify any issues relevant to the responsibilities of FSA;
- to describe the development of the company over the previous 12 months;
- to provide historical background to the company.

GAD's detailed scrutiny reports in respect of Equitable's returns

1999 returns

This report is limited to a minor degree because certain questions need to be put to the company. Under the service agreement, GAD has written to the company directly on these. A copy of our letter is included in the Appendix to this report.

The advice and information contained in this report are solely for the use of FSA in fulfilling its responsibilities and should not be transmitted to third parties, including the company concerned, without the prior consent of GAD.

[redacted]

Government Actuary's Department
24 November 2000

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1989 returns

FORM A1 (6/89) INITIAL SCRUTINY - KEY CHECKS

1. Company The Equitable Life Assurance Society......

2. Valuation Date .....31.12.89........

COMPLETENESS OF RETURNS

3. Have the appropriate returns been submitted? YES/~~NO~~ (~~UK~~/GLOBAL/~~COMMUNITY~~)

4. Do all the forms appear to be present? YES/~~NO~~

CERTIFICATES

5. Has the directors' certificate been supplied in the format of Schedule 6 Part I, without any omissions or qualifications? YES/~~NO~~ *

6. Has the actuary's certificate been supplied in the format of Schedule 6 Part II? (Ignore any references to Form 14.) YES/~~NO~~ *

7. Has the auditors' report been supplied in the format of Schedule 6 Part III without any omissions or qualifications? YES/~~NO~~ *

8. * If NO, give details ....

....

....

SOLVENCY

9. What is the cover for the required minimum margin? (F9.34 divided by F9.41) ....4.77......

10. Is F9.43 either positive or zero? YES/~~NO~~

11. Is F58.10 either positive or zero? YES/~~NO~~

12. Is F58.15 either positive or zero? YES/~~NO~~

13. Is F.58.14 zero? YES/~~NO~~

14. Are F9.31, F9.32 and F9.33 all zero? YES/~~NO~~

D06ABM

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1989 returns

OTHER CHECKS

15.	Does F9.21 equal F10.11?	YES/~~NO~~
16.	Non-composites only. Does F9.22 equal F10.29?	YES/~~NO/NA~~
17.	Composites only. Does F9.22 equal F9.52?	~~YES/NO~~/NA
18.	Does F9.23 equal F14.11 plus F14.15 plus F14 note 3 reserves?	YES/~~NO~~
19.	Does F9.24 equal the sum of F14.21 to F14.47 plus F14 note 2 cash bonuses?	YES/~~NO~~
20.	Does F10.11 equal F13.93*?	YES/~~NO~~
21.	Does F10.12 equal F14.59?	YES/~~NO~~
22.	Does F10.11 equal F10.12?	YES/~~NO~~
23.	Does F13.85* equal F49.12?	YES/~~NO/NA~~
24.	Does F13.86* equal F47.4?	~~YES~~/NO/~~NA~~ Equals F47 + F4
25.	Does F14.11 equal F58.9 + F58.19 + F58.20 + F58.21?	YES/~~NO/NA~~
26.	Does F14.15 equal F58.9 + F58.19 + F58.20 + F58.21?	~~YES/NO~~/NA
27.	Does F14.12 equal F58.18 + F58.25?	YES/~~NO/NA~~
28.	Does F14.16 equal F58.18 + F58.25?	~~YES/NO~~/NA
29.	Are F14.13, F40.16 and F58.1 all equal?	YES/~~NO/NA~~
30.	Are F14.17, F40.16 and F58.1 all equal?	~~YES/NO~~/NA
31.	Does F16.11 equal F40.12?	YES/~~NO~~
32.	Does F40.12 correspond to either F58.3 or F58.12?	YES/~~NO~~
33.	Is F14.51 either zero or positive?	YES/~~NO~~
34.	Is F58.25 either zero or positive?	YES/~~NO~~
35.	If F58.25 is negative, is F16.24 zero?	~~YES/NO~~/NA
36.	Is the actuary's report in Schedule 4 stated to be in accordance with Regulation 54?	YES/~~NO~~
37.	100 times (F14.41 + F14.42) divided by F14.59.	0.027..

* total long term fund

INITIALS : [redacted].... DATE: 6.7.90................

D06ABM A1 (6/89)

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1989 returns

FOR A2 (6/90) INITIAL SCRUTINY - KEY CHECKS (ACTUARY)

1. Company ....The Equitable Life Assurance Society Ltd....

2. Valuation Date ....31.XII.89....

3. Do the interest rates used look supportable in terms of Regulation 59
   - for with profit business? YES/~~NO~~/~~NA~~
   - for non-profit business? YES/~~NO~~/~~NA~~

4. Is there an AIDS reserve on basis R or stronger? YES/~~NO~~/~~NA~~

   If not, what basis has been used? ....

   ....

   Do the mortality rates otherwise look reasonable? YES/~~NO~~/~~NA~~

5. Do the maturity guarantee reserves look reasonable? YES/NO/NA

6. Do the unit linked contract parameters look reasonable? YES/~~NO~~/~~NA~~

7. Have separate Forms 55 to 58 been supplied for sub-funds? ~~YES~~/~~NO~~/NA

8. If there is an entry in Form 58.23
   - are the S.29 requirements met? ~~YES/NO~~/NA
   - are the S.30 requirements met? ~~YES/NO~~/NA

9. Has a (ii) of the actuary's certificate been properly completed, in the light of Schedule 4, 5(1) (a) and (e) and 5(2) (a) and of any F14 footnote 3? YES/~~NO~~

10. Are the results of the 3%/25% resilience test set out? YES/~~NO~~/~~NA~~

11. What proportion of the major classes is reassured? (see Form 60 rows 1 to 3) 10% or less/ ~~over 10%~~

12. Is all reassurance with UK authorised companies? YES/~~NO~~/~~NA~~

    If not, are reassurances for non authorised companies on a deposit back basis? YES/NO/NA

13. If the A1 Q14 answer is NO, is there a relevant S68 order? ~~YES/NO~~/NA

D06ABM

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1989 returns

14. Actuary's comments on Form A1 answers, particularly where answer is "NO" :

15. Aspects which look worrying :

16. Other notes :

Drop in F.45 yield.

17. Items to be notified to DTI, to be taken up immediately with the company :

18. Priority rating : Previous ......5...... New ...5.........

INITIALS .. [redacted] DATE ....10-7-90..........

D06ABM A2 (6/90)

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1990 returns

Form A1 (6/91) **INITIAL SCRUTINY - KEY CHECKS**

1. Company THE EQUITABLE LIFE ASSURANCE SOCIETY

2. Valuation Date 31-12-90

COMPLETENESS OF RETURNS

3. Have the appropriate returns been submitted? YES/~~NO~~
(~~UK~~/GLOBAL/~~COMMUNITY~~)

4. Do all the forms appear to be present? YES/~~NO~~

CERTIFICATES

5. Has the directors' certificate been supplied in the format of Schedule 6 Part I, without any omissions or qualifications? YES/~~NO~~ *

   Has new paragraph 6(e) been included? YES/~~NO~~ *

6. Has the actuary's certificate been supplied in the format of Schedule 6 Part II? (Ignore any references to Form 14.) YES/~~NO~~ *

7. Has the auditor's report been supplied in the format of Schedule 6 Part III without any omissions or qualifications? YES/~~NO~~ *

8. * If NO, give details ....

   ....

   ....

SOLVENCY

9. What is the cover for the required minimum margin? (F9.34 divided by F9.41) 1.77

10. Is F9.43 either positive or zero? YES/~~NO~~

11. Is F58.10 either positive or zero? YES/~~NO~~

12. Is F58.15 either positive or zero? YES/~~NO~~

13. Is F.58.14 zero? YES/~~NO~~

14. Are F9.31, F9.32 and F9.33 all zero? YES/~~NO~~

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1990 returns

OTHER CHECKS

15.	Does F9.21 equal F10.11?	YES/~~NO~~
16.	Non-composites only. Does F9.22 equal F10.29?	YES/~~NO~~/~~NA~~
17.	Composites only. Does F9.22 equal F9.52?	~~YES~~/~~NO~~/NA
18.	Does F9.23 equal F14.11 plus F14.15 plus F14 note 3 reserves?	YES/~~NO~~
19.	Does F9.24 equal the sum of F14.21 to F14.47 plus F14 note 2 cash bonuses?	YES/~~NO~~
20.	Does F10.11 equal F13.93*?	YES/~~NO~~
21.	Does F10.12 equal F14.59?	YES/~~NO~~
22.	Does F10.11 eqaul F10.12?	YES/~~NO~~
23.	Does F13.85* equal F49.12?	YES/~~NO~~/~~NA~~
24.	Does F13.86* equal F47.4?	~~YES~~/NO/~~NA~~
25.	Does F14.11 equal O.B. F58.9 + F58.19 +F58.20 +F58.21?	YES/~~NO~~/~~NA~~
26.	Does F14.15 equal I.B. F58.9 + F58.19 +F58.20+F58.21?	~~YES~~/~~NO~~/NA
27.	Does F14.12 equal O.B. F58.18 + F58.25?	YES/~~NO~~/~~NA~~
28.	Does F14.16 equal I.B. F58.18 + F58.25?	~~YES~~/~~NO~~/NA
29.	Are F14.13, O.B. F40.16 and F58.1 all equal?	YES/~~NO~~/~~NA~~
30.	Are F14.17, I.B. F40.16 and F58.1 all equal?	~~YES~~/~~NO~~/NA
31.	Does F16.11 equal F40.12?	YES/~~NO~~
32.	Does F40.12 correspond to either F58.3 or F58.12?	YES/~~NO~~
33.	Is F14.51 either zero or positive?	YES/~~NO~~
34.	Is F58.25 either zero or positive?	YES/~~NO~~
35.	If F58.25 is negative, is F16.24 zero?	~~YES~~/~~NO~~/NA
36.	Is the actuary's report in Schedule 4 stated to be in accordance with Regulation 54?	YES/~~NO~~
37.	100 times (F14.41 + F14.42) divided by F14.59= ...0.50...	

*total long term fund

INITIALS : [redacted]... DATE: 24-7-91........

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1990 returns

Form A2 (6/91)   INITIAL SCRUTINY - KEY CHECKS (ACTUARY)

1. Company............Equitable Life........................

2. Valuation Date   31.xii.90 ....

3. Do the interest rates used look supportable in terms of Regulation 59
   - for with profit business? YES/~~NO/NA~~
   - for non-profit business? YES/~~NO/NA~~

4. Is there an AIDS reserve on basis R or stronger? YES/~~NO/NA~~

   Do the mortality rates otherwise look reasonable? YES/~~NO/NA~~

5. Do the unit linked contract parameters look reasonable? YES/~~NO/NA~~

   Have unit costs been updated from last year? YES/~~NO/NA~~

6. If there is an entry in Form 58.23
   - are the S.29 requirements met? ~~YES~~/~~NO~~/NA
   - are the S.30 requirements met? ~~YES~~/~~NO~~/NA

7. Has a (ii) of the actuary's certificate been properly completed, in the light of Schedule 4, 5(1) (a) and (e) and 5(2) (a) and of any F14 footnote 3? YES/~~NO~~

8. Are the results of the 3%/25% resilience test set out? YES/~~NO/NA~~

9. What proportion of the major classes is reassured? (see Form 60 rows 1 to 3) 10% or less/ ~~over 10%~~

10. Is all reassurance with UK authorised companies? YES/~~NO/NA~~

    If not, are reassurances for non authorised companies on a deposit back basis? ~~YES/NO~~/NA

11. If the A1 Q14 answer is NO, (ie there are implicit items) is there a relevant S68 order? ~~YES/NO~~/NA

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1990 returns

12. Actuary's comments on Form A1 answers, particularly where answer is "NO":

13. Aspects which look worrying:

14. Other notes:

① Deteriorating cover for the RMM.

② Loss of working capital for future expansion

15. Items to be notified to DTI, to be taken up immediately with the company:

16. Priority rating:
2 years ago.....5.....last year.....5.....New.....3.....

INITIALS....[redacted] DATE....29-7-91........

C:\0691-001

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1991 returns

Form A1 (6/91) **INITIAL SCRUTINY - KEY CHECKS**

1. Company....THE...EQUITABLE..LIFE..ASS...SOCIETY

2. Valuation Date ..31/12/91...

COMPLETENESS OF RETURNS

3. Have the appropriate returns been submitted? YES/~~NO~~
(~~UK~~/GLOBAL/~~COMMUNITY~~)

4. Do all the forms appear to be present? YES/~~NO~~

CERTIFICATES

5. Has the directors' certificate been supplied in the format of Schedule 6 Part I, without any omissions or qualifications? YES/~~NO~~ *

   Has new paragraph 6(e) been included? YES/~~NO~~ *

6. Has the actuary's certificate been supplied in the format of Schedule 6 Part II? (Ignore any references to Form 14.) YES/~~NO~~ *

7. Has the auditor's report been supplied in the format of Schedule 6 Part III without any omissions or qualifications? YES/~~NO~~ *

8. * If NO, give details ....

   ....

   ....

SOLVENCY

9. What is the cover for the required minimum margin? (F9.34 divided by F9.41) 1.667

10. Is F9.43 either positive or zero? YES/~~NO~~

11. Is F58.10 either positive or zero? YES/~~NO~~

12. Is F58.15 either positive or zero? YES/~~NO~~

13. Is F.58.14 zero? YES/~~NO~~

14. Are F9.31, F9.32 and F9.33 all zero? YES/~~NO~~

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1991 returns

OTHER CHECKS

15.	Does F9.21 equal F10.11?	YES/~~NO~~
16.	Non-composites only. Does F9.22 equal F10.29?	YES/~~NO/NA~~
17.	Composites only. Does F9.22 equal F9.52?	~~YES/NO~~/NA
18.	Does F9.23 equal F14.11 plus F14.15 plus F14 note 3 reserves?	YES/~~NO~~
19.	Does F9.24 equal the sum of F14.21 to F14.47 plus F14 note 2 cash bonuses?	YES/~~NO~~
20.	Does F10.11 equal F13.93*?	YES/~~NO~~
21.	Does F10.12 equal F14.59?	YES/~~NO~~
22.	Does F10.11 eqaul F10.12?	YES/~~NO~~
23.	Does F13.85* equal F49.12?	YES/NO~~/NA~~
24.	Does F13.86* equal F47.4? IF F48.4 ADDED AS WELL.	YES/~~NO/NA~~
25.	Does F14.11 equal O.B. F58.9 + F58.19 +F58.20 +F58.21?	YES/~~NO/NA~~
26.	Does F14.15 equal I.B. F58.9 + F58.19 +F58.20+F58.21?	~~YES/NO~~/NA
27.	Does F14.12 equal O.B. F58.18 + F58.25?	YES/~~NO/NA~~
28.	Does F14.16 equal I.B. F58.18 + F58.25?	~~YES/NO~~/NA
29.	Are F14.13, O.B. F40.16 and F58.1 all equal?	YES/~~NO/NA~~
30.	Are F14.17, I.B. F40.16 and F58.1 all equal?	~~YES/NO~~/NA
31.	Does F16.11 equal F40.12?	YES/~~NO~~
32.	Does F40.12 correspond to either F58.3 or F58.12?	YES/~~NO~~
33.	Is F14.51 either zero or positive?	YES/~~NO~~
34.	Is F58.25 either zero or positive?	YES/~~NO~~
35.	If F58.25 is negative, is F16.24 zero?	~~YES/NO~~/NA
36.	Is the actuary's report in Schedule 4 stated to be in accordance with Regulation 54?	YES/~~NO~~
37.	100 times (F14.41 + F14.42) divided by F14.59= ...0.381..	

*total long term fund

INITIALS : [redacted] .. DATE: ..3/8/92........

c:\0691-002.fah

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1991 returns

Form A2 (6/91) **INITIAL SCRUTINY - KEY CHECKS (ACTUARY)**

1. Company........The Equitable Life Assurance Society

2. Valuation Date ....31. xii. 91

3. Do the interest rates used look supportable in terms of Regulation 59
   - for with profit business? YES/~~NO/NA~~
   - for non-profit business? YES/~~NO/NA~~

   (10% for 1A very high — query)

4. Is there an AIDS reserve on basis R or stronger? YES/~~NO/NA~~

   Do the mortality rates otherwise look reasonable? YES/~~NO/NA~~

5. Do the unit linked contract parameters look reasonable? YES/~~NO/NA~~

   Have unit costs been updated from last year? YES/~~NO/NA~~

6. If there is an entry in Form 58.23
   - are the S.29 requirements met? YES/NO/NA
   - are the S.30 requirements met? YES/NO/NA

7. Has a (ii) of the actuary's certificate been properly completed, in the light of Schedule 4, 5(1) (a) and (e) and 5(2) (a) and of any F14 footnote 3? YES/~~NO~~

8. Are the results of the 3%/25% resilience test set out? YES/~~NO/NA~~

9. What proportion of the major classes is reassured? (see Form 60 rows 1 to 3) 10% or less/ ~~over 10%~~

10. Is all reassurance with UK authorised companies? YES/~~NO/NA~~

    If not, are reassurances for non authorised companies on a deposit back basis? ~~YES/NO~~/NA

11. If the A1 Q14 answer is NO, (ie there are implicit items) is there a relevant S68 order? ~~YES/NO~~/NA

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1991 returns

12. Actuary's comments on Form A1 answers, particularly where answer is "NO":

13. Aspects which look worrying:

① Low FAR.

② other management expenses.

③ Transfer from IR.

14. Other notes:

15. Items to be notified to DTI, to be taken up immediately with the company:

16. Priority rating:
2 years ago......5......last year.3........New.2.......

INITIALS..[redacted]. DATE...10-8-92...................

C:\0691-001

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1992 returns

Form A1 (6/91) **INITIAL SCRUTINY - KEY CHECKS**

1. Company..The Equitable Life Assurance Society......................

2. Valuation Date .....31/12/92...

COMPLETENESS OF RETURNS

3. Have the appropriate returns been submitted? YES/~~NO~~ (~~UK~~/GLOBAL/~~COMMUNITY~~)

4. Do all the forms appear to be present? YES/~~NO~~

CERTIFICATES

5. Has the directors' certificate been supplied in the format of Schedule 6 Part I, without any omissions or qualifications? YES/~~NO~~ *

   Has new paragraph 6(e) been included? YES/~~NO~~ *

6. Has the actuary's certificate been supplied in the format of Schedule 6 Part II? (Ignore any references to Form 14.) YES/~~NO~~ *

7. Has the auditor's report been supplied in the format of Schedule 6 Part III without any omissions or qualifications? YES/~~NO~~ *

8. * If NO, give details ....

   ....

   ....

SOLVENCY

9. What is the cover for the required minimum margin? (F9.34 divided by F9.41) .....2.36.....

10. Is F9.43 either positive or zero? YES/~~NO~~

11. Is F58.10 either positive or zero? YES/~~NO~~

12. Is F58.15 either positive or zero? YES/~~NO~~

13. Is F.58.14 zero? YES/~~NO~~

14. Are F9.31, F9.32 and F9.33 all zero? YES/~~NO~~

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1992 returns

OTHER CHECKS

15.	Does F9.21 equal F10.11?	YES/~~NO~~
16.	Non-composites only. Does F9.22 equal F10.29?	YES/~~NO~~/~~NA~~
17.	Composites only. Does F9.22 equal F9.52?	~~YES~~/~~NO~~/NA
18.	Does F9.23 equal F14.11 plus F14.15 plus F14 note 3 reserves?	YES/~~NO~~
19.	Does F9.24 equal the sum of F14.21 to F14.47 plus F14 note 2 cash bonuses?	YES/~~NO~~
20.	Does F10.11 equal F13.93*?	YES/~~NO~~
21.	Does F10.12 equal F14.59?	YES/~~NO~~
22.	Does F10.11 eqaul F10.12?	YES/~~NO~~
23.	Does F13.85* equal F49.12?	YES/~~NO~~/~~NA~~
24.	Does F13.86* equal F47.4?	~~YES~~/NO/~~NA~~ Equals F.47+F.48
25.	Does F14.11 equal O.B. F58.9 + F58.19 +F58.20 +F58.21?	YES/~~NO~~/~~NA~~
26.	Does F14.15 equal I.B. F58.9 + F58.19 +F58.20+F58.21?	~~YES~~/~~NO~~/NA
27.	Does F14.12 equal O.B. F58.18 + F58.25?	YES/~~NO~~/~~NA~~
28.	Does F14.16 equal I.B. F58.18 + F58.25?	~~YES~~/~~NO~~/NA
29.	Are F14.13, O.B. F40.16 and F58.1 all equal?	YES/~~NO~~/~~NA~~
30.	Are F14.17, I.B. F40.16 and F58.1 all equal?	~~YES~~/~~NO~~/NA
31.	Does F16.11 equal F40.12?	YES/~~NO~~
32.	Does F40.12 correspond to either F58.3 or F58.12?	YES/~~NO~~
33.	Is F14.51 either zero or positive?	YES/~~NO~~
34.	Is F58.25 either zero or positive?	YES/~~NO~~
35.	If F58.25 is negative, is F16.24 zero?	~~YES~~/~~NO~~/NA
36.	Is the actuary's report in Schedule 4 stated to be in accordance with Regulation 54?	YES/~~NO~~
37.	100 times (F14.41 + F14.42) divided by F14.59=	...0.67.....

*total long term fund

INITIALS : ..[redacted]. DATE: ....30/6/93.......

c:\0691-002.fah

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1992 returns

Form A2 (6/91) **INITIAL SCRUTINY - KEY CHECKS (ACTUARY)**

1. Company....The Equitable Life Assurance Society

2. Valuation Date .....31.12.92.....

3. Do the interest rates used look supportable in terms of Regulation 59
   - for with profit business? YES/~~NO/NA~~
   - for non-profit business? YES/~~NO/NA~~

4. Is there an AIDS reserve on basis R or stronger? YES/~~NO/NA~~

   Do the mortality rates otherwise look reasonable? YES/~~NO/NA~~

5. Do the unit linked contract parameters look reasonable? YES/~~NO/NA~~

   except Growth rate 8%, inflation 5%: Δ3

   Have unit costs been updated from last year? YES/~~NO/NA~~ [Same as last year

6. If there is an entry in Form 58.23
   - are the S.29 requirements met? ~~YES/NO~~/NA
   - are the S.30 requirements met? ~~YES/NO~~/NA

7. Has a (ii) of the actuary's certificate been properly completed, in the light of Schedule 4, 5(1) (a) and (e) and 5(2) (a) and of any F14 footnote 3? YES/~~NO~~

8. Are the results of the 3%/25% resilience test set out? YES/~~NO/NA~~

9. What proportion of the major classes is reassured? (see Form 60 rows 1 to 3) 10% or less/ ~~over 10%~~

10. Is all reassurance with UK authorised companies? ~~YES~~/NO/~~NA~~

    If not, are reassurances for non authorised companies on a deposit back basis? ~~YES~~/NO/~~NA~~ (trivial amounts only)

11. If the A1 Q14 answer is NO, (ie there are implicit items) is there a relevant S68 order? ~~YES/NO~~/NA

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1992 returns

12. Actuary's comments on Form A1 answers, particularly where answer is "NO":

13. Aspects which look worrying:

UL parameters (though not a major class) (see Q 5)

14. Other notes:

FI ppn up to 38% (was 26%)

15. Items to be notified to DTI, to be taken up immediately with the company:

16. Priority rating:
2 years ago.....3.....last year.....2.....New.....3.....

INITIALS [redacted] ... DATE.....5.7.93.....

C:\0691-001

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1993 returns

Form A1

INITIAL SCRUTINY - KEY CHECKS

1. Company ....The Equitable Life Assurance Society....

2. Valuation Date ....31/12/93....

COMPLETENESS OF RETURNS

3. Have the appropriate returns been submitted? YES/~~NO~~
   (~~UK~~/GLOBAL/~~COMMUNITY~~)

4. Do all the forms appear to be present? YES/~~NO~~

CERTIFICATES

5. Has the directors' certificate been supplied in the format of Schedule 6 Part 1, without any omissions or qualifications? YES/~~NO~~ *

6. Has the actuary's certificate been supplied in the format of Schedule 6 Part III as amended by SI 1993 No. 946? YES/~~NO~~ *

7. Does the auditor's report comply with the format prescribed by the Auditing Practices Board? YES/~~NO~~
   If not, is it in the format of Schedule 6 Part III without any omissions or qualifications? ~~YES~~/~~NO~~/NA *

8. * If NO, give details....

SOLVENCY

9. What is the cover for the required minimum margin? (F9.34 divided by F9.41) ....3.75....

10. Is F9.43 either positive or zero? YES/~~NO~~

11. Is F58.10 either positive or zero? YES/~~NO~~

12. Is F58.15 either positive or zero? YES/~~NO~~

13. Is F58.14 zero? YES/~~NO~~

14. Are F9.31, F9.32 and F9.33 all zero? YES/~~NO~~

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1993 returns

OTHER CHECKS

15.	Does F9.21 equal F10.11?	YES/~~NO~~
16.	Non-composites only. Does F9.22 equal F10.29?	YES/~~NO~~/~~NA~~
17.	Composites only. Does F9.22 equal F9.52?	~~YES~~/~~NO~~/NA
18.	Does F9.23 equal F14.11 plus F14.15 plus F14 note 3 reserves?	YES/~~NO~~
19.	Does F9.24 equal the sum of F14.21 to F14.47 plus F58.18?	YES/~~NO~~
20.	Does F10.11 equal F13.93*?	YES/~~NO~~
21.	Does F10.12 equal F14.59?	YES/~~NO~~
22.	Does F10.11 equal F10.12?	YES/~~NO~~
23.	Does F13.85* equal F49.12?	YES/~~NO~~/~~NA~~
24.	Does F13.86* equal F47.4?	~~YES~~/NO/~~NA~~ Equals F47 line 1 & F48.
25.	Does F14.11 equal O.B. F58.9 + F58.19+ F58.20 + F58.21?	YES/~~NO~~/~~NA~~
26.	Does F14.15 equal I.B. F58.9 + F58.19+ F58.20 + F58.21?	~~YES~~/~~NO~~/NA
27.	Does F14.12 equal O.B. F58.18 + F58.25?	YES/~~NO~~/~~NA~~
28.	Does F14.16 equal I.B. F58.18 + F58.25?	~~YES~~/~~NO~~/NA
29.	Are F14.13, O.B. F40.16 and F58.1 all equal?	YES/~~NO~~/~~NA~~
30.	Are F14.17, I.B. F40.16 and F58.1 all equal?	~~YES~~/~~NO~~/NA
31.	Does F16.11 equal F40.12?	YES/~~NO~~
32.	Does F40.12 correspond to either F58.3 or F58.12?	YES/~~NO~~
33.	Is F14.51 either zero or positive?	YES/~~NO~~
34.	Is F58.25 either zero or positive?	YES/~~NO~~
35.	If F58.25 is negative, is F16.24 zero?	~~YES~~/~~NO~~/NA
36.	Is the actuary's report in Schedule 4 stated to be in accordance with Regulation 54?	YES/~~NO~~
37.	Loan proportion/liabilities: 100 times (F14.41 + F14.42)/F14.59 =	......0.50...

* total long term fund

INITIALS : [redacted] DATE : ....15/7/94............

FA1-94.DOC 11/07/94

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1993 returns

Form A2

INITIAL SCRUTINY - KEY CHECKS (ACTUARY)

1. Company ....Equitable........

2. Valuation Date ....31.12.93........

3. Do the interest rates used look supportable in terms of Regulation 59
   - for with profit business? YES/~~NO/NA~~
   - for non-profit business? YES/~~NO/NA~~ } On NP

4. Is there an AIDS reserve on basis 50%R or stronger? YES/~~NO/NA~~
   (100% R)

   Do the mortality rates otherwise look reasonable? YES/~~NO/NA~~

5. Do the unit linked contract parameters look reasonable? YES/~~NO/NA~~
   except g=8%, i=5% again.

   Have unit costs been updated from last year? YES/~~NO/NA~~

6. If there is an entry in Form 58.23
   - are the S.29 requirements met? ~~YES/NO~~/NA
   - are the S.30 requirements met? ~~YES/NO~~/NA

7. Has a (ii) of the actuary's certificate been properly completed, in the light of Schedule 4, 5(1) (a) and (e) and 5(2) (a) and of any F14 footnote 3? YES/~~NO~~

8. Has a resilience test been carried out in accordance with the GA's guidelines? YES/~~NO/NA~~

9. What proportion of the major classes is reassured? (see Form 60 rows 1 to 3) ~~NIL~~/10% or less/ ~~[illegible]~~ (< 1%

10. Is all reassurance with UK authorised companies? YES/~~NO/NA~~
    All but a trivial amount

    If not, are reassurances for non authorised companies on a deposit back basis? YES/~~NO/NA~~

11. If an implicit item has been included on F9, is there a relevant S68 order? ~~YES/NO~~/NA

12. Have the company set up any identifiable provision to meet potential exposure to Personal Pensions transfer problems? ~~YES~~/NO/~~NA~~
    but very unlikely to be significant.

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1993 returns

13. Actuary's comments on Form A1 answers, particularly where answer is "NO":

14. Aspects which look worrying:

15. Other notes:

16. Items to be notified to DTI, to be taken up immediately with the company:

17. Priority rating:
2 years ago ....2..........last year ....3..........New ....3..........

Target Date ....31.12.94..........

INITIALS.[redacted].... DATE ....7.7.94..........

FA2-94.DOC

27/06/94

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1994 returns

Form A1

INITIAL SCRUTINY - KEY CHECKS

1. Company ....The Equitable Life Assurance Society..

2. Valuation Date ....31/12/94.......

COMPLETENESS OF RETURNS

3. Have the appropriate returns been submitted? YES/~~NO~~
(~~UK~~/GLOBAL/~~COMMUNITY~~)

4. Do all the forms appear to be present? YES/~~NO~~
In particular, is there a F13A for each F13? YES/~~NO~~
If YES, is there a derivatives statement? YES/~~NO~~

CERTIFICATES

5. Has the directors' certificate been supplied in the format of Schedule 6 Part 1, without any omissions or qualifications? YES/ ~~NO~~

Is there a statement of published guidance (SI 1994 No.1515)? YES/~~NO~~

6. Has the actuary's certificate been supplied in the format of Schedule 6 Part III, with reference added YES/~~NO~~
(i) to the relevant Guidance Notes (SI 1993 No. 946), and YES/~~NO~~
(ii) to the adequacy of premiums (SI 1994 No.1515)? YES/~~NO~~

7. Does the auditors' report comply with the format prescribed by the Auditing Practices Board? YES/~~NO~~

If not, is it in the format of Schedule 6 Part III, without any omissions or qualifications? ~~YES~~/~~NO~~/NA

8. Is the actuary's report in Schedule 4 stated to be in accordance with Regulation 64? YES/~~NO~~

9. If the answer to any of questions 5 to 8 is NO, give details:-
....
....
....

SOLVENCY

10. Is F9.44 either positive or zero? YES/~~NO~~

11. Is F58.10 either positive or zero? YES/~~NO~~

12. Is F58.15 either positive or zero? YES/~~NO~~

13. Is F58.14 zero? YES/~~NO~~

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1994 returns

OTHER CHECKS

15. Does F9.21 equal F10.11? YES/~~NO~~

16. Non-composites only. Does F9.22 equal F10.29? YES/~~NO~~/~~NA~~

17. Composites only. Does F.22 equal F9.52? ~~YES~~/~~NO~~/NA

18. Does F9.23 equal F14.11 plus F14.15 plus F14 note 3 reserves? YES/~~NO~~

19. Does F9.24 equal the sum of F14.21 to F14.47 plus F58.18? YES/~~NO~~

20. Does F10.11 equal F13.93*? YES/~~NO~~

21. Does F10.12 equal F14.59? YES/~~NO~~

22. Does F10.11 equal F10.12? YES/~~NO~~

23. Does F13.85* equal F49.12? ~~YES~~/~~NO~~/NA

24. Does F13.86* equal F47.4? ~~YES~~/NO/~~NA~~ Equals F47+F48

25. Does F14.11 equal O.B. F58.9 + F58.9+ F58.20 + F58.21? YES/~~NO~~/~~NA~~

26. Does F14.15 equal I.B. F58.9 + F58.19+ F58.20 + F58.21? ~~YES~~/~~NO~~/NA

27. Does F14.12 equal O.B. F58.18 + F58.25? YES/~~NO~~/NA

28. Does F14.16 equal I.B. F58.18 + F58.25? ~~YES~~/~~NO~~/NA

29. Are F14.13 O.B. F40.16 and F58.1 all equal? YES/~~NO~~/NA

30. Are F14.17 I.B. F40.16 and F58.1 all equal? ~~YES~~/~~NO~~/NA

31. Does F16.11 equal F40.12? YES/~~NO~~

32. Does F40.12 correspond to either F58.3 or F58.12? YES/~~NO~~

33. Is F14.51 either zero or positive? YES/~~NO~~

34. Is F58.25 either zero or positive? YES/~~NO~~

35. If F58.25 is negative is F16.24 zero? ~~YES~~/~~NO~~/NA

* total long term fund

INITIALS : .....[redacted]............ DATE : ....24/7/95.......

FA1-95.DOC 10/07/95

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1994 returns

Form A2

INITIAL SCRUTINY - KEY CHECKS (ACTUARY)

1. Company ......EQUITABLE LIFE ASSURANCE SOCIETY..........

2. Valuation Date ......31/12/94......

3. Do the interest rates used look supportable in terms of Regulation 69,
   - for with profit business? YES/~~NO/NA~~
   - for non-profit business? YES/~~NO/NA~~

4. Is there an AIDS reserve on basis 50%R or stronger? YES/~~NO/NA~~

   Do the mortality rates otherwise look reasonable? YES/~~NO/NA~~
   but thin

5. Do the unit linked contract parameters look reasonable? YES/~~NO/NA~~

   Have unit costs been updated from last year? ~~YES~~/NO/~~NA~~
   generally done.

6. If there is an entry in Form 58.23,
   - are the S.29 requirements met? ~~YES/NO~~/NA
   - are the S.30 requirements met? ~~YES/NO~~/NA

7. Has a (ii) of the actuary's certificate been properly completed? YES/~~NO~~

8. Has a resilience test been carried out in accordance with the GA's guidelines? YES/~~NO/NA~~

9. What proportion of the major classes is reassured? (see Form 60 rows 1 to 3) ~~NIL~~/10% or less/~~over 10%/100%~~

10. Is all reassurance with UK authorised companies? YES/~~NO/NA~~

    If not are reassurances for non authorised companies on a deposit back basis? ~~YES/NO~~/NA

11. If an implicit item has been included on F9 is there a relevant S68 order? YES/~~NO/NA~~

12. Have the company set up any identifiable provision to meet potential exposure to Personal Pensions transfer problems? ~~YES~~/NO/~~NA~~

13. If Form 13A is present has the company annexed a statement in accordance with Regulation 22B? YES/~~NO/NA~~

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1994 returns

14. Actuary's comments on Form A1 answers, particularly where answer is "NO":

15. Aspects which look worrying:

Mismatching ?

16. Other notes:

Derivatives – investigate
Ethical fund general investments.
4(2)(c) omitted.
CGT – "sufficient margins"
Check into mis-selling.

17. Items to be notified to DTI, to be taken up immediately with the company:

18. Priority rating:
2 years ago ....3.... last year ....3.... New ....3....

Target Date ....31/1/96....

INITIALS [redacted] DATE ....25/7/96....

FA2-95.DOC 09/06/95

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1995 returns

Form A1

INITIAL SCRUTINY - KEY CHECKS

1. Company ....The Equitable Life Assurance Society........

2. Valuation Date ....31/12/95......

COMPLETENESS OF RETURNS

3. Have the appropriate returns been submitted? — YES/~~NO~~
   (~~UK~~/GLOBAL/~~COMMUNITY~~)

4. Do all the forms appear to be present? — YES/~~NO~~
   In particular, is there a F13A for each F13? — YES/~~NO~~
   If YES, is there a derivatives statement? — YES/~~NO~~
   p. 9/10.

CERTIFICATES

5. Has the directors' certificate been supplied in the format of Schedule 6 Part 1, without any omissions or qualifications? — YES/~~NO~~

   Is there a statement of published guidance (SI 1994 No.1515)? — YES/~~NO~~

6. Has the actuary's certificate been supplied in the format of Schedule 6 Part III, with reference added — YES/~~NO~~
   (i) to the relevant Guidance Notes (SI 1993 No. 946), and — YES/~~NO~~
   (ii) to the adequacy of premiums (SI 1994 No.1515)? — YES/~~NO~~

7. Does the auditors' report comply with the format prescribed by the Auditing Practices Board? — YES/~~NO~~

   If not, is it in the format of Schedule 6 Part III, without any omissions or qualifications? — ~~YES~~/~~NO~~/NA

8. Is the actuary's report in Schedule 4 stated to be in accordance with Regulation 64? — YES/~~NO~~

9. If the answer to any of questions 5 to 8 is NO, give details:-
   ....
   ....
   ....

SOLVENCY

10. Is F9.44 either positive or zero? — YES/~~NO~~

11. Is F58.10 either positive or zero? — YES/~~NO~~

12. Is F58.15 either positive or zero? — YES/~~NO~~

13. Is F58.14 zero? — YES/~~NO~~

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1995 returns

OTHER CHECKS

15.	Does F9.21 equal F10.11?	YES/~~NO~~
16.	Non-composites only. Does F9.22 equal F10.29?	YES/~~NO~~/~~NA~~
17.	Composites only. Does F.22 equal F9.52?	~~YES~~/~~NO~~/NA
18.	Does F9.23 equal F14.11 plus F14.15 plus F14 note 3 reserves?	YES/~~NO~~
19.	Does F9.24 equal the sum of F14.21 to F14.47 plus F58.18?	YES/~~NO~~
20.	Does F10.11 equal F13.93*?	YES/~~NO~~
21.	Does F10.12 equal F14.59?	YES/~~NO~~
22.	Does F10.11 equal F10.12?	YES/~~NO~~
23.	Does F13.85* equal F49.12?	YES/~~NO~~/~~NA~~ Equals F47+F48.
24.	Does F13.86* equal F47.4?	~~YES~~/NO/~~NA~~
25.	Does F14.11 equal O.B. F58.9 + F58.9+ F58.20 + F58.21?	YES/~~NO~~/~~NA~~
26.	Does F14.15 equal I.B. F58.9 + F58.19+ F58.20 + F58.21?	~~YES~~/~~NO~~/NA
27.	Does F14.12 equal O.B. F58.18 + F58.25?	YES/~~NO~~/~~NA~~
28.	Does F14.16 equal I.B. F58.18 + F58.25?	~~YES~~/~~NO~~/NA
29.	Are F14.13 O.B. F40.16 and F58.1 all equal?	YES/~~NO~~/~~NA~~
30.	Are F14.17 I.B. F40.16 and F58.1 all equal?	~~YES~~/~~NO~~/NA
31.	Does F16.11 equal F40.12?	YES/~~NO~~
32.	Does F40.12 correspond to either F58.3 or F58.12?	YES/~~NO~~
33.	Is F14.51 either zero or positive?	YES/~~NO~~
34.	Is F58.25 either zero or positive?	YES/~~NO~~
35.	If F58.25 is negative is F16.24 zero?	~~YES~~/~~NO~~/NA

* total long term fund

INITIALS : ....[redacted]......... DATE : ....8/7/96........

FA1-95.DOC 10/07/95

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1995 returns

Form A2

INITIAL SCRUTINY - KEY CHECKS (ACTUARY)

1. Company .... EQUITABLE LIFE ASSURANCE SOCIETY ....

2. Valuation Date 31.12.95

3. Do the interest rates used look supportable in terms of Regulation 69,
   - for with profit business? YES/~~NO/NA~~
   - for non-profit business? YES/~~NO/NA~~

4. Is there an AIDS reserve on basis 50%R or stronger? *Within reserve for future bonus in B. Res. Val.* YES/~~NO/NA~~

   Do the mortality rates otherwise look reasonable? YES/~~NO/NA~~

5. Do the unit linked contract parameters look reasonable? YES/~~NO/NA~~

   Have unit costs been updated from last year? *(except for annuities)* ~~YES~~/NO/~~NA~~

6. If there is an entry in Form 58.23,
   - are the S.29 requirements met? ~~YES/NO~~/NA
   - are the S.30 requirements met? ~~YES/NO~~/NA

7. Has a (ii) of the actuary's certificate been properly completed? YES/~~NO~~

8. Has a resilience test been carried out in accordance with the GA's guidelines? YES/~~NO/NA~~

9. What proportion of the major classes is reassured? (see Form 60 rows 1 to 3) ~~NIL~~/10% or less/ ~~over 10%/100%~~

10. Is all reassurance with UK authorised companies? ~~YES~~/NO/~~NA~~

    If not are reassurances for non authorised companies on a deposit back basis? *Query regarding Bond business?* ~~YES~~/NO/~~NA~~

11. If an implicit item has been included on F9 is there a relevant S68 order? YES/~~NO/NA~~

12. Have the company set up any identifiable provision to meet potential exposure to Personal Pensions transfer problems? *April '95 letter indicated that technical liabilities "overstated" by £50m* ~~YES~~/NO/~~NA~~

13. If Form 13A is present has the company annexed a statement in accordance with Regulation 22B? YES/~~NO/NA~~

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1995 returns

14. Actuary's comments on Form A1 answers, particularly where answer is "NO":

15. Aspects which look worrying:

16. Other notes:

① S68 Order permitted implicit future profits item of up to £500m.
£263,731K used → cover for RMM of 2.89

② Coy provides mgt. services to University Life, German [illegible] & Permanent Ins. Co. Ltd

③ 4(2)(c) still omitted (investment guidelines, incl derivatives) — Covered in 4(2)(a)

④ Reduced management charges for Funds !

⑤ Unchanged expense allowances for linked contracts, but raised allowances for annuities

⑥ New reinsurance treaty with connected coy. for Major Medical Cash Plans. ~~Query no Dep back for Bond business~~
No current reassurance seems to be in place.

17. Items to be notified to DTI, to be taken up immediately with the company:

18. Priority rating:
2 years ago ......3...... last year ......3...... New ......4......

Target Date ......31.12.96......

INITIALS...[redacted] DATE ......18.7.96......

FA2-95.DOC 09/06/95

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1996 returns

Form A1

INITIAL SCRUTINY - KEY CHECKS

1 Company THE EQUITABLE LIFE ASSURANCE COMPANY

2 Valuation date 31/12/96

COMPLETENESS OF RETURNS

3 Have the appropriate returns been submitted? (~~UK BRANCH~~/GLOBAL/~~EEA BRANCHES~~) — YES/~~NO~~

4 Do all the Forms appear to be present, including in particular a F17 for each F13, and summary Forms where these are required? — YES/~~NO~~

If NO, is there a note to the returns coded FF00 for each missing Form (where FF is the Form number) stating that it would have been blank? — ~~YES~~/~~NO~~/NA — Page no. –

5 Is the Regulation 23 derivatives statement present? — YES/~~NO~~ — Page no. 339 340

6 Is the Regulation 24 statement on shareholder controllers present (UK companies only)? — YES/~~NO/NA~~ — Page no. 341

7 Is the Regulation 31 statement giving additional information on the appointed actuary present? — YES/~~NO~~ — Page no. 342

8 Have the Companies Act Report & Accounts been received? — YES/~~NO~~

If NO, has this fact been recorded so that they can be requested? — ~~YES~~/~~NO~~/NA

9 Do the returns appear to contain references to any S68 orders? — YES/~~NO~~

If YES, where do they appear? — Page no. 343 349

CERTIFICATES

10 Has the directors' certificate been supplied in the format of Schedule 6 Part 1, without any omissions or qualifications? — YES/~~NO~~ — Page no. 353-354

In particular,

- Is there a statement that the RMM has been maintained throughout the year? — YES/~~NO~~
- Is there a statement that the investment policy and practice throughout the year in respect of any internal linked funds was consistent with representations made to policyholders? — YES/~~NO/NA~~
- Is there a statement that each of PGNs 1994/6, 1995/1, 1995/3 and 1996/3 and guidance on Money Laundering revised in February 1995 have been complied with? — YES/~~NO~~

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1996 returns

11 Has the Appointed Actuary's certificate been supplied in the format of Schedule 6 Part II, without any omissions or qualifications? YES/~~NO~~ Page no. 355

12 Is the auditors' report in the format of Schedule 6 Part III, without any omissions or qualifications? ~~YES~~/NO Page no. 356-357

If NO, is there a reference in the notes to the returns to any relevant S68 orders allowing specific omissions? YES/~~NO~~/NA Page no. 357

13 Is the Appointed Actuary's report in Schedule 4 stated to be in accordance with Regulation 64? YES/~~NO~~

14 If the answer to any of questions 10 to 13 is **NO**, give details:

THE ORDER OF 6/6/97 REMOVED FROM THE AUDIT
ANY STATEMENTS RELATING TO MONEY LAUNDERING

INITIALS: [redacted] DATE: 18/07/97

Fa1-96;30/06/97 2

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1996 returns

Form A2

INITIAL SCRUTINY - KEY CHECKS (ACTUARY)

1 Company........THE EQUITABLE LIFE ASSURANCE SOCIETY........

2 Valuation date 31. 12. 96

STRENGTH OF VALUATION BASIS

3 Are all the interest rates in F57 (including those in line 39) supported by the risk adjusted yields on the matching assets
- for with-profit business? But ? Acc. W.P. Line 39 YES/~~NO/NA~~
- for non-profit business? YES/~~NO/NA~~

Do the with-profit rates in lines 29 and 39 appear to make provision for PRE? YES/NO/~~NA~~

Has allowance been made for the change to asset classes brought about by derivatives (see Regulation 23(d) statement and paragraph 6(1)(a) of Schedule 4)? ~~YES/NO~~/NA

4 On the evidence of the margins between the interest rates in F57 and the corresponding risk adjusted yields, does the overall interest basis appear to be best described as strong (A), adequate (C), weak (D) or potentially unacceptable (E)? ~~A~~/C / D/~~E~~

5 Are the mortality rates acceptable within GAD guidelines
- for assurances? YES/~~NO/NA~~
- for annuities? Might query ! ✕ YES/~~NO/NA~~

Where PHI is a material class, do the morbidity rates look reasonable? ~~YES/NO~~/NA

6 Does the aggregate expense allowance disclosed in paragraph 10(2) of Schedule 4 look reasonable compared with management expenses in connection with maintenance of business shown in F41.44? - £30.2m. YES/~~NO~~

Are other management expenses shown in F41.45 material? - £2.5m ~~YES~~/NO Modest

7 Do the linked contract valuation basis parameters look reasonable? YES/NO/~~NA~~
? ✕ Surprisingly raised unit growth assumption in 1996.

Have per policy expense allowances been increased since last year? ~~YES~~/NO/~~NA~~

8 Is the resilience test described in paragraph 7(6) of Schedule 4 in accordance with the GA's latest published guidance? YES/~~NO/NA~~

9 Taken overall, does the valuation basis appear to be best described as strong (A), adequate (C), weak (D) or potentially unacceptable (E)? ~~A~~/C / D/~~E~~

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1996 returns

SOLVENCY POSITION

10 Taking into account the individual characteristics of the company, is the absolute level of cover for the RMM shown in F9 best described as very healthy (A), healthy (B), adequate (C), of concern (D) or negative/such as to require immediate action by DTI (E)? — ~~A/B~~ / C ~~/ D / E /~~ NA

As a major w.p. office is unlikely to be insolvent – but may be building higher expectations than can be met.

What has the trend in the level of cover been over recent years? — ~~UP/DOWN~~/FLAT/ ~~VOLATILE/NA~~

If DOWN, is the slope of decline steepening? — ~~YES/NO~~/NA

11 If an implicit item has been included in F9, is there a relevant S68 order referred to in a note to the returns coded 0902? — YES/~~NO/NA~~

SUITABILITY OF ASSETS

12 Does the hypothecation of assets to liabilities in F57 look reasonable
- for with-profit business? — YES/~~NO/NA~~
- for non-profit business? — YES/~~NO/NA~~

Is it reasonable after the change to asset classes brought about by derivatives (see Regulation 23(d) statement)? — ~~YES/NO~~/NA

13 Does the company have significant exposure to derivatives? — ~~YES~~/NO/~~NA~~

IF YES, do adequate margining arrangements appear to be in place in respect of derivatives
- shown in F17? — ~~YES/NO~~/NA
- shown in F56? — ~~YES/NO~~/NA

14 Is the level of mismatching by currency revealed by the schedule shown in paragraph 11(1) of Schedule 4 material? — ~~YES~~/NO

15 Are any of the linked asset surpluses/deficits shown in column 10 of F55 material? — ~~YES~~/NO/~~NA~~

(Up to about 1% in some cases)

16 Does the company have any large counterparty exposures (see paragraph 11(2) of Schedule 1) described in a note to the returns coded 1312? — ~~YES~~/NO

OPERATING RESULTS

17 Is either the absolute level of surplus/deficit emerging or its trend over recent years such as to give current cause for concern? — ~~YES~~/NO

18 Is either the absolute level of any capital injection into the company or its trend over recent years such as to give current cause for concern? — ~~YES/NO~~/NA

Fa2-96;09/07/97 2

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1996 returns

19 Is either the absolute level of management expenses or their trend over recent years such as to give current cause for concern? ~~YES~~/NO

20 Is either the absolute level of sales or their trend over recent years such as to give current cause for concern? ~~YES~~/NO (V. high!)

21 Is either the absolute level of the initial commission ratio or its trend over recent years such as to give current cause for concern? ~~YES/NO~~/NA

22 Is the amount of reinsurance material? ~~YES~~/NO (but all Class IV bus
If YES,
- Are there any material financing arrangements in force? ~~YES/NO~~/NA
- Is there a material exposure to non-UK authorised reinsurers without deposit back? ~~YES/NO~~/NA

PRE ISSUES

23 Has the percentage of distributed surplus allocated to policyholders been reduced? ~~YES~~/~~NO~~/~~NA~~
Method.
If YES,
- Is the reduction allowable under section 30 of the Act? ~~YES/NO~~/NA
- Is the current percentage less than 90%? ~~YES/NO~~/NA

24 Is the surplus carried forward negative? ~~YES~~/NO
If YES, has a dividend been paid? ~~YES/NO~~/NA

25 Does the method used for the creation and cancellation of units in internal linked funds and determining unit prices for the allocation of units to, and the cancellation of units from, policies described in paragraph 5(4) of Schedule 4 look reasonable? YES/~~NO/NA~~

Does the method used to determine the provision for CGT described in paragraph 5(5) of Schedule 4 look reasonable? YES/~~NO/NA~~

26 Do the circumstances in which, and the method by which, a MVA may be applied under accumulating with-profit policies described in paragraph 4(1)(a)(i) of Schedule 4 look reasonable? YES/~~NO/NA~~

Is the answer given in paragraph 4(1)(a)(ii) of Schedule 4 satisfactory? ? YES/NO/~~NA~~

CURRENT ISSUES

27 Has the company set up any identifiable pensions mis-selling reserve? ~~YES~~/NO/~~NA~~
NOT CLEAR (Understood to hold £50. within technical reserves, st and 9
If YES, has this been increased since last year? ~~YES/NO/NA~~

28 Does it appear that overall the company has completed the new style returns well (A), adequately (C) or poorly (E)? ~~A~~ C ~~E~~
Review Forms 57

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1996 returns

29 Actuary's comments on Form A1 answers, particularly where answer is in **BOLD**:

—

30 Aspects which look worrying:

Substantial unitised w.p. - high declared bonuses
but reduced reserves could rely too much on
application of MVA.
[Coy. would be in more comfortable position if held back more
as terminal bonus.]

31 Other notes:

1. Review Pension / Annuity mortality assumptions
2. Consider raised level for assumed unit growth.
3. Review u.w.p. reserves in resilience scenario.
[4. o/s review of Implicit Profit item calculation.] ✓ Dealt with.

32 Items to be notified to DTI, to be taken up immediately with the company:

—

33 Priority rating:
2 years ago 3 Last year 4 New 3

Target date 30.09.97

INITIALS: [redacted] DATE: 7/8/97

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1997 returns

Form A1

INITIAL SCRUTINY - KEY CHECKS

1 Company THE EQUITABLE LIFE ASSURANCE SOCIETY

2 Valuation date 31-12-97

COMPLETENESS OF RETURNS

3 Have the appropriate returns been submitted? (UK BRANCH/GLOBAL/EEA BRANCHES) — YES/**NO**

4 Do all the Forms appear to be present, including in particular a F17 for each F13, a F14 for each long term assets F13, and summary Forms where these are required? — YES/~~NO~~

If NO, is there a note to the returns coded FF00 for each missing Form (where FF is the Form number) stating that it would have been blank? — YES/**NO**/NA — Page no. 377

5 Is the Regulation 23 derivatives statement present? — YES/**NO** — Page no. 371

6 Is the Regulation 24 statement on shareholder controllers present (UK companies only)? — YES/**NO**/NA — Page no. 373

7 Is the Regulation 31 statement giving additional information on the appointed actuary present? — YES/**NO** — Page no. 374

8 Have the Companies Act Report & Accounts been received? — YES/**NO**

If NO, has this fact been recorded so that they can be requested? — YES/**NO**/NA

9 Do the returns appear to contain references to any S68 orders? — **YES**/NO

If YES, where do they appear? — Page no. 375

CERTIFICATES

10 Has the directors' certificate been supplied in the format of Schedule 6 Part 1, without any omissions or qualifications? — YES/**NO** — Page no. 384
In particular,
- Is there a statement that the RMM has been maintained throughout the year? — YES/**NO**
- Is there a statement that the investment policy and practice throughout the year in respect of any internal linked funds was consistent with representations made to policyholders? — YES/**NO**/NA
- Is there a statement that each of PGNs 1994/6, 1995/1, 1995/3 and 1998/1 and guidance on Money Laundering revised in February 1995 have been complied with? — YES/**NO**

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1997 returns

11	Has the Appointed Actuary's certificate been supplied in the format of Schedule 6 Part II, without any omissions or qualifications?	YES/**NO**	Page no. 386
12	Is the auditors' report in the format of Schedule 6 Part III, without any omissions or qualifications?	YES/**NO**	Page no. 389
	If NO, is there a reference in the notes to the returns to any relevant S68 orders allowing specific omissions?	YES/**NO**/NA	Page no.
13	Is the Appointed Actuary's report in Schedule 4 stated to be in accordance with Regulation 64?	YES/**NO**	

14 If the answer to any of questions 10 to 13 is **NO**, give details:

....
....
....

SOLVENCY

15	Is F9.44 either positive or zero?	YES/**NO**
16	Is each F58.29 either positive or zero?	YES/**NO**
17	Is each F58.35 either positive or zero?	YES/**NO**
18	Is each F58.34 zero?	YES/**NO**

OTHER CHECKS

19	Does F9.21 equal F10.11?	YES/**NO**
20	Non-composites only. Does F9.22 equal F10.29?	YES/**NO**/NA
21	Composites only. Does F9.22 equal F10.29 minus F9.11?	YES/**NO**/NA
22	Does F9.23 equal summary F14.11 plus summary F14.63?	YES/**NO**
23	Does F9.24 equal summary F14.12 plus summary F14.49?	YES/**NO**
24	Does F9.41 equal F60.69?	YES/**NO**
25	Does F10.11 equal F13.89 (long term business)?	YES/**NO**
26	Does F10.12 equal summary F14.59?	YES/**NO**
27	Does F10.11 equal F10.12?	YES/**NO**
28	Does OB F14.11 equal OB (F58.21 + F58.43+ F58.44 + F58.45)?	YES/**NO**/NA

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1997 returns

29	Does IB F14.11 equal IB (F58.21 + F58.43+ F58.44 + F58.45)?	YES/**NO**/NA
30	Does OB F14.12 equal OB F58.42?	YES/**NO**/NA
31	Does IB F14.12 equal IB F58.42?	YES/**NO**/NA
32	Does OB F14.13 equal OB F58.49?	YES/**NO**/NA
33	Does IB F14.13 equal IB F58.49?	YES/**NO**/NA
34	Are OB F14.14, OB F40.59 and OB F58.11 all equal?	YES/**NO**/NA
35	Are IB F14.14, IB F40.59 and IB F58.11 all equal?	YES/**NO**/NA
36	Does F16.13 equal summary F40.26?	YES/**NO**/NA
37	Does each F40.26 correspond to either the corresponding F58.13 or F58.32?	YES/**NO**
38	Is summary F14.51 either zero or positive?	YES/**NO**
39	Is each F58.49 either zero or positive?	YES/**NO**
40	If summary F58.49 is negative, is F16.51 zero?	YES/**NO**/NA

INITIALS: ....[redacted]............ DATE: 17-7-98

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1997 returns

Form A2

INITIAL SCRUTINY - KEY CHECKS (ACTUARY)

1 Company.......EQUITABLE LIFE ASSURANCE SOCIETY.......

2 Valuation date 31.12.97

STRENGTH OF VALUATION BASIS

3 Are all the interest rates in F57 (including those in col 6) supported by the risk adjusted yields on the matching assets
- for with-profit business? YES/~~NO/NA~~
- for non-profit business? YES/~~NO/NA~~

Do the with-profit rates in cols 2 and 6 appear to make provision for PRE? (just about!) YES/~~NO/NA~~

Has allowance been made for the change to asset classes brought about by derivatives (see Regulation 23(d) statement and paragraph 6(1)(a) of Schedule 4)? ~~YES/NO~~/NA

4 On the evidence of the margins between the interest rates in F57 and the corresponding risk adjusted yields, does the overall interest basis appear to be best described as strong (A), adequate (C), weak (D) or potentially unacceptable (E)? ~~A~~ C ~~D E~~

5 Are the mortality rates acceptable within GAD guidelines
- for assurances? YES/~~NO/NA~~
- for annuities? Thought about querying on 1996 Return, but did not. YES/NO/~~NA~~

Where PHI is a material class, do the morbidity rates look reasonable? ~~YES/NO~~/NA

6 Does the aggregate expense allowance disclosed in paragraph 10(2) of Schedule 4 look reasonable compared with management expenses in connection with maintenance of business shown in F41.44? – £33.3m YES/~~NO~~ £61m in N.P Vals

Are other management expenses shown in F41.45 material? – £7.3m YES/~~NO~~

7 Do the linked contract valuation basis parameters look reasonable? YES/~~NO/NA~~
Equitable takes 3% margin between gross unit fund growth + expense inflation.

Have per policy expense allowances been increased since last year? ~~YES~~/NO/~~NA~~

8 Is the resilience test described in paragraph 7(6) of Schedule 4 in accordance with the GA's latest published guidance? YES/~~NO/NA~~

9 Taken overall, does the valuation basis appear to be best described as strong (A), adequate (C), weak (D) or potentially unacceptable (E)? ~~A~~/C/D/~~E~~

Enormous Growing liability for terminal bonuses on U.W.P. business is not reserved for, so that FORM 9 margin overstates strength!

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1997 returns

SOLVENCY POSITION

10 Taking into account the individual characteristics of the company, is the absolute level of cover for the RMM shown in F9 best described as very healthy (A), healthy (B), adequate (C), of concern (D) or negative/such as to require immediate action by HMT (E)?	~~A/~~B/C/~~D/E/NA~~ See comments under 9. & 18 below.
What has the trend in the level of cover been over recent years?	~~UP/DOWN~~/FLAT/ ~~VOLATILE/NA~~
If DOWN, is the slope of decline steepening?	~~YES/NO~~/NA
11 If an implicit item has been included in F9, is there a relevant S68 order referred to in a note to the returns coded 0902?	YES/~~NO/NA~~

SUITABILITY OF ASSETS

12 Does the hypothecation of assets to liabilities in F57 look reasonable	
- for with-profit business?	YES/~~NO/NA~~
- for non-profit business?	YES/~~NO/NA~~
Is it reasonable after the change to asset classes brought about by derivatives (see Regulation 23(d) statement)?	~~YES/NO~~/NA
13 Does the company have significant exposure to derivatives? IF YES, do adequate margining arrangements appear to be in place in respect of derivatives	~~YES~~/NO/~~NA~~
- shown in F17?	~~YES/NO~~/NA
- shown in F56?	~~YES/NO~~/NA
14 Is the level of mismatching by currency revealed by the schedule shown in paragraph 11(1) of Schedule 4 material?	~~YES~~/NO
15 Are any of the linked asset surpluses/deficits shown in column 10 of F55 material?	~~YES~~/NO/~~NA~~
16 Does the company have any large counterparty exposures (see paragraph 11(2) of Schedule 1) described in a note to the returns coded 1312?	~~YES~~/NO

OPERATING RESULTS

17 Is either the absolute level of surplus/deficit emerging or its trend over recent years such as to give current cause for concern?	~~YES~~/NO
18 Is either the absolute level of any capital injection into the company or its trend over recent years such as to give current cause for concern?	~~YES~~/NO/~~NA~~ Raised £350m from Subordinated Loan.

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1997 returns

19 Is either the absolute level of management expenses or their trend over recent years such as to give current cause for concern?	~~YES~~/NO
20 Is either the absolute level of sales or their trend over recent years such as to give current cause for concern?	YES/NO V. high and negligible estate
21 Is either the absolute level of the initial commission ratio or its trend over recent years such as to give current cause for concern?	~~YES/NO~~/NA
22 Is the amount of reinsurance material?	~~YES~~/NO (but All Class IV business
If YES,	
- Are there any material financing arrangements in force?	~~YES/NO~~/NA
- Is there a material exposure to non-UK authorised reinsurers without deposit back?	~~YES/NO~~/NA
PRE ISSUES	
23 Has the percentage of distributed surplus allocated to policyholders been reduced?	~~YES/NO~~/NA (Matured)
If YES,	
- Is the reduction allowable under section 30 of ICA82?	~~YES/NO~~/NA
- Is the current percentage less than 90%?	~~YES/NO~~/NA
24 Is the surplus carried forward negative?	~~YES~~/NO
If YES, has a dividend been paid?	~~YES/NO~~/NA
25 Does the method used for the creation and cancellation of units in internal linked funds and determining unit prices for the allocation of units to, and the cancellation of units from, policies described in paragraph 5(4) of Schedule 4 look reasonable?	YES/~~NO/NA~~
Does the method used to determine the provision for CGT described in paragraph 5(5) of Schedule 4 look reasonable?	YES/~~NO/NA~~
26 Do the circumstances in which, and the method by which, a MVA may be applied under accumulating with-profit policies described in paragraph 4(1)(a)(i) of Schedule 4 look reasonable?	YES/~~NO/NA~~
Is the answer given in paragraph 4(1)(a)(ii) of Schedule 4 satisfactory?	YES/NO/NA

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1997 returns

CURRENT ISSUES

27 Has the company set up any identifiable pensions mis-selling reserve? ~~YES~~/NO/~~NA~~
In cy. response, £75m stated to be included (FORM 52)
If YES,
- is the reserve consistent with the total provision as at the valuation date given in the company's response to HMT's letter dated 12 March 1998 on pensions mis-selling provisions (incl Phase II costs)? ~~YES/NO~~/NA
- is the updated 31 March 1998 position given in that response such as to give current cause for concern? ~~YES~~/NO/~~NA~~

28 Is the company known/~~likel~~y to have a material exposure to annuity guarantees? YES/~~NO/NA~~
Adjusts terminal bonuses - so no value to policyholder!
No additional reserves considered necessary.

29 Actuary's comments on Form A1 answers, particularly where answer is in **BOLD**:

30 Aspects which look worrying:

Is Q28. position satisfactory?

31 Other notes:
(1) Actuary was requested to disclose mis-selling provision in letter of 16/1/98, promised to do so in letter of 4/2/98 – but ~~has~~ appears to have ~~failed to do so in these Returns.~~ [REVIEW]
NO – in FORM 52
(2) Review annuitant mortality assumptions
(3) Issue of £350m Subordinated Loan appears to be sole reason for increase in available assets over year.

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1997 returns

32 Items to be notified to HMT, to be taken up immediately with the company:

—

33 Priority rating:
2 years ago....4....Last year....3....New....4....

Target date....28.02.99....

INITIALS: ....[redacted].... DATE: 20/8/98

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1998 returns

Form A1

INITIAL SCRUTINY - KEY CHECKS

1 Company ...The Equitable Life Assurance Society...

2 Valuation date ...31/12/98...

COMPLETENESS OF RETURNS

3	Have the appropriate returns been submitted? (UK BRANCH/GLOBAL/EEA BRANCHES)	YES/~~NO~~	
4	Do all the Forms appear to be present, including in particular a F17 for each F13, a F14 for each long term assets F13, and summary Forms where these are required?	YES/~~NO~~	
	If NO, is there a note to the returns coded FF00 for each missing Form (where FF is the Form number) stating that it would have been blank?	~~YES~~/~~NO~~/NA	Page no.
5	Is the Regulation 23 derivatives statement present?	YES/~~NO~~	Page no. 394-5
6	Is the Regulation 24 statement on shareholder controllers present (UK companies only)?	YES/~~NO~~/~~NA~~	Page no. 396
7	Is the Regulation 31 statement giving additional information on the appointed actuary present?	YES/~~NO~~	Page no. 397
8	Have the Companies Act Report & Accounts been received?	~~YES~~/NO	
	If NO, has this fact been recorded so that they can be requested?	YES/~~NO~~/~~NA~~	
9	Do the returns appear to contain references to any S68 orders?	YES/~~NO~~	
	If YES, where do they appear?		Page no. 398, 414.

CERTIFICATES

10	Has the directors' certificate been supplied in the format of Schedule 6 Part 1, without any omissions or qualifications? In particular,	YES/~~NO~~	Page no. 409-41
	- Is there a statement that the RMM has been maintained throughout the year?	YES/~~NO~~	
	- Is there a statement that the investment policy and practice throughout the year in respect of any internal linked funds was consistent with representations made to policyholders?	YES/~~NO~~/~~NA~~	
	- Is there a statement that each of PGNs 1994/6, 1995/1, 1995/3 and 1998/1 and guidance on Money Laundering revised in February 1995 have been complied with?	YES/~~NO~~	

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1998 returns

11	Has the Appointed Actuary's certificate been supplied in the format of Schedule 6 Part II, without any omissions or qualifications?	YES/~~NO~~	Page no. 411.
12	Is the auditors' report in the format of Schedule 6 Part III, without any omissions or qualifications?	YES/~~NO~~	Page no. 413-41
	If NO, is there a reference in the notes to the returns to any relevant S68 orders allowing specific omissions?	~~YES~~/~~NO~~/NA	Page no.
13	Is the Appointed Actuary's report in Schedule 4 stated to be in accordance with Regulation 64?	YES/~~NO~~	

14 If the answer to any of questions 10 to 13 is <u>NO</u>, give details:

....

....

....

SOLVENCY

15	Is F9.44 either positive or zero?	YES/~~NO~~
16	Is each F58.29 either positive or zero?	YES/~~NO~~
17	Is each F58.35 either positive or zero?	YES/~~NO~~
18	Is each F58.34 zero?	YES/~~NO~~

OTHER CHECKS

19	Does F9.21 equal F10.11?	YES/~~NO~~
20	Non-composites only. Does F9.22 equal F10.29?	YES/~~NO~~/~~NA~~
21	Composites only. Does F9.22 equal F10.29 minus F9.11?	~~YES~~/~~NO~~/NA
22	Does F9.23 equal summary F14.11 plus summary F14.63?	YES/~~NO~~
23	Does F9.24 equal summary F14.12 plus summary F14.49?	YES/~~NO~~
24	Does F9.41 equal F60.69?	YES/~~NO~~
25	Does F10.11 equal F13.89 (long term business)?	YES/~~NO~~
26	Does F10.12 equal summary F14.59?	YES/~~NO~~
27	Does F10.11 equal F10.12?	YES/~~NO~~
28	Does OB F14.11 equal OB (F58.21 + F58.43+ F58.44 + F58.45)?	YES/~~NO~~/~~NA~~

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1998 returns

29	Does IB F14.11 equal IB (F58.21 + F58.43+ F58.44 + F58.45)?	YES/NO/NA
30	Does OB F14.12 equal OB F58.42?	YES/NO/NA
31	Does IB F14.12 equal IB F58.42?	YES/NO/NA
32	Does OB F14.13 equal OB F58.49?	YES/NO/NA
33	Does IB F14.13 equal IB F58.49?	YES/NO/NA
34	Are OB F14.14, OB F40.59 and OB F58.11 all equal?	YES/NO/NA
35	Are IB F14.14, IB F40.59 and IB F58.11 all equal?	YES/NO/NA
36	Does F16.13 equal summary F40.26?	YES/NO/NA
37	Does each F40.26 correspond to either the corresponding F58.13 or F58.32?	YES/NO
38	Is summary F14.51 either zero or positive?	YES/NO
39	Is each F58.49 either zero or positive?	YES/NO
40	If summary F58.49 is negative, is F16.51 zero?	YES/NO/NA

INITIALS: ......[redacted].............. DATE: ......1/4/99.......

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1998 returns

Form A2

INITIAL SCRUTINY - KEY CHECKS (ACTUARY)

1 Company........THE EQUITABLE LIFE ASSURANCE SOCIETY

2 Valuation date 31. 12. 1998

STRENGTH OF VALUATION BASIS

3 Are all the interest rates in F57 (including those in col 6) supported by the risk adjusted yields on the matching assets
- for with-profit business? Query sustained yield on deposits ? YES/~~NO/NA~~
- for non-profit business? YES/~~NO/NA~~

Do the with-profit rates in cols 2 and 6 appear to make provision for PRE? * Review implications of discount rates shown for UWP business. YES/NO/~~NA~~

Has allowance been made for the change to asset classes brought about by derivatives (see Regulation 23(d) statement and paragraph 6(1)(a) of Schedule 4)? ~~YES/NO~~/NA

4 On the evidence of the margins between the interest rates in F57 and the corresponding risk adjusted yields, does the overall interest basis appear to be best described as strong (A), adequate (C), weak (D) or potentially unacceptable (E)? ~~A~~ C ~~D E~~ but see above *

5 Are the mortality rates acceptable within GAD guidelines (not yet revised)
- for assurances? YES/~~NO/NA~~
- for annuities? YES/~~NO/NA~~

Where PHI is a material class, do the morbidity rates look reasonable? ~~YES/NO~~/NA

6 Does the aggregate expense allowance disclosed in paragraph 10(2) of Schedule 4 look reasonable compared with management expenses in connection with maintenance of business shown in F41.44? £34.2m YES/~~NO~~ £69m O.K. combined

Are other management expenses shown in F41.45 material? £8.5m YES/~~NO~~

7 Do the linked contract valuation basis parameters look reasonable? YES/~~NO/NA~~
Margin between gross rate of unit growth & inflation rate now reduced to 2% (prev. somewhat dubious 3% margin)

Have per policy expense allowances been increased since last year? ~~YES~~/NO/~~NA~~

8 Is the resilience test described in paragraph 7(6) of Schedule 4 in accordance with the GA's latest published guidance? YES/~~NO/NA~~

9 Taken overall, does the valuation basis appear to be best described as strong (A), adequate (C), weak (D) or potentially unacceptable (E)? ~~A~~ C ~~D E~~

See 6(1)(h) | But, gross g'teed annuity reserves have been established assuming that would not be taken in all cases – allowances appears to be greater than suggested in GA's guidance.
N.B. Higher gross reserves would have been offset by higher reassurance credit.

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1998 returns

(1) We still need to be satisfied that reins. treaty with Irish ERC works in the way intended - REQUEST COPY OF TREATY as finally agreed.

SOLVENCY POSITION

10 Taking into account the individual characteristics of the company, is the absolute level of cover for the RMM shown in F9 best described as very healthy (A), healthy (B), adequate (C), of concern (D) or negative/such as to require immediate action by HMT (E)? — ~~A/B~~/C/~~D/E/NA~~

(2) Loss of the Court case on treatment of G'teed Annuities would put position in doubt - would need to cut all bonuses.

What has the trend in the level of cover been over recent years? — ~~UP/DOWN~~/FLAT/~~VOLATILE/NA~~

(Increasing use of Imp. F.P. Item has raised the 4+ margin)

If DOWN, is the slope of decline steepening? — ~~YES/NO~~/NA

11 If an implicit item has been included in F9, is there a relevant S68 order referred to in a note to the returns coded 0902? — YES/~~NO/NA~~

SUITABILITY OF ASSETS

12 Does the hypothecation of assets to liabilities in F57 look reasonable
- for with-profit business? — YES/~~NO/NA~~
- for non-profit business? — YES/~~NO/NA~~

Is it reasonable after the change to asset classes brought about by derivatives (see Regulation 23(d) statement)? — ~~YES/NO~~/NA

13 Does the company have significant exposure to derivatives? — ~~YES~~/NO/~~NA~~
IF YES, do adequate margining arrangements appear to be in place in respect of derivatives
- shown in F17? — ~~YES/NO~~/NA
- shown in F56? — ~~YES/NO~~/NA

14 Is the level of mismatching by currency revealed by the schedule shown in paragraph 11(1) of Schedule 4 material? — ~~YES~~/NO

15 Are any of the linked asset surpluses/deficits shown in column 10 of F55 material? — ~~YES~~/NO/~~NA~~

A surplus of modest proportions is held for most internal funds. Σ: £19.26m, equal overall to 0.77% of Σ unit value. [All included in line 59 of F13.

16 Does the company have any large counterparty exposures (see paragraph 11(2) of Schedule 1) described in a note to the returns coded 1312? — ~~YES~~/NO

OPERATING RESULTS

17 Is either the absolute level of surplus/deficit emerging or its trend over recent years such as to give current cause for concern? — ~~YES~~/NO (but fall shown for 1998)

18 Is either the absolute level of any capital injection into the company or its trend over recent years such as to give current cause for concern? — ~~YES~~/NO/~~NA~~

but remember £350m Subordinated Loan issued in 1997.

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1998 returns

19 Is either the absolute level of management expenses or their trend over recent years such as to give current cause for concern? — ~~YES~~/NO | but reserve growing OHE entries.

20 Is either the absolute level of sales or their trend over recent years such as to give current cause for concern? — ~~YES~~/NO | but reduced sales of AP contracts in 1998

21 Is either the absolute level of the initial commission ratio or its trend over recent years such as to give current cause for concern? — ~~YES/NO~~/NA

22 Is the amount of reinsurance material? — YES/~~NO~~ Special treaty to cover emerging g'teed annuity liabilities
If YES,
- Are there any material financing arrangements in force? — ~~YES~~/NO/~~NA~~
- Is there a material exposure to non-UK authorised reinsurers without deposit back? — YES/NO/NA for this treaty.

PRE ISSUES

23 Has the percentage of distributed surplus allocated to policyholders been reduced? — ~~YES/NO~~/NA (Mutual)
If YES,
- Is the reduction allowable under section 30 of ICA82? — ~~YES/NO~~/NA
- Is the current percentage less than 90%? — ~~YES/NO~~/NA

24 Is the surplus carried forward negative? — ~~YES~~/NO
If YES, has a dividend been paid? — ~~YES/NO~~/NA

25 Does the method used for the creation and cancellation of units in internal linked funds and determining unit prices for the allocation of units to, and the cancellation of units from, policies described in paragraph 5(4) of Schedule 4 look reasonable? — YES/~~NO/NA~~

Does the method used to determine the provision for CGT described in paragraph 5(5) of Schedule 4 look reasonable? — YES/~~NO/NA~~

26 Do the circumstances in which, and the method by which, a MVA may be applied under accumulating with-profit policies described in paragraph 4(1)(a)(i) of Schedule 4 look reasonable? — YES/~~NO/NA~~

Is the answer given in paragraph 4(1)(a)(ii) of Schedule 4 satisfactory? — YES/NO/NA

Reserve ~~can be~~ is normally less than asset share,
but SVs only limited to asset share & normally achieved by reducing terminal bonus
~~Abt~~ i.e. Society would normally pay out more than reserve anyway

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1998 returns

CURRENT ISSUES

27 Has the company set up any identifiable pensions mis-selling reserve? — YES/~~NO/NA~~
£70m (prev. £75m)
If YES,
- is the reserve consistent with the total provision as at the valuation date given in the company's response to HMT's letter dated 12 March 1998 on pensions mis-selling provisions (incl Phase II costs)? — YES/~~NO/NA~~
- is the updated 31 March 1998 position given in that response such as to give current cause for concern? — ~~YES~~/NO/~~NA~~

28 Is the company known/likely to have a material exposure to annuity guarantees? — YES/~~NO/NA~~
Reason for early submission of this Return.

29 Actuary's comments on Form A1 answers, particularly where answer is in **BOLD**:

30 Aspects which look worrying:

(1) Consider 6(1)(h) response.
(2) Need to examine Irish ERC treaty.
(3) Possible loss of court case – implications for the Society?

31 Other notes:

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1998 returns

32 Items to be notified to HMT, to be taken up immediately with the company:

Refer items 30. 1 & 2

33 Priority rating:
2 years ago........3........Last year........4........New........2........
Target date........30. 6. 1999........

INITIALS: ....[redacted]........ DATE: ....8/4/99........

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1999 returns

Form A1

INITIAL SCRUTINY - KEY CHECKS

1 Company The equitable Life Assurance Society

2 Valuation date 31st Dec 99

COMPLETENESS OF RETURNS

3	Have the appropriate returns been submitted? (~~UK BRANCH~~/GLOBAL/~~EEA BRANCHES~~)	YES/~~NO~~	
4	Do all the Forms appear to be present, including in particular a F17 for each F13, a F14 for each long term assets F13, and summary Forms where these are required?	YES/~~NO~~	
	If NO, is there a note to the returns coded FF00 for each missing Form (where FF is the Form number) stating that it would have been blank?	~~YES/NO~~/NA	Page no.
5	Is the Regulation 23 derivatives statement present?	YES/~~NO~~	Page no. 401 402
6	Is the Regulation 24 statement on shareholder controllers present (UK companies only)?	YES/~~NO/NA~~	Page no. 403
7	Is the Regulation 31 statement giving additional information on the Appointed Actuary present?	YES/~~NO~~	Page no. 404
8	Have the Companies Act Report & Accounts been received?	~~YES~~/NO	
	If NO, has this fact been recorded in a spreadsheet so that they can be requested?	YES/~~NO/NA~~	
9	Do the returns appear to contain references to any S68 orders?	YES/~~NO~~	
	If YES, where do they appear? i) Persmalicd Fund. 2) Future profits implicit item		Page no. 405

CERTIFICATES

10	Has the directors' certificate been supplied in the format of Schedule 6 Part 1, without any omissions or qualifications? In particular,	YES/~~NO~~	Page no. 416 417
	- Is there a statement that the RMM has been maintained throughout the year?	YES/~~NO~~	
	- Is there a statement that the investment policy and practice throughout the year in respect of any internal linked funds was consistent with representations made to policyholders?	~~YES/NO~~/NA	
	- Is there a statement that each of PGNs 1994/6, 1995/1, 1995/3 and 1998/1 and guidance on Money Laundering revised and consolidated in June 1997 have been complied with?	YES/~~NO~~	

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1999 returns

11 Has the Appointed Actuary's certificate been supplied in the format of Schedule 6 Part II, without any omissions or qualifications? YES/~~NO~~ Page no. 418

12 Is the auditors' report in the format of Schedule 6 Part III, without any omissions or qualifications? ~~YES~~/NO Page no. 419. 420.

If NO, is there a reference in the notes to the returns to any relevant S68 orders allowing specific omissions? YES/~~NO/NA~~ Page no. 405

13 Is the Appointed Actuary's report in Schedule 4 stated to be in accordance with Regulation 64? YES/~~NO~~

14 If the answer to any of questions 10 to 13 is **NO**, give details:

Q.12 reference to Section 68 order.
See Comment overleaf

SOLVENCY

15 Is F9.44 either positive or zero? YES/~~NO~~

16 Is each F58.29 either positive or zero? YES/~~NO~~

OTHER CHECKS

17 Does F9.21 equal F10.11? YES/~~NO~~

18 Non-composites only. Does F9.22 equal F10.29? YES/~~NO/NA~~

19 Composites only. Does F9.22 equal F10.29 minus F9.11? ~~YES/NO~~/NA

20 Does F9.23 equal summary F14.11 plus summary F14.63? YES/~~NO~~

21 Does F9.24 equal summary F14.12 plus summary F14.49? YES/~~NO~~

22 Does F9.41 equal F60.69? YES/~~NO~~

23 Does F10.11 equal F13.89 (long term business)? YES/~~NO~~

24 Does F10.12 equal summary F14.59? YES/~~NO~~

25 Does F10.11 equal F10.12? YES/~~NO~~

26 Does OB F14.11 equal OB (F58.21 + F58.43+ F58.44 + F58.45)? YES/~~NO/NA~~ difference = 1,000

27 Does IB F14.11 equal IB (F58.21 + F58.43+ F58.44 + F58.45)? ~~YES/NO~~/NA

28 Does OB F14.12 equal OB F58.42? YES/~~NO/NA~~

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1999 returns

29 Does IB F14.12 equal IB F58.42?	~~YES/NO~~/NA
30 Does OB F14.13 equal OB F58.49?	~~YES/NO/NA~~ NO
31 Does IB F14.13 equal IB F58.49?	~~YES/NO~~/NA
32 Are OB F14.14, OB F40.59 and OB F58.11 all equal?	YES/~~NO/NA~~
33 Are IB F14.14, IB F40.59 and IB F58.11 all equal?	~~YES/NO~~/NA
34 Does F16.13 equal summary F40.26?	~~YES/NO~~/NA
35 Does each F40.26 correspond to either the corresponding F58.13 or F58.32?	YES/~~NO~~
36 Is summary F14.51 either zero or positive?	YES/~~NO~~
37 Is each F58.49 either zero or positive?	YES/~~NO~~
38 If F16.51 is positive, are summary F58.49 and F10.56 both non-negative?	~~YES/NO~~/NA

INITIALS: ....[redacted]................ DATE: 28/7/00

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1999 returns

.orm A2

INITIAL SCRUTINY - KEY CHECKS (ACTUARY)

1 Company.......ECQUITABLE LIFE ASSURANCE SOCIETY.......

2 Valuation date ....31.12.99.......

STRENGTH OF VALUATION BASIS

3 Are all the interest rates in F57 (including those in col 6) supported by the risk adjusted yields on the matching assets
- for with-profit business? YES/**NO**/NA
- for non-profit business? YES/**NO**/NA

Do the with-profit rates in cols 2 and 6 appear to make provision for PRE? YES/**NO**/NA

Looks tight

Appears value some life business @ guar rates : these are annuities

Has allowance been made for the change to asset classes brought about by derivatives (see Regulation 23(d) statement and paragraph 6(1)(a) of Schedule 4)? YES/**NO**/NA

4 On the evidence of the margins between the interest rates in F57 and the corresponding risk adjusted yields, does the overall interest basis appear to be best described as strong (A), adequate (C), weak (D) or potentially unacceptable (E)? A / C / **D** / **E**

5 Are the mortality rates acceptable within GAD guidelines
- for assurances? See Table 5102 p. 412 YES/**NO**/NA
- for annuities? YES/**NO**/NA

Where PHI is a material class, do the morbidity rates look reasonable? YES/**NO**/NA

6 Does the aggregate expense allowance disclosed in paragraph 10(2) of Schedule 4 look reasonable compared with the maintenance expenses plus renewal commission shown in F41.44 and F41.42? YES/**NO**

£74m c/w £36m

Are other management expenses shown in F41.45 material? **YES**/NO

£13m

7 Do the linked contract valuation basis parameters look reasonable? YES/**NO**/NA

Have per policy expense allowances been increased since last year? YES/**NO**/NA

8 Is the resilience test described in paragraph 7(6) of Schedule 4 in accordance with the GA's latest published guidance? YES/**NO**/NA

9 Taken overall, does the valuation basis appear to be best described as strong (A), adequate (C), weak (D) or potentially unacceptable (E)? A / C / **D** / **E**

GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1999 returns

before House of Lords ruling!

SOLVENCY POSITION

10 Taking into account the individual characteristics of the company, is the absolute level of cover for the RMM shown in F9 best described as very healthy (A), healthy (B), adequate (C), of concern (D) or negative/such as to require immediate action by FSA (E)? — A / B / C / **D** / **E** / NA

What has the trend in the level of cover been over recent years? — UP/**DOWN**/FLAT/ VOLATILE/NA

If DOWN, is the slope of decline steepening? — **YES**/NO/NA

11 If an implicit item has been included in F9, is there a relevant S68 order referred to in a note to the returns coded 0902? — YES/**NO**/NA

SUITABILITY OF ASSETS

12 Does the hypothecation of assets to liabilities in F57 look reasonable
- for with-profit business? — YES/**NO**/NA
- for non-profit business? — YES/**NO**/NA

Is it reasonable after the change to asset classes brought about by derivatives (see Regulation 23(d) statement)? — YES/**NO**/NA

13 Does the company have significant exposure to derivatives? — **YES**/NO/NA

IF YES, do adequate margining arrangements appear to be in place in respect of derivatives
- shown in F17? — YES/**NO**/NA
- shown in F56? — YES/**NO**/NA

14 Is the level of mismatching by currency revealed by the schedule shown in paragraph 11(1) of Schedule 4 material? — **YES**/NO

15 Are any of the linked asset surpluses/deficits shown in column 10 of F55 material? Exist, but < 1% unit values — **YES**/NO/NA

16 Does the company have any large counterparty exposures (see paragraph 11(2) of Schedule 1) described in a note to the returns coded 1312? — **YES**/NO

OPERATING RESULTS

17 Is either the absolute level of surplus/deficit emerging or its trend over recent years such as to give current cause for concern? — **YES**/NO

18 Is either the absolute level of any capital injection into the company or its trend over recent years such as to give current cause for concern? — **YES**/NO/NA

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1999 returns

19 Is either the absolute level of management expenses or their trend over recent years such as to give current cause for concern?	YES/NO	one material though
20 Is either the absolute level of sales or their trend over recent years such as to give current cause for concern?	YES/NO	
21 Is the amount of reinsurance material? If YES, - Are there any material financing arrangements in force? - Is there a material exposure to non-UK authorised reinsurers without deposit back?	YES/NO YES/NO/NA YES/NO/NA	GAD treaty with Irish European

PRE ISSUES

22 Has the percentage of distributed surplus allocated to policyholders been reduced? If YES, - Is the reduction allowable under section 30 of ICA82? - Is the current percentage less than 90%?	YES/NO/NA YES/~~NO~~/NA ~~YES~~/NO/NA	
23 Is the surplus carried forward negative? If YES, has a dividend been paid?	YES/NO ~~YES/NO/NA~~	
24 Does the method used for the creation and cancellation of units in internal linked funds and determining unit prices for the allocation of units to, and the cancellation of units from, policies described in paragraph 5(4) of Schedule 4 look reasonable?	YES/NO/NA	
Does the method used to determine the provision for CGT described in paragraph 5(5) of Schedule 4 look reasonable?	YES/NO/NA	
25 Do the circumstances in which, and the method by which, a MVA may be applied under accumulating with-profit policies described in paragraph 4(1)(a)(i) of Schedule 4 look reasonable?	YES/NO/NA	
Is the answer given in paragraph 4(1)(a)(ii) of Schedule 4 satisfactory?	YES/NO/NA	

Don't understand it
- review DMW' correspondence post 1996 scrutiny

CURRENT ISSUES

26 Has the company, or any group of which it forms part, been the subject of a major restructuring during the year such that the content or format of the tables required in this year's detailed scrutiny report will be materially different from those in last year's report?	YES/NO	

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GAD's A1 and A2 initial scrutiny key checks in respect of Equitable

1999 returns

27 Has the company set up any identifiable reserve in respect of pensions mis-selling? £132m on F52 (up from £70m) — YES/**NO**/NA

If YES,

- is the reserve consistent with the total provision as at the valuation date given in the company's response to any letter from FSA asking for updated pensions mis-selling figures as at 29 February 2000? — YES/**NO**/NA
- is the updated 29 February 2000 position given in that response, or the company's exposure to pensions mis-selling in general, such as to give current cause for concern? — **YES**/NO/NA

28 Did the company's response to the 1998 GAD questionnaire indicate that it has a material exposure to annuity guarantees? — **YES**/NO

IF YES,

- is either the amount of any additional reserve held in respect of these guarantees, or any aspect of the basis used to calculate it, such as to give cause for concern? — **YES**/NO/NA

  – An understatement on this occasion.

29 Comments on Form A1 answers, particularly where answer is in **BOLD**:

–

30 General comments: Company now for sale. GAO treaty being renegotiated. Implicit item. Sub loan issued 1992

Review UWP reserving basis. DMW queried this following 1996 scrutiny (shown as 4% interest on FF52/57).

Review val^n int. rate margins (some life bus valued @ gross rates?

Resil. Reserve £2.1bn (NPV) £1.35bn (BRV)

OME £13m

31 Priority rating:
2 years ago.......4.......Last year.......2.......New.......2....... (because of Co. Sale & adverse House of Lords ruling.)

Target date.......31.10.2000.......

Next expected valuation date.......31.12.2000.......

32 Have you entered the required Form A2 data onto CSM? (tick box when done) ☑

33 Have you completed an initial scrutiny report in the suggested format and saved this at S:\CSM\scrutinies\[company name]\is1999.doc? (tick box when done) ☑

INITIALS: ...[redacted]................... DATE: ......14/8/2000......

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Section 7

Other primary documents

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated September 1990

September 1990

VALUATION AND BONUS DECLARATION AT 31 DECEMBER 1990

1. The recent falls in world stockmarkets could mean that we may face a more difficult position at the end of this year than has applied for some time. Although the current position is very uncertain, it seems highly likely that the earnings on the fund at market value will represent a negative return over 1990. In view of that position, I feel it appropriate to begin discussion of some possible alternative courses of action rather earlier than normal. That is the purpose of this paper.

2. In a time of depressed market values there are significant constraints on what can be achieved technically or within the current regulatory regime. I think, however, that our approach should be first of all to identify what we feel to be the 'right' result and then to consider the extent to which that can actually be achieved in practice.

3. With profits business is fundamentally about the smoothing and averaging of performance. Where there are dramatic changes in conditions from year to year, any 'objective' system of averaging tends to break down. A comparison of the position to the end of June 1990, reported to the board in July, with that at the end of August is given in the Appendix. That demonstrates how things have moved in the last two months. On current projections, assuming stability for the remainder of the year, the returns available on the with profits business might look something as follows:

1988	15.1%
1989	26.0%
1990	-8.0%

It is by no means clear what a smoothed return for 1990 should be.

4. I think, therefore, that we need to return to basics. In essence we offer our with profits policyholders an investment in a mixed portfolio of professionally-managed assets. It seems reasonable to assume that, over time, such a fund will out-perform money on deposit. A 'deposit rate' return could, therefore, be regarded as the minimum that a policyholder might expect to receive in respect of any one year.

5. Over 1990 it has been possible to earn 14-15% on deposits. To the extent that new money has been invested in other types of asset, it does not appear an unreasonable approach to assume that eventually those assets will earn 14-15% in respect of 1990. A similar argument can be made in respect of existing assets, otherwise they would theoretically have been switched. In other words we are talking about a timing problem.

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated September 1990

6. Of course the real world is not as simple as implied in paragraph 5 and the required return for 1990 may never be obtained or may be obtained at so remote a date in the future that the possibility of doing so should be ignored. Given that we have not switched to deposits in a significant way, we are, presumably, reasonably confident of matching the deposit rate for 1990 in due course. It might, however, be prudent to take a precautionary margin on the required rate and set it at 12%, say. Clearly this margin is arbitrary but if it is too large it makes a comment about recent investment activity.

7. The with profits policyholder has not bought a unit linked policy which directly follows fluctuations in market values, he has been told about the smoothing and averaging approach to with profits business and he will be surprised if his contract does not grow at least in line with something like average deposit rates. I believe that as a starting point for the returns to be allotted over the year we might think of something between 12% and 15%. That is consistent with the earnings required to support a declared rate at last year's level of £7.50%.

8. A return at the 12% to 15% level would be more than sufficient to maintain long-term pay-outs at their 1990 levels but would lead to some reduction in published 10 year results. That is likely to be true for other offices also and is consistent with the information that the [redacted] have published in their 'with profits guide'.

9. The most technically and financially efficient way of allotting the return for the year would be to apply it wholly by way of an increase in the 'unconsolidated' or 'final bonus' element of policy values. This element is not guaranteed, requires no capital to finance it and is only paid out on policies leaving the fund. Hence it is very well suited to the situation where future earnings are being anticipated. If it eventually emerges that we have 'got it wrong' the damage is limited and room for future manoeuvre is retained.

10. In considering how much of the 'potential' earnings might be 'consolidated' as declared bonus, however, the constraints mentioned in paragraph 2 above must be brought into account. Declared bonuses are guaranteed policy benefits and appropriate additional reserves must be established for them. Such reserves eat into the Investment Reserve otherwise available and from which the solvency margin must be found.

11. In technical terms, any presentational problems created by declaring a bonus can almost certainly be mitigated by weakening the valuation basis. There are, however, constraints on the extent to which that can be done. Once done there is then also no leeway available in a future year. Further technical measures are also available to help the DTI Return presentation (but not the Company Act balance sheet). The use of such measures has to be publicly stated and could be construed as a sign of weakness. Again, these are largely 'one off' measures.

'Valuation and bonus declaration at 31 December 1990', dated September 1990

12. In considering such technical issues the possible position in future years needs to be kept in mind. Maximising the declared bonus might be a dangerous course of action. It might require pushing all margins to the limit this year thereby leaving no room for manoeuvre in the future. Clearly if 1991 again turned out to be a poor year for investment returns, the possible courses of action at 31 December 1991 might be severely limited. Special action might be required and other offices might not be in the same position.

13. A reduction in declared rates below £7.50% would, of course, ease the position by reducing the additional reserves which need to be established. A cut in a single year, unless dramatic, does not, however, bring significant immediate relief. For example, a reduction in the rate from £7.50% to £6.50% would 'save' only some £40m at 31 December 1990. A cut does, of course, lead to significant savings in due course.

14. After a year of high interest rates there is, also, no objective basis on which to base a reduction in declared rates. Any cut would be arbitrary and, if it were other than fairly marginal, could be seen as weak. As noted above, a marginal cut would only bring a small benefit. The current situation is quite different from that of 1986/7 when we last cut declared bonus rates. At that time interest rates had fallen to a level which would not support the previous level of bonuses and a continued dependence on the out-performance of equities seemed imprudent. At current interest levels, declared bonus rates of £7.50% are supportable on interest rate considerations alone.

15. If the more radical approach implied in paragraph 9 above were adopted, we should have no declared rate at all. The whole of the earnings allotted would be passed on by way of final bonus. That would strengthen the balance sheet position by something of the order of £300m which would be a true strengthening since no additional guaranteed benefits would have been granted.

16. Such action would be dramatic and might be perceived as weak. It might, however, equally be seen as logical and good tactics, given careful presentation to policyholders and the public. I believe that it could be presented as a positive and original approach to a confused and disorderly position on world stockmarkets. We could also present it as a way of retaining the freedom to pass on a higher return to policyholders than would otherwise be the case.

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated September 1990

17. To summarise:

- unless there is a significant upturn in markets, it will be an uncomfortable year end for bonus purposes
- interest rates have been relatively high for the whole year and policyholders might expect benefits based on returns ranging from about 12% to about 15%
- that could argue for maintenance of declared rates at last year's level of £7.50%
- it might be possible technically to produce the required surplus for such a declaration but this would necessarily be a 'one off' operation. A bad year in 1991 would almost certainly lead to even greater discomfort at the end of 1991
- declaration of a marginally lower rate would not really provide adequate savings in surplus. Declaration at a significately lower rate would be difficult to justify and would inevitably look weak
- we now show policyholders how their policy values roll up from year to year at an overall rate of return. It should not really matter to what extent that roll up rate is consolidated by way of declared bonus or left in unconsolidated or final bonus form providing policyholders have confidence in us
- allotting the 1990 return in wholly unconsolidated form would retain a significant amount of freedom, freedom which might eventually be required in respect of 1991
- it seems to me, at this point in the year, that a case could be made either for maintaining declared rates at £7.50% or for having no declared bonus at all. Both courses of action contain significant risks. Maintaining declared rates would result in a significant technical and financial weakening of the Society whilst having no declared rate would run significant public relations risks. There seems no objective basis for an intermediate position and such a position would bring in train both types of risk.

[redacted]

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated September 1990

APPENDIX - REVENUE INFORMATION

	6 months to 30.6.90	8 months to 31.8.90
	£m	£m
Revenue data		
Premiums	691.4	909.9
Investment income	169.1	232.8
Claims	255.9	389.2
Expenses	45.7	62.2
Tax	4.8	6.5
Growth in fund	554.1	684.8
Market value of assets		
Linked assets	416	387
Non-linked assets	5488	5290
Total assets	5904	5677
Yields at market value		
Total business	-6.2% p.a.	-11.9% p.a.
Non-linked business	-6.0% p.a.	-11.2% p.a.

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated November/December 1990

November | December 1990

VALUATION AND DECLARATION AT 31 DECEMBER 1990

Introduction

1. My paper to the September board made some general observations to the effect that the forthcoming 'end of year' was likely to be a more difficult one than we had seen for some time. Since then there has been no significant sustained improvement in financial markets and, consequently, it becomes increasingly likely that we shall not be 'baled out' by a dramatic improvement in conditions before 31 December 1990.

2. I think, therefore, that it is appropriate to consider the position further so that we can begin to develop views on the alternative courses of action available. The purpose of this paper is to set out information as a basis for discussion.

3. This paper is essentially all about the external constraints on the running of a life office - we do not have a 'free hand'. No criticism is implied of the running of any particular part of the office. We are 'where we are' because of a combination of factors - but we can control events to some extent from now on. It needs to be remembered that in a commercial sense there can be no doubt that we have a very sound business - we have strong business flows, expenses are well controlled, our with profits policyholders are told that future bonuses will depend upon future investment returns and we have relatively low guarantees. Unfortunately the regulations bite despite that.

4. To put the position into perspective it may be helpful to look at 1990 in a long-term context. It seems extremely unlikely that the return earned in 1990 will be positive; indeed, a return of around -10% seems likely. If the return is negative that will be the first time that has happened since 1974 (when the return was -28%). If earnings are around -10% that will be 15% lower than in the previous worst year since 1974 (i.e. 1979).

Solvency and DTI requirements

5. The current regulatory regime does not permit the sort of action taken at the end of 1974; there are now significant constraints. Any consideration of the position needs to begin with an understanding of those constraints.

6. The primary requirement is for the office to demonstrate an excess of assets over valuation liabilities. In fact there must be excess assets at least equal to the so-called 'minimum guarantee fund' which, in the Society's case, is 1/6th of the solvency margin (i.e. around £40m out of some £240m projected at 31 December 1990). If the actual excess of assets over liabilities is greater than the 'minimum guarantee fund' but less than the required solvency margin, then a special dispensation can be obtained from the DTI (called a S68 order) to bring so-called 'implicit items' into account. In our case we could use an estimate of future surplus. The use of such orders might be regarded as showing a weak position by external commentators.

'Valuation and bonus declaration at 31 December 1990', dated November/December 1990

7. Assets must be valued on the basis set out in regulations which is, effectively, a market valuation. There is no room to manoeuvre on that side of the comparison. Any difficulties on the public presentation can, therefore, only be overcome by changing the value placed on the liabilities.

8. I have freedom in the value placed on the liabilities, subject to the following regulatory constraints:

(a) the reserves established must, in my professional opinion as the Appointed Actuary, represent a proper level of provision for the liabilities based on 'prudent assumptions';

(b) the reserves must, in any event, be no lower than those produced on a basis laid down in regulations, coupled with additional requirements specified by the Government Actuary in relation to AIDS and 'mismatching'. Mismatching is concerned with looking at the situation if there is a $\pm$ 3% change in interest rates associated with a 25% fall in the value of equities and property. We must demonstrate that our reserves are at a level such that the assets backing those reserves would still cover reserves satisfying the valuation regulations in the changed conditions.

9. It is not necessarily the case that a valuation satisfying constraint (b) above will also satisfy constraint (a). In current conditions it is, however, unlikely that, given a free hand, I should want to place a value on the liabilities higher than that on the statutory basis.

10. I have carried out projections on a range of bases to assess the effect of further market movements over the remainder of the year. These indicate that, except in the event of a further sharp fall in markets before 31 December 1990, I should be able to set liability reserves at a level which would enable a bonus to be declared at last year's level and still satisfy all the regulatory requirements. Looking at this year alone, it is, therefore, fairly unlikely that we shall be unable to do what we should like.

Looking ahead to 31 December 1991

11. A point made in my September paper was that we also need to be mindful of the 1991 position. In particular, we should not put ourselves in a position where we exhausted all room for manoeuvre at 31 December 1990 and then had to take exceptional action, out of line with the market, at 31 December 1991. Accordingly, I have carried out further projections looking a year ahead.

12. In the projections I have assumed capital movements of -10%, 0% and +10%, in 1991. The income yield on the fund will be around 7% at current levels and so these movements are broadly equivalent to overall earnings of -3%, 7% and 17% respectively.

'Valuation and bonus declaration at 31 December 1990', dated November/December 1990

13. The results of the projections for 1991, combined with two different levels of capital movement over December 1990, can be summarised as follows:

		Capital movement in 1991		
		+10%	0%	-10%
Capital movement in December 1990	+5%	90 and 91 declarations covered	90 and 91 declarations covered	90 or 91 declaration covered (but not both)
	0%	90 and 91 declarations covered	90 or 91 declaration covered (but not both)	neither declaration affordable but still solvent at 31.12.91

14. It is, I believe, still too early to form firm views but certain conclusions can be drawn from the figures above. If markets do recover by around 5% by the end of the year then the risks of maintaining bonuses might be acceptable. If there is no such recovery then there are clearly significant risks by having a declaration - that is of being forced to pass the declaration at 31 December 1991 if earnings in 1991 are modest (although significantly better than in 1990) or of having serious problems if 1991 is another bad year for earnings. Those comments imply no changes in investment strategy. One way to make the position in 1991 'more comfortable' would be to place all new money in fixed interest, for example. That would have the effect of increasing the interest rate at which the liabilities can be discounted but would also constrain, of course, the future earning power of the fund. If the situation became really desperate some of the existing portfolio of assets could also be switched - at least in theory.

Policy proceeds

15. The paper so far has been all about the Society's overall financial position. We now need to consider what kinds of action might be appropriate in relation to policy proceeds.

16. As I said in the September board paper, the issue here is fundamentally about smoothing. When violent changes in earnings levels occur, normal averaging processes break down. The board took a view at 31 December 1989 that assets were essentially neither over nor under valued on an historical perspective. We need to consider whether the experience of this year demonstrates that that view was wrong, which would imply that we should start moving policy values down in order to be consistent with the new, lower, asset valuations. Alternatively, we can take the view that 1990 represents a temporary lack of confidence in markets which will be reversed in due course. In that case there is a strong argument for smoothing out most of the effects of the 'trough'.

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated November/December 1990

17. The risks of these two attitudes are fairly clear. In the former case a savage reduction in policy values could weaken confidence and, if we are not followed in that by other offices, a significant weakening of our competitive position. By taking the second course we should have policy values substantially above the level indicated by asset values. If asset values did not recover within a reasonable period we might find the maintenance of that stance uncomfortable. In particular, policies leaving the fund would be taking away substantially more than their share of assets, thereby weakening the fund for the future.

18. What the market might do is by no means clear. There is speculation that a number of offices are considering cuts in bonus rates of various types. The [redacted] which is normally amongst the first of the offices to make its declaration, is reputed to have decided on a later announcement this year. It seems likely that a situation of some uncertainty will prevail and it may be some weeks before any clear picture of overall trends becomes apparent.

19. If we look at interest rate levels alone, those have now recovered to levels consistent with the 1989 declared bonus rates. Following our usual arguments there are, therefore, no grounds for cutting declared rates. For new business effected in 1990 we could have invested in fixed interest stocks and policyholders could reasonably expect to see declared bonuses at 1989 levels with no final bonus element as an appropriate return for the year. By extension, a return of around 11% becomes a reasonable overall growth rate for all business, provided one takes the view that the set-back in asset values is temporary.

20. If we gave an 11% overall return on gross business and 9% on net business, then the approximate change in proceeds from 1990 to 1991 at different durations will be:

Term (years)	Personal pension %	Endowment assurance %
5	- 8%	- 5%
10	- 9½%	- 4%
15	- 2½%	- 2½%
20	-	- ½%
25	+ 1%	+½%

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated November/December 1990

21. Once we have decided what we should like to achieve with policy results we can then turn to how to achieve that. If an overall return of around 11% gross is to be granted (and that in itself needs to be debated) the choices are:

(a) effectively all via maintaining declared bonuses at 1989 levels;

(b) all through final bonus with no declared bonus;

(c) an intermediate position between (a) and (b).

The various options involve risks of various kinds, either in publicity terms or the risks of technical insolvency followed by investment constraints, or both. Much must depend upon the informed views which experts can bring to the possible investment scene over 1991. A note summarising the discussion at the December Investment Committee meeting is accompanying this paper.

Summary

22. The position at 31 December 1990 is likely to be more uncomfortable than for many years. All courses of action carry risks of various types and the decisions to be taken will not be easy. This paper has tried to set out, as objectively as possible, the various alternatives available and their implications, as a basis for discussion. As to timing, my current view is what we should leave decisions as late as is practically possible. I do not believe that we are in a position to take firm decisions at this stage, as we have in previous years.

[redacted]

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated January 1991

January 1991

VALUATION AND DECLARATION AT 31 DECEMBER 1990

Introduction

1. This paper re-examines the matters discussed in earlier papers in the light of the draft actual results for 1990 and the announcements made to date by our competitors. Recommendations are then made as to the approach to be taken to the 1990 bonus declaration.

Preliminary results

2. At this stage only 'first draft' figures are available and these may be subject to change as the detailed end-of-year and audit work progresses but hopefully no significant changes will be required. The current draft revenue account figures are as follows:

	£m
Opening fund	4704
Net revenue for year	959
	5663
Change in value of linked assets	-81
Closing fund	5582

3. The estimated market value of assets at 31 December 1990 is £5795m. This will imply an Investment Reserve of some £210m in the Company Act accounts to show a Balance Sheet value equal to the fund value of £5582m. This position, which is a little more favourable than some earlier projections, reflects the somewhat improved market conditions in the final weeks of the year. The overall return at market value for 1990 was around -8½% which, again, is a little better than some earlier estimates.

4. As previously discussed, it is intended to increase the rate of interest used to value the liabilities in order to reflect the high asset yields resulting from current depressed asset values. I anticipate that the reduction in liability reserves arising from that will enable bonuses to be declared at 1989 levels without any transfer from the Investment Reserve. Indeed, I would expect the liability reserves, including new declared bonuses, to be substantially below the closing fund of £5582m. That is, there will be a larger margin between asset and liability values in the DTI 'Form 9' than simply the amount of the Investment Reserve. Work is in progress on a detailed evaluation of the position and it is intended to provide further figures at the board meeting.

'Valuation and bonus declaration at 31 December 1990', dated January 1991

Review of the market

5. Seven offices have so far made their bonus announcements. Only two, [redacted] and [redacted], have made a cut in declared bonus rates. Various adjustments have been made to terminal bonuses, the precise nature of which depends on the mechanics of each office's individual scales.

6. Rather than looking at the bonus announcements themselves, it is more helpful to look at the effect on policy proceeds. These are shown below for 10 and 25 year term endowment assurance policies, which are the results most commonly quoted in public announcements. Comparable figures for the Society, based on the approach recommended later in this paper, are shown for comparative purposes. We are trying to get some information about pensions policies but this is rather slowly and grudgingly provided.

Office	Change in endowment assurance results 1990-91	
	10 year term	25 year term
	%	%
[redacted]	-5.1	+2.5
	-1.3	+2.4
	+0.5	+12.3
	-10.7	-3.4
	- 8.1	+7.0
	-3.3	+5.0
	-6.7	-6.0
(ELAS	-1.3	+3.4)

If significant further information becomes available over the next few days, updated details will be provided at the board.

7. Two general messages seem to emerge from these initial announcements:

(a) There is no evidence of an industry-wide move to cut declared bonus rates.

(b) Offices generally are acting to smooth out, to a significant extent, the effects of low 1990 earnings. Indeed, the [redacted] has publicly spoken of earnings of 14% p.a. over each of the next 4 years and their 1991 results appear to imply at least that level of earnings deemed for 1990.

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated January 1991

Consideration of the appropriate action for the Society

8. In previous discussions we have felt that a deemed rate of growth in the region of 11/12%, which is consistent with the earnings underlying our declared rates, might be appropriate for 1990. The actual outcome for 1990 and the actions of our competitors to date reinforce my view that this would represent a degree of smoothing consistent with our stated approach to with profits business and the market.

9. The board will recall that, owing to changes in the life office tax system, the Society effectively received a gross return in 1989. For 1990 a broadly similar position applies, although we expect to suffer a moderate level of tax (mainly irrecoverable foreign tax). We did not give the full benefit of a gross return to our 'net' business last year and I think it would be appropriate to do so on this occasion.

10. If we applied a rate of 12% in respect of 1990 for our pensions business then I would expect to use the same rate for endowment assurances. Resulting from the way the expenses are charged for the relevant contracts, a small margin is appropriate between the rates allocated to 'conventional' and 'recurrent single premium' net business. Consistent with these rates I would, therefore, expect to recommend a total growth rate of 11½% for our with profits bond and similar business.

11. Application of a total growth rate of 12% for pensions and endowment assurance business would give the following changes in total policy proceeds on 1 April 1991 compared with those a year earlier:

Term	Change in policy results 1990 - 91	
	Personal pension	Endowment assurance
	%	%
5	-8.1	N/A
10	-9.4	-1.3
15	-2.6	+0.3
20	+0.4	+2.3
25	+1.4	+3.4

From the results quoted for other offices in paragraph 6 it would appear that these results should broadly maintain our competitive position, and might marginally improve it.

12. As noted above, there is no general market move to cut declared rates. Dramatic action, such as passing the declaration altogether, would, in my view, carry an unacceptably high risk of a collapse in confidence. The only circumstances in which it might be appropriate to re-open that question would be in the event of a dramatic collapse in markets during the next few weeks. (One office, [redacted], has publicly stated that it is awaiting further developments in the Gulf before finalising its bonus announcement).

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated January 1991

13. I have previously argued that current conditions give no logical basis for a cut in declared rates. That remains my view. If we were to be one of the few offices to make a reduction in declared rates whilst maintaining the overall level to be allotted, then the publicity that would attract could well counteract the effects of the overall announcement which, as noted above, seems likely to be reasonably competitive. We might, therefore, attract considerable adverse publicity for a relatively trivial financial benefit this year.

14. The course of action described above is not, of course, without risk. Although it has been possible to reduce the liability valuation to permit a declaration at last year's level, the scope for further weakening in the face of another year of low earnings would be seriously constrained. In crude terms, the viability of the action described above relies upon the achievement of better investment returns in the relatively short-term future. We are at risk of needing to take drastic action if those better returns do not materialise.

15. As discussed in December, one can look at projected scenarios for 1991 in order to put those risks into perspective. In broad terms 1991 earnings would need to be:

(a) At around 15% to allow the Society to declare again at 1989 rates and present a similar level of strength to that at 31 December 1990.

(b) At least 8% to enable a declaration to be made at the 1989 level, but showing a weaker position than at 31 December 1990.

(c) At least 0% to avoid problems in demonstrating solvency. This would imply no 1991 declaration.

Our discussion of the investment outlook in December led to the firm view that an estimated return of 13.6% for 1991 should be used as the basis for the consideration of bonus and solvency matters. That view then leads to the conclusion that it is appropriate to take the risks inherent in the course of action described above in current conditions.

Conclusion

16. In the absence of unforeseen circumstances, such as dramatic changes in investment markets or announcements by other leading offices which indicate a market trend different from that emerging to date, I would expect to recommend bonus rates at next month's Special Board meeting based on the following principles:

(a) Declared rates at the same levels as announced last year.

(b) Final bonuses based on a total return of 12% for pensions and conventional net business and 11½% for net business of the recurrent single premium type.

[redacted]

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated February 1991

DIRECTORS ONLY

THE EQUITABLE LIFE ASSURANCE SOCIETY

Special Board Meeting to be held at 11.00 a.m. on Wednesday, 13 February 1991

Valuation and Bonus Declaration as at 31 December 1990

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated February 1991

VALUATION AND BONUS DECLARATION AS AT 31 DECEMBER 1990

Introduction

1. This paper provides an update on the valuation of the Society's assets and liabilities as at 31 December 1990 and contains various recommendations concerning the declaration of bonuses.

Valuation position

2. The board will recall that the approach being taken to the valuation is rather different this year than in recent years. In summary, the basis for valuing the liabilities is being weakened to reflect the higher yields available on assets at 31 December 1990. The effect of that weakening will enable bonuses to be declared at the 31 December 1989 levels without any transfer from the investment reserve in the Companies Act accounts.

3. The final accounting figures, subject to audit, are as follows:

	£m
Market value of assets	5788
Revenue account fund	5580
Investment reserve	208

This will be the position shown in the Society's Report and Accounts.

4. At the January board I indicated that the minimum level of reserves, including new declared bonuses, which could be published was of the order of £5325m. A full revaluation is being carried out on a basis which I feel to be appropriate to the 31 December 1990 position. The results of that will be available at the Special Board meeting in the form of an addition to this formal paper. The reserves including new declared bonuses will be well below the revenue account fund of £5580m. As intended, therefore, no transfer from the investment reserve is needed to support the cost of the declaration.

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated February 1991

5. A detailed analysis of the cost of new declared bonuses, at the same rates as those announced a year ago, on the revised basis of valuation of liabilities will be included in the figures presented at the board.

6. The bonuses will vest on 1 April 1991 on those policies still in force on that day.

<u>Final bonus rates</u>

7. For the major part of our business, final bonus rates are now determined by the effect of allocating a specific growth rate which is applied to total policy proceeds. Consistent with previous discussions, I am recommending the allocation of a rate of 12% for gross recurrent single premium business and 11½% for the equivalent taxed contracts. Rates for business in conventional form, such as endowment assurances have been determined on consistent bases, the final form of such rates producing policy results in line with those indicated in earlier papers.

8. As well as a final bonus element at the declaration date itself, rates of growth are needed to apply in the final period between that date and the date on which the policy benefits become payable. The rates currently applicable to the period since 31 December 1989 are 12% p.a. for gross business and 10% p.a. for net business. I am recommending the maintenance of those rates into 1991. Such rates may be changed by the board at any time, if they appear to be becoming inappropriate in the light of emerging experience.

<u>Recommendations</u>

9. The formal recommendations should include the specific monetary figures for the total and distributed surplus. The recommendations will, therefore, be included in the additional paper to be presented at the meeting. They will be along the following lines:

(i) that part of the surplus disclosed by the valuation should be declared as distributable surplus and used to allocate declared bonuses at the rates shown in detail in the statement attached.
(ii) that the declared bonuses should vest on 1 April 1991
(iii) that final bonus entitlements should be announced as described in the statement of bonuses.
(iv) that the directors should reserve the right to reconsider the rates of final bonus at any time

[redacted]

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated February 1991

VALUATION AND BONUS DECLARATION AS AT 31 DECEMBER 1990

1. This paper provides the detailed results of the valuation of liabilities as at 31 December 1990 so completing the material in the paper issued in advance of the Special Board meeting. It also includes the formal recommendations regarding bonus rates.

2. The results of the valuation of liabilities are as follows:

	£m
Market value of assets	5788
Basic liabilities	5093
Surplus	695
Cost of new declared bonuses	268
Surplus carried forward	427

3. The carried forward surplus of £427m in paragraph 2 above is essentially equivalent to the assets available to cover the solvency margin in 'Form 9' of the DTI Returns. In practice the figures are likely to be a little different, since there are small differences in the way some assets are valued between the DTI requirements and the approach for the Report and Accounts.

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated February 1991

Cost of bonus

4. The cost of declaring bonuses at the rates described in the main paper is as follows:

	Rate of Bonus	Cost
Assurance fund		
Endowment type business	Based on £5.00% on sum assured and £3.50% on attaching bonus	£16.84m
Recurrent single premium type contracts	£7.75% p.a. on basic benefits and £7.75% on attaching bonus	£ 6.00m
General Annuity Fund		
Level annual premium contracts	£5.75% on basic benefit and £5.75% on attaching bonus	£ 1.09m
Recurrent single premium contracts (including annuities in payment)	£7.50% p.a. on basic benefits and £7.50% on attaching bonus	£ 5.70m
Pension Business Fund Level annual premium contracts	£6.75% on basic benefits and £6.75% on attaching bonus	£16.67m
Recurrent single premium contracts*	£7.50% p.a. on basic benefits and £7.50% on attaching bonus	£222.01m
Minor profits policies (in both Assurance and General Annuity Funds)	Bonuses based on £2.25% on sum assured or deferred annuity	£ 0.09m
Total		£268.40m

* Retirement annuities, personal pensions, annuities in payment and individual and group pension schemes

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Valuation and bonus declaration at 31 December 1990', dated February 1991

Recommendations

5. I recommend:

(i) that of the surplus of £695m disclosed by the valuation, £268.40m be declared as distributable surplus

(ii) that bonuses costing £268.40m be declared at the rates referred to in paragraph 4 above. These are shown in detail in the statement attached to the main part of the paper.

(iii) that the declared bonuses vest on 1 April 1991

(iv) that final bonus entitlements be announced as described in the statement of bonuses.

(v) that the directors reserve the right to reconsider the rates of final bonus at any time

[redacted]

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Investment considerations 1991', dated March 1991

March '91

INVESTMENT CONSIDERATIONS 1991

Introduction

1. Last year I presented the paper on investment matters in a rather different form from that used in earlier years in order to focus on the investment nature of our with profits business. This year I am taking that process a little further and, in particular, looking again at the views on which our recent bonus decisions were based so that any investment implications can be brought out.

2. The paper is in three main sections:

(i) A review of the composition of our with profits managed fund over recent years.

(ii) A comparison of the investment strategy we have followed with that of some leading competitors.

(iii) A review of the recent bonus decisions, their associated risks and their implications for future strategy.

Composition of with profits fund

3. As at 31 December 1990, the distribution at market values of the Society's invested assets (excluding those held against unit-linked business) was:

	£m	%age of whole	(1989 %age distribution)
Fixed interest	1397	26.2	(23.6)
Index-linked stock	119	2.2	(3.0)
Equities - UK	2036	38.2	(41.8)
- Overseas	621	11.7	(15.2)
Properties	705	13.2	(12.3)
Other (e.g. mortgages, loans etc.)	453	8.5	(4.1)
	5331	100.0	(100.0)

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Investment considerations 1991', dated March 1991

4. The Society is required to hol sterling assets equal in value to at east 80% of the value of its liabilities which are all in sterling currently. At 31 December 199ᴗ the sterling assets represented 96% of the liabilities. That is a lower percentage than that at 31 December 1989 (104%) despite the lower proportion of overseas equities in the asset mix. That is a reflection of the fact that, due to the weak performance of assets last year, the total liabilities represent a higher proportion of the total asset values than was the case at the end of 1989.

5. An amount of £634m represented the Society's reserves in respect of non-profit business at 31 December 1990. Of that amount, £55m was held in respect of index-linked annuity contracts. In order to determine the assets relating to our with profit business, we should regard £55m of index-linked stock and £579m of conventional fixed interest securities as matching the non-profit reserves.

6. After making these adjustments, the invested assets at market value held against the with profits business are as shown in the following table.

	£m	%age of whole	(1989 %age distribution)
Fixed interest	818	17.4	(15.5)
Index-linked stock	64	1.4	(2.5)
Equities - UK	2036	43.4	(46.7)
- Overseas	621	13.2	(17.0)
Properties	705	15.0	(13.7)
Other (e.g. mortgages, loans etc.)	453	9.6	(4.6)
	4697	100.0	(100.0)

7. The changing composition reflects both the relative performance of different asset types and the disposition of new money during 1990. In general, the relative weighting of equities, particularly overseas securities, has declined. The relatively high level of 'other' assets at 31 December 1990 is attributable to money held on short-term deposit at that date.

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Investment considerations 1991', dated March 1991

8. We have been looking at the cc ›sition of the with profits managed ıd in this way since the end of 1985. The following table shows the changing proportions over the peιiod since then:

	31.12.90	31.12.89	31.12.88	31.12.87	31.12.86	31.12.85
	%	%	%	%	%	%
Fixed interest	17.4	15.5	21.7	23.0	24.9	29.2
Index-linked stock	1.4	2.5	5.3	7.0	4.3	3.5
Equities - UK	43.4	46.7	42.6	39.7	40.1	37.5
- Overseas	13.2	17.0	11.3	10.3	12.6	10.0
Properties	15.0	13.7	16.5	16.0	14.5	15.8
Other	9.6	4.6	2.6	4.0	3.6	4.0
	100.0	100.0	100.0	100.0	100.0	100.0

9. The key features of our experience (which reflect both deliberate investment strategy and different relative performance of asset categories) are as follows:

(a) A steadily reducing emphasis on fixed interest stocks, which has been deliberate.

(b) A broadly parallel shift in favour of equity investments.

(c) Investment in index-linked securities peaked in 1987 and has declined fairly sharply since then.

(d) A broadly stable property component comprising between 13½% and 16½% of the portfolio. The holding at 31 December 1990 was almost exactly at the average level for the last 6 years.

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Investment considerations 1991', dated March 1991

Comparison with our competitors

10. In recent years we have also estimated the with profit fund composition for a number of other leading offices. Offices are now providing these figures themselves in their 'With Profits Guides' and so we have used those figures. The latest figures currently available are those at 31 December 1989. The following table shows the most recent distributions available, together with the Society's position at the end of 1989 and 1990:

	ELAS		[redacted]				
	1990	1989					
Fixed interest	17	15	4	-	20	18	14
Property	15	14	33	24	15	10	17
Equities - UK	44	47	54	60	48	44	42
non-UK	13	17	9	16	9	23	18
Mortgages, deposits etc.	11	7	-	-	8	5	9
	100	100	100	100	100	100	100

11. The requirements for producing this information are not completely unambiguous and different offices appear to take different approaches. For example, [redacted]'s 4% 'fixed interest' investments would appear to be mortgages. Other offices, including the Society, might include these in 'other' investments. The figures are, however, of value as a guide to the way in which other offices view the composition of their with profits funds.

12. As in previous years, [redacted] and [redacted] stand out as taking a more 'aggressive' stance than other offices with all, or virtually all, their with profit funds invested in equities and properties. Because of that approach, the market conditions of 1990 are likely to have resulted in a lower return for them than for offices, such as the Society, holding a proportion of their assets in fixed interest stock, deposits etc. However, as we have seen from previous analyses, their ability to take this more aggressive stance has, over longer periods, been to their advantage. No doubt that is a major contributory factor to their ability to produce competitive with profits results. Both these offices have a strong balance sheet or 'Form 9' position and should have had little difficulty weathering the poor investment conditions of 1990.

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Investment considerations 1991', dated March 1991

13. The Society does not currently have, nor is likely, given our policy of full distribution, to attain the strength to pursue such an aggressive investment policy as [redacted] and [redacted]. We shall, for the foreseeable future, need to continue with a more 'balanced' portfolio. A recent survey of the With Profits Guides of 17 offices indicated that at 31 December 1989 the Society's investment mix was fairly typical of the group as a whole.

14. The fact that our investment mix is generally similar to that for a number of other offices re-emphasises the importance of a point made on previous occasions. Namely, if that is the case, we must look to out-perform within sectors in order to achieve a competitive advantage.

Implications of and risks associated with the recent bonus decisions

15. In putting the Society's financial position into context at the recent declaration, I indicated that a return of around 15% would be needed in 1991 in order to 'stand still'. That is, to be able to declare again at the same bonus rates at 31 December 1991 and present a no weaker position to the DTI than at 31 December 1990. If the 1991 return fell to around 8% we would begin having problems in maintaining declared bonuses and demonstrating solvency. In those circumstances the balance sheet position would clearly be significantly weaker than at the end of 1990.

16. At the December 1990 Investment Committee, the firm view was expressed that the most likely return for 1991 was around 13½%. On that basis, it was agreed that the risks associated with the declaration decisions were acceptable. It is, however, clear that a return much below the most likely estimate could lead to an uncomfortable position in the sense of our published position being sufficiently weak to attract adverse comment, unless most other offices were similarly placed. At some point we could also begin to attract closer scrutiny from the DTI.

17. The signs so far this year are, of course, encouraging. If at some point, however, achievement of a return of the order of 13-14% began to appear in jeopardy, then we should need to take a serious look at the potential solvency position at the year end. That may lead to the need to increase the yield on the fund rapidly so as to increase the rate of interest that can be used to discount the liabilities. For example, it may then be necessary to direct new money towards fixed interest stocks, possibly combined with some switching of existing holdings. Clearly such action, which may be in conflict with other investment objectives, would only be taken if absolutely necessary.

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Investment considerations 1991', dated March 1991

18. The weakening of the liability ıluation at 31 December 1990 reflect the depressed asset values at that time. As capital values regain a more normal relationship with, say, their 31 December 1989 values, I shall be forced by the regulations to begin strengthening the basis again since the liability valuation discount rate is related to the running yield on the assets. That will imply writing-up of the fund by amounts in excess of those needed merely to cover new declared bonuses at future declarations. Clearly, the higher the income yield on the fund in any one year, the greater the room for manoeuvre we shall have in the liability valuation.

19. The above discussion is essentially concerned with declared bonuses and the solvency implications. The position on overall policy proceeds also carries investment implications. These are now considered.

20. If, in broad terms, we regard the 31 December 1989 position as one of balance between policy values and asset values, then in 1990 we allocated growth of 12% against actual fund earnings of around $-8\frac{1}{2}$%. There is, thus, a shortfall of some 20% for the year to be recovered from future earnings in order to restore a position of balance. If we allocated 12% again for 1991 then actual earnings would need to be around 30% to achieve a balanced position again by 31 December 1991. In practice the 'recovery' is likely to be achieved over a number of years. It is, however, important to remember where we are. The fact that we have got through the difficulties of 1990, and smoothed a substantial part of the effects of that for our policyholders, does not mean that we are starting 1991 from a neutral base.

21. The conclusion to be drawn is that the higher the return at market value achieved this year and next the more comfortable. A balance, therefore, needs to be struck between selecting assets expected to perform well in the short-term and those where the returns will emerge over longer timescales. That is, the deliberate sacrifice of return in the short-term needs to be controlled.

Summary and recommendations

22. Investment returns provide by far the major ingredient in with profits policy results. As always, we need to look to competitive investment performance to provide the basis for competitive policy results. The unusual experience of 1990 does, however, indicate some special considerations, particularly in the balance between long and short-term factors.

Equitable Board papers sent by the Society's Appointed Actuary to GAD on 11 June 1991

'Investment considerations 1991', dated March 1991

23. In very broad terms, for non-linked business the Society had £5bn of invested assets at 31 December 1990 together with £0.4bn on deposit. About a further £1bn of new money is likely to be available for investment during 1991. In practice, the returns achieved for the year will be dominated by the existing portfolio and the influence of the disposition of new money will be secondary, although still significant. Provided investment conditions appear reasonably 'normal', I see no reason to deviate significantly from our customary approach to the investment of new money. It is only if conditions appear likely to deteriorate that some special considerations would need to come into operation.

24. My specific recommendations in relation to investment strategy in 1991 are as follows. It is assumed that we will continue our practice of directly matching unit-linked liabilities by purchase of the corresponding assets.

(a) There is no need at the present time for any re-arrangement of the portfolio on actuarial grounds.

(b) The level of investment in index-linked securities should continue to be monitored against the growing liabilities under index-linked annuity contracts.

(c) In determining strategy, we clearly need to look to maximise overall returns. Whilst continuing our usual approach of balancing long and short-term considerations, a reasonable degree of emphasis should be placed on producing high returns in the short-term. That implies, for example, that whilst committing a 'normal' proportion of new money to assets like property with an initially low, or zero, yield would be consistent with that view, investing an unusually high proportion in that way would be inconsistent.

(d) There need be no specific actuarial constraints on investment strategy at present, beyond that mentioned in (b) above. If at any point there appears a risk of not achieving a return at least of the order of 13-14% there should be an immediate formal reassessment of investment strategy for the remainder of the year. In such circumstances some actuarial constraints may need to be imposed.

(e) If investment considerations are neutral, higher-yielding stocks should be purchased in preference to lower-yielding, as this will assist the solvency position.

[redacted]

The *Hyman* policy document

The Equitable Life Assurance Society
Equitable Life House, Walton Street, Aylesbury, Bucks HP21 7QW

18 JUN 1979

[redacted]

Proposal for a Retirement Annuity Contract

(to be approved under the provisions of section 226 of the Income and Corporation Taxes Act 1970)

A. Personal Information Please write in block letters

1 Style or title: Mr / ~~Mrs~~ / ~~Miss~~

2 Forenames in full [redacted]

3 Surname [redacted]

4 Qualifications in abbreviated form (which are to be used in address)

5 Permanent address (which will be used for correspondence unless the proposer directs otherwise – see alongside)

[redacted]

Postcode

Telephone [redacted]

6 Other Address (if any – please specify use)

For correspondence ☐

For personal contact ☐

Postcode

Telephone*

7 Exact occupation [redacted]

8 Marital status Single/Married/Widowed

Country of birth [redacted]

10 Date of birth Day [redacted] Month [redacted] Year [redacted]

11 Sex Male/~~Female~~

If age has not been admitted by the Society under a previous policy, the Society will now require to see the proposer's birth certificate and, for a married woman, her marriage certificate as well – please indicate on the right hand side

12 Existing policy with the Society Yes ☑ No ☐

B. Details of the proposed policy Please complete one of (a), (b) and (c) below

(a) With major profits by variable premiums — First premium £[redacted] (minimum £150, further premiums are payable at the option of the policyholder)

(b) With major profits by regular monthly premiums — First monthly premium (by cheque) £______ (minimum £10; a form of standing order must be completed for subsequent payments)

(c) Without profits — Single premium £______ (minimum £500) or annual premium £______ (minimum £150)

Pension age ______ Reduced annuity and cash sum at retirement Yes ☐ No ☐

C. Statement and declaration by the proposer

1 Are you engaged on your own account or as a partner personally acting in some trade, profession or occupation? Yes ☑ No ☐

2 (i) Are you an employed person (or the holder of an Office or Employment)? ☐ ☑

(Note: A controlling directorship of a company whose income consists wholly or mainly of investment income is not an office or employment for this purpose – see section 226(9) Income and Corporation Taxes Act 1970 and Schedule 16 Part II paragraph 11 Finance Act 1972.)

(ii) If so, is one or more of your occupations non-pensionable? ☐ ☐

(Note: An occupation is pensionable if in connection therewith you are a member of a "sponsored superannuation scheme" which is any scheme or arrangement from which you expect to receive a retirement benefit whether in lump sum or pension form which will not have been wholly provided out of your own resources.)

3 Are you in receipt of any retirement benefit or entitled to any future benefit as a result of a previous full time occupation? ☐ ☑

(Note. This question need be answered only if you were born before 1916 and propose to pay a premium of more than £750 in respect of the tax year 1970/71 or any earlier tax year, or a premium of more than £1,500 in respect of one of the tax years 1971/72 to 1975/76, or a premium of more than £2,250 in respect of the tax year 1976/77 or any later tax year.)

I declare that, to the best of my knowledge and belief, (a) I am eligible to pay premiums under a retirement annuity contract approved by the Commissioners of Inland Revenue under the provisions of section 226 of the Income and Corporation Taxes Act 1970 and (b) the proposed premium together with the premiums under all such other approved contracts effected by me will qualify for relief of income tax.

I declare that the above statements and declaration are true and I agree that this declaration shall be the basis of the contract between me and The Equitable Life Assurance Society.

I understand that no annuity under the contract shall be capable of being surrendered, assigned or commuted except as provided by section 226 of the Income and Corporation Taxes Act 1970.

If the proposed contract shall be in the major profits class I agree, if and when the said contract shall be effected, to become a member of the Society in respect thereof.

13

Date 11/6/79 13 Signature [redacted]

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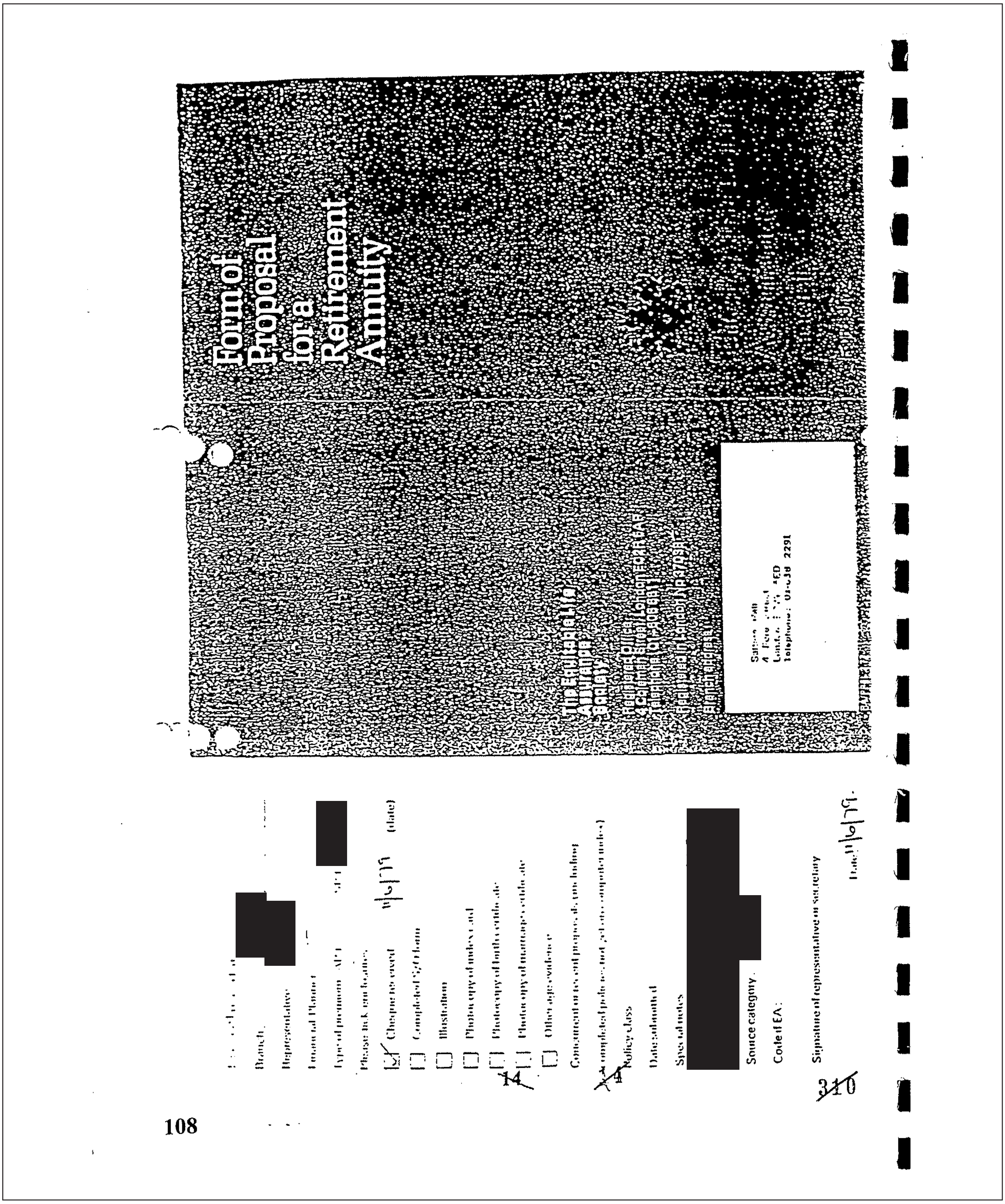
The *Hyman* policy document



Form of Proposal for a Retirement Annuity

The Equitable Life Assurance Society

Source category

Code of EA

Signature of representative or secretary

Date 11/6/79.

[redacted]

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The *Hyman* policy document

Policy

Policy No. [redacted]

Grantee [redacted]

THIS IS AN IMPORTANT DOCUMENT
PLEASE KEEP IT CAREFULLY

Registered Company No. 37038
Registered Office: 4 Coleman Street, London EC2R 5AP

The Equitable Life
Assurance
Society
Founded 1762

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Tı Equitable Life Assurance Socie ,

Whereas

(1) The Grantee has proposed to the Society whose registered office is at 4 Coleman Street in the City of London to purchase from the Society a retirement annuity in the With Profits Class on the life of the Grantee in accordance with the provisions hereinafter contained and has delivered to the Society as the basis of the contract a proposal and declaration and has paid to the Society the premium specified in Endorsement 1

(2) The Grantee is entitled by virtue of this Policy in accordance with the Regulations of the Society to be a Member of the Society

(3) This Policy is approved by the Commissioners of Inland Revenue under Section 226 of the Act

Now this policy witnesseth as follows:

1. In this Policy unless there is something in the subject or context inconsistent therewith the expressions contained in the First Schedule shall have the meanings set opposite them respectively

2. The Society hereby covenants with the Grantee that if the Policy shall continue to be approved as aforesaid then:

   (a) if the Grantee shall survive to the Selected Pension Date the Society will pay to the Grantee the Annuity increased by Related Bonuses (if any); or

   (b) if the Grantee shall die before the Selected Pension Date the Society will pay to the Executors or Administrators of the Grantee the Death Benefit

   upon and subject to the terms and conditions set out in this Policy

3. The Grantee shall be entitled to exercise the option to pay a further premium or premiums to secure a Further Annuity or Further Annuities which is contained in the Second Schedule upon and subject to the terms and conditions therein set out

4. The Grantee shall be entitled to exercise the options to take alternative benefits which are contained in the Fourth Schedule upon and subject to the terms and conditions therein set out

5. This Policy is subject to the terms conditions and provisions contained in the Schedules hereto and in Endorsement 1 and any other Endorsements subsequently issued for attachment hereto and signed by an Officer of the Society duly authorised for that purpose and the said Schedules (the page reference numbers whereof are 2 3 4 5 6 7 8 9 10 11 12 13 14 15) and the said Endorsements shall form part of this Policy

In witness whereof we have hereunto subscribed our names on the Date shown at the foot of Endorsement 1

[redacted] Director

[redacted] General Manager and Actuary

Checked	[redacted]
Examined	[redacted]

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Page ref No 1

The Equitable Life Assurance Society

The First Schedule

Definitions

the Society	means The Equitable Life Assurance Society
the Grantee	means the Grantee named in Endorsement 1
the Annuity	means the Annuity purchased by the premium specified in Endorsement 1 and calculated in the manner specified in the Sixth Schedule
Further Annuity	means a Further Annuity purchased pursuant to the provisions of the Second Schedule and calculated in the manner specified in the Sixth Schedule
the Death Benefit	means the benefit described in paragraph 7.0 of the Third Schedule
Related Bonuses	means in relation to the Annuity or (as the case may be) any Further Annuity such amounts (if any) as shall under the rules and regulations of the Society have been allotted by way of addition to or bonus thereon
the Selected Pension Age	has the meaning ascribed thereto by the provisions of the Third Schedule
the Selected Pension Date	means the date upon which the Grantee attains the Selected Pension Age
Accumulation Value	means in relation to any premium the Accumulation Value thereof calculated in the manner specified in the Sixth Schedule
Policy Annuity Value	means in relation to all or part of the Annuity increased by Related Bonuses (if any) or (as the case may be) all or part of any Further Annuity increased by Related Bonuses (if any) the Policy Annuity Value attributable thereto calculated in the manner specified in the Sixth Schedule
Premium Day	means in any particular year the Premium Day specified in Endorsement 1
Policy Year	means a year commencing on a Premium Day
the Act	means the Income and Corporation Taxes Act 1970
Substituted Contract	means a contract providing benefits in substitution for all or part of those provided under this Policy as provided for in Section 26 of the Finance Act 1978 and approved by the Commissioners of Inland Revenue under Section 226 of the Act
Eligible Individual	means an individual who is or would but for an insufficiency of profits or gains be chargeable to tax in respect of "relevant earnings" (as defined in Section 226 of the Act) from any trade profession vocation office or employment carried on or held by him or her
Table A	means the Table so described which is contained in the Sixth Schedule
Table B	means the Table so described which is contained in the Sixth Schedule or any Table substituted therefor pursuant to the terms hereof

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The Equ. .ble Life Assurance Society

The Second Schedule

Option To Pay a Further Premium or Premiums

Option to pay a further premium or premiums

1.1 The Grantee shall have the option under this Policy of paying to the Society on any day or days during any Policy Year a further premium or premiums to secure a Further Annuity or Further Annuities in the With Profits Class

1.2 The amount of each further premium shall be determined by the Grantee at the time of payment but in any event shall not be less than £150 provided always that the total amount of all premiums paid in any Policy Year shall not in any event exceed the maximum amount approvable by the Commissioners of Inland Revenue

1.3 The Further Annuity purchased by any such further premium shall be calculated in the manner specified in the Sixth Schedule

1.4 If the Grantee shall in any Policy Year fail to exercise the option contained in paragraph 1.1 of this Schedule then the said option shall forthwith cease to be exercisable provided that the Society may at its absolute discretion accept a further premium or premiums thereafter upon such terms as the Society shall in its absolute discretion think fit

1.5 On payment of any further premium the Society shall issue to the Grantee for attachment hereto an endorsement recording the amount of such further premium

1.6 The option contained in paragraph 1.1 of this Schedule shall not be exercisable after the Selected Pension Date

Eligibility of the Grantee

2.1 The Society may before accepting any further premium payable hereunder in accordance with paragraph 1.1 of this Schedule require the Grantee to supply such information and make such declarations as the Society may deem necessary to satisfy the Society that the Grantee continues to be an Eligible Individual

2.2 Upon the basis of such information and declaration the Society may from time to time determine whether the Grantee remains an Eligible Individual and if the Grantee shall fail to produce such information or make such declarations in a form satisfactory to the Society within six months of being required so to do the Grantee shall be deemed to have ceased to be an Eligible Individual

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The Equitable Life Assurance Society

The Second Schedule (continued)

2.3 If at any time either the Commissioners of Inland Revenue shall give notice to the Society that they have withdrawn approval of this contract or the Society shall cease to be satisfied that the Grantee continues to be an Eligible Individual then from and after the date specified in such notice or (as the case may be) the date on which the Society ceases to be so satisfied the option contained in paragraph 1.1 of this Schedule shall cease to be exercisable and the Society will return any premiums submitted after that date which shall then be treated as not having been paid

Page ref No 4

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Th. Equitable Life Assurance Society

The Third Schedule

Benefit Schedule

The Annuity payable hereunder

1.1 The Annuity shall be calculated in the manner specified in the Sixth Schedule

1.2 The Annuity increased by Related Bonuses (if any) shall be payable from the Selected Pension Date during the remainder of the lifetime of the Grantee by equal quarterly instalments in advance the first instalment being payable on the Selected Pension Date and subsequent instalments being payable at the commencement of each subsequent period of three months during the lifetime of the Grantee

Further Annuities

2.0 Any Further Annuity purchased hereunder increased by Related Bonuses (if any) shall be payable at the same time and in the same manner as the Annuity increased by Related Bonuses (if any) as if it were part thereof and any provisions of this Policy relating to the Annuity shall apply also to such Further Annuity

The Selected Pension Age

3.1 The Selected Pension Age shall be:

3.1.1 the age chosen by the Grantee as provided in paragraph 3.2 of this Schedule as being that at which the Annuity is to commence or (as the case may be)

3.1.2 the age deemed to be the Selected Pension Age pursuant to paragraph 4.0 or paragraph 5.0 of this Schedule

3.2 The Grantee shall choose the Selected Pension Age on or within one calendar month of attaining that age by completing and signing an application in such form as the Society shall stipulate and producing the same to the Society at its Registered Office for registration together with this Policy

3.3 The Grantee may choose as the Selected Pension Age the age of 70 years or any lesser age provided that if the age selected be less than 60 years it shall be proved to the satisfaction of the Society that the Grantee is incapable through infirmity of mind or body of carrying on his own occupation or any occupation of a similar nature for which he is trained or fitted in which case the annuity payable at the Selected Pension Age shall be of such amount as may be agreed between the Grantee and the Society and shall be paid in lieu of all other benefits hereunder

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The Equitable Life Assurance Society

The Third Schedule (continued)

Position until the Selected Pension Age has been chosen	4.0	Unless and until the Grantee shall have chosen an age as the Selected Pension Age the Selected Pension Age for all the purposes of this Policy (including the calculation of the Annuity and any Further Annuities and the Policy Annuity Value(s) of the Annuity and any Further Annuities) shall be deemed to be the age of 70 years
Failure to choose the Selected Pension Age	5.0	If the Grantee shall have attained the age of 70 years plus one calendar month without having chosen an age in accordance with the provisions of paragraph 3.2 of this Schedule then and in such case he or she shall be deemed for all the purposes of this Policy (including those mentioned in paragraph 4.0 of this Schedule) to have chosen the age of 70 years as the Selected Pension Age and the right of choice given by paragraph 3.2 of this Schedule shall thereupon cease to be exercisable
Selection of a later age than 70 years	6.0	If the premium specified in Endorsement 1 shall have been paid by the Grantee after he or she has attained the age of 70 years or if the Grantee shall on or within one calendar month of attaining that age elect by making written application to the Society in such form as the Society shall stipulate to be able to choose as the Selected Pension Age an age exceeding 70 years but not exceeding 75 years then
	6.0.1	an endorsement to that effect shall be prepared by the Society for attachment to this Policy
	6.0.2	a new Table calculated on the same basis as Table B but applicable after the age of 70 years shall be substituted for Table B
	6.0.3	the age of 75 shall be substituted for the age of 70 whenever the latter age appears in this Policy other than in this paragraph 6.0 and the sub-paragraphs thereof
	6.0.4	an appropriate amount of additional Stamp Duty will be paid to the Commissioners of Inland Revenue in respect of the variation of the Policy

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The Equitable Life Assurance Society

The Third Schedule (continued)

Death Benefit	7.0	If the Grantee shall die before the Selected Pension Date then after satisfactory proof shall have been delivered to the Society of the death of the Grantee and of the title to receive payment and on delivery of this Policy duly discharged the Society will pay to the Executors or Administrators of the Grantee in lieu of all other benefits payable under this Policy a sum equal to the aggregate amount of the premium specified in Endorsement 1 and any further premiums paid and retained hereunder together with compound interest on each such premium calculated at the rate of six per centum per annum with yearly rests from the date of payment thereof to the date of death of the Grantee
Interest on Death Benefit	8.0	Interest on the Death Benefit will be paid by the Society calculated from a date one month after the date upon which written notification of the death of the Grantee shall have been received by the Society up to the actual date of payment the rate of interest being at the Society's absolute discretion and any payment of interest being subject to deduction of any tax applicable thereto
Illustration of Benefits	9.0	The section of Endorsement 1 which is headed "Illustration of Benefits" and the section so headed in any endorsement subsequently issued for attachment to this policy are inserted by way of illustration only

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e Equitable Life Assurance So

The Fourth Schedule

Options to Take Alternative Benefits

Option to effect a Substituted Contract

1.1 At the time of choosing the Selected Pension Age the Grantee may elect upon the terms and conditions hereinafter appearing to renounce all or part of the Annuity increased by Related Bonuses (if any) and in lieu thereof to have the Policy Annuity Value in respect thereof at the Selected Pension Age applied as a premium under a Substituted Contract

1.2 Such election shall be made by the Grantee by giving written notice to the Society in such form as the Society shall stipulate

1.3 The assurer with whom the Substituted Contract is to be effected shall be selected by the Grantee and named by him in the written notice mentioned in paragraph 1.2 of this Schedule and before giving the said written notice the Grantee shall ascertain that the assurer named therein is prepared to accept the premium mentioned in paragraph 1.1 of this Schedule and to issue the Substituted Contract

1.4 The application of the Policy Annuity Value in respect of the Annuity pursuant to paragraph 1.1 of this Schedule shall be subject to such terms and conditions as the Commissioners of Inland Revenue may from time to time impose

Option to take an annuity calculated by reference to tables in use by the Society at the Selected Pension Date

2.0 At the time of choosing the Selected Pension Age the Grantee may elect by giving written notice to the Society in such form as the Society shall stipulate to renounce all or part of the Annuity increased by Related Bonuses (if any) (or all or part of what remains thereof after the option contained in paragraph 1.1 of this Schedule shall have been exercised) and to be paid in lieu thereof an annuity calculated by reference to the Policy Annuity Value of the benefit so renounced and the table of rates in use by the Society at the Selected Pension Date for a contract providing an immediate annuity approved under Section 226 of the Act having regard to the sex of the Grantee and the age of the Grantee at the Selected Pension Date

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The Equitable Life Assurance Society

The Fourth Schedule (continued)

Option to alter benefits

3.0 At the time of choosing the Selected Pension Age the Grantee may elect by giving written notice to the Society in such form as the Society shall stipulate to alter the benefit payable hereunder (or what remains thereof after the options contained in paragraphs 1.1 and 2.0 of this Schedule shall have been exercised) in such manner and to such extent as the Society and the Grantee shall agree (whether by commutation of part thereof for a cash sum or by substitution therefor of an annuity of reduced amount which shall be payable during the remainder of the lifetime of the Grantee but in any event for a minimum period of years or by renunciation of part thereof in exchange for a subsidiary annuity or annuities for the benefit of a spouse or child or other dependant of the Grantee or otherwise howsoever) but subject always to any limitations or conditions from time to time imposed in respect of such alteration by the Commissioners of Inland Revenue including those specified in paragraph 4.0 below

Limitation in benefits

4.0 Unless the limitations or conditions imposed by the Commissioners of Inland Revenue which apply at the time when an election under paragraph 3.0 of this Schedule is made by the Grantee do not so require the following conditions shall apply when such election is made:

4.0.1 The amount to be paid by way of commutation of part of the benefit payable hereunder shall not exceed three times the amount of the annuity remaining payable to the Grantee after such commutation

4.0.2 The minimum period for which any annuity payable to the Grantee shall be expressed to be payable in any event shall not exceed 10 years

4.0.3 In respect of the renunciation of a part of the benefit payable hereunder in exchange for a subsidiary annuity or annuities (taking into account any reduction of such benefit resulting from any commutation thereof) the amount of the subsidiary annuity or (as the case may be) the aggregate amount of the subsidiary annuities shall not exceed the amount of the annuity remaining payable to the Grantee after such renunciation and the first payment of the subsidiary annuity or (as the case may be) the subsidiary annuities shall be made on the due date next following the death of the Grantee or (if later) the expiry of any minimum period for which the annuity payable to the Grantee shall be expressed to be payable in any event

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The Equitable Life Assurance Society

The Fifth Schedule

Schedule of Conditions

Restrictions on dealings with benefits	1.1	No annuity payable under this Policy shall be capable in whole or in part of surrender or commutation except as provided for in the Fourth Schedule
	1.2	The Society will not recognise any assignment or purported assignment (legal or equitable) of any annuity payable under this Policy or of the Death Benefit and notwithstanding notice of any such assignment or purported assignment the Society shall: 1.2.1 pay such annuity to the Grantee or other the trustees of any other annuitant or (as the case may be) 1.2.2 pay the Death Benefit to the Executors or Administrators of the Grantee whose receipt shall be a full and sufficient discharge to the Society except where bankruptcy or other laws or Court Orders shall require payment otherwise than to the Grantee or such trustees as aforesaid or (as the case may be) to the Executors or Administrators of the Grantee
Alterations	2.0	No alteration in the terms of this Policy shall be permitted without the approval of the Commissioners of Inland Revenue
Proof of existence and title	3.0	Every annuity payable under this Policy shall be paid upon proof satisfactory to the Society of the annuitant being alive and of title to receive the payment and the Society may in addition before granting any subsidiary annuity pursuant to paragraph 3.0 of the Fourth Schedule require the production to the Society of proof satisfactory to the Society of the age of the proposed subsidiary annuitant and his or her relationship to the Grantee

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Equitable Life Assurance Soc.

The Fifth Schedule (continued)

Participation in Profits	4.0	This Policy shall confer right to participation in the profits of the Society up to the Selected Pension Date and no longer
Limitation of Liability	5.0	The Society shall only be liable under this Policy to the extent of its assets and property from time to time existing and available for satisfying claims under this Policy and no Member of the Society and no other person who is at any time in any way interested in any policy shall be liable to any call or contribution whether in any liquidation of the Society or otherwise howsoever for satisfying any claim or demand under or in respect of this Policy whether by the Grantee or by any other person for the time being interested herein
Interpretation	6.1	References in this Policy to any section in an Act of Parliament shall be deemed to include any statutory re-enactment or amendment of such section
	6.2	Marginal headings are inserted for convenience only and shall not be taken into account in the interpretation of this Policy
Payments	7.1	All payments by the Society under this Policy shall be payable at the Registered Office of the Society
	7.2	All premiums payable under this Policy shall be paid at the Registered Office of the Society or in such other manner as the Society may approve in writing

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The .quitable Life Assurance Societ.

The Sixth Schedule

Calculation of Annuities and Policy Annuity Values

Calculation of the Annuity and any Further Annuity

1.1 The Annuity and any Further Annuity payable at the Selected Pension Date shall be calculated in the following manner

1.2 The Accumulation Value at the Selected Pension Date of the premium paid in respect of the Annuity and (as the case may be) the Further Annuity shall first be ascertained in accordance with paragraph 1.3 or (as the case may be) paragraph 1.4 of this Schedule

1.3 The Accumulation Value at the Selected Pension Date of any premium paid on a date falling on or within 30 days after any Premium Day shall be calculated as follows:

1.3.1 the number of complete years between the Premium Day in question and the Selected Pension Date shall be ascertained

1.3.2 the amount of Accumulation Value attributable to such complete number of years and to the amount of the premium in question shall then be ascertained by reference to Table A

1.3.3 unless the Selected Pension Date is a Premium Day the Accumulation Value so determined shall be increased by one half of one per cent in respect of each complete calendar month between the Selected Pension Date and the Premium Day immediately preceding that date

and the Accumulation Value so determined and (where appropriate) increased shall be the Accumulation Value of the premium in question at the Selected Pension Date

1.4 The Accumulation Value at the Selected Pension Date of any premium paid at any time other than on or within 30 days after any Premium Day shall be calculated as follows:

1.4.1 the number of complete years between the Premium Day next following the date of payment of the premium in question and the Selected Pension Date shall be ascertained

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The Equitable Life Assurance Society

The Sixth Schedule (continued)

1.4.2 the amount of Accumulation Value applicable to such number of complete years and to the amount of the premium in question shall be ascertained by reference to Table A (provided that if the Premium Day next following the date of payment of the premium in question falls after the Selected Pension Date the amount of Accumulation Value applicable to a premium of £100 shall be taken as £92.27 and the amount of Accumulation Value applicable to premiums greater or smaller than £100 shall be calculated proportionately)

1.4.3 the Accumulation Value so determined shall be increased by one half of one per cent in respect of each complete calendar month or part of a calendar month between the date of payment of the premium in question and the Premium Day next following that date

1.4.4 unless the Selected Pension Date is a Premium Day the Accumulation Value so determined and increased shall be further increased by one half of one per cent in respect of each complete calendar month between the Selected Pension Date and the Premium Day immediately preceding that date

and the Accumulation Value so determined and (where appropriate) so increased shall be the Accumulation Value of the premium in question at the Selected Pension Date

1.5 Having ascertained the Accumulation Value at the Selected Pension Date of the premium paid in respect of the Annuity and (as the case may be) the Further Annuity in accordance with the preceding paragraphs of this Schedule the amount of Annuity and (as the case may be) the Further Annuity shall be the amount of annuity attributable to such Accumulation Value at the Selected Pension Age by reference to Table B

Calculation of Policy Annuity Value

The Policy Annuity Value at the Selected Pension Date of the Annuity increased by Related Bonuses (if any) and the Policy Annuity Value at the Selected Pension Date of any Further Annuity increased by Related Bonuses (if any) shall be the amount of Accumulation Value attributable thereto which shall be ascertained by reference to Table B

And the Policy Annuity Value at the Selected Pension Date of a part of the Annuity increased by Related Bonuses (if any) and (as the case may be) a part of any Further Annuity increased by Related Bonuses (if any) shall be calculated proportionately

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Equitable Life Assurance Soci

The Sixth Schedule (continued)

Table A

Number of complete years ascertained pursuant to the terms of paragraph 1.3.1 or (as the case may be) paragraph 1.4.1 of this Schedule	Accumulation Value applicable to a premium of £100 (see Note below)	Number of complete years ascertained pursuant to the terms of paragraph 1.3.1 or (as the case may be) paragraph 1.4.1 of this Schedule	Accumulation Value applicable to a premium of £100 (see Note below)
	£		£
0	95.50	30	268.05
1	98.84	31	277.43
2	102.30	32	287.14
3	105.88	33	297.19
4	109.59	34	307.59
5	113.42	35	318.36
6	117.39	36	329.50
7	121.50	37	341.03
8	125.76	38	352.97
9	130.16	39	365.32
10	134.71	40	378.11
11	139.43	41	391.34
12	144.31	42	405.04
13	149.36	43	419.22
14	154.59	44	433.89
15	160.00	45	449.08
16	165.60	46	464.79
17	171.39	47	481.06
18	177.39	48	497.90
19	183.60	49	515.32
20	190.02	50	533.36
21	196.68	51	552.03
22	203.56	52	571.35
23	210.68	53	591.35
24	218.06	54	612.04
25	225.69	55	633.46
26	233.59	56	655.64
27	241.76	57	678.58
28	250.23	58	702.33
29	258.98	59	726.92

Note: Accumulation Values applicable to premiums greater or smaller than £100 are to be calculated proportionately

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The Equitable Life Assurance Society

The Sixth Schedule (continued)

Table B

Selected Pension Age	Amount of annuity equivalent to £100 of Accumulation Value (see Note below)	
	Males £	Females £
60	10.32	9.32
61	10.56	9.52
62	10.80	9.72
63	11.12	9.92
64	11.40	10.12
65	11.72	10.36
66	12.08	10.64
67	12.48	10.92
68	12.88	11.20
69	13.32	11.52
70	13.80	11.88

Note: The amount of annuity provided by an Accumulation Value greater or smaller than £100 is to be calculated proportionately

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Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Original treaty

IRECO

LIFE REINSURANCE AGREEMENT

between

Irish European Reinsurance Company Limited

of

Dublin, Ireland

(hereinafter called the Reinsurer)

and

The Equitable Life Assurance Society

Of

Aylesbury, England

(Hereinafter called the Reinsured)

Document Number:02564 Page 1

Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Original treaty

IRECO

Article I - Business Covered:

All Retirement Annuities, Individual Pension Plans and Transfer Plans issued by the Reinsured on or before 30 June 1988

Article II Inception Date:

The contract will incept on 31 December 1998

Article III - Duration:

The reinsurance is of unlimited duration but may be cancelled by the Reinsured in respect of future years, subject to 3 months notice prior to any December 31.

If notice is given, no further Deposit Premiums will be paid but any and all future Adjustment Premiums under this reinsurance will be paid in accordance with the terms outlined below.

Article IV Claims:

The Reinsurer will be liable for claims arising from the business covered to the extent detailed in Appendix I to this agreement.

Furthermore, the Reinsurance Claims Amount as defined in said Appendix I will be withheld by the Reinsurer. However, at any 31 December, the Reinsurer will pay an interest amount (being 12 months LIBOR) on the outstanding Reinsurance Claims Amount if requested to do so by the Reinsured if required by the Reinsured to properly satisfy the requirements of s35A(1)(a) of the Insurance Companies Act 1982 or, if the payment of an interest amount has not been requested , the Reinsured will be entitled to request a cash payment of up to 10% of the outstanding Reinsurance Claims Amount.

Article V Premium:

For each year that this reinsurance is in force, the Reinsured will pay a deposit premium of £400,000, adjusted in line with the increase in the UK Retail Prices Index from November 1998 to the the month of November immediately preceding the Renewal Date. The deposit premium for the first year will be payable in two instalments: the first being £150,000 is due as at the Commencement Date and the second instalment of £250,000 on April 1st 1999. For each subsequent year the full deposit premium shall be due on the Renewal Date. The deposit premium is payable in cash to the Reinsurer. However, should a reinsurance Claim Event occur an adjustment premium will be calculated as described in Appendix II to this agreement.

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Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Original treaty

IRECO

Article VI - Accounts:

The Reinsured will prepare Accounts and submit them to the Reinsurer by the end of February each year. The first Account will be in respect of calendar year 1999.The Reinsured will supply information for the Reinsurer to check the Accounts in outline. The exact format of the Documentation will be agreed between the parties.

Article VII Currency:

All amounts referred to and all accounts under this contract shall be in British Pounds.

Article VIII - Inspection of Records:

The Reinsurer will have the right to inspect the records of the Reinsured in respect of the Business Covered. For as long as either party remains under any liability hereunder, the Ceding Office shall, upon request by the Reinsurer, make available for inspection at any reasonable time by such representatives as may be authorised by the Reinsurer for that purpose, all information relating to the business reinsured hereunder in the Ceding Offices possession or under its control and the said representatives may arrange for copies to be made of any of the records containing such information as they may require.

Article IX Errors & Omissions:

Errors and inadvertent omissions shall not affect the rights and obligations of either party under this agreement, however, they shall be immediately rectified upon discovery

Article X - Termination:

Each party is entitled to terminate the treaty without giving prior notice if

1. The fulfilment of the treaty becomes legally or practically impossible for reasons which are beyond the responsibilities of the treaty parties (such as the country where either party is domiciled becomes involved in a war);
2. The other party becomes insolvent or goes into liquidation or a Receiver/Administrator is appointed or has its licence to conduct insurance business revoked as defined in Section 13 of the Insurance Companies Act 1982;
3. The other party loses more than 50% of its paid up capital;
4. The other party transfers its business to a third party;
5. The other party is acquired by or merged with or comes under the control of another company;
6. The other party does not meet its obligations under this treaty despite having received formal reminders to do so.

In the event of cancellation under parts 2, 3, 4 ,5 and 6 of this clause the portfolio at the date of termination will be withdrawn and the Reinsured shall refund to the Reinsurer at the same point in time any Reinsurance Claims Amount and any outstanding cash balance in full, subject to the requirement that in the event of cancellation under part 2 of this clause such

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IRECO

refund will be subordinate to the Reinsured's liabilities in liquidation towards its policyholders under the terms of its long term policies. However, the Reinsurer will retain the right of offset against future Recovery Amounts due.

In the event of cancellation under part 1 of this clause no further Reinsurance Claim Events will be admissible. The reinsurance will be terminated at the earliest date at which no Recovery Amount is due. However, not later than 5 years from the termination date, the Reinsured shall refund to the Reinsurer any remaining Reinsurance Claims Amount and outstanding cash balance in full. The above notwithstanding should cancellation be effected under part 1 and part 2 simultaneously the rights granted to policyholders as a result of cancellation under part 2 as outlined above shall have precedence.

Article XI Arbitration:

The Reinsured and the Reinsurer intend to follow the customs and practices of the insurance and reinsurance industry in the operation of and interpretation of this Agreement. The parties agree to act in all things with the highest good faith.

In the event of any dispute between contracting parties concerning any matters arising from this Agreement including those pertaining to its validity, the dispute will be referred to two Arbitrators, one to be chosen by each party.

If either party refuses or neglects to appoint an Arbitrator within two calendar months after the other party has appointed an Arbitrator and has served notice upon the first mentioned party requiring that party to make such an appointment, then the Arbitrator appointed as aforesaid will, at the request of the party appointing him, proceed to hear and determine the matters in difference as sole Arbitrator.

The two Arbitrators (if both parties have duly appointed Arbitrators) will, before entering on the reference, in writing appoint an Umpire and, unless they appoint an Umpire within one calendar month, after the date of the appointment as Arbitrator of whichever of them has last been appointed, an Umpire will be appointed by the Chairman for the time being of the Life Insurance Council of the Association of British Insurers if Arbitration is to be held in the United Kingdom or, if Arbitration is to be held in the Republic of Ireland, the Umpire will be appointed by a senior official of an equivalent or similar local body. The Umpire will not take part in the proceedings unless the two Arbitrators fail to agree and then only regarding the points unsettled.

The Arbitration will be held in the United Kingdom if the Reinsured is the defendant party and in the Republic of Ireland if the Reinsurer is the defendant party and the award will be final and binding on both parties.

The cost of the reference and award will be in the discretion of the Arbitrators, Arbitrator or Umpire who may direct to and by whom and in what manner the same or any part thereof will be paid with power to tax or settle the amount of the costs to be so paid or any part thereof.

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Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Original treaty

IRECO

The Arbitrators, Arbitrator and Umpire will hold leading positions in Companies transacting Life Insurance and/or Life Reinsurance and will regard this Agreement rather from the standpoint of practical business and equity than from that of strict law and their award will have regard to these principals.

This agreement to submit disputes to Arbitration will be construed as a separate and independent contract between the parties hereto.

Article XII Governing Law:

This Agreement shall be governed by and construed in accordance with the Law of the United Kingdom.

Article XIII Miscellaneous:

This Agreement may be amended on the agreement of both parties. In the event of any dispute, this will be subject to arbitration on the basis set down in Article XI of this Agreement.

The Reinsurer offers the reinsurance cover on the basis of information supplied to it by the reinsured. The reinsured will warrant that the information supplied is, to the best of its knowledge and belief correct and an accurate summary of its records. Should any material differences emerge from the information supplied then any dispute that may arise will be referred to arbitration for the reinsurance terms to be amended or rescinded.

The reinsurance will apply so long as the Reinsured makes no change to its current practice regarding the exercising of guaranteed annuity options as represented to the Reinsurer in the attached schedule (Appendix III). Should any change occur, either at the choice of the Reinsured or as a result of any legal action brought against the Reinsured, then no further Reinsurance Claim Events will be admissible. In that event, the reinsurance will be terminated at the earliest date at which no Recovery Amount is due.

In the event that the total withheld reinsurance claims balance exceeds £100,000,000 at any December 31 negotiations will take place to find a mutually agreeable restructuring of the treaty which will include a redefinition of the Adjustment Premiums in respect of future years.

For and on behalf of

[redacted]

The Equitable Life Assurance Society Date: 11 October 1999

For and on behalf of

[redacted]

Date: 30 September 1999

[Irish European Reinsurance Company Limited]

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IRECO

Appendix I

Reinsurance Claim Event :

For each calendar year the Reinsured will calculate the following amounts:-

GA = The total guaranteed funds for all retirements under the business covered

GG = The total guaranteed funds used to secure guaranteed annuity benefits for all retirements under the business covered where the policyholder exercises the guaranteed annuity option.

FG = The total funds (including final bonus) available to all retirements under the business covered where the policyholder exercises the guaranteed annuity option

For the purposes of the reinsurance, guaranteed funds will be taken to mean the total funds available from the original guaranteed benefit defined in the policy schedule and the total attaching reversionary bonus. The total funds will be taken to mean the guaranteed funds plus any and all final bonuses added to a maturing policy.

A Reinsurance Claim Event will be deemed to occur in respect of any year where the ratio GG/GA exceeds 25%.

Reinsurance Claim :

When a Reinsurance Claim Event is deemed to occur in respect of any calendar year, the Reinsurer's Liability for that year will be determined as the sum of

$$\frac{\text{Guaranteed Funds} * \text{Guaranteed Annuity Rate}}{\text{Current Annuity Rate}}$$

where the summation is carried out over all policies for which the guaranteed annuity option has been exercised. The result of this calculation will be denoted by GO.

The Guaranteed Annuity Rate will be that applicable in the policy document for each relevant case.

The Current Annuity Rate will be that available from the Reinsured at the date of retirement for the same mode of payment as that in the Guaranteed Annuity Rate.

The Reinsurer's Liability is then given by:

$$(1 - 0.25*GA/GG) * (GO - GG)$$

[redacted]

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Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Original treaty

IRECO

Claims Recovery Premium :

When a Reinsurance Claim Event is deemed to occur in respect of any calendar year, a Claims Recovery Premium will be due for simultaneous payment by the Reinsured to the Reinsurer.

The Recovery Premium will be determined as :

$$(1 - 0.25*GA/GG) * (FG - GG)$$

Reinsurance Claims Amount :

In respect of any calendar year, the Reinsurance Claims Amount will be determined as the Reinsurer's Liability less the Claims Recovery Premium.

[redacted]

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Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Original treaty

IRECO

Appendix II

Adjustment Premium :

If a Reinsurance Claim event has occurred, then the Reinsured will pay an Adjustment Premium determined in two parts:

i) A Recovery Amount of 35% of the Reinsurance Claims Amount payable each year until the total amount paid is equal to the Reinsurance Claims Amount.

For a Reinsurance Claim event in Year N, the first Recovery Amount will be due as at the end of Year (N+1). The Recovery Amount will be withheld by the Reinsured and used to write down the amount owing from the Reinsurer.

ii) A Risk Amount of 2% of the outstanding Reinsurance Claims Amount, payable as long as a Recovery Amount is due.

For a Reinsurance Claim event in Year N, the first Risk Amount will be due as at the end of Year N. The Risk Amount will be paid in cash to the Reinsurer.

Furthermore, should an interest amount be paid on the outstanding Reinsurance Claims Amount by the Reinsurer or should any portion of the Reinsurance Claims Amount be paid as cash in any year, then a fee of LIBOR plus 3.5% shall be payable annually on the opening balance of this individual portion for each annual period until such time as this interest amount or cash payment is repaid in full to the Reinsurer.

The Adjustment Premium payable at the end of a year will not exceed the lower of:

a) the change during that year in the excess of the Available Assets over the Required Minimum Margin plus the Bonus Payments made to Policyholders in Anticipation of a Surplus during the year; and
b) the total of the amounts calculated in (a) for all years since the Commencement Date of this treaty,

excluding for the purpose of these calculations the amount of the Adjustment Premium that is being determined.

Hereby the following definitions apply:

Available Assets = Form 9 Line 25 of the HM Treasury Returns
Required Minimum Margin = Form 9 Line 41of the HM Treasury Returns
Bonus Payments made to Policyholders in Anticipation of a Surplus = Form 58 Line 41 of the HM Treasury Returns

[redacted]

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Original treaty

IRECO

The Adjustment Premium payable in any year will be used first to pay

A) Any annual interest fees on the unpaid part ii)Risk Amounts for previous years as described below ;

B) Any unpaid part ii) Risk Amounts for previous years ;

C) the part ii) Risk Amount due for the current year,
on the basis that the annual interest fees in A) are paid first then the part ii) Risk Amounts in B) and C) are paid, on a first in, first out basis. The remaining balance of the Adjustment Premium, if any, will be used to pay the part i) Recovery Amounts as described above.

If the Adjustment Premium for any year is insufficient to pay all of the part ii) Risk Amounts which are due, as described in B) and C) of the previous paragraph, an annual interest fee of LIBOR plus 3.5% shall be payable on the opening balances of the unpaid part ii) Risk Amounts for each annual period until all part ii) Risk Amounts have been paid to the Reinsurer in full. The Adjustment Premiums for future years will be increased, subject to the limit on the Adjustment Premium set out above, by the total amount of the unpaid part ii) Risk Amounts and the unpaid annual interest fees on those amounts.

That part of the Adjustment Premium which is required to pay part ii) Risk Amounts and annual interest fees, as described in A), B) and C) above, must be paid in cash to the Reinsurer each year within 30 days of receipt of the annual account. Any overdue payment will incur a late payment charge of LIBOR plus 3.5% from the due date until the actual payment date.

If in any year that part i) of the Adjustment Premium is not paid then the Reinsurance Claims Amount will be carried forward and settled when it is possible to pay that unpaid balance from the Adjustment Premium. If there has been more than one Reinsurance Claim Event for which part i) Recovery Amounts have not been paid then, subject to the provisions of the previous paragraph, the available funds will be applied to the Reinsurance Claim Events on a first in, first out basis.

[redacted]

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Appendix III

The Reinsured's current practice with regard to the exercising of guaranteed annuity options, as represented to the Reinsurer, is described below.

A guaranteed annuity option can be exercised only if annuity benefits are taken in a form of annuity for which guaranteed annuity rates are prescribed in the policy terms.

If a guaranteed annuity option is exercised by the policyholder selecting a form of annuity to which guaranteed annuity rates apply, the annuity secured by that part of the policy proceeds is calculated as the greater of :

a) The "relevant policy proceeds" excluding the final bonus element of those proceeds multiplied by the appropriate guaranteed annuity rate ; and
b) The annuity secured by the total "relevant policy proceeds" using the Society's current annuity rates in force at that time for the selected form of annuity,

where the "relevant policy proceeds" are defined as that part of the total policy proceeds which are used to provide the selected form of annuity benefits .

[redacted]

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Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Amendment

IRECO

[redacted]
The Equitable Life Assurance Society
Walton Street
Aylesbury
Bucks HP21 7QW
United Kingdom

26 August, 1999

Re: Our Reinsurance Treaty

[redacted]

Further to our telephone conversation of this morning, I would like to confirm that both parties agree to the following amendment to the treaty.

In the event of the Equitable Life having to change its current practice regarding the exercising of guaranteed annuity options as a result of the discussed court case, on which Equitable Life are awaiting a decision, the reinsurance coverage shall remain in place, in full, for a further 90 days following such a decision.

This amendment does not in any way effect any other rights or obligations of either party under this treaty and is in principle a deferral of the application of Article XIII paragraph 3 for 90 days should the specific situation outlined above occur.

This letter will form an integral part of the overall treaty, as such your signing and returning of one copy of this letter, as confirmation of your agreement would be most appreciated.

Yours sincerely,

[redacted]
Managing Director

[redacted]
~~Underwriter~~

Signed, in confirmation, as requested:

[redacted]
Managing Director
3.9.99

Irish European Reinsurance Co. Ltd.
International House
International Financial Services Centre • Dublin 1
Telephone 353-1-605 4220
Facsimile 353-1-605 4235

Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Addendum 1

IRECO

Addendum 1

To

LIFE REINSURANCE AGREEMENT

between

Irish European Reinsurance Company Limited

of

Dublin, Ireland

(hereinafter called the "Reinsurer")

and

The Equitable Life Assurance Society

Of

Aylesbury, England

(Hereinafter called the "Reinsured")

Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Addendum 1

IRECO

As at 31.12 1999 the following conditions of the above Life Reinsurance Agreement will be changed as follows:

Article I - Business Covered:

All Retirement Annuities, Individual Pension Plans and Transfer Plans issued by the Reinsured on or before 30 June 1988, and

all Group Pension Business, other than Simplified Administration Pension Scheme (SAPS) business and Group Final Salary business, in respect of members of schemes effected with the Reinsured on or before 30 June 1988 who have a contractual option to take annuity benefits on guaranteed minimum rates.

Article V - Premium

For each year that this reinsurance is in force, the Reinsured will pay a deposit premium of GBP 625,000, adjusted in line with the increase in the UK Retail Price Index from November 1999 to the month of November immediately preceding the Renewal Date. For each year the full deposit premium shall be due on the Renewal Date. The deposit premium is payable in cash to the Reinsurer. However, should a reinsurance Claim Event occur an adjustment premium will be calculated as described in Appendix II to this agreement.

All other conditions will be unchanged.

For and on behalf of

[redacted] [redacted]

The Equitable Life Assurance Society Date: 4.1.00

For on behalf of

[redacted]

Date: [illegible]

IRISH - EUROPEAN
REINSURANCE
Irish - European Reinsurance Co. Ltd.

[Irish European Reinsurance Company Limited]

Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Addendum 2

IRECO

Addendum 2

To

LIFE REINSURANCE AGREEMENT

between

Irish European Reinsurance Company Limited

of

Dublin, Ireland

(hereinafter called the "Reinsurer")

and

The Equitable Life Assurance Society

Of

Aylesbury, England

(Hereinafter called the "Reinsured")

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Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Addendum 2

IRECO

As at 31 December 1999 the following conditions of the above Life Reinsurance Agreement will be changed with effect from 10 August 2000 as follows:

Article IV - Premium

For each year that this reinsurance is in force, the Reinsured will pay a deposit premium of GB£700,000, adjusted in line with the increase in the UK Retail Price Index from November 1999 to the month of November immediately preceding the Renewal Date. The deposit premium for year commencing 31 December 1999 will be payable in two instalments: the first instalment of GB£625,000 is due as at 31 December 1999 and the second instalment of GB£75,000 is due on 1 September 2000. For each subsequent year the full deposit premium shall be due on the Renewal Date. The deposit premium is payable in cash to the Reinsurer. However, should a reinsurance Claim Event occur an adjustment premium will be calculated as described in Appendix II to this agreement.

Appendix I

The conditions set out below will be changed as follows:

Reinsurance Claim Event :	A Reinsurance Claim Event will be deemed to occur in respect of any year where the ratio GG/GA exceeds 60%.
Reinsurance Claim :	The Reinsurer's Liability will be given by: (1 - 0.60*GA/GG) * (GO - GG)
Claims Recovery Premium :	The Claims Recovery Premium will be determined as : (1 - 0.60*GA/GG) * (FG - GG) subject to a maximum equal to the Reinsurer's Liability.

All other conditions in Appendix I will be unchanged.

Appendix III

The Reinsured's current practice with regard to the exercising of guaranteed annuity options, as represented to the Reinsurer, is described below.

A guaranteed annuity option can be exercised only if annuity benefits are taken in a form of annuity for which guaranteed annuity rates are prescribed in the policy terms.

If a guaranteed annuity option is exercised by the policyholder selecting a form of annuity to which guaranteed annuity rates apply, the annuity secured by that part of the policy proceeds is calculated as the "relevant policy proceeds" multiplied by the appropriate guaranteed

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Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Addendum 2

IRECO

annuity rate, where the "relevant policy proceeds" are defined as that part of the total policy proceeds which is used to provide the selected form of annuity benefits.

All other conditions will be unchanged.

For and on behalf of

The Equitable Life Assurance Society Date: 22 August 2000

[redacted] [redacted]

For and on behalf of

Irish European Reinsurance Company Limited Date : 16 August 2000

[redacted] [redacted]

IRISH - EUROPEAN
REINSURANCE
Irish - European Reinsurance Co. Ltd.

Document Number:02586 Page 3

Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Addendum 3

[redacted]

ADDENDUM 3

TO

LIFE REINSURANCE AGREEMENT

between

Irish European Reinsurance Company Limited

of

Dublin, Ireland

(hereinafter called the Reinsurer)

and

The Equitable Life Assurance Society

of

London, England

(hereinafter called the Reinsured)

London 3/815868/01

Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Addendum 3

With effect from , the parties have entered into this Addendum No. 3 to:

(1) confirm, clarify and consolidate into one document their existing Agreement incepting on 31 December 1998 comprising the Life Reinsurance Agreement signed 30 September 1999 and 10 October 1999 including Appendices I to III thereto, Addendum No. 1 effective from 31 December 1999 and signed on 16 December 1999 and 4 January 2000 and Addendum No. 2 effective from 10 August 2000 and signed on 16 August 2000 and 22 August 2000; and

(2) effect certain amendments to the terms of this Agreement; and

(3) record their conclusion of a restructuring of the Agreement as envisaged by the final paragraph of Article XIII of the existing Agreement should the total withheld reinsurance claims balance exceed £100m at any 31 December.

Article I - Business Covered:

All Retirement Annuities, Individual Pension Plans and Transfer Plans issued by the Reinsured on or before 30 June 1988; and

All Group Pension Business, other than Simplified Administration Pension Scheme (SAPS) business and Group Final Salary business, in respect of members of schemes effected with the Reinsured on or before 30 June 1988 who have a contractual option to take annuity benefits on guaranteed minimum rates.

Article II - Inception Date:

The contract will incept on 31 December 1998 ("the Inception Date").

Article III - Duration and Cancellation by the Reinsured:

The Reinsured may cancel this Agreement by written notice with immediate effect at any time hereafter.

If notice of cancellation is given pursuant to this Article, there will be no return of premium in respect of the Deposit Premium payable at the immediately preceding Renewal Date. However, if notice of cancellation is given, no further Deposit Premiums (unless already due but unpaid) will be payable.

If the Reinsured cancels the Agreement in accordance with this Article, this Agreement shall be determined and commuted with effect from the date of cancellation upon terms that:

(a) the Reinsured will be immediately liable to pay the Reinsurer in cash any outstanding Deposit Premium due and payable in accordance with Article V, any outstanding Additional Fee and/or any outstanding Risk Amount (including any accrued interest thereon) due and

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Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Addendum 3

payable in accordance with Appendix II. Any such amounts will first be paid by the Reinsured by way of deduction, in favour of the Reinsurer, from any Additional Premium withheld by the Reinsurer at the date of cancellation as prescribed in Appendix II. To the extent that such withheld Additional Premium is insufficient to satisfy the amounts due, the Reinsured will immediately pay the balance in cash;

(b) the Reinsured shall be immediately liable to repay the Reinsurer in cash any cash payments made by the Reinsurer to the Reinsured pursuant to Article IV below together with any accrued fee interest thereon as provided in Article V. Any such amounts will first be repaid by the Reinsured by way of deduction, in favour of the Reinsurer, from any Additional Premium withheld by the Reinsurer at the date of cancellation as prescribed in Appendix II. To the extent that such withheld Additional Premium is insufficient to repay these amounts, the Reinsured will immediately pay the balance in cash;

(c) if after payment of the amounts due from the Reinsured to the Reinsurer under (a) and (b) above, there is any unused Additional Premium withheld by the Reinsurer, the Reinsurer will within 30 days of cancellation refund the remaining Additional Premium to the Reinsured;

(d) with effect from the date of cancellation, the Reinsurer and Reinsured shall be immediately subject to equal and opposite obligations to each other in respect of any and all other amounts payable or due to each other (i.e. other than those at (a) to (c) above) pursuant to this Agreement;

(e) the mutual obligations of the Reinsurer and the Reinsured under this Agreement shall be set off with the result that, save for the amounts due from the Reinsured in respect of (a) and (b) above and any unused Additional Premium due from the Reinsurer in respect of (c) above, the net amount owing by either the Reinsurer or the Reinsured pursuant to this Agreement shall always be zero;

(f) save for the Reinsured's liability in respect of (a) and (b) above and any unused Additional Premium due from the Reinsurer in respect of (c) above, the Reinsured and Reinsurer shall be mutually released and discharged from any and all further rights and liabilities under this Agreement.

If the Reinsured does not cancel the Agreement as provided above, it will automatically renew annually with effect from 31 December each year ("the Renewal Date").

The Reinsured's right to cancel under this Article is in addition to the termination circumstances set out in Article XII.

Article IV Cover and Limit — This has changed from the draft text on which our earlier comments were based

As at 31 December each year, the Reinsurer will be liable for any Reinsurance Claims Amount arising from the Business Covered as defined in Appendix I to this Agreement ("the Cover"). With effect from 31 December 2001, the total aggregate Reinsurance Claims Amount that can be claimed

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Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Addendum 3

from the Reinsurer under this Agreement discounted back from the relevant Renewal Date to 31 December 2001 will be subject to an aggregate limit. At any Renewal Date, that aggregate limit of Cover will be the sum of:

(1) the lowest of:

(a) 120% of the reduction in mathematical reserves as a consequence of this Agreement shown by the Reinsured in Form 52 of the Reinsured's Financial Services Authority returns (or the statutory equivalent from time to time (the "FSA Returns") for the calendar year ending at that Renewal Date; or

(b) 17% of the amount of mathematical reserves for the Business Covered which is shown in Form 52 of the Reinsured's FSA Returns for the calendar year ending at the Renewal Date; or

(c) the limit for the relevant calendar year as set out in Appendix IV to this Agreement;

and

(2) the Reinsurance Claims Amount withheld, determined at that Renewal Date,

subject at all times to a maximum amount of £1,000,000,000.

Save for the maximum £1,000,000,000 limit, all amounts used in the calculation of the aggregate limit of the Cover shall be discounted to 31 December 2001. For the period between the Renewal Date and 31 December 2001, the rate of discount for each year shall be the average of the annualised redemption yields available on 15 year UK Government fixed interest securities on the current and previous Renewal Dates respectively or on the immediately preceding working days respectively.

All Reinsurance Claims Amounts will be withheld by the Reinsurer. Notwithstanding this, at any 31 December, the Reinsurer will pay at the Reinsured's request (a) an interest amount being the one year Sterling LIBOR (as published by the British Bankers Association on that date or the immediate preceding working day ("LIBOR")) multiplied by the outstanding Reinsurance Claims Amount but only if such interest amount is required by the Reinsured to properly satisfy its requirements under s35A(1)(a) of the Insurance Companies Act 1982 or, (b) a cash payment of up to 10% of the outstanding Reinsurance Claims Amount. The aggregate limit referred to above includes any such cash payments and the Reinsurer will not be liable to pay any part of any interest amount under (a) to the extent that the payment of such a part would otherwise result in the aggregate limit being exceeded.

Article V Premium:

The Reinsured will pay premium as follows:

Deposit Premium

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Reinsurance treaty between Equitable Life and the Irish European Reinsurance Company

Addendum 3

For each year that this Agreement is renewed, the Reinsured will pay a Deposit Premium of GB£700,000, adjusted in line with the increase in the UK Retail Price Index from November 1999 to the month of November immediately preceding the Renewal Date. The full Deposit Premium is due on the Renewal Date. The Deposit Premium is payable in cash to the Reinsurer.

Adjustment Premium

In addition to the Deposit Premium, if as at any 31 December, a Reinsurance Claims Amount is due from the Reinsurer, an Adjustment Premium will be due from the Reinsured and will be calculated in accordance with Appendix II to this Agreement.

Fee if interest or cash paid by the Reinsurer under Article IV

Furthermore, should the Reinsurer make a cash payment in any year as provided for under Article IV above, then a fee of one year Sterling LIBOR plus 3.5% of any outstanding cash payment which has not been repaid by the Reinsured during that year shall be payable by the Reinsured in cash on the Renewal Date falling in that calendar year. Such fee will be payable annually on the same basis until such time as this interest amount and the cash payment is repaid in full to the Reinsurer. This fee shall not affect the amount of cash owed to the Reinsurer.

Restructuring Fee

In consideration of the Reinsurer agreeing this Addendum, the Reinsured will pay a fee of £10,000 to the Reinsurer. Such fee will be payable within 7 days of this Addendum being executed by both parties.

Article VI - Conditions Precedent to the Reinsurer's Liability

It is a condition precedent to any liability of the Reinsurer that the Reinsured will make no change to its current practice regarding the exercising of guaranteed annuity options as represented to the Reinsurer in Appendix III to this Agreement which is reasonably likely to increase the Reinsurer's Liability under this Agreement. The Reinsurer shall acting reasonably be the sole judge of whether a change in the Reinsured's practice is reasonably likely to increase the Reinsurer's Liability under the Agreement. If any such change occurs, either at the choice of the Reinsured or as a result of any legal action brought against the Reinsured, then no further Reinsurance Claim Events will be admissible.

If the Scheme of Arrangement pursuant to section 425 of the Companies Act 1985 between the Reinsured and the Scheme policyholders as defined in the Scheme of Arrangement ("the Compromise") is either not proposed by the Reinsured or if proposed is not approved by the court (for whatever reason) by 1 March 2002, it is a condition precedent to any future liability of the Reinsurer under this Agreement that the Reinsured purchases instruments to hedge against changes in equity values or falls in interest rates comprising a minimum spend by the Reinsured of £50 million. Such instruments to be purchased within 75 days of 1 March 2002 or of any earlier date if the Compromise is either not proposed or is withdrawn or suspended by the Reinsured prior to 1 March 2002. The instruments will be purchased from a counterparty with at least an AA rating from Standard & Poor's.

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Article VII - Warranties given by the Reinsured

The Reinsurer offers the Cover on the basis of information supplied to it by the Reinsured. The Reinsured warrants that the information supplied is, to the best of its knowledge and belief correct and an accurate summary of its records. In the event that any material differences emerge from the information supplied by the Reinsured, any dispute will be referred to an arbitration in accordance with Article XIII.

Article VIII - Statement of Account:

The Reinsured will prepare a statement of account as at any 31 December which shall include all relevant financial information as the Reinsurer may from time to time reasonably require (a "Statement of Account") in order to ascertain the limit of Cover under Article IV, the Reinsurer's Liability and any Reinsurance Claims Amount under Appendix I and any Adjustment Premium payable under Appendix II. The Statement of Account will be submitted by the Reinsured to the Reinsurer within 30 days of the Reinsured filing its FSA returns. The first Statement of Account will be in respect of calendar year 2001. The Reinsured will supply information (including all relevant information from the Reinsured's FSA returns for the previous calendar year needed to determine the limit under Article IV and any Adjustment Premium payable under Appendix II) and make available for inspection pursuant to Article X any further documentation reasonably needed by the Reinsurer to check the accuracy of the Statement of Account.

Article IX - Currency:

All amounts referred to and all Statements of Account under this contract shall be in British Pounds.

The introduction of the euro shall not have the effect of altering any term of this Agreement or of discharging or excusing performance under this Agreement, nor will it give a party the right unilaterally to alter or terminate this Agreement.

Article X - Inspection of Records:

The Reinsurer will have the right to inspect the records of the Reinsured in respect of the Business Covered. For as long as either party remains under any liability hereunder, the Reinsured shall, upon request by the Reinsurer, make available for inspection at any reasonable time by such representatives as may be authorised by the Reinsurer for that purpose, all information relating to the Business Covered hereunder and/or the Reinsured's financial position as far as it relates to future emergence of surplus as defined in this Agreement which is in the Reinsured's possession or under its control. The said representatives may arrange for copies to be made of any of the records containing such information as they may require.

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The Reinsurer (and its representatives) will keep confidential any information or copy documentation it acquires as a result of any inspection. Unless agreed to by the Reinsured (such agreement not to be unreasonably withheld), the Reinsurer will not disclose the information to any person other than its regulators, professional advisors, its employees and agents, employees of affiliates and then only as required by law or on a "need to know" basis.

Article XI - Errors & Omissions:

Errors and inadvertent omissions shall not affect the rights and obligations of either party under this Agreement, however, they shall be rectified as soon as reasonably practicable upon discovery. No failure to exercise and no delay on the part of any party in exercising any right, remedy, or power under this Agreement and no course of dealing between the parties shall be construed or operate as a waiver thereof, nor shall any single or partial exercise of any other right, remedy or power.

Any waiver of a breach of any of the terms of this Agreement or of any default hereunder shall not be deemed to be a waiver of any subsequent breach or default and shall in no way affect the other terms of this Agreement.

Article XII - Termination:

Each party is entitled to terminate the Agreement without giving prior notice if:

1. The fulfilment of the Agreement becomes legally or practically impossible for reasons which are beyond the responsibilities of the parties (such as the country where either party is domiciled becomes involved in a war).

2. The other party becomes insolvent or goes into liquidation or a receiver/administrator is appointed or has its licence to conduct insurance business revoked as defined in Section 13 of the Insurance Companies Act 1982.

3. The other party loses more than 50% of its paid up capital.

4. The other party transfers its business to a third party.

5. The other party is acquired by or merged with or comes under the control of another company.

6. The other party does not meet its obligations under this Agreement despite having received formal reminders to do so.

7. The Reinsured fails to purchase the hedging instruments as prescribed in Article VI within 75 days of 1 March 2002 if the Compromise has not been approved by the court (for whatever reason) by that date or within 75 days of any earlier date if the Compromise is either not proposed or is withdrawn or suspended by the Reinsured prior to 1 March 2002.

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8. The Reinsured changes its current practice regarding the exercise of guaranteed annuity options as represented to the Reinsurer in Appendix III but only if such a change is reasonably likely to increase the Reinsurer's Liability under this Agreement.

9. The Reinsured fails to pay the Additional Premium within 30 days of the Reinsurer giving written notice of non-payment to the Reinsured as prescribed in Appendix II.

If the Agreement is terminated pursuant to this Article, this Agreement shall be determined and commuted with effect from the date of termination upon terms that:

(a) the Reinsured will be immediately liable to pay the Reinsurer in cash any outstanding Deposit Premium due and payable in accordance with Article V, any outstanding Additional Fee and/or Risk Amount (including any accrued interest thereon) due and payable in accordance with Appendix II. Any such amounts will first be paid by the Reinsured by way of deduction from any Additional Premium withheld by the Reinsurer at the date of termination as prescribed in Appendix II. To the extent that such withheld Additional Premium is insufficient to repay these amounts, the Reinsured will immediately satisfy the balance in cash;

(b) the Reinsured shall be immediately liable to repay the Reinsurer in cash any cash payments made by the Reinsurer to the Reinsured pursuant to Article IV together with any accrued fee interest thereon as provided in Article V. Any such amounts will first be paid by the Reinsured by way of deduction from any Additional Premium withheld by the Reinsurer at the date of termination as prescribed in Appendix II. To the extent that such withheld Additional Premium is insufficient to repay these amounts, the Reinsured will immediately pay the balance in cash;

(c) if after payment of the amounts due from the Reinsured to the Reinsurer under (a) and (b) above, there is any unused Additional Premium withheld by the Reinsurer, the Reinsurer will within 30 days of termination refund the remaining Additional Premium to the Reinsured;

(d) with effect from the date of termination, the Reinsurer and Reinsured shall be immediately subject to equal and opposite obligations to each other in respect of any and all other amounts payable or due to each other (i.e. other than those at (a) to (c) above) pursuant to this Agreement;

(e) the mutual obligations of the Reinsurer and the Reinsured under this Agreement shall be set off with the result that, save for the amounts due from the Reinsured in respect of (a) and (b) above and any unused Additional Premium due from the Reinsurer in respect of (c) above, the net amount owing by either the Reinsurer or the Reinsured pursuant to this Agreement shall always be zero:

(f) save for the Reinsured's liability in respect of (a) and (b) above and any unused Additional Premium due from the Reinsurer in respect of (c) above, the Reinsured and Reinsurer shall be

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mutually released and discharged from any and all further rights and liabilities under this Agreement.

However, the above is subject to the requirement that, in the event of termination as a result of the Reinsured's insolvency under part (2) of this Article, the Reinsured's liabilities to its policyholders under the terms of its long term policies will take priority over any set off rights of the Reinsurer (other than in respect of any Additional Premium withheld by the Reinsurer at the time of termination under part (2)). Upon termination as a result of insolvency under part (2), the Reinsurer may at its sole discretion apply the whole of part of any withheld Additional Premium as prescribed in Appendix II against:

(i) any outstanding Reinsurance Claims Amount due from the Reinsurer by way of set off; and/or

(ii) any sums due from the Reinsured referred to in (a) and (b) above and such sums will be set off against the amounts owed by the Reinsured accordingly.

To the extent there is any unused Additional Premium still withheld by the Reinsurer after applying (i) and (ii) above, the Reinsurer will refund such Additional Premium to the Reinsured.

In addition, notwithstanding policyholders' rights in the event of the Reinsured's insolvency, the Reinsurer will also retain the right to set off any future Recovery Amounts due.

Article XIII Arbitration:

The Reinsured and the Reinsurer intend to follow the customs and practices of the insurance and reinsurance industry in the operation of and interpretation of this Agreement. The parties agree to act in all things with the highest good faith.

In the event of any dispute or differences arising under or in connection with this Agreement including those pertaining to its validity, the dispute will be referred to three Arbitrators, one to be appointed by each party and the third to be appointed by the two appointed Arbitrators.

If either party refuses or neglects to appoint an Arbitrator within 28 days after the other party has appointed an Arbitrator and has served notice upon the first mentioned party requiring that party to make such an appointment, then the Arbitrator appointed as aforesaid will, at the request of the party appointing him, proceed to hear and determine the dispute as a sole Arbitrator.

The two Arbitrators (if both parties have duly appointed Arbitrators) will in writing appoint the third Arbitrator and, unless they appoint the third Arbitrator within one calendar month after the date of the appointment as Arbitrator of whichever of them has last been appointed, the Third Arbitrator will be appointed by the Chairman for the time being of the Bar Council. The Tribunal shall be constituted upon the appointment of the third Arbitrator.

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The arbitration will be held in London and will be conducted in accordance with the ARIAS (UK) Arbitration Rules.

The cost of the reference and award will be in the discretion of the Arbitrators or sole Arbitrator who may direct to and by whom and in what manner the same or any part thereof will be paid with power to tax or settle the amount of the costs to be so paid or any part thereof.

The Arbitrators appointed by the parties or any sole Arbitrator will be persons who hold (or have held) leading positions in Companies transacting Life Insurance and/or Life Reinsurance and will be persons with not less than ten years' experience in that field. The third Arbitrator will be a Queen's Counsel who has not less than ten years' experience in the insurance or reinsurance field. The Arbitrators or any sole Arbitrator will regard this Agreement from the standpoint of practical business and will interpret its provisions according to an equitable rather than a strict legal interpretation and their award will have regard to these principles.

This agreement to submit disputes to arbitration will be construed as a separate and independent contract between the parties hereto.

Article XIV Governing Law:

This Agreement shall be governed by and construed in accordance with English law.

Article XV Miscellaneous:

For the purpose of the Contracts (Rights of Third Parties) Act 1999 nothing in this Agreement is intended to confer any benefit on any third party and no term in this Agreement is intended to be enforceable by any person who is not a party to this Agreement.

This Agreement may be amended on the written agreement of both parties. In the event of any dispute, this will be subject to arbitration on the basis set down in Article XIII of this Agreement.

All notices to be provided pursuant to this Agreement shall be given in writing by recorded delivery post and with appropriate postage paid, or by personal delivery, or by facsimile or by overnight courier service to the addressess or facsimile numbers set out below for each respective party; provided that, if any party gives notice of a change of name or address or number, notices to that party shall thereafter be given as demanded in the notice. All notices so given shall be effective upon the date of receipt by the parties to whom notice is given, except notice by post which shall be deemed delivered three days after deposit in the mail:

The Reinsurer: Irish European Reinsurance Company Limited
Ground Floor
IFSC House
Customs House Quay
Dublin 1

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Fax no. +353 (0)1 6720 421
Attention of: M[redacted]

The Reinsured: The Equitable Life Assurance Society
City Place House
55 Basinghall Street
London
EC2V 5DR
Fax no. +44 (0) 20 7710[redacted]
Attention of: Chief Financial Officer

This Agreement may be executed in separate counterparts with the same force and effect as if signed in an original document by each of the parties hereto. Signatures on each counterpart may be sent via facsimile transmission of such signature and any facsimile transmission of such signature shall be deemed to have the same force and effect as an original signature. Each separate counterpart when executed and delivered shall be deemed to be an original but all the counterparts shall together constitute one and the same instrument which shall only be deemed executed when counterparts executed by all the parties are delivered.

The Agreement contained in this Addendum No. 3 constitutes the entire Agreement between the parties and supercedes all previous Agreements of any kind between them in relation to the subject matter. This does not affect the duty of utmost good faith owed by each party to the other hereunder nor the ability of either party to exercise remedies for any breach of the duty of utmost good faith by the other.

For and on behalf of [redacted]

The Equitable Life Assurance Society Date: 16 November 2001

For and on behalf of

Irish European Reinsurance Company Limited Date:

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Appendix I

Reinsurance Claim Event:

For each calendar year the Reinsured will calculate the following amounts as at 31 December:-

GA = The total guaranteed funds for all retirements under the Business Covered.

GG = The total guaranteed funds used to secure guaranteed annuity benefits for all retirements under the Business Covered where the policyholder exercises the guaranteed annuity option.

FG = The total funds (including final bonus) available to all retirements under the Business Covered where the policyholder exercises the guaranteed annuity option.

For the purposes of this Agreement, guaranteed funds will be taken to mean the total funds available from the original guaranteed benefit defined in the policy schedule and the total attaching reversionary bonus. The total funds will be taken to mean the guaranteed funds plus any and all final bonuses added to a maturing policy.

A Reinsurance Claim Event will be deemed to occur in respect of any year where the ratio GG/GA exceeds 60%.

Reinsurance Claim:

When a Reinsurance Claim Event is deemed to occur in respect of any calendar year, the Reinsurer's Liability for that year will be determined as the sum of

$$\frac{\text{Guaranteed Funds * Guaranteed Annuity Rate}}{\text{Current Annuity Rate}}$$

where the summation is carried out over all policies for which the guaranteed annuity option has been exercised in that year. The result of this calculation will be denoted by GO.

The Guaranteed Annuity Rate will be that applicable in the policy document for each relevant case.

The Current Annuity Rate will be that available from the Reinsured at the date of retirement for the same mode of payment as that in the Guaranteed Annuity Rate.

However, if at any 31 December, the cumulative Reinsurance Claims Amount due from the Reinsurer (prior to any deduction for any Recovery Amount payable in that calendar year) exceeds £100 million, GO will be recalculated using a Current Annuity Rate that is subject to a minimum rate determined on the assumptions used to determine the mathematical reserve in the most recent FSA returns in respect of mortality and expenses and using an interest rate equal to the annualised yield for 15 year UK Government fixed-interest securities. This revised calculation of GO will continue to apply until the cumulative Reinsurance Claims Amount due falls below £50 million. Thereafter the

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original calculation of GO will apply unless and until the cumulative Reinsurance Claims Amount due exceeds £50 million. At all times thereafter the revised calculation will apply whenever the cumulative Reinsurance Claims Amount due from the Reinsurer exceeds £50 million.

The Reinsurer's Liability will be given by:

$$(1 - 0.60*GA/GG) * (GO - GG)$$

Claims Recovery Premium:

When a Reinsurance Claim Event is deemed to occur in respect of any calendar year, a Claims Recovery Premium will be due for simultaneous payment by the Reinsured to the Reinsurer and will be set off simultaneously against the Reinsurer's Liability.

The Claims Recovery Premium will be determined as :

$$(1 - 0.60*GA/GG) * (FG - GG)$$

subject to a maximum equal to the Reinsurer's Liability.

Reinsurance Claims Amount:

In respect of any calendar year, the Reinsurance Claims Amount will be determined subject to Article IV as the Reinsurer's Liability less the Claims Recovery Premium. The Reinsurance Claims Amount will be withheld by the Reinsurer.

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Appendix II

Adjustment Premium:

1. If as at any 31 December, a Reinsurance Claims Amount is due from the Reinsurer, then the Reinsured will pay an Adjustment Premium which will comprise four elements (as applicable):

   1.1 A Recovery Amount

   1.2 A Risk Amount

   1.3 An Additional Premium (which will only be due and payable in the event that the cumulative Reinsurance Claims Amount exceeds £100 million).

   1.4 An Additional Fee (which will only be due and payable in the event an Additional Premium is due and payable).

The calculation of the four elements of the Adjustment Premium will depend upon the cumulative Reinsurance Claims Amount due from the Reinsurer as at any 31 December as set out below.

If the cumulative Reinsurance Claims Amount due from the Reinsurer is £100 million or less

2. If the cumulative Reinsurance Claims Amount due from the Reinsurer (including any amount arising from the experience in that calendar year) as at any 31 December is £100 million or less, the Adjustment Premium will be due and payable from the Reinsured as follows:

   2.1 A Recovery Amount of 35% of the Reinsurance Claims Amount will be due each year until the total amount paid is equal to the Reinsurance Claims Amount.

      2.1.1 For a Reinsurance Claims Amount due as at the 31 December in any year, the first Recovery Amount will be due at the next 31 December. The Recovery Amount will only be payable to the extent there is surplus emerging as prescribed in paragraph 3 below at the year end in question.

      2.1.2 If there is surplus emerging at the relevant year end, the Recovery Amount will not be paid in cash but will be set off to the extent surplus is available against the Reinsurance Claims Amount due from the Reinsurer at that time.

      2.1.3 If in any year there is insufficient surplus to pay the Recovery Amount in whole or in part, the outstanding Recovery Amount will be carried forward and recovered as surplus emerges as prescribed in paragraph 3 below in later years in the order of priority set out in paragraph 9.

   2.2 A Risk Amount of 2% of the outstanding Reinsurance Claims Amount will be due as long as a Recovery Amount is due.

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2.2.1 For a Reinsurance Claims Amount due as at 31 December in any year, the first Risk Amount will be due at the same 31 December. The Risk Amount will only be payable to the extent there is surplus emerging as prescribed in paragraph 3 below at the year end in question.

2.2.2 If there is surplus emerging at the relevant year end, the Risk Amount will be paid in cash to the Reinsurer at the same time as submission of the Statement of Account by the Reinsured. Any overdue payment will incur a late payment charge of one year Sterling LIBOR plus 3.5% from the due date until the actual payment date.

2.2.3 If in any year, there is insufficient surplus to pay the Risk Amount due in whole or in part, any unpaid Risk Amount will be carried forward and recovered as surplus emerges as prescribed in paragraph 3 below in later years in the order of priority set out in paragraph 9.

2.2.4 An annual interest fee of one year Sterling LIBOR plus 3.5% of any cumulative unpaid Risk Amounts will be payable in cash provided surplus emerges as prescribed in paragraph 3 below until all outstanding Risk Amounts (together with any accrued annual interest fees thereon) have been paid to the Reinsurer in full. The annual interest fee due will be payable at the time of submission of the Statement of Account by the Reinsured. Any overdue payment will incur a late payment charge of one year Sterling LIBOR plus 3.5% from the due date until the actual payment date.

2.2.5 The Adjustment Premium for future years will be increased, subject to the limit on the Adjustment Premiums (set out in this Appendix) by the total amounts of the unpaid Risk Amounts and any unpaid annual interest fees on those amounts.

3. The Adjustment Premium will only be payable at the end of a year if there is surplus emerging and payment will not therefore exceed the lower of:

3.1 the change during that year in the excess of the Available Assets over the Required Minimum Margin plus the Bonus Payments made to Policyholders in Anticipation of a Surplus during the year; and

3.2 the total of the amounts calculated in 3.1 for all years since the Inception Date of this Agreement,

excluding for the purpose of these calculations the amount of the Adjustment Premium that is being determined.

Hereby the following definitions apply:

Available Assets = Form 9 Line 25 of the FSA Returns

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Required Minimum Margin = Form 9 Line 41of the FSA Returns

Bonus Payments made to Policyholders in Anticipation of a Surplus = Form 58 Line 41 of the FSA Returns

If the cumulative Reinsurance Claims Amount due from the Reinsurer exceeds £100 million

4. If the cumulative Reinsurance Claims Amount due from the Reinsurer as at any 31 December (including any amount arising from the experience in that calendar year) exceeds £100 million, the Adjustment Premium will be due and payable from the Reinsured as follows:

4.1 An Additional Premium will be due and payable immediately from the Reinsured to the Reinsurer in cash (regardless of whether surplus emerges).

4.1.1 The Additional Premium will amount to 12% of the reduction in mathematical reserve as a consequence of this Agreement as shown by the Reinsured in Form 52 of its FSA Returns as at the relevant 31 December.

4.1.2 The Additional Premium will be payable at the same time as submission of the Statement of Account by the Reinsured for the relevant year. If the Reinsured fails to pay the Additional Premium on the due date, the Reinsurer may serve written notice upon the Reinsured to pay the Additional Premium within 30 days of service of the notice. If after that 30 days, the Reinsurer has failed to pay the Additional Premium, the Reinsurer will have the right to terminate the Agreement in accordance with Article XII.

4.1.3 In the event the Reinsurer does not terminate for late payment under 4.1.2 above, any overdue payment will incur a late payment charge of one year Sterling LIBOR plus 3.5% from the due date until the actual payment date.

4.1.4 The Additional Premium will be withheld by the Reinsurer until this Agreement is cancelled or terminated. However, upon giving written notice to the Reinsured within 14 days of submission of the Statement of Account from the Reinsured, the Reinsurer may in its absolute discretion refund all or part of the Additional Premium on the basis that such refund is used by way of set off so as to reduce by an equal and corresponding amount any Reinsurance Claims Amount due (after deduction of any Recovery Amount actually paid for that calendar year) with effect from the immediately preceding 31 December.

4.1.5 Upon cancellation or termination of the Agreement, any withheld Additional Premium (which has not already been refunded to the Reinsured pursuant to 4.1.4 above) will be used for repayment and set off purposes as prescribed in Article III or Article XII accordingly.

4.1.6 For the avoidance of doubt, the Additional Premium will only become due and payable once and only with effect from the 31 December in the year that the Reinsurance Claims Amount first exceeds £100 million.

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4.2 An Additional Fee will be due and payable from the Reinsured to the Reinsurer in cash (regardless of whether surplus emerges). The Additional Fee will be calculated as 9% of the Additional Premium calculated in accordance with 4.1.1 above. The Additional Fee will be payable at the same time as submission of the Statement of Account by the Reinsured for the relevant year and is non-refundable. Any overdue payment will incur a late payment charge of one year Sterling LIBOR plus 3.5% from the due date until the actual payment date. For the avoidance of doubt, the Additional Fee will only become due and payable once and only with effect from the 31 December in the year that the Reinsurance Claims Amount first exceeds £100 million.

4.3 A Recovery Amount of 100% of the Reinsurance Claims Amount will be due immediately.

4.3.1 The Recovery Amount will be due but will only be payable to the extent there is surplus emerging as prescribed in paragraph 5 below in that year. Any actual payment will be with effect from the immediately preceding 31 December in question.

4.3.2 If there is such surplus emerging, the Recovery Amount will not be paid in cash but will be set off to the extent surplus is available against the Reinsurance Claims Amount owing from the Reinsurer at that time.

4.3.3 If in any year there is insufficient surplus to pay the Recovery Amount in whole or in part, the outstanding Recovery Amount will be carried forward and recovered as surplus emerges as prescribed in paragraph 5 below in later years in the order of priority set out in paragraph 9.

4.4 Subject to paragraph 6 below, with effect from the next 31 December after the Reinsurance Claims Amount has exceeded £100 million, a Risk Amount of 4% of the outstanding Reinsurance Claims Amount (calculated before deduction of any Recovery Amounts actually payable in that year) will be due in cash immediately.

4.4.1 The Risk Amount will be due but will only be payable to the extent there is surplus emerging as prescribed in paragraph 5 below in that year.

4.4.2 If there is surplus emerging at the relevant year end, the Risk Amount will be paid in cash to the Reinsurer at the same time as submission of the Statement of Account by the Reinsured. Any overdue payment will incur a late payment charge of one year Sterling LIBOR plus 3.5% from the due date until the actual payment date.

4.4.3 If in any year, there is insufficient surplus to pay the Risk Amount due in whole or in part, any unpaid Risk Amount will be carried forward and recovered as surplus emerges as prescribed in paragraph 5 below in later years in the order of priority set out in paragraph 9.

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4.4.4 An annual interest fee of one year Sterling LIBOR plus 3.5% of any cumulative unpaid Risk Amounts will be payable in cash provided surplus emerges as prescribed in paragraph 5 below until all outstanding Risk Amounts (together with any accrued annual interest fees thereon) have been paid to the Reinsurer in full. The annual interest fee due will be payable within 30 days of receipt of the Statement of Account. Any overdue payment will incur a late payment charge of one year Sterling LIBOR plus 3.5% from the due date until the actual payment date.

4.4.5 The Adjustment Premium for future years will be increased, subject to the limit on the Adjustment Premiums (set out in this Appendix) by the total amounts of the unpaid Risk Amounts and any unpaid annual interest fees on those amounts.

5. The Recovery Amount, the Risk Amount and any annual interest fees thereon will only be payable to the extent there is surplus emerging in any given calendar year. The surplus available to meet the Adjustment Premium will be the greater of:

5.1 zero; or

5.2 the Distributed Surplus less the Explicit Bonus Reserve plus the Change in the Undistributed Surplus plus the Change in the Excess Value of Net Assets over Statutory Liabilities,

excluding for the purpose of these calculations the amount of the Adjustment Premium that is being determined.

Herewith the following definitions apply:

Distributed Surplus = Form 58 Line 48 of the FSA Returns
Change in Undistributed Surplus = Form 58 Line 49 less Form 58 Line 31 of the FSA Returns
Change in the Excess Value of Net Assets over Statutory Liabilities = Form 14 Line 51 less Form 14 Line 63 of the FSA returns minus the result of that same calculation for the amounts shown in the previous year's FSA Returns
The Explicit Bonus Reserve shall be the amount certified by the Reinsured's Appointed Actuary as the mathematical reserve held at the previous 31 December to provide for reversionary bonus in the following calendar year.

6. Once the cumulative Reinsurance Claims Amount due from the Reinsurer exceeds £100 million, the Recovery Amount and Risk Amount shall be calculated on the basis set out in paragraphs 4 and 5 until the cumulative Reinsurance Claims Amount due from the Reinsurer falls below £50 million. Thereafter, the calculation for the Recovery Amount and Risk Amount set out in paragraphs 2 and 3 will apply unless and until the cumulative Reinsurance Claims Amount due from the Reinsurer exceeds £50 million again. Therefore if the cumulative Reinsurance Claims Amount due from the Reinsurer exceeds £50 million again at any time thereafter, the Recovery Amount and Risk Amount set out in paragraphs 4 and 5 will apply. Except that if the cumulative

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Reinsurance Claims Amounts due from the Reinsurer exceeds £200 million at any time, the Recovery Amount and Risk Amount will be calculated on the basis set out in paragraphs 7 and 8 below. For the purposes of ascertaining the cumulative Reinsurance Claims Amount due at any 31 December, no deductions will be made for any Recovery Amount payable in relation to that year.

If the cumulative Reinsurance Claims Amount due from the Reinsurer exceeds £200 million

7. If the cumulative Reinsurance Claims Amount as at any 31 December exceeds £200 million, the Adjustment Premium will be due and payable from the Reinsured on the basis set out in paragraphs 4 to 6 above except that the Risk Amount will be 8% of the outstanding Reinsurance Claims Amount and not 4%. All other terms and conditions as set out in paragraphs 4 to 6 will apply.

8. The revised basis for calculating the Risk Amount will continue until the cumulative Reinsurance Claims Amount balance has reduced to £100 million after which the Adjustment Premium will be calculated in accordance with paragraphs 4 to 6.

Order of priority for payment of the Recovery Amount, the Risk Amount and any annual interest fees thereon as surplus emerges (regardless of the level of Reinsurance Claims Amount due from the Reinsurer)

9. The Recovery Amount, the Risk Amount and any annual interest fees thereon payable from surplus emerging (as set out either in paragraph 3 or paragraph 5 as applicable) in any year will be used first to pay:

   9.1. any annual interest fees on any unpaid Risk Amounts for previous years as described above on a first in, first out basis;

   9.2 any unpaid Risk Amounts for previous years which have been carried forward as set out above on a first in, first out basis;

   9.3 the Risk Amount due for the current year;

   9.4 the remaining balance payable, if any, will be used to pay any Recovery Amounts due as set out above. If there has been more than one Reinsurance Claims Amount for which Recovery Amounts have not been paid in full, subject to the Articles of the previous paragraph, the available funds will be applied to the Reinsurance Claim Amounts on a first in, first out basis.

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Appendix III

The Reinsured's current practice with regard to the exercising of guaranteed annuity options, as represented to the Reinsurer, is described below.

A guaranteed annuity option can be exercised only if annuity benefits are taken in a form of annuity for which guaranteed annuity rates are prescribed in the policy terms.

If a guaranteed annuity option is exercised by the policyholder selecting a form of annuity to which guaranteed annuity rates apply, the annuity secured by that part of the policy proceeds is calculated as "relevant policy proceeds" multiplied by the appropriate guaranteed annuity rate, where the "relevant policy proceeds" are defined as that part of the total policy proceeds which is used to provide the selected form of annuity benefits.

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APPENDIX IV

LIMIT OF COVER AS PER ARTICLE IV

Calendar Year	Limit £
2001	1,000,000,000
2002	995,000,000
2003	990,000,000
2004	985,000,000
2005	980,000,000
2006	975,000,000
2007	935,000,000
2008	895,000,000
2009	855,000,000
2010	815,000,000
2011	775,000,000
2012	715,000,000
2013	655,000,000
2014	595,000,000
2015	535,000,000
2016	475,000,000
2017	435,000,000
2018	395,000,000
2019	355,000,000
2020	315,000,000
2021	275,000,000
2022	235,000,000
2023	195,000,000
2024	155,000,000
2025	115,000,000
2026	85,000,000
2027	60,000,000
2028	40,000,000
2029	25,000,000
2030	15,000,000
2031 and later years	10,000,000

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Regulatory response to Equitable's compromise scheme proposals

FSA assessment of compromise (7 December 2001)

THE FSA'S ASSESSMENT OF EQUITABLE LIFE'S COMPROMISE SCHEME

Summary

1. The Equitable Life Assurance Society ("Equitable Life") has recently written to its with-profits policyholders inviting them to vote on its proposed compromise (the "Compromise").

2. The FSA is issuing this statement to explain how we have reviewed and assessed the Compromise, and our conclusions.

3. The FSA is content that, in relation to the relevant groups of guaranteed annuity rate ("GAR") and non-GAR policyholders, the level of increase to policy values is a fair offer in exchange for the GAR rights and potential mis-selling claims that would be given up. While there are variations from person to person, within each relevant group, we are content that there are no categories of policyholder within the groups who would receive disproportionately greater or lesser benefits.

4. Although much of the Compromise documentation sent to policyholders for the vote is complex, so are the problems. We are content that it is sufficiently clear to enable them to form their own view on how they should vote, in the light of their individual circumstances.

5. We hope that this summary of the FSA's views will help policyholders to make up their own minds on how to vote. The FSA cannot give personal advice to policyholders. Where Equitable Life policyholders believe they require assistance in deciding how to vote, they will need to seek independent financial advice. Further information about how to find a financial adviser is available on the FSA's website (www.fsa.gov.uk/consumer) or from our Consumer Helpline on (0845 606 1234).

The FSA's Role

6. Equitable Life is seeking to give effect to the Compromise by proposing a scheme of arrangement under section 425 of the Companies Act 1985. The Companies Act does not give the FSA a formal role in the process, but it has general regulatory powers, under the Financial Services and Markets Act 2000, to take action in relation to the Compromise if it considers it appropriate in order to protect the interests of policyholders. The FSA decided it had no reason to intervene to object to the proposals being put to policyholders. The FSA could seek to be heard if the Compromise is put to the Court for formal approval after the vote.

Regulatory response to Equitable's compromise scheme proposals

FSA assessment of compromise (7 December 2001)

7. As the FSA has made clear, we firmly believe that a successful compromise would, in principle, offer the best prospect of bringing stability to the with-profits fund and improving the outlook for concerned policyholders.

8. At the time that Equitable Life launched its consultation on the Compromise, the FSA said it would assess whether, for each relevant group of policyholders, the proposal was a fair exchange for the rights and potential claims they were being asked to give up. We also said that if that test was passed, we would look to see that the Compromise did not give disproportionately greater benefits or disbenefits to some groups of policyholders.

9. The FSA also said that it believed it was important that the Compromise put to policyholders should be clear and should provide them with the information they need to form their own judgement about how to vote on the proposals put to them.

10. The Compromise is explained by Equitable Life in the Compromise documents. The main feature of the Compromise is the proposed increases in policy values which each relevant group of policyholders would receive in return for giving up certain of their current rights and potential claims. Our assessment has focussed on arriving at a view as to whether these uplifts are reasonable. In considering this, and for the purposes of their own assessment, policyholders will want to refer to those parts of the Compromise documents which explain the way in which Equitable Life has calculated those values.

11. In forming its conclusions, the FSA has taken account of the assessment given by [redacted], who has been appointed by Equitable Life as an independent actuary. The Compromise documentation includes a summary of his report, which provides an important guide to the fairness of the Compromise. [redacted] considers that the terms of the Compromise have been established in a fair and reasonable way from an actuarial point of view.

<u>Detail</u>

GAR policyholders

12. Equitable Life has calculated the total amount being offered to GAR policyholders as a group on the basis of a realistic assessment of the likely cost to the Society of honouring the guarantees as policies mature, taking into account a range of considerations. The likely cost of the GARs depends on a number of factors, some of which are uncertain, such as interest rates, life expectancy and the form of benefits the policyholders select at retirement.

Regulatory response to Equitable's compromise scheme proposals

FSA assessment of compromise (7 December 2001)

13. The FSA reviewed the basis on which such likely costs were calculated. This involved reviewing the actuarial assumptions underlying Equitable Life's calculations of the likely costs of meeting the GAR liabilities. The FSA is content that the estimated cost of meeting the GAR liabilities, discounted to current values, is an appropriate amount for non-GAR policyholders to "pay" to GAR policyholders in exchange for their GAR rights.

14. We then looked at the way Equitable Life planned to share that total amount among the GAR policyholders in exchange for giving up their GAR rights. Details of the assumptions made by Equitable Life can be found in the Compromise documents. In reviewing the proposed uplifts to policy values, the FSA first assessed the objective economic values of the different types of GAR, then compared those values to the value of the uplift proposed for policyholders in each relevant group. We agree with the view of the independent actuary that the uplifts were calculated in a fair and reasonable way.

15. As part of our assesssment, we looked at a range of cases. For example, we compared the income that a policyholder who is able to retire now, or in the very near future, would have if he or she took a GAR annuity without the Compromise (on the basis of their current policy value) with an annuity bought in the open market (with the increased policy value) after the Compromise.

16. Of course, annuity rates change constantly – these calculations were on the basis of November 2001 rates. An analysis of this kind also does not take account of any of the less tangible benefits of the Compromise, which are considered later in this statement, such as the increased stability of the with-profits fund and the greater choice of retirement benefits that will be available if the Compromise is approved.

17. The analysis showed that policyholders using all their pension fund to buy an annuity now (with the GAR) would be better off than if they bought an annuity on the open market with the enhanced policy value, taking into account the uplift. However, only a small minority of policyholders would do that. The vast majority take part of their fund as a tax free lump sum. If that is taken into account, and we think it is appropriate to do so, policyholders may well find that the increase in policy value (assuming the Compromise is approved) would enable them to get an annuity close to or even slightly greater than the annuity that they would have obtained if they had exercised their GAR. Of course, those policyholders who never intended to exercise their GAR rights at all, would also get the benefit of an enhanced fund from which to buy their annuity at retirement.

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18. In current market conditions, when long term interest rates are at low levels, the GAR options are very attractive. The GAR options could become more valuable if interest rates fell further, but could just as easily become less valuable if interest rates rise again. The FSA considers that a value can be placed on the certainty of an uplift in policy values now.

19. Policyholders will also need to look at other factors which could affect the value of their GAR rights if the Compromise does not go ahead. The calculations above assume that a substantial non-guaranteed final bonus would be paid by Equitable Life at retirement. However, without the Compromise, the amount of non-guaranteed final bonus would remain very much more uncertain. Applying the GARs to a smaller retirement fund might result in a lower level of annuity than policyholders might currently be expecting, or might obtain if the Compromise is approved. And in order to have the benefit of the GAR, the annuity would have to be taken with Equitable Life.

20. On the other hand, if the Compromise went ahead, all policyholders would be in a stronger fund and would be able to use their enhanced funds to buy different kinds of annuities from Equitable Life. They would also be able, at retirement, to use the funds to buy an annuity from another provider or buy an income drawdown product.

21. GAR policyholders will need to form their own view about such risks and other less tangible benefits and disbenefits when considering the value of the Compromise to them.

Non-GAR policyholders

22. Equitable Life has published legal advice from [redacted] QC and [redacted] that non-GAR policyholders might have grounds to bring a claim for mis-selling on the basis that they were not told about the possible implications of the GAR policies to them. The FSA commissioned its own legal advice on this issue and that advice from [redacted] QC and [redacted] has also been published and is available on its website. While there were some differences on points of detail, the FSA's advice reached broadly similar conclusions. All of the published advice indicates that the strength of any claim which a non-GAR policyholder may have and the amount of any loss for which damages might be recoverable will vary and will depend on his or her particular circumstances.

23. We have considered the proposal to increase non-GAR policy values in exchange for giving up possible mis-selling claims associated with the GAR. Some non-GAR policyholders will find it easier than others to demonstrate mis-selling and the amount of any loss will vary. The amount of any loss depends on the type of policy, when it was taken out and the profile of

premium payments. Our analysis suggests that by comparing the performance - in terms of current payouts - of Equitable Life policies with those of its competitors, many policyholders may be worse off than they would have been if they had invested through another company, though others may not.

24. In addition, an analysis of loss needs to take account of the value of the greater flexibility in many Equitable Life policies. This is a difficult factor to quantify. Further, when comparing pay outs under policies issued by other life insurance companies, it should not be overlooked that Equitable Life took steps in July 2001 to adjust policy values to bring them back into line with underlying asset values. Other with-profit offices are now reviewing their terminal bonus rates and surrender values. The recent performance of equity markets has made it increasingly difficult for other companies to continue to smooth their pay outs in a way which protects consumers from the effect of recent falls in equity prices. This means that a simple snapshot comparison of policy pay outs may now overstate the potential loss to Equitable Life policyholders.

25. The FSA's legal advice is that the amount of loss that a policyholder could recover in Court would be likely to be limited to the loss of policy value which is attributable the cost of the GARs. The recoverable loss would not include losses attributable to poor investment performance and, importantly, would probably not include damages to compensate non-GAR policyholders for the fact that Equitable Life may also have mis-selling liabilities to other policyholders.

26. Accordingly, the Compromise documents identify the loss of bonus for the first seven months of 2000 (used by Equitable Life to fund the transfer of value to GARs after the House of Lords judgment) as a suitable proxy for the loss to non-GAR policyholders from the non-disclosure of the existence of the GAR risk. The FSA accepts this. As the Compromise documents explain, this amount is subject to two discounts: one for the uncertainty of success of the potential non-GAR claims and one for the probability that the costs of meeting non-GAR claims would fall to be met substantially by non-GAR policyholders themselves.

27. The FSA can see that it would be possible for different judgments to be reached about the discount which should be applied to reflect the variable strengths of the potential claims and the likelihood of demonstrating loss. The FSA is satisfied that the discount used by Equitable Life is reasonable in the circumstances for the reasons described in the Compromise documents. Similarly, we are satisfied that it is appropriate to discount for the fact that non-GARs would effectively have to meet roughly three quarters of the costs

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of paying non-GAR compensation themselves as they represent three quarters of the total value of the with-profits fund.

28. Certain policyholders have argued that they are in a materially different position to the generality of non-GAR policyholders who have possible mis-selling claims. They include with-profits annuitants, the so-called late joiners and overseas policyholders. We have considered whether those - or other - policyholders constitute separate groups with sufficiently different interests which justify different treatment. We have concluded that the Compromise does not give these groups of policyholders disproportionately greater benefits or disbenefits.

29. We have agreed that Equitable Life need not take any further steps to deal with complaints of mis-selling by policyholders whilst it is seeking to put in place a compromise of the possible claims. However, the FSA has also made it clear that if a compromise were not approved, we would be likely to require Equitable Life to carry out a review to establish whether or not there had been mis-selling and, if necessary, to rectify the problem. Policyholders would also have the right to take their claims to the Financial Ombudsman Service or to pursue them through the Courts if the Compromise is not adopted.

30. We consider, on balance, that overall the non-GAR policyholders would be unlikely to be better off were they to seek redress by such other means. Given Equitable Life's particular circumstances, the uncertainties over the claims and the competing interests in the with-profits fund, we think that the Compromise is a reasonable way to address non-GAR policyholders' potential mis-selling claims.

Wider considerations

31. All policyholders who are being asked to vote should consider the longer term benefits of the Compromise compared to the alternatives.

32. In undertaking our analysis, we have concentrated on the value of the claims that policyholders may have now. But when considering the benefits and disbenefits of the uplifts offered under the Compromise, there are some important wider points that policyholders should take into account.

Continued uncertainty

33. Without the Compromise, the outlook for all policyholders would remain much more uncertain. In already difficult market conditions, the with-profits fund would remain seriously unstable. In practice, the problem arises because Equitable Life must plan on the basis of prudent assumptions when managing its business, to ensure that it is not exposed if its actual experience turns out to be worse than it had expected. Equitable Life would need to

FSA assessment of compromise (7 December 2001)

continue to keep reserves against the range of competing rights and claims that would have been resolved under the Compromise. It would also need to adopt a more restrictive investment policy, which could affect policyholders' returns over the long term. There would also be a greater risk of extensive and costly litigation to sort out the various claims for mis-selling that would otherwise be settled by the Compromise. And those claims would in turn have to compete with the cost to the fund of meeting the GARs. All these costs would have to be met out of the with-profits fund. It is also likely that many of the remaining non-GAR policyholders would take the view - that some others have already taken - that they should take their money out rather than stay in a weaker fund.

34. In order to be able to manage the business so that it continues to comply with regulatory requirements, Equitable Life could well, as the appointed actuary has made clear, find it necessary to take an extremely cautious approach to its management of the with-profits fund and to setting future bonus policy, in order to ensure that those leaving the fund in the near future, whether contractually or otherwise, do not take more than their fair share of the fund. If bonus rates had to be cut further, this could mean that all policyholders could find themselves materially worse off than if the Compromise had gone ahead.

Halifax money

35. Another consequence of not agreeing to the Compromise is that the benefit of the additional £250 million Halifax money would be lost, as would any chance of the further £250 million that is also contingent on certain future business targets being met. The implications of that are spelt out clearly in the Compromise documentation – and having the benefit of the Halifax money is a material consideration for non-GAR policyholders.

Winding up

36. Some policyholders have suggested that winding up Equitable Life would be better, even though Equitable Life is solvent. The FSA does not agree. For a start, this would affect all Equitable Life policyholders, not just the with-profits policyholders who would be affected by the Compromise. If a winding up order were made, we would expect a liquidator to continue to run the with-profits fund and to attempt to assess and pay claims in the short term. However, a liquidator would probably be unable to declare any final bonuses, so the fund available to both GARs and non-GARs would be smaller. A liquidator would then attempt to transfer the policies to another insurer, if a willing recipient could be found. The value of a policy could be reduced on such a transfer. If a transfer were not practicable, then a liquidator would need to value all policies, on a basis agreed by the court, in order to make a distribution of the available assets. Significant costs arise

FSA assessment of compromise (7 December 2001)

on a liquidation, and any lump sum payments to policyholders might be taxed.

37. There are additional consequences of a liquidation in the event of insolvency. We would expect the Financial Services Compensation Scheme ("FSCS") to protect the interests of policyholders, in the first instance by seeking to assist the liquidator to transfer the business to another insurer. As an alternative, the Court might be asked to reduce policyholders' contractual benefits, or crystallise them, in order to restore solvency and stability. If a transfer were not possible, the FSCS is able to compensate policyholders but any compensation would be limited to 90% of the value of the policy. The fact that the future returns or other benefits under a policy were guaranteed in certain circumstances, does not necessarily mean that the FSCS can pay compensation for those guarantees. This is because the FSCS is required to consider whether the benefits under a policy may be excessive.

Implications for other policyholders

38. Many with-profits policyholders (including with-profits annuitants) will wish to understand that their votes have the potential to affect the rights of all policyholders, including those who have no vote. Non-profit annuitants, and also the unit-linked policyholders (even though that business has been reinsured by Halifax Life), stand to benefit from the increased security, which the Compromise would bring, as would the with-profits policyholders.

7 December 2001

Regulatory response to Equitable's compromise scheme proposals

FSA press release (10 December 2001)

FSA assessment of Equitable Lifes compromise scheme
FSA/PN/164/2001
10/12/2001

The Financial Services Authority has today confirmed that it has reviewed and assessed the Compromise Scheme proposals being put to Equitable Lifes with-profits policyholders to ensure that the interests of all policyholders have been properly and fairly taken into account.

[redacted] FSA Managing Director, said,

The FSA has already said that a successful compromise would, in principle, offer the best prospect of bringing stability to Equitable Lifes with-profits fund and so improving the outlook for policyholders. Having taken into account all the relevant considerations, we have concluded that the proposed Compromise now put forward is a fair offer for the rights and claims given up.

In a statement published on its website (copy attached), the regulator explains the basis for its opinion. It has assessed whether, for each relevant group of policyholders, the proposed Compromise offers a fair exchange for the rights and potential claims they are being asked to give up. The FSA is content that it does and that the Compromise does not give disproportionately greater benefits or disbenefits to some groups of policyholders.

[redacted] commented:

The FSA is not required to approve the proposed Compromise but it does have powers to take action in order to protect the interests of policyholders. We have concluded that, taken in the round, the Compromise is a fair offer and we saw no reason to intervene to stop the proposals being put to policyholders.

The FSAs assessment of the proposed Compromise does not constitute a recommendation by the FSA as to how individuals should vote; our view reflects the merits of the scheme overall. Individual policyholders must of course decide how they themselves vote in the light of their own individual circumstances.

The full FSA statement may be found at www.fsa.gov.uk.

Notes for editors
The FSA issued a release about Equitable Lifes draft proposals on 20 September 2001, Press Notice number 117.

The FSA regulates the financial services industry and has four objectives under the Financial Services and Markets Act 2000: maintaining market confidence; promoting public understanding of the financial system; the appropriate protection of consumers; and fighting financial crime.

The FSA aims to maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal.

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Millbank Tower
Millbank
London SW1P 4QP

Report enquiries
Tel: 020 7217 3904
Fax: 020 7217 4061

Email: equitable.investigation@ombudsman.org.uk

General enquiries
Tel: 0845 015 4033
Fax: 020 7217 4000

Email: phso.enquiries@ombudsman.org.uk

www.ombudsman.org.uk

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Part five: guide to the main report and summary of findings and recommendations

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Fourth report

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Contents

Section 1: Introduction

1.1 This document provides a guide to the full report of my investigation into the prudential regulation of The Equitable Life Assurance Society (the Society) during the period prior to 1 December 2001. It also summarises the findings and recommendations of that report.

1.2 The guide sets out in summary form the conclusions which I have reached in that report. However, it does not aim to explain the full rationale for those conclusions or to set out every consideration that has been taken into account in reaching those conclusions.

1.3 This guide is not a substitute for reading Part 1 of my report, to which the reader is referred if they wish to understand the reasons for my findings and determinations or to see on what evidence I have based those findings and determinations. A glossary of terms used within my report is also set out in Part 1.

1.4 The investigation which led to my report centred on allegations of regulatory failure on the part of the public bodies responsible for the prudential regulation of insurance companies in the period prior to 1 December 2001, as those responsibilities were discharged in the case of the Society.

1.5 The full report of my investigation is in four Parts (or volumes):

Part 1 describes the background to my investigation, summarises the evidence and representations submitted to me by the parties to the complaints, explains the tests I have applied in determining those complaints, sets out my key findings of fact and contains my determinations as to whether maladministration occurred and, if so, whether it has resulted in any unremedied injustice. It concludes by setting out my recommendations concerning questions of remedy.

Part 2 contains a factual description of the historical development of the regime that was relevant to the prudential regulation of life insurance companies during the period prior to 1 December 2001.

Part 3 contains a detailed chronology of events relating to the prudential regulation of the Society during the relevant period.

Part 4 contains some key primary and secondary documents, reproduced in full or in part, which I consider are either key to a full understanding of the matters that I have investigated or which help to place my determination of the relevant complaints in a wider context.

1.6 This document focuses on providing a summary of my findings. It therefore provides the reader principally with a guide to Part 1 of my full report. However, some Chapters of Part 1 are themselves a summary of more detailed evidence and documentation contained in Parts 2, 3 and 4.

1.7 So this document does not tell the full story and is not intended to do so. It is deliberately brief and focuses primarily on the complaints that I received and my determination of them.

1.8 I would encourage anyone who wishes to know more about the events which form the background to, and context for, this investigation, or about the detailed regime relevant to the prudential regulation of life insurance companies during the period in question, or who wishes to read a detailed account of the way in which the prudential regulation of the Society was undertaken, to read Part 1 in full.

The structure of Part 1

1.9 The structure of Part 1 of my report is as follows.

Chapter 1 is an introductory Chapter.

Chapter 2 sets the scene for the investigation I have conducted, focusing on the events which form the background to, and the context for, my investigation, and also on the other reviews, inquiries and litigation which have taken place (or which continue to take place) in respect of the Society.

Chapter 3 explains the involvement of my Office in respect of the events related to the Society and which led to my decision to conduct this investigation. It also outlines the legal and administrative framework for the investigation and describes the process that I have used to conduct it.

Chapter 4 sets out the general and detailed complaints that have been made to me about the prudential regulation of the Society. It also sets out the initial response to those complaints of the public bodies whose actions were the subject of complaint.

Chapter 5 sets out the basis for my determination of the complaints. It describes my general approach to investigating complaints of injustice sustained as a consequence of maladministration; and sets out both the general principles of good administration and public law and the specific legal and administrative framework of prudential regulation applicable to my consideration of those complaints. It concludes with a summary of the key obligations of the prudential regulators and/or the Government Actuary's Department (GAD) which are relevant to this investigation.

Chapters 6, 7 and 8 set out a summary of the way in which the prudential regulation of the Society was undertaken in three time periods:

- the first period being prior to 20 June 1998;
- the second period being from 20 June 1998 to 8 December 2000, when the Society closed to new business;
- the third period being the post-closure period from 8 December 2000 to 1 December 2001, when my jurisdiction ends.

Chapter 9 contains the preliminary assessments which I have made in respect of disputed questions concerning what standard of regulation it would be appropriate to apply when reviewing the acts and omissions of those undertaking the prudential regulation of the Society, and what powers were available to those regulators.

Chapter 10 sets out the results of my review of the evidence I have obtained and contains my findings of fact.

Chapter 11 sets out my determinations as to whether the acts and omissions of the prudential regulators and/or GAD constitute maladministration.

Chapter 12 sets out my determinations as to whether any such maladministration has led to injustice to those who have complained to me.

Chapter 13 contains my disposal of each complaint within the terms of reference for the investigation, setting out which I have upheld in full, which I have upheld in part, and which I have dismissed.

Chapter 14 considers questions of remedy and contains my recommendations.

Chapter 15 contains my concluding remarks.

Section 2: The background

2.1 My report sets out my determinations of complaints which alleged that the regulators of insurance companies had failed properly to exercise their functions in relation to the Society for more than a decade.

2.2 The scope of that report was determined by the limits to my powers to conduct investigations into the actions of those bodies whose actions were the subject of those complaints.

The Equitable Life Assurance Society

2.3 My report does not make findings about the actions of the Society itself and is concerned instead with regulation. However, in Chapter 2 of Part 1 of my report, I set the scene for that regulation. This includes a description of the nature of the Society's business and of how the problems it faced came about.

2.4 The Society was founded in 1762 and it was incorporated in the United Kingdom as a private unlimited company in 1892. The Society is generally accepted to be the oldest surviving mutual life assurance company in the world.

2.5 As a mutual life insurance company, the Society has no shareholders and is owned by its with-profits policyholders. Those policyholders effectively stand in the position of proprietors, sharing in any profits made or losses incurred in running the Society's business.

2.6 On 8 December 2000, the Society announced that it would stop writing new business with immediate effect. Since then, the Society has undergone a difficult period and has implemented cuts in the policy values of its with-profits policies or the income derived from its with-profits annuities.

2.7 The announcement by the Society of its closure to new business was prompted by the withdrawal of the last potential bidder from a sales process that had been launched to seek a buyer to acquire the Society following a decision of the House of Lords.

2.8 The operation of the Society's differential terminal bonus policy in respect of a representative policy for which the default benefit was an annuity paid at a guaranteed rate had become the subject of legal proceedings once doubts arose as to the legality of that policy. The differential terminal bonus policy, which Equitable had adopted since January 1994, involved the paying of different levels of terminal bonus to policyholders exercising their right to take an annuity at the guaranteed rate than were paid to policyholders not exercising such a right.

2.9 The House of Lords held on 20 July 2000 – in *Equitable Life Assurance Society v Hyman* ([2002] 1 AC 408) – that the Society's differential terminal bonus policy was unlawful.

2.10 At the time, it was recognised that the Society was distinctive within the life insurance industry and also that this distinctiveness had played a part in the circumstances which had led the Society to close to new business.

2.11 The four central factors which were of importance to the Society's problems, recognised by the Treasury at the time of its closure, were:

- first, that the Society had for many years operated a policy of full distribution of any surplus through bonuses to its with-profits policyholders and a policy of not building up a free estate, leaving the Society with a comparatively low level of free assets;

- secondly, that the Society, being a mutual, had no access to additional, shareholder capital;

- thirdly, that the Society had offered relatively generous and flexible guarantees on certain types of policy; and

- finally, that the proportion of the Society's business to which those guarantees applied was much higher than was the case for other companies.

2.12 The closure of the Society to new business as a result of those problems set the scene for the complaints that I have received. While the actions of others, such as the Society itself or its former auditors, became also the subject of complaint to others, the complaints that were made to me concerned the role of the regulators of the Society.

Insurance regulation

2.13 Before 1 December 2001, there were two forms of insurance regulation in the United Kingdom – prudential regulation and conduct of business regulation.

2.14 Prudential regulation was governed by the provisions of the Insurance Companies Act 1982 and by the Regulations made under that Act. Such regulation primarily related to the supervision of the solvency of life insurance companies and their ability to meet and continue to meet their liabilities to policyholders and to fulfil the reasonable expectations of policyholders or potential policyholders.

2.15 Conduct of business regulation was governed by the provisions of the Financial Services Act 1986 and concerned the regulation of the conduct of investment business, including the marketing activities of life insurance companies.

2.16 During the period prior to 5 January 1998, the prudential regulator was the Department of Trade and Industry (the DTI) and its predecessors; from 5 January 1998 to 1 December 2001, the prudential regulator was Her Majesty's Treasury (the Treasury).

2.17 From January 1999 until 1 December 2001 aspects of the day-to-day prudential supervision of insurance companies were contracted out to the Financial Services Authority (the FSA) – which, in this role, acted on behalf of the Treasury.

2.18 Furthermore, throughout the period relevant to this report legal advice to the prudential regulators was provided by in-house lawyers and, until 26 April 2001, actuarial advice was provided by GAD. Thereafter, actuarial advice was provided to the FSA by actuaries directly employed by the FSA, some of whom had previously worked for GAD.

My jurisdiction

2.19 I am only able to investigate certain action taken by or on behalf of those bodies which are within my jurisdiction.

2.20 Actions taken by all of the bodies which at the relevant time had statutory responsibility for prudential regulation are within my jurisdiction, where those actions are taken in the exercise of the administrative functions of such bodies. Thus the actions of the DTI and the Treasury are within my jurisdiction.

2.21 I am only able to conduct investigations in respect of the actions of GAD and the FSA on a limited basis. I have no power to conduct investigations in relation to conduct of business regulation.

2.22 GAD were not within my jurisdiction until the beginning of this investigation. I may only investigate action taken by GAD on or before 26 April 2001 in the giving of advice concerning the exercise of administrative functions under Part II of the Insurance Companies Act 1982 or any other enactment concerned with the regulation of insurance companies.

2.23 The actions of the FSA are only within my jurisdiction in so far as those actions relate to the prudential regulation of insurance companies during the period from 1 January 1999 to 1 December 2001, when the FSA undertook that regulation on behalf of the Treasury.

2.24 Conduct of business regulation throughout this first period was delegated to a system of industry and practitioner-based, self-regulatory organisations under the supervision of a designated agency. None of those bodies with statutory responsibility for conduct of business regulation is or was within my jurisdiction.

2.25 All of this meant that the scope of my investigation was limited to the actions taken during the period prior to 1 December 2001 by the DTI and the Treasury as the prudential regulators of the Society and to the actions taken by the FSA and GAD on behalf of those regulators.

Section 3: The complaints that were made and the Government's initial response

The general and specific complaints

3.1 My investigation – undertaken after wide consultation with those affected – began in July 2004. It was conducted in accordance with the provisions of the Parliamentary Commissioner Act 1967.

3.2 I have received 898 complaints referred by MPs in respect of 1,008 people. I also received 1,309 direct representations from a further 1,480 individuals.

3.3 With the help of the various action groups representing complainants, fifteen people were selected to act as lead complainants. Those people epitomise the position of all the principal groups of current and former policyholders and annuitants who had complained to me. The lead complainants authorised members of the action groups to act as their personal representatives during the course of the investigation.

3.4 The general complaint made was that:

> *... the public bodies responsible for the prudential regulation of insurance companies... and the Government Actuary's Department failed for considerably longer than a decade properly to exercise their regulatory functions in respect of the Equitable Life Assurance Society and were therefore guilty of maladministration.*

3.5 Eighteen detailed complaints were made. Those heads of complaint were labelled complaint A to complaint R and are set out in full in Annex A of this document. Those detailed complaints, together with the general complaint, formed the basis for my investigation.

3.6 All the complainants claimed that they had suffered financial and other injustice as a result of alleged maladministration by the prudential regulators and sought full redress for that injustice.

The Government's initial response

3.7 I put those complaints to the Treasury, the FSA, and GAD. Their initial response, in summary, was that:

(i) there had been no failure on the part of any of the prudential regulators or GAD properly to exercise their functions in respect of the Society. At all times those regulators and GAD had acted reasonably and properly, in the context of and having regard to the regulatory regime as it had been at the relevant time;

(ii) the nature and scope of that regime had been determined by legislation and by regulatory policies which informed and were adopted under the applicable legislation. At all times, the policies adopted had been proper ones and had been the result of choices which Parliament and Ministers had been fully entitled to make;

(iii) none of the complaints made by the complainants disclosed reasonable grounds for concluding that any of the public bodies responsible for the prudential regulation of the Society or GAD had been guilty of maladministration.

3.8 I was not satisfied that this response resolved the complaints which had been made to me and so I decided to continue my investigation.

3.9 I appointed an in-house team of investigators to conduct the investigation. I also appointed both legal and actuarial advisers to assist me and my investigation team. In addition, I arranged for the actuarial advice I received to be peer reviewed. The advice of both sets of professional advisers has greatly informed (and is fully integrated into) my report.

Terms of reference

3.10 The terms of reference for the investigation were:

To determine whether individuals were caused an injustice through maladministration in the period prior to December 2001 on the part of the public bodies responsible for the prudential regulation of the Equitable Life Assurance Society and/or the Government Actuary's Department; and to recommend appropriate redress for any injustice so caused.

Conduct of the investigation

3.11 In carrying out the investigation, we have reviewed:

- the operational and policy files of the public bodies whose actions were under investigation;
- all the documentary evidence from other sources that was available to Lord Penrose when he conducted an inquiry into the events which led to the Society closing to new business, the report of which was published in 2004;
- transcripts of evidence given to the Penrose inquiry, to the Baird inquiry, an internal FSA inquiry in 2001 into their role in the relevant events, and to my first investigation by current and former officials and actuaries connected with the prudential regulation of the Society;
- the relevant working documents and emails of those officials and actuaries; and
- publicly available material (such as actuarial papers and discussions); and historical and other material held at the National Archives, the British Library, and the libraries of the DTI, the Institute of Actuaries, and the Institute of Chartered Accountants of England and Wales.

3.12 At the end of January 2007, I sent the public bodies a first draft of my provisional views on relevant facts, whether maladministration had occurred and, if so, whether it had resulted in any injustice to complainants. This followed the sharing of draft excerpts from the factual background Parts of this report with the parties to the complaints.

3.13 In March 2007, I disclosed the provisional report of my actuarial advisers to the public bodies. Those bodies, in April 2007, made substantial representations to me about my draft report and about the content of the professional advice that had informed that draft report. In the light of those representations, I agreed to conduct a fundamental review of my draft report and to seek further professional advice.

3.14 The revised draft report that was the result of that review was issued in February 2008 to all the interested parties. My final report takes into account all the responses I received to those drafts.

Section 4: The basis for my determination of the complaints

My approach

4.1 In simple terms, when determining complaints that injustice has been sustained in consequence of alleged maladministration, I generally begin by comparing what actually happened with what should have happened.

4.2 So, in addition to establishing the facts that are relevant to a complaint, I also need to establish a clear understanding of the standards, both general and specific, which applied at the time. I call this establishing the overall standard.

4.3 In Chapter 5 of Part 1 of my report, I set out the general standard relevant to the investigation, as derived from established principles of good administration and from public law principles. I then go on to set out the specific standard relevant to the investigation, i.e. the specific legal and administrative framework of prudential regulation.

4.4 Having established the overall standard, I then assess the facts in accordance with that standard. First, I assess whether an act or omission on the part of the body complained about constituted a departure from the applicable standard. If so, I then assess whether that act or omission was so unreasonable, or fell so far short of acceptable standards of good administration, as to constitute maladministration.

The regulatory regime

4.5 The regulatory regime which developed over time to deliver prudential regulation and which pertained at the time relevant to this report had four cornerstones:

- The concept of 'freedom with publicity';
- The central place of the Appointed Actuary within the regulatory regime;
- The protection of the 'reasonable expectations' of both policyholders and potential policyholders; and
- The criteria of 'sound and prudent management'.

4.6 Those cornerstones laid the foundations on which were built:

- the way in which regulation was undertaken – in which information provided through the regulatory returns and the role played by the Appointed Actuary in ensuring that this information was so provided were given a central place; and
- the powers, duties and means conferred on the prudential regulators – which gave prominence to the protection of policyholders' reasonable expectations and ensuring the fulfilment of the statutory criteria of sound and prudent management.

4.7 The statutory framework which governed this system of regulation had four chief component parts:

- European Directives concerning life assurance;
- the Insurance Companies Act 1982;
- secondary legislation made under the Insurance Companies Act 1982; and
- certain other domestic statutory provisions related to the activity of insurance companies.

4.8 The prudential regulation of insurance companies such as the Society was primarily undertaken through two mechanisms: the submission of regulatory returns and the scrutiny of those returns.

4.9 Each company was required to submit annual returns containing detailed information about the business and financial strength of the company in a prescribed format. Once checked by the prudential regulators for completeness, those returns were placed in the public domain at Companies House.

4.10 Scrutiny of those returns was undertaken by GAD on behalf of the prudential regulators until April 2001. The prime aims of this scrutiny were to ensure that the company had complied with the statutory and other obligations imposed on it, to verify the financial position of the company, and to check that the company was able to meet its liabilities and to fulfil the reasonable expectations of its policyholders and/or its potential policyholders.

4.11 The prudential regulators and GAD also obtained information through visits to, and meetings with, insurance companies and through information provided to them by such companies on an ad *hoc* basis. GAD also undertook industry-wide analysis, which informed their scrutiny of the returns.

The legal and administrative obligations of the prudential regulators and GAD

4.12 Chapter 5 of Part 1 of my report, supported by the relevant detail in Part 2, provides a detailed overview of the general and specific legal and administrative obligations which the prudential regulators and/or GAD had at the relevant time.

4.13 From that overview, I identified the following key legal and administrative obligations which I use in my consideration of the manner in which those regulators and/or GAD discharged their obligations. I also set out below what I would expect to have seen if the prudential regulators and/or GAD were fulfilling these obligations.

(i) The prudential regulators were under statutory duties, imposed by the specific regime contained within the Insurance Companies Act 1982 and the Regulations made under it:

- to consider the regulatory returns with a view to ensuring that those returns were complete and accurate (in the sense of them being compliant with the applicable Regulations).

  In complying with this duty, I would expect the prudential regulators to have considered the regulatory returns submitted by insurance companies and, if those returns appeared to be inaccurate or incomplete in any respect, to have communicated with the company with a view to the correction of any such inaccuracies and the supply of deficiencies.

- and to ensure that an insurance company valued its assets and determined its liabilities in accordance with the requirements that were imposed on it by the applicable Regulations.

  In complying with this duty, I would expect the prudential regulators to have considered whether the way in which an insurance company valued its assets and determined its liabilities as set out within the regulatory returns had been *undertaken in accordance with the relevant requirements and, if it appeared that the company had used a valuation basis that was not compliant with those requirements, to have considered whether to take action to remedy the position.*

(ii) The prudential regulators were also under a general public law duty to give proper consideration to the use of their powers of intervention where the circumstances had or may have arisen which gave grounds for the use of such powers.

In complying with this duty, I would expect the prudential regulators to have considered the use of their powers in the light of any information that they possessed – whether from the content of the regulatory returns, from contact with an insurance company, or from other sources – which gave rise to questions about the solvency position of that company, or about whether it was acting in line with the interests of its policyholders or in accordance with the reasonable expectations of those policyholders, or potential policyholders, or about whether it was acting soundly or prudently.

(iii) The prudential regulators were also under a general public law duty to exercise their statutory powers in a right and proper way, in accordance with the presumed intention of the legislature which conferred those powers, in good faith, reasonably, for a proper purpose, and with procedural propriety.

In complying with this duty, I would expect the prudential regulators to have dealt appropriately with any regulatory issues which arose in relation to any insurance company other than through the scrutiny process and to have acted in such a manner as to ensure the effective operation of the regulatory regime as Parliament had established it – informed as that regime was by the concepts of 'freedom with publicity', the protection of the reasonable expectations of policyholders and potential policyholders, and the fulfilment of the criteria of sound and prudent management.

(iv) Both the prudential regulators and GAD were under an obligation generally to act in accordance with established principles of good administration.

In complying with this obligation, I would expect the prudential regulators and/or GAD:

- *to have acted in accordance with their general and specific legal duties and powers;*
- *to have acted in accordance with their own published and internal policy and guidance;*
- *to have taken proper account of established good practice, including professional practice;*
- *to have taken reasonable decisions based on all relevant considerations and ignoring irrelevant ones;*
- *to have kept proper and appropriate records as evidence of their activities, including a record of the reasons for their decisions; and*

- *to have provided information, where it was appropriate to do so, which was clear, accurate, complete and not misleading.*

Section 5: Findings of fact

5.1 In Chapters 6, 7 and 8 of Part 1 of my report, supported by the relevant detail in Parts 3 and 4, I set out how the prudential regulation of the Society was undertaken during the period from when the Society's returns for 1990 were submitted to the prudential regulators until the end of my jurisdiction on 1 December 2001 – with the coming into force of the current regulatory regime.

5.2 As I explained in Section 4, my approach to determining complaints of maladministration leading to injustice is to assess the facts against the overall standard that I have established is relevant to the investigation.

5.3 First, I assess whether an act or omission by the body complained about constitutes a departure from the applicable standard. These are my findings of fact.

5.4 My review of all the evidence, submissions and other material and my application of the overall standard to that evidence have led me to make ten principal findings of fact.

My first finding of fact

5.5 The role of the Appointed Actuary was, at the time relevant to this report, a central component of the system of prudential regulation of insurance companies.

5.6 Given this regulatory role, which was one cornerstone of the system of prudential regulation in the United Kingdom, an Appointed Actuary needed to ensure that he or she had sufficient independence from the executive management of a life insurance company to enable him or her to undertake effectively the responsibilities (to the company, to its policyholders, and to the prudential regulators and GAD) that were conferred on the Appointed Actuary and to enable him or her to do so in line with the intention of Parliament when it had created the role in 1973.

5.7 If an Appointed Actuary was unable to secure or retain the necessary degree of operational independence, this would raise serious questions about the ability of the Appointed Actuary in those circumstances to perform the regulatory functions conferred on him or her.

5.8 **My first finding of fact** is that, in June 1991, the prudential regulators approved, when they should not have done, the appointment of a new Chief Executive without insisting that he should demit office as the Society's Appointed Actuary and without applying subsequently a closer degree of scrutiny of the Society's affairs.

5.9 Furthermore, for the next six years, those regulators failed to consider the use of their powers to seek the removal of that person from his 'dual role', despite the assurance that had been given at the time of his appointment that he would hold such a dual role for 18 months only. Yet the dual role existed from 1 July 1991 to 31 July 1997.

5.10 After having considered the representations I had received, I concluded that the way in which the DTI, as prudential regulators, handled the creation and continued existence of the 'dual role' fell short of the standard that could reasonably be expected of such regulators.

My second finding of fact

5.11 Each year, the Society, like every other insurance company, was required to submit annual returns to the prudential regulators. Those returns set out a considerable amount of detail about the business of the Society, about its liabilities, about the assets covering those liabilities, and about the solvency position of the Society.

5.12 As I have noted, the submission and scrutiny of those returns were the two prime mechanisms of prudential regulation during the period covered by this report.

5.13 The Society's returns for the years 1990 to 1993 raised certain issues about the approach that the Society was adopting to its business, which the scrutiny process was designed to highlight in order to enable the prudential regulators, acting with advice and assistance from GAD, to ascertain whether there was any need to raise and pursue those issues.

5.14 **My second finding of fact** is that, with regard to the scrutiny of the Society's annual regulatory returns for the year ends for 1990 to 1993, GAD, in providing advice to the prudential regulators, failed to satisfy themselves that the way in which the Society had determined its liabilities and had sought to demonstrate that it had sufficient assets to cover those liabilities accorded with the requirements of the applicable Regulations.

5.15 Accordingly, those regulators were unable to verify the solvency position of the Society as they were under a duty to do. The aspects in respect of which the Society's returns for these years raised questions which should have been identified, pursued and resolved were:

- the valuation rate of interest used to discount the liabilities, which appeared to be imprudent and/or impermissible (discounting liabilities well below the guaranteed face value of policies); and
- the affordability and sustainability of the bonuses previously declared by the Society, which appeared to raise the expectations of the Society's policyholders which might not be met.

5.16 On the information before GAD, the Society's approach to discounting meant that a significant amount of any future surplus would be required simply to fund current guaranteed benefits.

5.17 This occurred in a situation in which GAD knew that the Society had informed its policyholders that, subject to smoothing, the additional returns they would receive by way of future bonus declarations would reflect the future investment performance of the with-profits fund.

5.18 In addition, serious questions arose from the information within the returns about whether the Society could afford the level of bonus it was paying and whether it could continue to pay out at that level. This occurred in a situation in which, as GAD knew, the Society was unique in illustrating to its policyholders the full policy fund value, including terminal bonus.

5.19 From the information before GAD, it was not clear how the Society could fund guaranteed future bonuses (applying the guaranteed investment return) or manage to pay future discretionary bonuses, in line with the reasonable expectations of the Society's policyholders that such bonuses would continue to be paid.

5.20 Despite those questions, raising issues concerning the prudence of the Society's approach and whether the Society would be able to fulfil the reasonable expectations of its policyholders, no action was taken by GAD to seek to resolve those questions or to raise them with the prudential regulators.

5.21 After having considered the representations I had received, I concluded that the failures by GAD, as part of the scrutiny process, to raise and seek to resolve questions within the Society's regulatory returns for each year from 1990 to 1993, related to (i) the valuation rate of interest used to discount the Society's liabilities and (ii) to the affordability and sustainability of the Society's bonus declarations, fell short of what could reasonably be expected of GAD.

My third finding of fact

5.22 As is well known, the Society wrote policies containing guaranteed annuity rates. Those policies guaranteed the rate at which the proceeds available at retirement (based on the sum assured plus associated bonuses) would be converted to a pension – and thus the minimum amount of pension available at retirement.

5.23 The Society stopped providing guaranteed annuity rates on new policies from June 1988, although new members of some existing group schemes continued to be provided with policies containing guaranteed annuity rates until the early 1990s.

5.24 The Society's guaranteed annuity rates continued to apply to the benefits that would be purchased by any future premiums (including in relation to recurrent single premium policies) that might be paid in respect of policies which already enjoyed this guarantee.

5.25 Those guaranteed annuity rates were both more flexible, in that they applied over a wide range of ages without penalty, and potentially more widespread than was the case with similar guarantees provided by other companies. In addition, policyholders could pay future premium payments and still benefit from the same guaranteed annuity rate at the same range of ages.

5.26 No new fund was established by the Society at the time of the changes it made to exclude guaranteed annuity rates and, subsequently, guaranteed investment returns from the policies it wrote. Thus the assets held in respect of the different classes of policy thereby created were held in one fund.

5.27 Nor was there a separate bonus series declared or any differentiation in treatment between the various classes of with-profits policyholders in terms of the level of bonuses declared by the Society, despite the changes in policy terms and the associated guarantees that had occurred.

5.28 In late 1993 and early 1994 and continuously from April 1995 onwards, the Society's guaranteed annuity rates became generally more favourable than then current annuity rates, due to lowering interest rates and improved mortality. This meant that the cost of providing the guaranteed annuity benefit exceeded the total policy fund, which was only sufficient to provide the lower benefit available at the current annuity rate.

5.29 In order to deal with this situation, the Society introduced what came to be known as the differential terminal bonus policy, by restricting the value of benefit paid to the amount of the total policy fund.

5.30 The Society said that this was done to enable it to continue to reflect the Society's philosophy of 'full and fair' distribution to all its policyholders in its bonus policy and to pay each policyholder just their share of the fund.

5.31 Under the Society's differential terminal bonus policy, the amount of final bonus payable when a policyholder took benefits would be dependent on the form in which those benefits were taken and so, if the guaranteed annuity benefit was selected, the amount of the final bonus was reduced.

5.32 **My third finding of fact** is that GAD identified the introduction of a differential terminal bonus policy when scrutinising the Society's 1993 returns in October 1994, but failed to inform the prudential regulators, as GAD should have done, of that introduction or to raise the matter with the Society.

5.33 This failure by GAD to raise the matter occurred despite there having been full disclosure by the Society within its 1990 returns of the extent and level of the guaranteed annuity rates within its older policies and despite the Society referring to such guarantees when it disclosed the introduction of the differential terminal bonus policy in its 1993 returns. GAD also noted that this policy had the effect of reducing the final bonus payable to policyholders.

5.34 That failure also occurred despite GAD knowing, or having information before them which suggested, both that the Society had told its policyholders that the Society would only change bonus policy gradually and also that the Society's With-Profits Guides did not (at that time) inform its policyholders of the differential terminal bonus policy.

5.35 After having considered the representations I had received, I concluded that the failures by GAD, when they identified the introduction of the Society's differential terminal bonus policy as part of their scrutiny of the 1993 returns, (i) to inform the prudential regulators about the policy, (ii) to raise the matter with the Society, or (iii) to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders, fell short of the standard that could reasonably be expected of GAD.

My fourth finding of fact

5.36 As noted above, the Society submitted annual returns to the prudential regulators. Further issues arose in respect of the Society's returns for 1994 to 1996.

5.37 **My fourth finding of fact** is that, in carrying out the scrutiny of the Society's annual regulatory returns for each year from 1994 to 1996, GAD, in providing advice to the prudential regulators, failed to satisfy themselves that the way in which the Society had determined its liabilities and had sought to demonstrate that it had sufficient assets to cover those liabilities accorded with the requirements of the applicable Regulations. Those regulators were thus unable to verify the solvency position of the Society.

5.38 The matters arising from the Society's returns which GAD failed to address and resolve to a satisfactory conclusion were:

- the continuation of the two issues which had arisen within the returns for 1990 to 1993 (questions concerning discounting through the use of imprudent and/or impermissible valuation interest rates and the affordability and sustainability of the Society's bonus declarations);

- what appeared to be arbitrary changes to the assumed retirement age for personal pension policies, contrary to European Directives and the applicable domestic Regulations;

- the absence of explicit reserves for prospective liabilities for capital gains tax and for pensions review mis-selling costs, stating instead that such liabilities were covered by implicit margins in the valuation basis; and

- the absence of reserves in respect of guaranteed annuity rates, which by then GAD should have known were 'biting' and should therefore have been provided for.

5.39 GAD failed to identify all of those matters, to pursue them with the Society, or to seek to resolve the issues that they raised.

5.40 After having considered the representations I had received, I concluded that the failure by GAD, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1994 to 1996, related to (i) the valuation rate of interest, (ii) the affordability and sustainability of bonus declarations, (iii) apparently arbitrary changes to the assumed retirement ages, and (iv) the holding of no explicit reserves for the liabilities associated with prospective liabilities for capital gains tax, for pensions mis-selling costs, and for guaranteed annuity rates, fell short of what could reasonably be expected of GAD.

My fifth finding of fact

5.41 Most insurance companies used the valuation method and basis set out in the applicable Regulations to calculate their Mathematical Reserves.

5.42 However, throughout the period covered by this report, insurance companies were entitled to use an approach which differed from the statutory minimum basis, so long as the alternative method that was used produced Mathematical Reserves that were at least as high as that which would have been produced using the statutory minimum basis.

5.43 During the period covered by this report, the Society always used an alternative valuation method within its returns.

5.44 In order to seek to demonstrate compliance with the Regulations, the Society set out information about the amount of its Mathematical Reserves using a basis that its Appointed Actuary considered was compatible with the method set out in the Regulations. This was done in an appendix at the end of Schedule 4 of the Society's returns.

5.45 **My fifth finding of fact** is that GAD failed in certain respects to act, when they should have acted, to question the Society's practice of producing two valuations within the regulatory returns but omitting crucial information from one of those valuations. After 1996, the Society continued to produce two valuations but published the missing information.

5.46 That information was the amount of the resilience reserves required in the Society's appendix valuation, produced to demonstrate compliance with the Regulations. That omission meant that the Society appeared financially stronger than it was and that its solvency position was capable of being misconstrued.

5.47 While GAD asked the Society for the missing information in all but one year, GAD did not take steps to ensure that a reader of the returns had that information.

5.48 Even though the Society was not in breach of any of the applicable Regulations by presenting its valuations in the way that the Society did, GAD recognised at the time that this position meant that the Society's returns, which were the main mechanism through which 'freedom with publicity' was delivered, might mislead those who read them.

5.49 Although the Society was permitted to produce an alternative valuation from that specified in the applicable Regulations, it was required, by those Regulations, to demonstrate that its chosen alternative valuation was at least as strong as that specified in those Regulations.

5.50 GAD considered that such demonstration was provided through the provision by the Society to GAD – but not through the returns – of the amount of the reserves omitted from the Society's alternative valuation. However, GAD failed to ask for this information in November 1996 when conducting their scrutiny of the Society's 1995 returns. GAD were therefore unable to verify whether those returns had complied with the applicable Regulations.

5.51 In addition, from November 1993 onwards GAD had possessed information, in the form of ratings of the Society produced by Standard & Poor's – an expert ratings agency, which showed that the position was not only capable of being misconstrued but also that it was being misconstrued.

5.52 Standard & Poor's erroneously concluded that the Society was stronger than it really was. This was as a direct result of the information which GAD knew was missing from the returns. Those ratings were also provided to GAD by the Society and retained on GAD's files and were used by the prudential regulators as part of briefing for Ministers and in other ways.

5.53 GAD took no action to raise or to seek to resolve these issues.

5.54 After having considered the representations I had received, I concluded that the failures by GAD (i) to ask for the information they needed in respect of the Society's 1995 returns to enable them to be sure that the Society had produced a valuation that was at least as strong as the minimum required by the applicable Regulations, and (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society, fell short of what it was reasonable to expect from GAD.

My sixth finding of fact

5.55 During 1998, the prudential regulators and GAD became aware that the Society had not made provision for the liabilities arising from guaranteed annuity rates contained within certain of its policies and those regulators required that the Society should do so within its 1998 returns.

5.56 That requirement had led to an immediate increase of £1,600 million in the amount of reserves required to be shown as at 31 December 1998, as well as additional associated resilience reserves. As a result, the Society investigated means whereby those additional liabilities could be offset in order not to disclose a much weaker financial position in those returns.

5.57 Had such offsetting action not been taken, the 1998 regulatory returns would have shown such a weak financial position that the Society's future as an independent mutual would have been threatened and its continued ability to write new business and declare bonuses would have been in doubt.

5.58 The prudential regulators told the Society in December 1998 that they would take action if they considered that the 1998 bonus declaration made by the Society was imprudent. The Society therefore needed to take urgent action to either raise capital or to reduce its Mathematical Reserves.

5.59 The Society did this through a financial reinsurance arrangement. Within its published returns for 1998, 1999, and 2000, the Society took credit for the arrangement that it had entered into with IRECO.

5.60 The amount of the credit taken for those years was, respectively, £809 million, £1,098 million, and £808 million. The Society's Mathematical Reserves were reduced by more than those amounts, however, as the resilience reserves it was required to hold were also reduced. The prudential regulators permitted those credits to be taken.

5.61 The Society's published returns for 1998 showed that it had excess available assets and implicit items of £1,516 million over the required minimum margin, the returns for 1999 showed the excess asset figure as £2,747 million, and those for 2000 showed a figure of £411 million.

5.62 **My sixth finding of fact** is that the FSA permitted the Society, when they should not have done so, to take credit within its 1998 returns, which were submitted on 30 March 1999 and which were available to the public by 1 May 1999, for a financial reinsurance arrangement which had not been concluded either at the valuation date or at the date that those returns were submitted. This was done without an appropriate reporting concession being given.

5.63 Moreover, even leaving that aside, the FSA permitted the Society within its returns for 1998, 1999, and 2000 to take credit for the financial reinsurance arrangement that did not reflect the economic substance of that arrangement.

5.64 This was despite the fact that GAD had identified the potential problems with the proposed financial reinsurance arrangement and had informed the FSA of those problems, recognising that this arrangement had little or no value for the purposes of the determination of the Society's solvency position.

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

My seventh finding of fact

5.66 As is well known, the Society sought clarity as to the validity of its differential terminal bonus policy through seeking the view of the Courts. While that litigation was proceeding through the Courts, the Society – and the prudential regulators – undertook scenario planning to consider the likely impact of a range of possible outcomes to that litigation.

5.67 Consideration was given to what those scenarios would mean for the financial position of the Society and for its freedom to maintain the policies it had adopted to manage its affairs, and what other consequences the possible outcomes of the *Hyman* case could have for the Society and its members.

5.68 Even assuming that the financial reinsurance arrangement which the Society had entered into, and for which it proposed to take a substantial offset within its 1998 regulatory returns, entitled the Society so to do, the continuation of that arrangement was contingent on the Society being able to continue to apply its differential terminal bonus policy. Yet that ability was precisely the issue at stake in the *Hyman* proceedings.

5.69 Furthermore, if the Society were found not to have been able to apply its differential terminal bonus policy, the question would arise as to how to remedy the position of those policyholders with policies which contained guaranteed annuity rates who had retired since 1 January 1994, but who had not been provided with the option of taking benefits without the reduction in terminal bonus applied under the Society's differential terminal bonus policy. The question of compensating such policyholders would thus arise if the Society lost the *Hyman* case.

5.70 **My seventh finding of fact** is that the FSA failed to pursue the failure by the Society to include contingent liability notes within its regulatory returns for 1998 and 1999 regarding the potential impact of losing the *Hyman* litigation. This failure to check why the Society had not included any such disclosure in those returns occurred despite the reminders by the prudential regulators that the Society should do so, reminders given prior to the submission of the Society's 1998 returns.

5.71 No action was taken to seek to ensure that the Society had a sound basis for not publicly disclosing the fact that the outcome of the litigation could have profound effects, including for the operation of its differential terminal bonus policy (and hence its reserving practices) – effects which would have a significant impact on the solvency position of the Society and on the amount of money available to meet the liabilities it had to its policyholders and the future bonus expectations of those policyholders.

5.72 This failure by the FSA to act also occurred in relation to the Society's 1999 returns in a context in which the FSA knew that the Society had informed its policyholders that no significant costs would be imposed on the Society if it lost the *Hyman* case.

5.73 After having considered the representations I had received, I concluded that the failure of the FSA, acting on behalf of the prudential regulators, to pursue the issue of the proper disclosure, within the Society's regulatory returns for 1998 and 1999, of the potential impact on the Society of it losing the *Hyman* litigation fell short of the standard that could reasonably be expected of such regulators.

My eighth and ninth findings of fact

5.74 Following the decision of the House of Lords in the *Hyman* case, the Society had been faced with an extremely serious situation. That decision had profound effects.

5.75 The financial reinsurance arrangement that the Society had entered into was, as a result of the ending of the Society's differential terminal bonus policy, to lapse. Without the credit that had been taken for that arrangement, a serious question arose as to whether the Society could or would continue to meet its required solvency margin.

5.76 The Society was immediately faced with a significant reduction in what the Society regarded as the assets available to meet the costs in respect of those policyholders who chose to take benefits calculated with regard to guaranteed annuity rates. Those costs had to be shared, almost certainly by benefit reductions, across all policyholders – as any 'ring-fencing' of policyholders with annuity guarantees had been declared unlawful by the House of Lords.

5.77 This gave rise to inbuilt conflicts between the interests of different classes of policyholders that, in the circumstances facing the Society at the time, could not be resolved using the normal mechanisms available to life insurance companies and which meant that the Society's situation was inherently unstable.

5.78 In that context, the Society decided to put itself up for sale. The question arose as to what the regulatory response to that decision should be. The FSA decided not to intervene to require the Society to close to new business whilst it sought a buyer.

5.79 I make two findings of fact concerning the decision to permit the Society to remain open to new business following the decision of the House of Lords in the *Hyman* case.

5.80 **My eighth finding of fact** is that the FSA failed to record that decision. No contemporaneous record was made of that decision or of the factors and evidence which were taken into account by the FSA when they took it, or what alternative options, if any, the FSA had considered. That decision was highly significant for the interests both of existing and potential policyholders.

5.81 **My ninth finding of fact** is that, having established from those involved the basis on which the FSA took that decision, the decision to permit the Society to remain open at that time was not grounded in a sound factual or legal basis.

5.82 Relevant considerations – such as the nature of the Society's business, which meant that it was not just new policyholders who were potentially affected by the decision – were not taken into account. No proper consideration was given to the use of the full range of powers that the prudential regulators possessed.

5.83 After having considered the representations I had received, I concluded that the failure by the FSA, acting on behalf of the prudential regulators, to record their decision to permit the Society to remain open to new business, following its loss of the *Hyman* litigation fell short of the standard that could reasonably be expected of such regulators.

5.84 I also concluded that the basis on which the decision was taken by the FSA, acting on behalf of the prudential regulators, to permit the Society to remain open to new business was unsound, not taking into account all relevant considerations and not having a proper legal and factual basis and that this fell short of the standard that could reasonably be expected of such regulators.

My tenth finding of fact

5.85 In the period between the Society's closure to new business on 8 December 2000 and the end of my jurisdiction in relation to relevant events on 1 December 2001, the FSA, acting on behalf of the Treasury as the prudential regulators of insurance companies, were contacted by many hundreds of the Society's policyholders who were concerned about the position that the Society was in and about their own future options.

5.86 The FSA during this period also issued general information relating to the Society through updates, website material, and factsheets.

5.87 As the Society prepared proposals for a scheme of arrangement under the Companies Act 1985, to compromise the competing claims of the Society's policyholders, the FSA were also contacted by policyholders about the Society's proposals and about the attitude of the FSA to those proposals.

5.88 **My final finding of fact** is that the information provided by the FSA in the post-closure period was misleading and unbalanced, with assurances being provided that the Society was solvent, when that was in considerable doubt and was not the view that was always held within the FSA, who, on behalf of the prudential regulators, had exercised formal intervention powers on the grounds that the

Society was likely to be in breach of its regulatory solvency requirements.

5.89 Nor were the assurances given by the FSA that the Society was at that time fulfilling and always had fulfilled all of its other regulatory requirements appropriate, when the FSA knew that this was not the case.

5.90 After having considered the representations I had received, I concluded that the misleading information, about the Society's solvency position and its record of compliance with other regulatory requirements, that was produced by the FSA, acting on behalf of the prudential regulators, during the period after the Society closed to new business fell short of the standard that could reasonably be expected of such regulators.

Section 6: Determinations of maladministration

6.1 In section 5, I set out the ten findings I have made that the acts or omissions of the prudential regulators and/or GAD fell short of the standard that could reasonably be expected of them.

6.2 Having done so, I then go on to assess whether those acts or omissions were so unreasonable, or fell so far short of acceptable standards of good administration, as to constitute maladministration. The assessments that I have made on these questions are set out in Chapter 11 of Part 1 of my report.

6.3 I have made ten determinations of maladministration – one against the DTI, four against GAD, and five against the FSA. I have done so because I am satisfied that the departures that each finding represent were unreasonable in the circumstances and/or fell far short of acceptable standards of good administration.

6.4 Those determinations are:

- that the failures (i) to insist, when approving the appointment in June 1991 of a new Chief Executive, that he should demit office as the Society's Appointed Actuary, and (ii) during the period from 1 July 1991 to 31 July 1997, to consider the use of their powers to seek to remove that person from such a 'dual role' constitutes maladministration by the DTI;

- that the failure, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1990 to 1993, related to (i) the valuation rate of interest used to discount the Society's liabilities and (ii) to the affordability and sustainability of the Society's bonus declarations, constitutes maladministration by GAD;

- that the failures, when the introduction of the Society's differential terminal bonus policy was identified as part of the scrutiny of the 1993 returns, (i) to inform the prudential regulators about the policy, (ii) to raise the matter with the Society, or (iii) to seek to identify what the rationale was for the introduction of the policy and how it was being communicated to policyholders, constitutes maladministration by GAD;

- that the failure, as part of the scrutiny process, to question and seek to resolve questions within the Society's regulatory returns for each year from 1994 to 1996, related to (i) the valuation rate of interest, (ii) the affordability and sustainability of bonus declarations, (iii) apparently arbitrary changes to the assumed retirement ages, and (iv) the holding of no explicit reserves for the liabilities associated with prospective liabilities for capital gains tax, for pensions mis-selling costs, and for guaranteed annuity rates, constitutes maladministration by GAD;

- that the failures (i) to ask for the information GAD needed in respect of the Society's 1995 returns to enable them, as part of the scrutiny process, to be sure that the Society had produced a valuation that was at least as strong as the minimum required by the applicable Regulations, and (ii) to pursue the information before them that the omitted information had led to the users of the returns misconstruing the financial strength of the Society constitutes maladministration by GAD;

- that the failures (i) to ensure that the financial reinsurance arrangement was not taken into account within the Society's 1998 returns without an appropriate concession being given, and (ii) to ensure that the credit taken by the

Society within its returns for 1998, 1999, and 2000 properly reflected the economic substance of that arrangement constitutes maladministration by the FSA;

- that the failure to pursue the issue of the proper disclosure, within the Society's regulatory returns for 1998 and 1999, of the potential impact on the Society of it losing the *Hyman* litigation constitutes maladministration by the FSA;

- that the failure to record their decision to permit the Society to remain open to new business, following its loss of the *Hyman* litigation constitutes maladministration by the FSA;

- that the unsound basis on which the decision was taken to permit the Society to remain open to new business, following its loss of the *Hyman* litigation constitutes maladministration by the FSA; and

- that the misleading information, about the Society's solvency position and its record of compliance with other regulatory requirements, that they produced during the period after the Society closed to new business constitutes maladministration by the FSA.

Section 7: Determinations of injustice

7.1 When determining in general terms whether or not any maladministration which I have found to have occurred has resulted in injustice to those who have complained to me, I first identify what were the consequences of that maladministration and then I assess whether those consequences constitute an injustice for which no or no sufficient remedy has been provided.

7.2 The **consequences of my first finding of maladministration**, related to the 'dual role' were, first, that the prudential regulators and GAD became overly reliant on the information provided by one person within the Society – through his completion of the returns and through the meetings that those regulators and GAD often had with only that person. The Society was also not prompted and/or invited by the prudential regulators to address the unsatisfactory nature of the 'dual role'.

7.3 A further – and important – consequence of this failure was that the system of prudential regulation, designed on the basis that the Appointed Actuary (with operational independence from the executive management of a life insurance company) would play a central role, operated in a dysfunctional manner during this period in respect of the Society.

7.4 The maladministration which I have found to have occurred resulted in the effective operation of the system of prudential regulation in respect of the Society, and the governance of the Society, becoming compromised. There was effectively no 'whistle-blower' during this period within the Society, to the detriment of the proper governance of the Society and of the prudential regulation of the Society.

7.5 The **consequences of my second finding of maladministration**, related to the scrutiny of the Society's regulatory returns for each year from 1990 to 1993 were, first, that the prudential regulators and GAD could not be satisfied that the Society was acting prudently and with proper regard to the reasonable expectations of its policyholders. Another consequence of this failure is that the Society was never asked to justify whether it could afford its bonus declarations or how it proposed to sustain the level of bonus that it declared.

7.6 A further consequence was that the impression was given to existing and potential policyholders that the Society was financially sound and able to pay generous bonuses, when the prudential regulators and GAD could not have been sure that either was the case.

7.7 The maladministration which I have found to have occurred led to lost opportunities to seek further understanding as to whether the Society's business model was inherently prudent or whether that model exposed the Society's members to unnecessary risks.

7.8 The **consequences of my third finding of maladministration**, related to the intimation of the Society's differential terminal bonus policy were, first, that the prudential regulators were disabled from discharging their duties.

7.9 Another consequence of that failure was that the Society was not asked by the prudential regulators and/or GAD to justify its approach in the light of the reasonable expectations of its existing policyholders and/or of the contents of its advertising, which did not draw to the attention of potential policyholders (or existing policyholders, especially those considering making further contributions to policies which did not contain guaranteed annuity rates) that such a policy existed.

7.10 A further consequence of this failure was that the Society took its decisions, such as not to consider ring-fencing new entrants into a different fund, rejecting certain approaches that it received from those interested in acquiring the Society's business, and/or as to the validity of its general practices, in a context in which the Society could reasonably believe that it had secured regulatory approval – albeit tacit approval – for its new bonus policy and associated practices.

7.11 The maladministration I have found to have occurred resulted in the loss of a number of critical opportunities. Such opportunities included those to test the appropriateness of the differential terminal bonus policy and to ensure that the illustrations and advertisements provided to existing and potential policyholders explained the Society's policy and practice.

7.12 Opportunities were also lost to take decisions about the future direction of the Society in full knowledge of the reserving requirements to which it was subject and to which the prudential regulators and GAD would eventually draw attention. The Society lost the option to make provision gradually over time for the costs arising each year from those requirements as those costs accumulated.

7.13 The maladministration which I have found also resulted in the problems which caused the Society eventually to close to new business being obscured until July 1998 and to the loss of opportunities for the Society and for the prudential regulators and/or GAD to begin to address those issues much earlier than they all eventually did.

7.14 The **consequences of my fourth finding of maladministration**, related to scrutiny of the Society's regulatory returns for each year from 1994 to 1996 were, first, that an early opportunity was lost to address the issue of the Society's practice as to reserving for guaranteed annuity rates. Another consequence was that the Society's liabilities were considerably understated.

7.15 The maladministration which I have found to have occurred reinforced that which I have found in relation to the introduction of the differential terminal bonus policy, in that the problems which caused the Society eventually to close to new business were further obscured and opportunities were lost to address those issues earlier.

7.16 The **consequences of my fifth finding of maladministration**, related to the presentation of the Society's two valuation results were, first, that those reading the Society's returns during this period were capable of being misled as to the strength of the Society's true financial position.

7.17 Another consequence was that those who used the information and conclusions drawn from the returns by rating agencies and other third parties – including financial advisers, industry publications, and those briefing Ministers – were enabled to rely on information that did not contain a complete and accurate assessment of the Society's true position. They were thus actively misled.

7.18 A further consequence was that GAD were unable, with respect to the Society's 1995 returns, to verify the financial position of the Society, as they were not able on that occasion reasonably to be satisfied that the Society's chosen valuation method had produced a result at least as strong as the minimum prescribed in the Regulations as they lacked the information needed to be so satisfied.

7.19 The maladministration which I have found to have occurred resulted in the reader of the returns not having the information that was before GAD and which, arguably, should have been available to all readers of the Society's published returns.

7.20 No action was taken when it was clear that those readers were misconstruing the information that was provided. Maladministration also resulted in those who expressed concerns about the Society's solvency being reassured on grounds which were not sustainable.

7.21 The **consequences of my sixth finding of maladministration**, related to financial reinsurance were, first, that the Society was permitted to declare a bonus in March 1999. Had the Society not done so, a warning would have been given to those considering investing in the Society for the first time or to those considering making further contributions to existing policies that the Society was in significant financial difficulty.

7.22 Another consequence of those acts and omissions was that the solvency position of the Society, as published by 1 May 1999 within its 1998 returns, was misrepresented. Those reading the Society's published 1998 returns would have been misled as to the strength of the Society's financial position. That reinforced the misleading message of the strength of the financial position of the Society which had been given by the declaration of a bonus a month earlier.

7.23 A further consequence of the acts and omissions of the prudential regulators and GAD was that the ongoing weakness of the Society's financial position was hidden from public view in the Society's published returns for 1999 and 2000. Those considering their options – whether to invest, to make further contributions to existing policies, to convert a policy into an annuity, or simply to stay – were given a wholly misleading picture of the true position faced by the Society and of its solvency position due to the unreasonable credit taken for the reinsurance arrangement.

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

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

7.26 The **consequences of my seventh finding of maladministration**, related to the potential impact of the *Hyman* litigation on the Society were, first, that the prudential regulators and GAD could not be certain that the Society's policyholders and those potential policyholders considering investing or continuing to invest in the Society were being given complete and accurate information about what were the extent and nature of the possible effects should the House of Lords deliver a judgment that was adverse to the Society.

7.27 Existing and potential policyholders were thus denied information about their potential exposure to significant risk, which was an integral part of informed decision-making as to their financial options.

7.28 Another consequence of those acts and omissions was that the Society and the prudential regulators and GAD lost an opportunity to consider, either separately or together, whether the scenario planning and other work they had undertaken as preparation for managing the possible outcomes of the *Hyman* litigation was sufficient to address the full range of factors which had exposed the Society to the range of problems which it faced during that period.

7.29 The maladministration which I have found to have occurred meant that the prudential regulators could not have been certain that the reality that an adverse judgment would crystallise for the Society was not being distorted.

7.30 Any such distorted reality might inform the published returns and the other publications that the Society produced during that period. The prudential regulators could not have been sure that existing and potential policyholders had the full information necessary to take informed decisions.

7.31 The **consequence of my eighth finding of maladministration**, related to the failure to record the decision to permit the Society to remain open to new business was that no proper and contemporaneous record exists as to the basis for that decision. The maladministration which I have found resulted in an absence of documentary evidence to support the basis for an important decision taken by the FSA.

7.32 The **consequences of my ninth finding of maladministration**, related to the basis on which the decision was taken to permit the Society to remain open to new business were, first, that policyholders lost any opportunity to receive the benefit of the sound and robust exercise of the discretionary powers that Parliament had conferred on the prudential regulators in order to protect the interests of such policyholders.

7.33 Another consequence of this failure was that those who invested for the first time during this period – which could not have occurred had certain intervention action such as the withdrawal or suspension of the Society's authorisation to write new business been taken – or who bought annuities, or who made further contributions to existing policies where there was no contractual requirement to do so, made those decisions in an environment in which accurate and complete information about the financial position of the Society was not available to them.

7.34 No warning had been given by the prudential regulators, as would have been provided by the exercise of intervention powers such as the withdrawal of authorisation, of the seriousness of the financial position that the Society was in.

7.35 A further consequence of this failure was that compensation for mis-selling, if any were provided, became an additional liability falling to be met by those existing policyholders.

7.36 The maladministration which I have found to have occurred resulted in those 'late joiners' and certain other existing policyholders making decisions about their financial affairs without the accurate and complete information necessary to make those decisions on an informed basis.

7.37 The **consequence of my final finding of maladministration**, related to the information provided by the FSA after closure was that reassurance was given to those who contacted the FSA to enquire about the financial position of the Society when that reassurance was not soundly based. Those who had regard to the information provided by the FSA made decisions about their financial affairs having regard to the incomplete and inaccurate information that was provided.

7.38 The maladministration which I have found to have occurred resulted in misleading information about the position of the Society being provided to existing policyholders, in a situation in which those policyholders were entitled to have regard to that information because of its source.

7.39 All of the above specific consequences of the determinations of maladministration that I have made also had three general consequences:

- that the Society's published returns were unreliable;
- that there were lost opportunities to address critical issues earlier; and
- that regulatory decisions were taken on a basis which had insufficient regard to the range of powers that the prudential regulators possessed.

7.40 I considered whether the consequences which I have determined flowed from the maladministration I have found to have occurred constitute injustice to those who have complained to me. Having done so, I make five findings of injustice, being:

- first, **financial loss**, where that has occurred, and/or **lost opportunities** to take informed decisions as a result of reliance on the information contained in the Society's returns for 1990 to 1996;
- secondly, the **loss of opportunities** in the period between July 1991 and April 1999 to take informed decisions in full knowledge of the exposure of the Society to guaranteed annuity rates and of the risks that such exposure generated;
- thirdly, **financial loss**, where that has occurred, to anyone who joined the Society or who paid a further premium that was not contractually required in the period after 1 May 1999 and/or **lost opportunities** to take those decisions on an informed basis;
- fourthly, **financial loss**, where that has occurred, and/or the **loss of opportunities** to take informed decisions to those individuals who can show, having regard to their particular circumstances, that they relied on deficient information provided by the FSA in the post-closure period, that such reliance was reasonable in the circumstances, and that it led to any such losses; and
- finally, a justifiable sense of **outrage** on the part of all those who complained to me at the failings of those operating the regulatory system during the period prior to the Society's closure to new business.

Section 8: Disposal of the complaints

8.1 Chapter 13 of Part 1 of my report sets out my disposal of each of the eighteen specific heads of complaint, and the general complaint, referred to in Section 4 above and detailed in Annex A.

8.2 I uphold the general complaint that the prudential regulators and GAD failed properly to exercise their regulatory functions in respect of the Society during the period prior to 8 December 2000. I do not uphold it for the period from 8 December 2000 to 1 December 2001.

8.3 Annex B shows how I have disposed of the eighteen specific heads of complaint.

Section 9: Remedy and recommendations

9.1 My approach to the provision of remedies for injustice or hardship resulting from maladministration is set out in my document, *Principles for Remedy*, published in October 2007. My underlying principle is to seek to ensure that the relevant public body restores someone to the position he or she would have been in, had the maladministration not occurred. If that is not possible, the relevant body should compensate them appropriately.

9.2 I received submissions from the public bodies which sought to persuade me that it would not be appropriate in the circumstances of this case to adopt my usual approach to questions of remedy. I was not persuaded by those submissions.

9.3 It is my normal practice, where someone has been inconvenienced or made to feel a justifiable sense of outrage at the way that they have been treated, to recommend that an apology is made and that consideration is given to whether that apology should be accompanied by a tangible recognition of such inconvenience or outrage.

9.4 Where financial loss is established, I would normally expect that, where appropriate, such a loss should be remedied in full, with payment of interest where that is relevant.

9.5 In that context, there are four questions that I need to address in this case before making any recommendations designed to remedy the injustice that I have found has been sustained on this occasion, namely:

- whether complainants have suffered a financial loss in absolute terms – that is, have they suffered an identifiable or quantifiable loss at all?;
- if so, whether complainants have suffered a financial loss in relative terms – that is, have they suffered a loss that they would not otherwise have suffered had they invested or saved elsewhere than the Society?;
- if so, whether there is a sufficient link between the acts and omissions of the bodies whose actions have been investigated and found to be deficient with that relative loss; and
- if there is, what would be appropriate in all the circumstances of this case to recommend by way of a remedy?

9.6 If I were to find no financial loss, or were to conclude that any such loss sustained was not sufficiently linked to maladministration, or were to consider that it would not be appropriate to recommend a remedy for any such loss, I would then need to consider whether it would be appropriate to recommend a remedy for the opportunities that I have found were lost as a result of maladministration.

9.7 I also need to consider whether any injustice has already been remedied by other means. Where that is so, I would not expect a further remedy to be provided, as it is an important principle that any recommendation I make should not lead to a complainant making a profit or gaining an unreasonable advantage.

9.8 As for **absolute loss**, I am very far from concluding that everyone who has complained to me about the prudential regulation of the Society has suffered a financial loss. Still less do I conclude that everyone who has saved with, or invested in, the Society during the period covered in my report has suffered such a loss.

9.9 It seems to me that it is a natural and unavoidable consequence of one of the basic premises of the allegations underpinning the complaints that have been made about the events covered in this report – namely, that distribution took place of the resources of the Society in what is said to be an imprudent manner which it could not afford – that some people have gained from their savings and investments with the Society more than they would have done had any such distribution not occurred.

9.10 However, there is no avoiding the fact that those who are, or were at the relevant time, members of the Society experienced the series of policy value and bonus cuts during the period after it closed to new business in December 2000. Details of those cuts are set out within Chapter 2 of Part 1 of my report.

9.11 That is sufficient evidence in my mind to persuade me to conclude that, for many people at least, financial loss has been sustained. In coming to that conclusion, I have also borne in mind the acceptance, which appears to be common ground among all the parties, that such losses were suffered across the with-profits industry at the relevant time. That loss generally occurred does not seem to be controversial.

9.12 That brings me to **relative loss**. Did those who have complained to me, and those in a similar position to those complainants, suffer a loss that they would not have suffered had they saved or invested elsewhere?

9.13 The Society has dealt with many types or categories of mis-selling complaints, or claims based on breach of contract. However, the most analogous category of complaint to the maladministration on the part of the prudential regulators and GAD is the complaints which were made due to the Society's failure to disclose the existence of guaranteed annuity rates.

9.14 I sought information from the Society as to what the outcome had been to the cases of those people who, not being caught by the effects of the Compromise Scheme, had complained to the Financial Ombudsman Service about such alleged mis-selling on the part of the Society. I understand that those cases were assessed using a comparative loss assessment using the performance of an average competitor of the Society as a comparator. That information shows that relative loss was established in approximately 60% of those cases concerning complaints of this type.

9.15 I understand that the cases dealt with by the Financial Ombudsman Service followed on from a review conducted by the Society, at the request of the FSA, of any mis-selling which related to the failure to disclose the existence of guaranteed annuity rates. In the course of that review, the Society also adopted an analagous comparative approach to assessing loss. Under that review, approximately 78% of those with mis-selling complaints of this type were found to have suffered a relative loss.

9.16 Those who have complained to me are in substantially the same circumstances as those who complained to the Society or to the Financial Ombudsman Service, with the exception that they were caught by the effects of the Compromise Scheme and thus could not pursue such complaints.

9.17 When the above information is considered together, it seems to me that this demonstrates that, for many of those covered by my recommendations, it could be established that a loss has been sustained, relative to what would have transpired had those individuals saved or invested with a comparable with-profits fund.

9.18 I therefore conclude that it would be difficult to sustain an argument that no person affected by '*the Equitable affair*' had suffered a relative loss.

9.19 I also conclude that the individual circumstances of each complainant and other people similarly affected are key to establishing whether those people are in the category of those who have suffered relative loss. Accordingly, whether relative loss in a particular case has been sustained has to be determined at an individual level.

9.20 As for whether there is a **sufficient link** between the acts and omissions of the bodies whose actions have been investigated and found to be deficient with any relative loss that is established, I conclude that there was such a link.

9.21 The aim of the system of regulation was to protect the interests of policyholders through the supervision of the affairs of insurance companies, in the manner in which Parliament intended and using the means that Parliament provided.

9.22 In the light of my determinations, set out in this guide, I conclude that there is a direct link between the acts and omissions of the prudential regulators and the information that throughout the period covered by my report was before those people who were making savings and investment decisions regarding the Society.

9.23 Those acts and omissions are also directly linked to the knowledge about the solvency position of the Society that policyholders and potential policyholders possessed during the period on or after 1 May 1999.

9.24 The prudential regulators, <u>and no-one else</u>, were given the functions of scrutinising the returns that the Society submitted and of verifying its solvency position. No other party can be said to be at fault because those regulators, acting with the advice and assistance of GAD, acted with maladministration.

9.25 I now turn to what I consider that it is **appropriate to recommend** as a remedy for the injustice that I have found resulted from maladministration on the part of the prudential regulators and GAD.

First recommendation

9.26 **My first recommendation is that, in recognition of the justifiable sense of outrage that those who have complained to me feel about the maladministration in the form of the serial regulatory failure that I have identified in this report, the public bodies should apologise to those people for that failure.**

Second recommendation

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

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

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

9.30 The scope of such a scheme should cover all those who have suffered similar injustice to those who have complained to me. That should include not just residents of the United Kingdom but all those who have sustained the injustice that I have found resulted from maladministration.

9.31 I consider that it would be reasonable to expect such a scheme to be established within six months of any decision by Government and Parliament to do so.

9.32 I recognise that how best to establish and administer any compensation scheme is a matter for Government and Parliament to decide. However, I would offer, as a contribution to that debate, my view of the principles which should govern any such compensation scheme.

9.33 It seems to me that such a scheme:

- should be **independent** and constituted along the lines of a tribunal or adjudication panel, with three members – one representing broadly the interests of those affected and one representing those of the relevant public bodies, with an independent chair;

- should operate in a **transparent** manner, with the basis being made public of the decisions as to how compensation should be calculated, as to what procedure will govern the consideration of individual cases, and as to the criteria which will be taken into account when considering those cases. Those decisions should only be made after appropriate consultation is undertaken, including with those directly affected; and

- should be **simple**, not imposing undue burdens, whether evidential or procedural, on those making claims to the scheme.

9.34 The above principles would, I hope, be accepted widely as being an appropriate and effective mechanism of decision and delivery of the remedy that I have recommended should be provided.

9.35 I hope, also, that it would be accepted that this mechanism has to have, as its guiding principle, the need to deliver as speedy a remedy as is possible in the circumstances, while recognising the complex issues that would need to be addressed and resolved.

9.36 In my view, the scheme should take no longer than two years from the date of its establishment to complete its work.

9.37 I recognise that the public interest is a relevant consideration and that it is appropriate to consider the potential impact on the public purse of any payment of compensation in this case.

9.38 Furthermore, I am acutely conscious of the potential scale of what I have recommended and that acceptance of my central recommendation might entail opportunity costs elsewhere through the diversion of resources.

9.39 In that context, **I invite Parliament to consider the issues that have been raised in this report and the recommendations that I have made and to further reflect on what its response to my report should be.**

9.40 Having alerted Parliament to the injustice that I have found was sustained in consequence of maladministration, I would be very happy to assist Parliament in its deliberations in any way that I can.

Section 10: Annex A

Terms of Reference and Statement of Complaint for the Equitable Life Investigation

December 2004

Investigation terms of reference

The terms of reference for the investigation are:

> *To determine whether individuals were caused an injustice through maladministration in the period prior to December 2001 on the part of the public bodies responsible for the prudential regulation of the Equitable Life Assurance Society and/or the Government Actuary's Department; and to recommend appropriate redress for any injustice so caused.*

Statement of complaint

Summary of complaint
The complainants complain that the public bodies responsible for the prudential regulation of insurance companies (successively the Department of Trade and Industry, Her Majesty's Treasury and the Financial Services Authority, collectively referred to in the rest of this statement as 'the regulators') and the Government Actuary's Department (GAD) failed for considerably longer than a decade properly to exercise their regulatory functions in respect of the Equitable Life Assurance Society (ELAS) and were therefore guilty of maladministration.

Specific complaints

1 <u>Organisational issues</u>

a. The regulators were not sufficiently resourced, and did not all possess the necessary skills, to contribute effectively to the overall regulatory process and to responsibly exercise their discretionary powers as intended by Parliament and by the European Community (now the European Union). Administrative decisions as to resourcing, priorities and methods contributed to a position in which the regulators did not properly undertake their functions as prudential regulator of ELAS.

b. The regulators failed to liaise and to co-operate effectively with those responsible for the regulation of the conduct of business by insurance companies. In particular, they failed to ensure that proper assessments were made of ELAS's individual practices and its communications with policyholders, and of the expectations that these generated, in the light of the information that was, or should have been, known to the prudential regulators.

2 <u>General operational issues</u>

c. The prudential regulators did not operate the regulatory regime as it was intended to be implemented by Parliament and in conformity with EC Directives. The regulators instead chose to regulate ELAS with a 'light touch' – a concept not evident from or provided for under the Insurance Companies Act 1982 and the EC Third Life Directive nor one consistent with these statutory provisions. The approach to the regulation of ELAS was exceptionally and unjustifiably lenient when compared to that adopted with other companies, with inadequate investigative site visits and lack of liaison with conduct of business regulators.

Much more rigorous standards of supervision and better co-operation with conduct of business regulators were adopted for smaller and unit-linked companies. This demonstrated that the regulators applied a two-tier standard of regulation.

d. The regulators and GAD allowed successive chief executives or managing directors of ELAS also to hold the post of appointed actuary, despite recognising the potential for conflict of interest in this position. These decisions were not consistent with the basis of the regulatory regime.

e. The regulators and GAD failed to keep pace with developments in the pensions and life insurance industry and to assess and adapt their methods to reflect those developments. This was particularly critical in a situation in which narrow, technical interpretations of regulatory solvency were becoming an increasingly irrelevant measure of any insurer's realistic financial position as the industry moved more and more towards non-guaranteed bonus declarations.

f. GAD had recommended ELAS as a pension plan or additional voluntary contribution scheme provider in their advice to the administrators of the Principal Civil Service Pension Scheme and to other public sector pension schemes. This led to a lack of proper separation of their responsibilities and to a clear conflict of interest between GAD's role in providing advice to government bodies in relation to public sector pensions and in assisting the prudential regulators of ELAS. This conflict of interest compromised the proper discharge of GAD's regulatory functions.

3 Supervision of regulatory solvency

g. From the mid 1980s until 1997, the regulators failed to evaluate the potential effect of Guaranteed Annuity Rates (GARs) on the solvency of ELAS in a context where current annuity rates were falling steadily, in line with the Bank of England's base rate, to below contracted GARs. The regulators learned explicitly in November 1993 of the degree of ELAS's exposure to risks associated both with the GAR issue and with ELAS's lack of prudent reserves. The regulators' failure to take action then or to impose reserving until 1999 played a direct part in the closure of ELAS to new business and to subsequent cuts in policy and annuity values. The regulators did not prepare a study on the extent of GARs in the industry until 1997: a decade too late.

h. From about 1990 onwards, the regulators and GAD failed to give sufficient consideration to the fact that some of the measures used to bolster ELAS's solvency position were predicated on the emergence of a future surplus. As a consequence, they did not properly assess the overall impact and adequacy of those measures. The regulators also allowed ELAS to mis-use the term 'surplus' and failed to consider the use of that word in the context of policyholders' reasonable expectations.

i. Over this same period, the regulators allowed ELAS to publish financial results and projections that were misleading in that they did not reflect the Society's true position. In particular, ELAS was allowed to habitually report growth rates alongside bonus rates, which gave the impression of a prudent margin for error, whereas the true position was that:

- assets were consistently less than policy values so that higher rates of growth were needed to cover any given rate of bonus; and

- as part of the growth was needed to cover expenses and the contractual liability for conventional annuities, the growth available to meet with-profits bonuses was always materially less than the rate quoted in ELAS literature. This was never made clear.

j. During this period, the regulators and GAD failed to act when ELAS adopted what Lord Penrose described as practices of '*dubious actuarial merit*'. These included valuing future liabilities at an inappropriate rate of interest between 1990 and 1996; treating selling costs as an asset; making no provision for GARs until much too late; valuing a financial re-insurance policy (which proved to be of no value) at over £800 million; allowing credit for 'aspirational' (i.e. effectively unrealisable) assets; responding too slowly to widely evidenced changes to mortality expectations; and the issuing of a subordinated debt worth £346 million which did not count as a liability.

k. On several specific occasions, as set out in the Penrose report, the regulators and GAD ignored or failed to act on information that might have led to formal or informal regulatory action against ELAS, thus also failing to alert new investors to the risks of investing. These include when ELAS board papers were sent to GAD by the Appointed Actuary on 11 June 1991, and when information was provided to GAD on 10 September 1992 which showed that, for the years 1989 to 1991, the aggregate policy values very significantly exceeded the value of the underlying assets.

4 <u>Payment of excess bonuses</u>

l. Over a period of many years the regulators and GAD permitted ELAS to operate an unsound business model, of which they were aware. ELAS had made public its policy of reliance on 'goodwill' in a 1989 actuarial paper *With Profits Without Mystery*, but the regulators never addressed the issue or challenged ELAS about it or about the consequences of the model. Instead, they allowed ELAS to operate the model, which entailed declaring bonuses in excess of admissible assets, while at the same time operating without a significant estate and with a smoothing fund persistently in deficit. These were major contributory factors to ELAS's development of what Lord Penrose quantified as a £3 billion asset deficit at the time of closure to new business and to the losses incurred by all those who held policies on 16 July 2001.

m. The regulators failed to ensure any satisfactory correlation between the total of declared policy values and ELAS's admissible assets in a context where ELAS, uniquely in the industry, had declared total policy values that included terminal bonuses and had, without exception, always paid all claims (both contractual and non-contractual) in accordance with these declarations.

5 <u>Policyholders' reasonable expectations (PRE)</u>

n. Ministers and officials decided that regulatory activities in relation to safeguarding PRE should be based solely on the regulatory returns, but failed to put in place adequate procedures and Regulations to enable this to be achieved. This failure was particularly critical in respect of ELAS, which had unique practices that elicited PRE.

o. As a result, the regulators and GAD failed over many years properly to monitor and assess ELAS's asset position and its practices in the light of PRE. The regulators and GAD did not properly determine PRE or act to protect them as intended by Parliament and to the standards set by EC Directives.

p. During the course of the *Hyman* litigation, the regulators failed in their duty to all policyholders in respect of PRE and postponed consideration of issues related to assets and reasonable expectations, both for GAR and non-GAR policyholders, until after the House of Lords' judgment (20 July 2000). In addition, the regulators totally failed to assess properly either the impact or the scope of the judgment and to evaluate the range of scenarios for ELAS following it. They failed to take appropriate action to mitigate the adverse effect of the judgment on the majority, non-GAR policyholders, and on new investors into the same with-profits fund. Their judgement that there was a 99.9% probability that ELAS would be sold demonstrated that, despite the extensive information that they possessed, the regulators failed to understand the parlous state of ELAS which was apparent to all prospective bidders.

q. In March 2001, the regulators permitted ELAS to declare a bonus for 2000 and an interim bonus for 2001 that were both inappropriate and unjustifiable given the then state of ELAS's finances, thus raising misleading expectations about the true state of ELAS just prior to significant across-the-board cuts that were imposed only four months later. Instead, ELAS's asset deficit of 13% at year-end 2000 in a closed fund should have precipitated regulatory intervention at that time.

r. In July 2001, the regulators failed to protect PRE by permitting policy value adjustments worth more than £4,000 million in the form of an inequitable uniform percentage cut across all with-profits policies, rather than the fairer alternative of reducing policy values by cutting only non-guaranteed bonuses. The regulators also refused to comment meaningfully on this to policyholders while discouraging independent financial advisers from giving proper advice to policyholders.

Remedy sought

The complainants seek full financial redress for the losses they have incurred in consequence of the maladministration outlined above.

Section 10: Annex B

Disposal of the heads of complaint

Head of Complaint	Topic: the actions of the prudential regulators and/or GAD in relation to allegations concerning:	Disposal
A	Resourcing and skills	Dismissed
B	Liaison with the conduct of business regulators	Dismissed
C	Inconsistent approach to regulation	Dismissed
D	Dual role	Not determined
E	Failure to keep pace with developments	Dismissed
F	Conflict of interests	Dismissed
G	Guaranteed annuity rates	Upheld in full
H	Measures predicated on the emergence of future surplus ignored	Dismissed
I	Misleading financial results	Upheld in part
J	Practices of 'dubious actuarial merit'	Upheld in part
K	The use of the information before GAD and the papers disclosed to GAD	Upheld in part
L	Unsound business model	Upheld in part
M	Correlation between policy values and assets	Dismissed
N and O	PRE	Upheld in part
P	Preparation for House of Lords	Upheld in part
Q and R	Bonus and policy value cuts	Upheld in part
GENERAL COMPLAINT	General regulatory failure	Upheld for the period prior to 8 December 2000

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Millbank Tower
Millbank
London SW1P 4QP

Report enquiries
Tel: 020 7217 3904
Fax: 020 7217 4061

Email: equitable.investigation@ombudsman.org.uk

General enquiries
Tel: 0845 015 4033
Fax: 020 7217 4000

Email: phso.enquiries@ombudsman.org.uk

www.ombudsman.org.uk

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