

Return to an Order of the
Honourable the House of Commons dated
16 October 2001 for the

**Report of the Financial Services Authority
on the Review of the Regulation of the
Equitable Life Assurance Society
from 1 January 1999 to 8 December 2000,
which Her Majesty's Government
is Submitting as Evidence
to the Inquiry Conducted by Lord Penrose**

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The attached Report contains references to opinions and advice and their contents obtained by Equitable Life Assurance Society and provided to HMT-ID (subsequently FSA (IFSD)) in the course of normal exchanges between a regulated body and its regulator and for the specific purpose of allowing HMT-ID to fulfil its regulatory functions. It is acknowledged by the FSA that Equitable Life Assurance Society has waived privilege in this material only for that specific purpose and that Equitable Life Assurance Society does not intend any wider or general waiver of privilege by agreeing to the inclusion of the material in this Report, which it is understood will be published.

Abbreviations

1994 Regulations	Insurance Companies Regulations 1994 (as amended)
1996 Regulations	Insurance Companies (Accounts and Statements) Regulations 1996 (as amended)
A day	29 April 1988 - the date on which regulatory regime under the FSAct 1986 came into force
Appointed Actuary	the actuary every life company must appoint in accordance with the ICA 1982
CA 1985	Companies Act 1985
DTI	The Department of Trade and Industry
Enforcement	a department known as Regulatory Enforcement (PIA firms/Bank Investigations) within a separate Enforcement Division of the FSA
Equitable Life	Equitable Life Assurance Society
EST	Economic Secretary to the Treasury
Faculty	Faculty of Actuaries
FIMBRA	Financial Intermediaries Managers and Brokers Regulatory Association
FMC	Firms and Markets Committee
the FSA	The Financial Services Authority
FSAct 1986	Financial Services Act 1986
FSMA 2000	Financial Services and Markets Act 2000
GAD	The Government Actuary's Department
GAD SLA	the service level agreement between the GAD and the DTI (originally, then the Treasury and now the FSA as the prudential regulators) dated 6 November 1998
GAO	Guaranteed Annuity Option
GAO policies	those policies containing an option to take a GAR
GAR	Guaranteed Annuity Rate

GAR policyholder	a policyholder who has the benefit of a GAR
GCD	General Counsel's Division of the FSA
GN1	Guidance Note 1: Actuaries and Long-Term Insurance Business issued by the Institute and Faculty
GN2	Guidance Note 2: Financial Condition Reports issued by the Institute and Faculty
GN8	Guidance Note 8: Additional Guidance for Appointed Actuaries and Appropriate Actuaries issued by the Institute and Faculty
Government Actuary	the head of the GAD
HMT	Her Majesty's Treasury
HMT-ID	the Insurance Directorate at HMT
IBD	the Investment Business Division of the FSA
IB-PIA	the department within IBD responsible for carrying out the functions of the PIA under the PIA SLA
IB-PIA (Advertising)	the specialist team within IB-PIA which monitors advertising by PIA firms
IB-PIA (Supervision)	the specialist team within IB-PIA which provides a support service to IB-PIA (and generally within the FSA) by answering queries about the PIA Rules
IB-Policy	the department within IBD which deals with the policy development issues in relation to the three SROs
ICA 1982	Insurance Companies Act 1982
IERC	Irish European Reinsurance Company
IFA	Independent Financial Adviser
IFSD	Insurance and Friendly Societies Division of the FSA
Inheritance Period	the period prior to the Review Period
Institute	the Institute of Actuaries
ISC	Insurance Supervisory Committee

Lautro	The Life Assurance and Unit Trust Regulatory Organisation
N2	The date on which FSMA 2000 will take full effect
OA-CSP	overall assessment and co-ordinated supervisory programme
PFW	a pension fund withdrawal (also called an income drawdown)
PIA	Personal Investment Authority
PIA Ombudsman	the independent complaints handling agency for resolving complaints by investors against firms which are regulated by PIA
PIA Rules	the rules of the PIA
PIA SLA	the service level agreement between the PIA and FSA dated 28 May 1998
PRE	policyholders' reasonable expectations
Review Period	the period from 1 January 1999 until 8 December 2000
Review Team	Ronnie Baird, Director, Quality Assurance and Internal Audit, Oscar Edridge, a member of his staff, PricewaterhouseCoopers and Norton Rose
RMM	required minimum margin
RMS	required margin of solvency
SIB	Securities and Investments Board
SLA	service level agreement
SRO	self-regulating organisation
TAD	Treasury Advisory Division
Treasury SLA	the service level agreement between HMT and the FSA dated 18 December 1998

Chapter One

Introduction

1.1 Introduction

- 1.1.1 Equitable Life Assurance Society (“**Equitable Life**”) is the world’s oldest mutual life assurance society. It was established as the “Society for Equitable Assurances on Lives and Survivorships” in 1762. Equitable Life has written a mixture of with-profits and non-profits business.
- 1.1.2 On 8 December 2000 the Board of Equitable Life announced that it would stop writing new business with immediate effect. Equitable Life reported that it remained solvent and would continue to pay out benefits and accept premiums under existing policies although investment performance and bonuses were likely to be impaired.
- 1.1.3 This announcement was the culmination of a period of uncertainty following a House of Lords’ judgment delivered on 20 July 2000 in legal proceedings which Equitable Life had commenced in January 1999 to test the lawfulness of a practice it had adopted with respect to the allocation of terminal bonuses amongst policyholders. The financial implications of the judgment of the House of Lords caused Equitable Life to put itself up for sale and, on failing to find a purchaser, the Board announced Equitable Life’s closure to new business.

1.2 Background - the Origins

- 1.2.1 The origin of Equitable Life’s problems related to a guarantee which had been a standard feature in some pension policies written between 1957 and June 1988. This guarantee provided policyholders, at the date of retirement, with the option of obtaining an annuity at a fixed guaranteed rate - a Guaranteed Annuity Rate (“**GAR**”). (This Report will refer to policyholders who had the benefit of a GAR as “GAR policyholders”, and will refer to policies containing a guaranteed annuity option (“**GAO**”) to take a GAR as “**GAO policies**”¹). The other options available to a GAR policyholder included the purchase of an annuity at current annuity rates (which fluctuate in line with interest and mortality rates) either from Equitable Life or from another life insurance company in the open market. Existing GAO policies remained valid after July 1988 and GAR policyholders could continue to contribute by paying additional premiums.
- 1.2.2 During the period when GAO policies were being sold, current annuity rates were consistently higher than the guaranteed rate. However, in late 1993, the position changed when current annuity rates slumped. Despite a brief resurgence in 1994, from mid-1995 the GAR has been consistently higher than current annuity rates. The problem was compounded by the fact that the margin between guaranteed and current rates had been increasing. By September 1998, GARs in policies issued between 1957 and 1988, were approximately 30% higher than current annuity rates.

¹ Chapter 3 provides a further explanation of the guaranteed annuity provisions. However, it should be noted that practitioners use the acronyms interchangeably. In order to reflect the contents of the relevant documents, we have adopted the acronym used in that document although we recognise that this may lead to inconsistency.

1.3 The Significance of the GAR to Equitable Life

- 1.3.1 Although GAR business was common throughout the life insurance market, the issue was of particular significance to Equitable Life for two reasons; firstly, because Equitable Life had written 116,000 GAR policies, a much bigger proportion of its business than was the case with other companies; and secondly, because Equitable Life's long-standing philosophy was always to provide a full distribution of profits to its policyholders and it had little excess capital over and above the funds necessary to meet its liabilities and satisfy solvency requirements and, as a mutual, it had no shareholder funds on which to draw.

1.4 The Terminal Bonus Practice

- 1.4.1 In 1993, the Board of Equitable Life sought to address the GAR issue in a way which it maintained was consistent with its established approach to distributing surplus. Equitable Life adopted a differential terminal bonus practice which reduced the level of terminal bonus paid to policyholders exercising their GAR, thereby equalising the benefits being taken by GAR policyholders and non-GAR policyholders. The practical effect of this was that the GAR provided GAR policyholders with no discernible additional benefit to those with non-GAR policies. The Board of Equitable Life believed that it was entitled to adopt this practice by exercising a discretion under the Articles of Association of the Society.
- 1.4.2 This practice became the subject of an increasing number of complaints and press attention during late 1998. These complaints were initially dealt with by the Personal Investment Authority Ombudsman ("**PIA Ombudsman**"). However, in December 1998, Equitable Life asked the PIA Ombudsman to relinquish jurisdiction over the complaints to the High Court as it was felt that this would provide the fairest and quickest way of resolving the issue.

1.5 The Court Case

- 1.5.1 In order that the GAR issue and the legality of Equitable Life's terminal bonus practice could be considered by the Court, it was decided that proceedings should be based on the case of one GAR policyholder who would act as a representative for all GAR policyholders, whilst Equitable Life was to represent the interests of the non-GAR policyholders. Mr Alan David Hyman was selected to be the GAR policyholder who would be the representative defendant. The Defendant's case challenged Equitable Life's terminal bonus practice on the grounds that it was in breach of the contractual arrangements which underpinned the guarantee. The case was taken on appeal ultimately to the House of Lords, who declared, unanimously, that the practice was in breach of contract; judicial interpretation of the contract was that it required Equitable Life to pay GAR policyholders the same terminal bonus as had been paid to non-GAR policyholders.

1.6 The Consequences

- 1.6.1 The consequence of the House of Lords' decision was that Equitable Life, without access to any sufficient free capital of its own, either in the form of reserves or shareholder capital, was unable to withstand, in the long-term, the impact of the very substantial and effectively unquantifiable liabilities which arose from the House of

Lords' judgment. The Board decided that it had to look to an external source of capital in the form of a buyer of the business in order to enable it to continue to write new business. Immediately following the handing down of the House of Lords' judgment, the Board of Equitable Life announced that Equitable Life was up for sale. It declared that its members' interests would be best served by the sale of the business to an organisation capable of providing capital support, thereby safeguarding long-term investment freedom. By 8 December 2000, however, all potential purchasers had decided not to proceed and, as a consequence, the Board of Equitable Life decided the only prudent course of action was to cease writing new business.

- 1.6.2 As of 8 December 2000, the with-profits fund became a "closed fund". The practical effect of this was that, whilst policyholders could continue making contributions under their policies and should expect benefits to be paid out in line with contractual obligations, it was likely that future investment performance would be impaired given the prudential constraints on Equitable Life's freedom of investment. Although Equitable Life's with-profits fund was not insolvent, there were considerable uncertainties amongst policyholders as to the likely future performance of the fund and as to how the assets of the fund would be shared among them.
- 1.6.3 On 19 December 2000, Mr Richard Ottaway, MP for Croydon South, secured a debate in the House of Commons on the subject of Equitable Life. In response to the concerns voiced during the course of that debate, the Economic Secretary to the Treasury ("EST"), reported that the Board of The Financial Services Authority ("FSA") would be invited by its Chairman to initiate a review of events that led to Equitable Life's decision to close to new business.
- 1.6.4 Against this background, the FSA issued a press release dated 22 December 2000 reporting that it had appointed Ronnie Baird, Director, Quality Assurance and Internal Audit, assisted by independent legal and actuarial advisers, to produce a full account of the FSA's regulation of Equitable Life for its consideration, to cover the period from 1 January 1999 until Equitable Life's closure to new business on 8 December 2000.

1.7 The Review

- 1.7.1 PricewaterhouseCoopers and Norton Rose were appointed as independent experts to assist in actuarial and legal matters respectively. Together with Mr Baird and Mr Edridge, a member of his staff, they form the Review Team. This Report has been prepared by the Review Team for the sole use of the Board of the FSA. Consequently, no other party may use this Report for any other purpose.
- 1.7.2 This Report has been prepared in accordance with the following Terms of Reference:
- (a) The reporting team will be led by the FSA's Director, Internal Audit, Ronnie Baird, who has been asked by the Board of the FSA to provide it with an independent account with the benefit of impartial professional support from external experts.
 - (b) The report will cover:

- (i) the FSA's discharge of the functions (under the Insurance Companies Act 1982) which it undertakes as delegate for HM Treasury; and
 - (ii) the Personal Investment Authority's discharge of its functions as a recognised self-regulating organisation (under the Financial Services Act 1986).
- (c) The report will:
- (i) describe the background and events leading up to the FSA's assumption of responsibility for the prudential regulation of Equitable Life on 1 January 1999;
 - (ii) describe the course of supervisory work from then until Equitable Life's closure to new business on 8 December 2000;
 - (iii) identify any lessons to be learned.
- (d) The report will access all relevant information within the possession or control of the FSA, the PIA, and their advisers.
- (e) The report will be made as soon as possible, though it is recognised that it is likely to take a number of months to finish. It will be published.

1.7.3 The Review Team has been provided with the relevant files by Her Majesty's Treasury ("**HMT**"), the FSA and the Government Actuary's Department ("**GAD**").

1.7.4 The Review Team carried out interviews with directors and employees of the FSA (who include former employees of HM Treasury ("**HMT**")) and GAD. On all occasions, interviews were carried out at the FSA's offices at North Colonnade, Canary Wharf. Some of the interviewees were interviewed on more than one occasion. All the interviewees were accompanied by Freshfields Bruckhaus Deringer, external legal advisers appointed by the FSA. In addition, the Treasury Solicitor attended the interviews with GAD officials. The Review Team wishes to acknowledge its appreciation for the co-operation and assistance which has been extended to it by all those who have been asked to assist.

1.7.5 The FSA, and certain of the relevant divisions involved within the FSA and GAD, were invited to make representations and observations on any preliminary proposed conclusions prior to the finalisation of this Report. Careful consideration has been given to the representations and comments made. Changes have been made when points have been accepted.

1.7.6 The Terms of Reference confined the Review Team to a review of the discharge by the FSA and the Personal Investment Authority ("**PIA**") of their respective functions and directed it to have access to all relevant information within the possession or control of the FSA, the PIA and their advisers. The Review Team has not had access to documents from any third parties. In particular, it was not deemed appropriate or necessary to extend the Review to include obtaining access to documents in the possession of Equitable Life or any of its advisers or to interviewing any employees or former employees of Equitable Life or any of its advisers. The Review Team wishes to make it clear that it has not sought, nor found it necessary, to draw or

express any conclusions about the conduct of Equitable Life's business and it would be wrong to infer fault on the part of Equitable Life or any of its employees (or former employees) from the contents of this Report.

1.8 The Review Team's Approach

1.8.1 In its press release announcing the appointment of the Review Team, the FSA Board stated:

“The Board believes that it is good discipline to learn the regulatory lessons from episodes such as this while acknowledging the fact that the Equitable remains solvent and has not ‘failed’.”

1.8.2 The purpose of the Review therefore has been to examine what happened in order to identify what lessons can be learned by the FSA from this episode. The Review Team has not seen it as its task to investigate with a view to apportioning blame to any individual in any way. Accordingly, where possible, the Review Team has avoided identifying individual participants at the FSA. It should also be clearly understood that in drawing any conclusions in respect of this matter with a view to identifying the lessons for the future, the Review Team has not sought to exclude the benefit of hindsight.

1.9 The Report

1.9.1 The matters which are the subject of this Report require an understanding of several relatively complex features of Equitable Life's business and the regulatory framework in order for the reader to appreciate the context in which the regulator was operating and the issues with which it was dealing. The following two chapters of the Report therefore give a detailed explanation of these features.

1.9.2 **Chapter Two** deals with the regulatory structure, within which both the prudential² and conduct of business³ regulation of Equitable Life operates and describes the regulatory matrix, within which a complex web of professional, contractual and statutory responsibilities is shared primarily between the Appointed Actuary, GAD, the Insurance and Friendly Societies Division of the FSA (“**IFSD**”) (formerly, when part of HMT, the Insurance Directorate (“**HMT-ID**”)), the PIA and the Investment Business Division (“**IBD**”) of the FSA.

1.9.3 **Chapter Three** describes the nature of the GAOs contained in some of Equitable Life's policies and the approach adopted by the Board of Equitable Life to deal with this problem. It also explains the solvency regime set out in the Insurance Companies Act 1982 (“**ICA 1982**”) and its associated regulations and prudential and professional actuarial guidance and how these applied to the GAO issue.

1.9.4 In **Chapter Four**, there follows a narrative account of:

²The objective of prudential regulation of life insurance companies can be summarised as to protect consumers by ensuring that persons or companies who are not fit and proper or appropriately resourced do not carry on insurance business in the UK.

³The aim of the conduct of business regulator is to protect investors by the regulation and supervision of the retail investment sector, enabling investors to make properly informed decisions in an open, competitive and innovative market place.

- (a) the background and events leading up to the FSA's assumption of the responsibilities for prudential regulation of Equitable Life on 1 January 1999 ("**Inheritance Period**"); and
- (b) the course of the supervisory work from 1 January 1999 until Equitable Life's closure to new business on 8 December 2000 (the "**Review Period**").

1.9.5 In **Chapter Five** there follows a narrative account of the FSA's discharge of the functions of the PIA.

1.9.6 In **Chapter Six** we give an assessment of the discharge by the FSA and the PIA of their statutory functions and in **Chapter Seven** we identify the lessons to be learned. The content of Chapter Seven has been discussed with the FSA Board prior to finalisation in order to ensure that any recommendations we made were practicable and proportionate.

1.9.7 In this Report we have included a number of quotations from various documents. In order to assist reading, we have corrected small, obvious typographical errors.

Chapter Two

The Regulatory Structure

2.1 Introduction

- 2.1.1 This Chapter describes the regulatory structure which applied to Equitable Life during the Review Period.
- 2.1.2 At present, life insurance companies are subject to two separate regulatory regimes:
- (a) Prudential regulation which relates primarily to the solvency of insurance companies and the soundness and prudence of their management. Prudential regulation is governed by the ICA 1982.
 - (b) Conduct of business regulation which relates primarily to the marketing and sale of retail investment products and advising investors on their rights in relation to such products. Conduct of business regulation is governed by the Financial Services Act 1986 (“FSAct 1986”).
- 2.1.3 Historically, prudential regulation and conduct of business regulation have been carried out by separate regulators. Since the early 1980s there have been three different regulatory bodies involved in the prudential regulation of insurance companies. Until the end of 1997, the Department of Trade and Industry (“DTI”) held responsibility. In January 1998, responsibility was transferred to HMT which, with effect from 1 January 1999, contracted out its role in the prudential regulation of insurance companies to the FSA. Since 1994, the PIA has had responsibility for conduct of business regulation but, with effect from 1 June 1998, contracted out its role to the FSA.
- 2.1.4 In May 1997, the Government announced its decision to establish a single regulator responsible for banking, investment business and insurance operating under a single legislative framework. The FSA will become the single regulator for financial services in the UK later this year when the Financial Services and Markets Act 2000 (“FSMA 2000”) is implemented in full.
- 2.1.5 Until full implementation of the FSMA 2000, the responsibility for managing the regulation of these industries has been transferred to the FSA on a transitional basis. There are a series of complex interim arrangements in place, the effect of which is as follows:
- (a) HMT remains formally responsible for the prudential regulation of insurance companies but has contracted out its functions and powers (with some exceptions) to the FSA; and
 - (b) The PIA is formally responsible for conduct of business regulation but the task of monitoring compliance with its rules is contracted out to the FSA.
- 2.1.6 This Chapter describes in further detail the statutory and contractual framework in which prudential and conduct of business regulation operated during the Review

Period. It also describes the various bodies involved in the regulation of Equitable Life and the elements of the regulatory regime.

Prudential Regulation

2.2 Introduction

2.2.1 IFSD told us that:

“The objectives of prudential supervision of life insurance companies can be summarised as to protect consumers by ensuring that persons or companies who are not fit and proper or appropriately resourced do not carry on insurance business in the UK. This is largely achieved through a system of authorisation under the ICA 1982 which requires companies to demonstrate initially that they meet the necessary standards and through the monitoring of companies’ compliance with those standards while they are authorised.”

2.2.2 In regulating authorised insurance companies, the main objective is to protect policyholders against the risk of companies being unable to pay valid claims. In the case of life insurance companies, this includes the risk that they will be unable to meet policyholders’ reasonable expectations (“**PRE**”). **PRE** is a concept which features significantly in this Report; it is explained in more detail below.

2.3 The Statutory and Contractual Framework

2.3.1 Until 4 January 1998, the DTI was responsible for the prudential regulation of insurance companies. The team within the DTI with immediate responsibility for prudential insurance regulation was known as the Insurance Directorate (the “**ID**”).

2.3.2 Following the Government’s announcement in May 1997 to establish a single regulator, on 5 January 1998, the functions and powers which had formerly been carried out by or on behalf of the Secretary of State for Trade and Industry were transferred to HMT. From 5 January 1998 until 1 January 1999 HMT assumed direct responsibility for the prudential regulation of insurance companies.

2.3.3 Although there was a formal transfer of responsibility for prudential regulation from the DTI to HMT¹, in practice, the day-to-day regulation was carried out by the same staff at ID at the same premises who temporarily joined HMT pending the transfer to the FSA. In this Report we refer to the Insurance Directorate at HMT as “**HMT-ID**”.

2.3.4 Responsibility for the prudential regulation of insurance companies was, in most respects, contracted out to the FSA from HMT with effect from 1 January 1999 although some of the regulatory powers under the ICA 1982 remain exercisable only by HMT. This transfer was effected by means of a Contracting Out Order² and a service level agreement between HMT and the FSA dated 18 December 1998 (the “**Treasury SLA**”). The staff who had comprised HMT-ID moved to the FSA’s

¹ Transfer of Functions (Insurance) Order 1997 (SI 1997 No 2781).

² The Contracting Out (Functions in Relation to Insurance) Order 1998 (SI 1998 No. 2842).

offices in Canary Wharf where they were joined by the supervisory staff of the Friendly Societies Commission. IFSD is the division of the FSA with responsibility for the prudential regulation of insurance companies and friendly societies.

2.4 The Treasury SLA

2.4.1 In order to understand the aims and objectives of the regime of prudential regulation as it applied during the Review Period and therefore the role of IFSD, it is necessary to set out, in some detail, some of the provisions of the Treasury SLA.

2.4.2 By virtue of the Treasury SLA, HMT conferred authorisation on the FSA to carry out certain statutory powers and functions of HMT. The statutory powers and functions which have been delegated to the FSA are set out in a schedule to the Treasury SLA, by way of reference to certain sections of the ICA 1982 and other statutes and secondary legislation. These functions and powers include the following:

- (a) to grant authorisation to carry on insurance business and to suspend or withdraw authorisation;
- (b) to receive the regulatory returns of an insurance company;
- (c) to require a company in breach of its margin of solvency to submit a plan for the restoration of a sound financial position;
- (d) to require a company which fails to maintain its minimum margin of solvency (as defined in the legislation) to submit a short term financial scheme;
- (e) to impose requirements about investments;
- (f) to require the maintenance of assets in the UK;
- (g) to impose requirements with respect to the custody and disposal of assets;
- (h) to limit the premium income;
- (i) to require a company to make an investigation into its financial condition;
- (j) to require a company to submit its annual returns early;
- (k) to obtain information and require the production of documents; and
- (l) the residual power to impose requirements for the protection of PRE³.

2.4.3 The introduction to Schedule 1 to the Treasury SLA states:

“This Schedule sets out the aims and objectives which the FSA is to adopt in respect of the functions which the FSA is authorised to exercise on behalf of the Treasury, and defines the standards and performance measures which the FSA will use its best endeavours to achieve.”

³ The powers of intervention, and the grounds upon which they may be exercised, are considered in further detail below.

2.4.4 Under the heading “Aims and Objectives”, Schedule 1 refers to the draft legislation⁴ which had been published on 30 July 1998. The FSA’s objectives which were set out in that draft legislation and which are recited in Schedule 1, were:

- (a) maintaining confidence in the UK financial system;
- (b) promoting public understanding of the financial system, including awareness of the benefits and risks associated with different kinds of investment or other financial dealing;
- (c) securing the appropriate degree of protection for consumers, having regard to the differing degrees of risk involved in different kinds of investment or other transaction, the differing degrees of experience and expertise which different consumers may have, and the general principle that consumers should take responsibility for their decisions; and
- (d) reducing the extent to which it is possible for a business that is carried on by a regulated person to be used for a purpose connected with financial crime.

2.4.5 Schedule 1 goes on to state:

“While these objectives are not yet enacted and may be amended during the passage of the legislation they serve to inform the general approach the FSA proposes to take during the period prior to the new legislation coming into force (“N2”). This will include the FSA’s approach to carrying out the functions which it will exercise on behalf of the Treasury for insurance supervision.

The FSA’s aim will be effectively to regulate the insurance industry so that policyholders can have confidence in the ability of UK insurers to meet their liabilities and fulfil policyholders’ reasonable expectations.”

2.4.6 The following are said to be the FSA’s “key supporting objectives”:

- (a) to ensure that persons or companies who are not fit and proper or appropriately resourced or otherwise not able to satisfy the criteria for authorisation do not carry on business in the UK;
- (b) to carry out the regulation of insurance companies...efficiently and effectively;
- (c) to meet the insurance industry’s reasonable requests for prompt and clear responses to their requests for information and advice and to keep the cost and inconvenience of regulation for insurers as low as is commensurate with effective protection of the consumer; and
- (d) to co-operate with HMT in seeking to deliver the efficient operation of the single market, including assistance in EU negotiations and to secure that EC law develops to maximise an open and competitive market in the EU.

2.4.7 Under the heading “Insurance Supervision Work Programme” the Schedule sets out the key areas of work for 1999. The key areas of work which are identified are:

⁴ The Financial Services and Markets Bill.

- (a) conduct of on-going regulatory, and related, work to specified standards;
- (b) initiatives to support the development of more effective and efficient regulatory procedures; and
- (c) preparation for the coming into effect of the new regulatory regime.

2.4.8 The Schedule then goes on to amplify these areas of work. So far as the first is concerned, various sub-headings are set out in Schedule 1. These include a sub-heading "Supervision" under which the FSA's "General responsibilities", "Key tasks" and "Performance Measures" are described. The "General responsibilities" include the following:

"Protecting policyholders against the risk of company failure and, more specifically, to protect them against the risk that UK authorised insurers might be unable to pay valid claims. In the case of life insurance companies this includes the risk that they will be unable to meet policyholders' reasonable expectations. The Treasury and FSA agree that it is neither realistic nor necessarily desirable in a climate which seeks to encourage competition, innovation and consumer choice, to seek to achieve 100% success in avoiding company failure. The FSA will therefore pursue its supervisory objectives by aiming to minimise, but not eliminate, the risk of company failure by identifying early signs of trouble, and taking preventative action."

2.4.9 Under "Key tasks" the Schedule states that the supervisory resource will be focused on:

"monitoring the financial soundness of insurers, to see that they are run in a sound and prudent manner by fit and proper people, based mainly on the scrutiny of financial returns and other information (with the assistance of the Government Actuary's Department particularly in the case of life companies), and site visits."

2.4.10 As set out above, another key area of work which is identified in Schedule 1 is "Initiatives to support the development of more effective and efficient regulatory procedures." The activities to be undertaken during the course of 1999 in relation to this area include:

- (a) review, and where necessary, undertake an interim update of non-life and life insurance supervisory procedures and internal guidance to ensure a consistent and properly documented approach (target date April 1999);
- (b) preparation of sectoral and market analyses to improve understanding of the context in which insurance companies operate; and
- (c) the enhancement of a risk-based approach to supervision.

2.4.11 In relation to the last of these, the Schedule notes that:

"As part of its work on procedures, the FSA will further develop a risk-based approach to insurance supervision against the FSA's broader canvas of financial regulation with a view to aligning the methodology and categorisation, to the extent possible whilst taking account of the particular complexity of assessing

insurance companies, with the practice in relation to other sectors of the financial industry. A particular focus of this work will be the identification of the key elements, and the development of a risk rating system which could be implemented within two years of N2, if appropriate ...”

- 2.4.12 Not all the powers under the ICA 1982 were transferred to the FSA from HMT. The Treasury SLA details the arrangements with respect to these powers⁵. In particular, the power under section 68 of the ICA 1982 to make an order which disapplies, or modifies the application of, certain provisions of the ICA 1982 and certain regulations made under it was not transferred to the FSA. As described in Chapter 3, Equitable Life had the benefit of Section 68 Orders which permitted it to include certain items in its solvency calculation.

2.5 The Regulatory Bodies: IFSD

- 2.5.1 IFSD is the division within the FSA which has responsibility for the prudential regulation of insurance companies. During the Review Period it was divided into four departments: life, non-life, London market and policy and international.
- 2.5.2 So far as life insurance is concerned, at the beginning of the Review Period, IFSD consisted of: 1 Head of Department, 4 managers, 13 associates and 5 administration/secretarial staff.
- 2.5.3 At the end of the Review Period, the breakdown of the staff was: 1 Head of Department, 4 managers, 17 associates and 5 administration/secretarial staff.
- 2.5.4 During the Review Period, there were approximately 200 firms (consisting of approximately 150 life insurance companies and 50 composite insurance companies) regulated by this section of IFSD.

2.6 The Regulatory Bodies: Insurance Supervisory Committee

- 2.6.1 Although IFSD has day to day responsibility for prudential regulation of insurance companies, the FSA Board has delegated, ultimately, to the Insurance Supervisory Committee (the “ISC”) the exercise of any power or discretion which has been conferred on the FSA by the Treasury SLA. The remit of the ISC is to:
- “consider any exercise of any power or discretion conferred by the [ICA 1982] in relation to any insurer, within the remit of IFSD. This includes any recommendation to the Treasury to exercise supervisory powers that the FSA has not been authorised to exercise, notably to issue Orders under s68.”
- 2.6.2 The members of the ISC are the Director of IFSD, Heads of Department, the Head of the Policy Unit and all managers with line responsibility for the supervision of insurance companies. GAD may attend meetings of the ISC for papers on which it has a particular contribution to make.

⁵ Treasury SLA, Schedule 1, para 16.

2.7 The Regulatory Bodies: General Counsel's Division

2.7.1 IFSD obtains legal advice from the General Counsel's Division of the FSA ("GCD"). In the period from 5 January 1998 to 31 December 1999, when prudential regulation was the responsibility of HMT, legal advice was provided to HMT-ID by the Treasury Advisory Division ("TAD").

2.7.2 We were told that GCD largely provided legal advice when asked to do so by IFSD. GCD's advice was sought when IFSD required specific legal input because a regulatory issue had a legal dimension to it. The legal issues which GCD dealt with ranged from being relatively routine to "bigger supervisory issues of which Equitable was the classic example."

2.7.3 IFSD informed us that:

"a lot of supervision of insurance companies goes on without that much legal advice. It tends to be the exception where a specific point has been raised that clearly has a legal aspect to it, then the lawyers are asked for specific advice but normally for company's supervision they don't have that sort of ongoing role...In Equitable's case there was more of an ongoing approach, largely because the court case was ongoing throughout the period and there clearly was that legal side to it."

"So in this case...the lawyers became involved really at an early stage, [and] took an interest and effectively monitored the case throughout. They were routinely copied in correspondence, so had there been any issue they wanted to raise they could do."

2.8 The Regulatory Bodies: Government Actuary's Department

2.8.1 IFSD obtains actuarial advice from GAD.

2.8.2 GAD was established by HMT in 1919. It consists of three directorates which, in broad terms, are concerned with occupational pension schemes, social security and insurance supervision. The head of GAD is the Government Actuary. GAD's role is advisory; it has no responsibility for the exercise of statutory powers under the ICA 1982.

2.8.3 Since 1984, GAD has operated a major part of life insurance supervision, as a delegated responsibility, under the terms of a service level agreement originally with the DTI, subsequently with HMT and now with the FSA, as the prudential regulators (the "GAD SLA"). The GAD SLA sets out the detailed services to be provided by GAD. In particular, GAD has the main role in the scrutiny of the regulatory returns and in providing advice to IFSD on what action needs to be taken in following up points arising from the scrutiny.

2.8.4 The product of GAD's examination of the regulatory returns is a "scrutiny report" which forms a key element of the regulatory process of the FSA. Both the regulatory returns and GAD's scrutiny reports are considered in further detail below.

2.8.5 In addition to the scrutiny report (and authorisation processes), GAD also provides advice on areas which impact on a life insurance company's solvency or PRE. To enable GAD to carry out its duties effectively, IFSD are required to copy to GAD all

relevant correspondence received from insurance companies. The GAD SLA provides that IFSD will request advice from GAD when there are issues which might affect, for example, the financial security of a life insurance company, PRE, or where the issues raised are actuarial or professional in nature. However, GAD is always free to comment on any document if it believes that there are issues that should be brought to IFSD's attention.

- 2.8.6 In considering whether the company's Appointed Actuary has met his statutory and professional obligations, GAD has regard to standards generally accepted within the profession and to specific research carried out by the profession. In some key areas of interpretation of the valuation regulations (which set out how the value of the assets and liabilities is to be determined for the purposes of determining statutory solvency), GAD has developed its own working rules to define what is acceptable and these have been issued as guidance⁶ in which the Government Actuary sets out details of what GAD considers to be good practice in relation to particular actuarial issues. Two examples of such letters are the letters which were sent in January 1999 and December 1999 on reserving for GAOs which are considered in greater detail in Chapters 3 and 4.
- 2.8.7 In addition, staff from GAD accompany IFSD on visits to life insurance companies and advise IFSD on new authorisations of life insurance companies and on a wide range of policy issues.
- 2.8.8 At the start of the Review Period, there were 10 actuaries, 2 trainee actuaries and 2 administrators/secretaries providing support to IFSD. At the end of the Review Period, the number of actuaries had reduced to 8 (as a result of retirements and resignations). The number of trainee actuaries and administrators/secretaries remained the same. Additional actuarial resource was available to support the supervision of friendly societies and non-life insurance companies.
- 2.8.9 As of 26 April 2001, the GAD staff involved in the prudential regulation of insurance companies have been transferred to the FSA to provide 'in-house' actuarial advice.

2.9 The Prudential Regulatory Matrix

- 2.9.1 Insurance companies are subject to a specific statutory solvency regime which is designed to ensure that they are able to meet their obligations to policyholders. Monitoring the financial soundness of insurance companies is based mainly on the regulatory returns which insurance companies are required to submit each year. IFSD described to us two important elements of the prudential regulatory regime:

"The whole essence of regulation was "freedom with disclosure". That the substantial amount of information put in the public domain, by contrast to the banking world, allowed the regulator, the analysts, everyone out there to look and see the position. That as it were allowed a much more relaxed system of regulation than was the case in many other countries and that had been so since the twenties or thirties. So that is one part of it. The other part of it...is the reliance on the appointed actuary and his statutory responsibilities. He was conceived by the actuarial profession certainly as rather a guardian of PRE and

⁶ Dear Appointed Actuary letters.

almost, if not in legal terms, almost a trustee of policyholders. So he was a safeguard there to make sure that decisions were taken properly and carefully and with proper regard to contractual liabilities and PRE. You have the professional guidance of the Institute, discipline and all that.”

2.9.2 In the sections which follow we describe these two elements in further detail. We first explain, in broad terms, the contents of the regulatory returns and how these are scrutinised by GAD. We then explain the role of the Appointed Actuary in the regulatory structure.

2.10 The Regulatory Returns

2.10.1 In addition to the annual report and accounts which are required under the Companies Act 1985, section 22 of the ICA 1982 requires a UK life insurance company to submit to the FSA each year a series of reports which are known as the “regulatory returns”⁷. (They are also referred to as the “annual” or “supervisory” returns.) They are the principal tool for enabling the FSA to form a view on an insurance company’s present and future solvency.

2.10.2 The Insurance Companies (Accounts and Statements) Regulations 1996 (the “**1996 Regulations**”) set out in detail the information required in the regulatory returns and the format in which the information is to be presented.

2.10.3 At present, the regulatory returns are required to be submitted to the FSA within 6 months of the year-end (which is also referred to as the “valuation date”⁸). Equitable Life’s year end was 31 December so its returns were required to be submitted to the FSA by 30 June. The regulatory returns are filed as a public document at Companies House. The regulatory returns are significantly longer and more detailed than a company’s annual report and accounts. Equitable Life’s regulatory returns for 1999, for instance, ran to 420 pages.

2.10.4 The regulatory returns are laid out as a series of Schedules. Of particular relevance to this Report are:

(a) Schedule 1, which gives a detailed analysis of the assets and liabilities making up the solvency position of the insurance company. Schedule 1 includes, amongst other matters, Forms 9, 13 and 14. Form 9 is the consolidated regulatory balance sheet. It includes a comparison of the excess of “available assets” over liabilities with the excess required by regulations (which is known as the “required minimum margin” or “**RMM**”). Form 13 sets out the available assets analysed by type of asset. Form 14 shows the long-term liabilities relating to insurance policies and the short-term liabilities of the company. The totals for assets and Form 14 liabilities are carried into Form 9 as the key elements of the regulatory balance sheet.

(b) Schedule 4, which describes in detail the approach taken and assumptions made by the Appointed Actuary in determining the liabilities. Schedule 4 also derives the surplus available in the year and sets out how the surplus is allocated to

⁷ The FSA may also require the company to provide more frequent returns. Hence a new insurance company is normally required to submit quarterly returns.

⁸ Section 22 ICA 1982. The timetable for submission of the regulatory returns will change from N2.

policyholders and shareholders, if any. Schedule 4 also contains detailed financial information on different insurance products issued by the company. Schedule 4 contains, *inter alia*, Forms 51 to 54, which detail the liabilities established for the various types of policies; Form 57 which describes the calculation of the resilience reserve; Form 58 which sets out the aggregation of the liabilities from Forms 51 to 54 and the surpluses emerging in the year; and Form 60, which describes the calculation of the RMM. The total of liabilities derived in Form 58⁹ is carried forward into Form 14 where it constitutes the liability for long-term business. The RMM calculated in Form 60 is carried into Form 9.

- 2.10.5 The regulatory returns also include a certificate from the Appointed Actuary. The contents of this certificate are described in further detail below. Chapter 3 provides an explanation of the statutory solvency regime and how the value of assets and liabilities is to be determined for the purposes of the regulatory returns.

Role of the auditors

- 2.10.6 In contrast to the report and accounts required under the Companies Act 1985, the 1996 Regulations provide that only specific parts of the regulatory returns are covered by an opinion from the auditors¹⁰. The auditors' report is not an opinion on a "true and fair" view but is a report on whether the particular parts of the regulatory returns which are subject to audit have been properly prepared in accordance with the 1996 Regulations. In particular, the auditors do not report on Schedule 4; nor do the auditors report on implicit items¹¹ which are shown on Form 9 of the regulatory returns.

- 2.10.7 The auditors have a duty under the Auditors (Insurance Companies Act 1982) Regulations 1994 to report to the regulator any matters which the auditors believe are of material significance to the regulator for determining whether to exercise any of its powers of intervention. The powers of intervention are considered in further detail below.

2.11 GAD's Scrutiny of the Regulatory Returns

- 2.11.1 GAD performs an initial scrutiny of the regulatory returns. For a company which has submitted its regulatory returns by the end of June, GAD aims to have performed the initial scrutiny by the end of August. The initial scrutiny report consists of:
- (a) a priority rating for each company based on the criteria set out in the GAD SLA and taking account of a number of indicators;
 - (b) an indication of solvency cover for each company; and
 - (c) a target date for full scrutiny of each company's regulatory returns.
- 2.11.2 The priority rating system has five levels:

⁹ This figure is referred to as the "mathematical reserves".

¹⁰ Regulation 29 of the 1996 Regulations.

¹¹ Implicit items are described in Chapter 3.

- (a) Priority 1 is allocated to companies which are either not demonstrating that they hold the RMM or where there are significant problems which lead GAD to believe that they do not meet the requirements under proper bases.
- (b) Priority 2 is allocated to companies where there are “significant and substantial concerns”. The indicators of such concerns include where the cover for RMM (i.e. the ratio of the value of assets in excess of the liabilities to the RMM) is less than 1.25x or there is evidence of material non-compliance with the valuation regulations.
- (c) Priority 3 is allocated to companies where there are sufficient concerns to warrant early attention or there are other reasons to require scrutiny early in the cycle. The indicators for this priority rating include where the cover for RMM is less than 1.5x or there is evidence of non-trivial but not material non-compliance with the valuation regulations.
- (d) Priorities 4 and 5 are allocated to companies whose regulatory returns are targeted for scrutiny within nine and eleven months respectively.

2.11.3 IFSD told us that:

“the priority ratings do not take account of the potential “impact” of failure of the company concerned (they essentially relate only to the “probability” of failure). While throughout the Review Period other life companies were assessed as more likely to fail, and so received a higher GAD rating, I think it is fair to say that overall none of those companies was seen as a greater overall risk and accorded more supervisory importance than Equitable Life.”

2.11.4 The GAD SLA provides that GAD will report immediately to IFSD if its initial scrutiny of any insurance company raises “serious concern”. Examples which are given in the GAD SLA of where serious concerns arise include the situation when a company has failed to meet its solvency margin or is in financial difficulties¹².

2.11.5 The GAD SLA provides that both GAD and IFSD will use their best endeavours to agree the time-tabling and allocation of priority ratings by mid-September. Provision of detailed scrutiny reports by GAD is prioritised according to the priority rating and the target for Priority 1 and 2 cases is the end of October. However, the GAD SLA states that GAD does not need to wait for the scrutiny programme to be agreed before starting the detailed scrutinies of what it perceives to be the most urgent cases.

2.12 The Scrutiny Report

2.12.1 The role of GAD in the detailed scrutiny process is to provide IFSD, in a standard report (called a “scrutiny report”), with a means of identifying and considering actions against those companies which:

- (a) are not complying with statutory requirements;

¹² GAD SLA Section 5, A7.

- (b) are failing to meet the solvency requirements, or are in danger of failing to meet them in the near future; or
- (c) appear not to be meeting PRE¹³.

2.12.2 The scrutiny report is the primary document on which IFSD bases its understanding of the financial soundness of an insurance company. Key sections include:

- (a) New Business: new products and new premium income;
- (b) Changes in business in force: premium income and claims and lapse experience;
- (c) Expenses;
- (d) Assets: type of assets;
- (e) Valuation: the bases, resilience test, options and guarantees;
- (f) Financial results;
- (g) Bonuses and PRE; and
- (h) Reinsurance agreements and financing arrangements.

2.12.3 In addition, the scrutiny report will include information on a basis for action in relation to an insurance company if any of these requirements are not being met or if trends in key performance indicators point to problems in the future or the scrutiny report will contain a basis for informed longer term discussion. The GAD SLA gives the following key performance indicators:

- (a) cover for the solvency margin and trends in free asset ratios;
- (b) actuarial issues (e.g. change in strength of valuation basis; matching);
- (c) type of new business being written, by volume and mix;
- (d) trends in expense ratios;
- (e) trends in lapse rates;
- (f) assets; worrying exposures, investment strategy, impact on bonus strategy; and
- (g) significant developments during the year¹⁴.

2.13 The Appointed Actuary

2.13.1 The second important element of the regulatory matrix is the Appointed Actuary.

¹³ GAD SLA Section 5, A8.

¹⁴ GAD SLA Section 5, A9.

- 2.13.2 Under section 19 of the ICA 1982 every life insurance company is required to appoint an actuary, who is known as the Appointed Actuary, to undertake certain duties.
- 2.13.3 The 1996 Regulations prescribe¹⁵ that an Appointed Actuary must be a Fellow of the Faculty of Actuaries (the “**Faculty**”) or of the Institute of Actuaries (the “**Institute**”) (the controlling bodies for actuaries in the United Kingdom) and have attained the age of 30. Before taking up the position, an Appointed Actuary must obtain from either the Faculty or the Institute a practising certificate authorising him to act in this capacity. Such a certificate will only be issued if the applicant is able to demonstrate to the Faculty or Institute that he has the relevant experience to undertake the duties of an Appointed Actuary, that he has complied with the scheme of continuing professional development and that he is fit and proper to act as an Appointed Actuary. The practising certificate is renewable annually.
- 2.13.4 In addition, under the GAD SLA, all new Appointed Actuaries (who have not previously held such a position) are to be interviewed by the Government Actuary and a note of the meeting forwarded to IFSD. Any changes of Appointed Actuary are notified by IFSD to GAD and it will liaise with IFSD over any action that is needed where there is any concern about the reasons for the change of Appointed Actuary¹⁶.
- 2.13.5 The Faculty and the Institute issue professional Guidance Notes. These Guidance Notes are either mandatory (referred to as “practice standard”) or regarded as best practice (in which case they are referred to as “recommended practice”). Evidence of a failure to comply with practice standards could lead to disciplinary action by the profession.
- 2.13.6 The relationship between the Appointed Actuary and the board of directors of an insurance company is one which is regarded by the profession as being between a professional and his principal. The normal professional relationship of confidentiality and independence of advice applies, whether the Appointed Actuary is an employee or an external consultant. The Appointed Actuary, as such, has no executive powers and, in many cases, is not a board member. It is his duty to advise the board of directors. However, as in the case of Equitable Life, many Appointed Actuaries also hold senior executive positions within life insurance companies.
- 2.13.7 The Appointed Actuary is appointed by the board of directors of the life insurance company and, equally, can be replaced by the directors if they so choose. However, if an Appointed Actuary is replaced, the incoming actuary must consult the outgoing actuary to ensure that there is no matter of professional concern of which he should be aware. Further, the directors must inform IFSD that the Appointed Actuary has changed and IFSD may choose to seek further information on the circumstances of the change if it wishes.

¹⁵ Regulation 30.

¹⁶ GAD SLA Section 5, C1.

2.14 The role of the Appointed Actuary

2.14.1 In a paper published by the Faculty and Institute entitled “The Role of the Appointed Actuary”¹⁷ the Appointed Actuary system was described as:

“central to the financial soundness of life companies in the UK.

The Appointed Actuary has responsibilities to the Company’s Board of Directors, to its policyholders and to [IFSD] for monitoring and reporting on the Company’s financial progress. It is his or her duty to assess the implications for the Company’s financial condition of external events and the Company’s own actions, and to advise the Company accordingly.”

2.14.2 The Appointed Actuary has wide responsibilities in relation to monitoring, on a continuing basis, the adequacy of the company’s assets to meet its liabilities. In particular, the Appointed Actuary is required by section 18 of the ICA 1982 to investigate each year the financial condition of the life insurance company and report on the findings to the directors. This includes a valuation of the company’s long-term liabilities and a calculation of any excess of its long-term assets over its long-term liabilities.

2.14.3 An abstract of the Appointed Actuary’s report to the board of directors is included in the regulatory returns¹⁸. In addition, the regulatory returns include a certificate from the Appointed Actuary¹⁹ in which he certifies:

- (a) that proper records have been kept adequate for the valuation of the company’s liabilities;
- (b) that proper provision has been made for the liabilities;
- (c) the amount of the minimum solvency margin which the company is obliged to maintain;
- (d) that premium rates for new business are adequate to enable the company to meet its commitments under the contract;
- (e) that the relevant guidance issued by the Faculty and Institute has been complied with; and
- (f) that the assets and liabilities have been valued in accordance with the Insurance Companies Regulations 1994 (“**1994 Regulations**”).

Where this certificate cannot be given without qualification, this must be stated and explained.

2.14.4 The Faculty and Institute’s paper referred to above acknowledged that:

¹⁷ May 2000.

¹⁸ Section 22 ICA 1982.

¹⁹ Regulation 28 of the 1996 Regulations.

“The process of valuation, reporting and certification by the Appointed Actuary enables the [regulator] to monitor the Company’s financial progress without carrying out its own detailed investigations.”

- 2.14.5 The Appointed Actuary’s responsibilities are described in Guidance Notes issued by the Faculty and Institute. The Guidance Notes place a professional duty on the Appointed Actuary rather than imposing any statutory duty. Of particular relevance to this Report are: “Guidance Note 1: Actuaries and Long-Term Insurance Business” (“GN1”) and “Guidance Note 8: Additional Guidance for Appointed Actuaries and Appropriate Actuaries” (“GN8”). Both GN1 and GN8 are designated as “practice standard” which means that they are, in effect, mandatory for Appointed Actuaries.
- 2.14.6 GN1 deals with general matters and GN8 deals with the interpretation of the valuation regulations. GN1 makes it clear that an important aspect of the Appointed Actuary’s role is the duty to advise the board on the interpretation of PRE. The provisions of GN1 are therefore considered in more detail below in the section relating to PRE. Both GN1 and GN8 are also considered in more detail in Chapter 3.
- 2.14.7 In addition to GN1 and GN8, “Guidance Note 2: Financial Condition Reports” (“GN2”) is also relevant. GN2, which is designated recommended practice, sets out the profession’s view on the advisability of supplementing the annual investigation into a company’s financial condition with a report to the directors on the results of a dynamic financial analysis. This dynamic financial analysis involves testing the company’s ability to withstand possible future adverse conditions, making use of cash flow projections on a variety of assumptions.
- 2.14.8 The Guidance Notes envisage that there may be occasions on which the Appointed Actuary might need to advise the prudential regulator directly of a situation where the company is following a course of action which could lead him to qualify a subsequent actuarial certificate. This situation is seen as being a rare occurrence and would only arise if the company’s directors had previously chosen to ignore clear advice from the Appointed Actuary.

2.15 Intervention by the Prudential Regulator

- 2.15.1 Intervention by a regulator usually denotes the exercise of formal powers of intervention prescribed by the relevant legislation. This obviously does not exclude the regulator from intervening in a less formal way with a view to enquiring, discussing and perhaps even questioning management decisions that give rise to regulatory concerns or potential concerns.
- 2.15.2 IFSD told us:

“our powers are very broad and very sweeping. They are quite strong powers, but they are very general. And we have found it effective to engage in discussion with companies about what a problem is and to try to reach agreement with them on an appropriate way forward. It is a fact of life that companies know we have got these powers, and although we don’t, I hope, abuse them, the club held behind the back can often get a quicker result, and a more effective result, than a formal exercise which would mean a very protracted and possibly difficult process.”

2.15.3 This section summarises the formal powers of intervention available to the prudential regulator under the ICA 1982 and the grounds upon which they may be exercised.

2.16 Powers of intervention

2.16.1 In the case of a UK insurance company²⁰, the ultimate sanction available to the FSA is the withdrawal of authorisation (in whole or in part) so as to prevent an insurance company entering into any new contracts of insurance or new contracts of insurance of a particular description²¹.

2.16.2 The FSA also has powers in certain defined situations with respect to the investments and the maintenance, custody and disposal of assets by insurance companies. It may also:

- (a) require an insurance company to limit the premium income which it underwrites²²;
- (b) require a company which carries on long-term business to institute an actuarial investigation by its Appointed Actuary into its financial condition in respect of that business or any part of it²³;
- (c) require the regulatory returns to be delivered on an earlier date (up to three months before the normal due date)²⁴; and
- (d) require a company to provide the FSA at specified times or intervals with information about specified matters, verified, if the FSA so requires, in a specified manner²⁵.

2.16.3 Under section 45 of the ICA 1982, the FSA also has a power:

“to take such action as appears to [the FSA] to be appropriate:

- (a) for the purpose of protecting policyholders or potential policyholders of the company against the risk that the company may be unable to meet its liabilities, or, in the case of long-term business, to fulfil the reasonable expectations of policyholders or potential policyholders; or
- (b) ...for the purpose of ensuring that the criteria of sound and prudent management are fulfilled with respect to the company.”

This is a residual power and is only exercisable where the purpose prescribed is not achievable by the exercise of any of the other powers.

²⁰ An insurance company which is incorporated, and has its head office, in the UK.

²¹ Sections 11 and 13 ICA 1982.

²² Section 41 ICA 1982.

²³ Section 42 ICA 1982.

²⁴ Section 43 ICA 1982.

²⁵ Section 44 ICA 1982 (insofar as the exercise of any of these functions would require any individual to produce any documents at such time and place as may be specified, the power has been reserved to HMT).

2.17 The Grounds for Intervention

2.17.1 Section 37 of the ICA 1982 sets out the grounds on which the powers of intervention may be exercised. These grounds include:

- (a) when it appears that any of the criteria of sound and prudent management is not, or has not been or may not be or may not have been fulfilled²⁶; and
- (b) when [the FSA] considers the exercise of the power to be desirable for protecting policyholders or potential policyholders of the company against the risk that the company may be unable to meet its liabilities or, in the case of long-term business, to fulfil the reasonable expectations of policyholders or potential policyholders²⁷.

2.18 Criteria of sound and prudent management

2.18.1 Schedule 2A to the ICA 1982 sets out the criteria of “sound and prudent management”. The criteria include the following requirements:

- (a) that the business of the insurance company must be carried on with integrity, due care and the professional skills appropriate to the nature and scale of its activities; and
- (b) each director, controller, manager or main agent of the insurance company must be a fit and proper person to hold that position.

2.18.2 The Schedule states that an insurance company will not be regarded as conducting its business in a sound and prudent manner if it:

- (a) fails to conduct its business with due regard to the interests of policyholders and potential policyholders; or
- (b) fails to satisfy an obligation to which it is subject by virtue of the ICA 1982; or
- (c) in the case of a UK company, it fails to satisfy an obligation to which it is subject by virtue of any provision of the law of another EEA State which applies to its insurance business in that state.

2.19 Policyholders’ Reasonable Expectations

2.19.1 PRE is a concept which features significantly in this Report and it is necessary to appreciate the statutory context in which it arises and the purpose it purports to serve.

2.19.2 The concept of PRE in relation to long-term insurance business was introduced by the Insurance Companies (Amendment) Act 1973. As described above, it now appears in section 37 of the ICA 1982, as a ground upon which the FSA may exercise any of its powers of intervention where the FSA considers the exercise of that power is desirable for protecting policyholders or potential policyholders against the risk that the company may be unable to fulfil the reasonable expectations of

²⁶ Section 37(2)(aa) ICA 1982.

²⁷ Section 37(2)(a).

policyholders or potential policyholders. PRE is also repeated as a precondition for the use of the residual power of intervention under section 45 of the ICA 1982.

- 2.19.3 PRE will rarely, if ever, be a claim or right that can be enforced by a policyholder. There is no specific requirement for life insurance companies to meet PRE and it is not, therefore, open to policyholders to sue for breach of PRE. It is a concept to which an Appointed Actuary must have regard; it is also a ground for intervention by the prudential regulator.

2.20 PRE - the Concept

- 2.20.1 Between 1990 and 1993, a Working Party of the Faculty and Institute sought:

“to consider the ways in which the expression ‘policyholders’ reasonable expectations’ [had] been used in practice and to recommend how it should be regarded within the UK actuarial profession.”

- 2.20.2 The Working Party carried out a series of interviews with Appointed Actuaries and attempted to distil key principles. In the event, none of the Working Party’s recommendations became mandatory and no formal guidance resulted. However, some of the principles which were recorded still serve to inform Appointed Actuaries as they prepare advice for their boards of directors.

- 2.20.3 The following paragraphs from the Working Party’s reports are relevant:

“The primary expectation of policyholders is that all guaranteed benefits will be met in full, regardless of the type of contract. It is also fundamental that the policyholder has the right to expect that the company’s affairs will be managed ethically and with due competence and diligence.

Many life assurance contracts include at least one discretionary element...

The holders of such contracts may reasonably expect that life offices will behave fairly and responsibly in exercising the discretion which is available to them. They may also expect a reasonable degree of continuity in an office’s approach to determining variable charges or benefits. Although these are imprecise concepts, there appears to be a fair measure of agreement among actuaries as to how they should be applied in practice.

For with-profits business, PRE will be focused on the total benefit payable in the event of a claim. Policyholders are entitled to expect that benefits will reflect the accumulated value of premiums paid less expenses and the cost of risk benefits, in accordance with the actual experience of the office. In actuarial terminology, asset shares should provide the starting point for determining maturity benefits. The degree to which returns are smoothed over time, and the extent to which part of the asset share is retained to finance future expansion, will vary considerably between offices. It is reasonable to expect that an office will change its policy in these areas only gradually; a sudden move from a passive to an active terminal bonus policy could be considered unreasonable.

...

In general, gradual changes are more likely to be accepted by policyholders as reasonable than major discrete changes. Communication with policyholders during the currency of their policies plays an important part in shaping their expectations and may help to avoid potential problems. Policyholders and their advisers will normally expect continuity in all areas of a life office's operations, including not only new business, investment policy and bonus philosophy but also general culture and management style.

...

In the final analysis it is the [prudential regulator] who is required to decide whether a company may be unable to fulfil the reasonable expectations of its policyholders. Interviews with representatives of the Department of Trade and Industry and the Government Actuary's Department have confirmed that there is no predetermined view of where the dividing line between reasonable and unreasonable behaviour lies; each case is considered according to the individual facts and circumstances."

2.20.4 The concept of PRE was the subject of a Ministerial Statement on 27 February 1995. This set out the views of the DTI (which, at that time, was the prudential regulator) of the factors which influenced PRE in respect of the attribution of surpluses in with-profits funds. These were:

- (a) the fair treatment of policyholders *vis-à-vis* shareholders;
- (b) any statements by the company as to its bonus philosophy and the entitlement of policyholders to a share in profit; for example, in its Articles of Association or in company literature;
- (c) the history and past practice of the company; and
- (d) general practice within the life insurance industry.

2.20.5 Implicit in this Ministerial Statement was that policyholders have a reasonable expectation that the terms of their contract will be met but that PRE may also extend beyond the contractual or other legal rights of the policyholder. This has generally been accepted by the actuarial profession and was specifically endorsed by the Vice-Chancellor in his judgment at first instance in the Equitable Life case.

2.21 The role of the Appointed Actuary with regard to PRE

2.21.1 In the first instance it is the responsibility of the company, with the advice of its Appointed Actuary, to ensure that it acts in a manner which has regard to PRE. The Appointed Actuary of a life insurance company has the primary role within the company of interpreting PRE in order to advise the board of directors.

2.21.2 GN1 contains a number of references to the Appointed Actuary's responsibilities in relation to PRE including the following:

"It is incumbent upon all Appointed Actuaries to ensure, so far as it is within their authority, that the long-term business of the company is operated on sound financial lines and with regard to its policyholders' reasonable expectations."

“It is part of the Appointed Actuary’s continuing responsibility to advise the company of the Appointed Actuary’s interpretation of its policyholders’ reasonable expectations. In general terms this interpretation should have regard to the broad nature of the company and its approach to the treatment of policyholders both individually and (where appropriate) collectively as a group *vis-à-vis* shareholders. When a significant change is likely to take place, the Appointed Actuary should take all reasonable steps to ensure that the company appreciates the implications for the reasonable expectations of its policyholders. It is also incumbent upon the Appointed Actuary to take all reasonable steps to ensure that the company’s incoming policyholders should not be misled as to their expectations.”

“Under the insurance legislation it is a requirement for continuing authorisation that the company should fulfil certain criteria of sound and prudent management. These criteria are set out in the legislation and include the need for insurance business to be conducted with due regard to the interests of policyholders and potential policyholders. In formulating advice to be given to the company, the Appointed Actuary must take account of these interests.”

“When assessing the liabilities of the long-term business of the company the Appointed Actuary must also have regard to policyholders’ reasonable expectations.”

“The possibility of insolvency, or intervention by the Supervisory Authority on the grounds of the company being unable to fulfil the reasonable expectations of its policyholders, may arise from factors, some of which are within the control of the company and some not. To the extent that they are under the control of the company, it is the Appointed Actuary’s duty to assess the limits within which the company must act and to advise the company of the necessity for these limits.”

“The Appointed Actuary must justify any recommendations regarding the allocation [of profits] and its consequences (if any) for the conduct of the company’s business by reference as appropriate to the Appointed Actuary’s:

- (a) appraisal of the relevant experience;
- (b) understanding of the company’s financial and business objectives;
- (c) assessment of the company’s continuing ability to meet its statutory solvency requirements; and
- (d) interpretation of the reasonable expectations of the company’s policyholders having regard to (a), (b) and (c). Such expectations are clearly influenced by policy literature and other publicly available information such as own charge illustrations. The Appointed Actuary should assume that among the conditions for the fulfilment of those expectations are:
 - (i) that, in the recognition and allocation of profits in accordance with the company’s terms of participation and its policy in respect of [the nature and timing of allocations of profits], groups of participating

policies are appropriately and equitably distinguished having regard *inter alia* to the terms of the policies, their duration and their relevant pooled experience; and

- (ii) that the company conducts its affairs, including its new business and investment strategies, with due regard for its financial resources.”

2.21.3 There are also other Guidance Notes that are “recommended practice” (compliance with which does not need to be certified) that refer to PRE. It is noticeable however that the requirements *vis-à-vis* PRE are not prescriptive. This may be recognition that the ICA 1982 provides legitimate flexibility, for example, to accommodate cases where the reasonable expectations of different classes of policyholders might be contradictory.

2.22 Role of the regulator with regard to PRE

2.22.1 IFSD described its role with regard to PRE as follows:

“In the first instance it is the responsibility of the company, with the advice of its [Appointed] Actuary to ensure that it acts in a manner which has regard to PRE.

...

The regulator’s role is not to proactively and routinely review the consistency of companies’ decisions with PRE and it does not automatically receive all the necessary information or have the resources to do so. Hence its approach is to review cases in response to complaints or information included in annual returns and any other information that comes to light that may cast doubt over the ability of a particular company to meet PRE or raises questions as to whether a company has acted (is acting or proposing to act) in a manner which is not consistent with PRE.”

2.23 The Role of the Prudential Regulator

2.23.1 The way in which the role and involvement of the prudential regulator has evolved over recent years is significant to a proper understanding of what the regulator perceived to be its role and how that was changing during the Review Period.

2.23.2 In February 1993, ID consisted of a department of about 24 staff split into four sections, only two of which dealt with life insurance companies. The total resource committed at that time to life insurance companies including composites was eleven. This team was supported by GAD which, at that time, had about eight actuaries (including two trainees), two Chief Actuaries and a high proportion of the time of the Directing Actuary.

2.23.3 The staff numbers responsible for life insurance remained broadly stable up to the beginning of the financial year 1998/9 when authority was received to increase the headcount to 19.

2.23.4 In January 1999, when HMT-ID transferred to the FSA it was joined by the supervisory staff of the Friendly Societies Commission.

2.23.5 We have set out above²⁸ the breakdown of the staff involved in the prudential regulation of life insurance companies at the beginning and at the end of the Review Period. To summarise, on 1 January 1999, the total number of staff involved in the prudential regulation of approximately 200 insurance companies (including the staff at GAD but excluding administration and secretarial staff) was less than 35. By way of comparison, there were approximately 135 staff (excluding administration and secretarial staff) involved in the regulation of approximately 400 authorised UK banks, building societies and UK branches of non-EU institutions.

2.23.6 The change in the level of involvement of the prudential regulator and its relationship with GAD during the 1990s was described to us:

“I noticed a significant change from the time I had last been involved back in 1992, and the time I returned to it in 1998. The division, first in the DTI then in the Treasury, had expanded somewhat and I think considerable improvement had been made in that time in the quantity and quality of staff involved in the supervision. I think there was, by the time I returned...a much better partnership arrangement between the division and GAD. I think...when I was first involved in the insurance division, GAD had been very much the dominant player in life supervision. Partly it was because they had more resource, partly because they had more expertise. And there was really not the opportunity then, certainly on a regular basis, to challenge and to understand properly the views that we were provided with by GAD. I think that there were particular cases where we needed to get involved in some detail, then ...in those cases challenge had happened and had been productive and useful. But for the generality of supervision, it was in effect subcontracted to GAD for the Life industry. But this had changed considerably by the time I returned.”

2.23.7 As regards the role of the regulator, IFSD sees it as one that is:

“limited to monitoring that companies comply with their regulatory obligations and exercising, as appropriate, the powers available to it where a company fails to do so. It is not for the regulator to question the strategy or course of action pursued by a company if it does not bring it into conflict (or significant risk of conflict) with the regulatory requirements.”

2.23.8 Others in IFSD have described their approach as follows:

“I think we start from the proposition that the present financial disclosure regime is prescribed in statute, and the disclosures are made by the companies but with substantial input from and validation from the Appointed Actuary. We have the Appointed Actuary being given statutory duties, having professional duties, and quite effective discipline from his professional body. I think the system as a whole placed a lot of weight on the disclosure regime and the professional competence of the Appointed Actuary and the professional discipline imposed on the Appointed Actuary.....A lot of emphasis is placed on the Appointed Actuary. But I don't think that we ever believed that that should be the end of the matter; or that what the Appointed Actuaries said, should go without challenge. But in practicality, I think that challenge was focused where there was some reason to

²⁸ Under the sections headed “IFSD” and “GAD”.

feel that what the Appointed Actuary was doing was questionable or doubtful or whatever.”

“The context of the regulatory framework that we brought with us and we are still operating under prior to N2 is a context which...is one of freedom with disclosure for insurance companies. I think that indicates that the threshold for what you describe as interference is quite high. The basic approach is that there is a legislative framework, and there are regulations under the statute, and companies have to obey... Those regulations in turn are underpinned by actuarial guidance, professional guidance. Provided that framework is adhered to, we would not expect to intervene.....The directors of a company have freedom to decide how to run their business and we have never tried to second-guess that. Our job is to see whether the way they are running their business is consistent with the principles of sound and prudent management in the terms of the Act. And...the criteria of sound and prudent management, are also set out in an annex, as part of the legislation, so they are pretty precise tests and they are quite high tests.”

Conduct of Business Regulation

2.24 Self-Regulating Organisations

- 2.24.1 The FSAct 1986 regulates the conduct of investment business by means of a system of self-regulation. Under the FSAct 1986, no person may carry on investment business unless authorised to do so or exempt²⁹. One of the ways of obtaining authorisation is to join a “self-regulating organisation” (“SRO”) which is itself recognised by the “designated agency” under the FSAct 1986 (formerly the Securities and Investments Board (“SIB”) and now the FSA). The SROs are financed by their members and supervise their members by reference to their particular rulebooks.
- 2.24.2 The FSAct 1986 provides that, in order to obtain recognition, a SRO must comply, *inter alia*, with the following requirements:
- (a) the SRO must have rules governing the carrying on of investment business by its members such as to afford an adequate level of protection for investors;
 - (b) the SRO must have adequate arrangements and resources for the effective monitoring and enforcement of compliance with its rules;
 - (c) the SRO must have effective arrangements for the investigation of complaints against the SRO or its members; and
 - (d) the SRO must be able and willing to promote and maintain high standards of integrity and fair dealing in the carrying on of investment business and to co-operate, by the sharing of information and otherwise, with the Secretary of State

²⁹ Section 3 FSAct 1986.

and any other authority, body or person having responsibility for the supervision or regulation of investment business or other financial services³⁰.

- 2.24.3 Prior to July 1994, the sale of retail investment products was, to a large extent, governed by two SROs:
- (a) the Financial Intermediaries Managers and Brokers Regulatory Association (“FIMBRA”); and
 - (b) the Life Assurance and Unit Trust Regulatory Organisation (“Lautro”).
- 2.24.4 FIMBRA was responsible for a large number of generally small intermediaries such as independent financial advisers (“IFAs”); Lautro’s membership comprised the life insurance companies and the unit trusts. In July 1994, the PIA was recognised as a new SRO with responsibility for retail investment business and the great majority of FIMBRA and Lautro members became members of the PIA.
- 2.24.5 Equitable Life was a member of Lautro and, in July 1994, it joined the PIA.
- 2.24.6 Although the PIA was not recognised as a SRO until July 1994, the fact that it effectively took over from FIMBRA and Lautro and adopted some of the rules of those SROs means that a member of Lautro, such as Equitable Life, would be subject both to the Lautro Rules adopted by PIA, which had been in force since 29 April 1988, the date on which the FSA came into force (referred to as “A” Day), and the PIA Rules introduced in July 1994 (although the latter would only apply to activities carried out since July 1994).

2.25 PIA Rules

- 2.25.1 The PIA Rules regulate the activities of dealing, arranging deals, managing and advising. The PIA Rules begin with the ten adopted SIB Principles which, *inter alia*, demand that a firm should:
- (a) observe high standards of integrity and fair dealing;
 - (b) act with due skill, care and diligence;
 - (c) observe high standards of market conduct;
 - (d) seek from customers it advises or for whom it exercises discretion any information about their circumstances and investment objectives to enable it to fulfil its responsibilities to them; and
 - (e) take reasonable steps to give a customer it advises....any information needed to enable him to make a balanced and informed decision.
- 2.25.2 The detailed Rules which follow the Principles require, *inter alia*, that as regards:
- (a) Information given to policyholders: A member must ensure that anything said or written or any document sent, given or shown to an investor or potential investor

³⁰ Schedule 2 FSAAct 1986.

by the member on its behalf is clear, fair and not misleading either in design or content³¹.

- (b) Advertisements: A member must ensure that advertisements do not contain statements of fact, promises, forecasts or opinions which are misleading or untrue, or in respect of which the member does not at the time have reasonable grounds for believing them to be true³².
- (c) Recommended transactions: Where a company representative recommends an investor (*inter alia*) to buy a life policy, to vary the terms of an existing life policy, to sell, convert, cancel or surrender a policy or suspend the payment of premiums or to elect to make pension fund withdrawals, the member must ensure that the investor is sent or given a written explanation which, *inter alia*, makes clear why the recommendation has been made (having regard to the investor's circumstances)³³.
- (d) Advice: A company representative, who has dealings with an investor, must give the investor all relevant information and use his best endeavours to enable the investor to understand the nature of any risks involved. In addition, a company representative must use his best endeavours to ensure that he recommends only that contract or those contracts which are suited to that investor, and that there is no other contract available from the member which would secure the investor's objectives more advantageously³⁴.

2.25.3 These Rules only apply to insurance companies to the extent that their business comprises "the marketing of investments and any business which is carried on in connection with the marketing of such investments"³⁵. Marketing is defined as:

- (a) "selling and procuring the sale of packaged products³⁶ and advising persons on such products and on the exercise of the rights conferred by them; and
- (b) activities ancillary to (a) above."

2.25.4 One of the consequences of this definition of marketing is that the Rule relating to information provided to investors only applies to information provided in the context of selling and advising and not to routine administrative information³⁷. This has some relevance in the context of the bonus notices issued by Equitable Life.

2.25.5 The PIA regulatory regime relies heavily on member firms regulating themselves. Under the Rules a member is required to monitor adequately its own staff and representatives to ensure compliance with the Rules and to ensure that the conduct of the staff and representatives is fit and proper. In the event of a material breach of these requirements, the member must take its own action to remedy the breach, to

³¹ Rule 4.1 We understand that the Lautro Rules did not have an equivalent to this rule. Documents issued between 1988 and 1994 would have to be assessed against the relevant Lautro Rules that were in force at that time.

³² Adopted Lautro Rule L6.6.

³³ Adopted Lautro Rule L3.15.

³⁴ Adopted Lautro Rule, Schedule 2(L8).

³⁵ Table 1C - PIA Rule 1.3.

³⁶ The term 'packaged products' includes any life policy, including a pension contract.

³⁷ See PIA (Commencement and Transitional Provisions) Rules 1994 Table 1C and Glossary.

ensure the customer who has suffered loss or damage receives redress, and to inform the PIA³⁸.

2.25.6 As IB-PIA³⁹ told us:

“It is first and foremost the responsibility of regulated firms to comply with their regulatory obligations. A large firm like Equitable has dedicated compliance professionals tasked with ensuring that they meet those obligations. The role of the regulator has been one of checking and monitoring that compliance, but regulators are quite properly not resourced to prevent or identify all breaches.”

2.26 PIA’s Service Level Agreement

2.26.1 Until N2 when the FSMA 2000 comes fully into force, the PIA retains responsibility for continuing to satisfy the criteria for recognition as a SRO under the FSAct 1986. In particular, it retains responsibility for determining (and, if necessary, varying) its policies, Rules and practices as to membership, admission, expulsion, discipline, safeguards for investors and arrangements for taking account of the costs of compliance.

2.26.2 In the interim, the PIA has entered into a service level agreement (dated 25 May 1998) with the FSA which took effect on 1 June 1998 (the “PIA SLA”). Under the PIA SLA, the FSA agrees to perform the PIA’s function of monitoring compliance with the PIA Rules and to second staff to the PIA for the purpose of carrying out other regulatory functions (including the function of enforcing compliance with the Rules)⁴⁰. As a result, by June 1998, the majority of the staff formerly employed by the PIA had become employees of the FSA.

2.26.3 We understand that similar arrangements were made between the FSA and the other SROs. The purpose of these agreements was to devolve as much management responsibility as possible to the FSA whilst leaving the SROs with legal responsibility for their obligations under the FSAct 1986. The agreements were intended to give the SROs the comfort that those obligations would be carried out to the requisite standard.

2.26.4 The standard of service required is that the FSA must use its best endeavours to carry out these functions to no less a standard than that which will enable the PIA to be satisfied that it can meet the criteria for recognition as a SRO⁴¹. In addition the PIA Board must be provided with a quarterly written report on the operation of the services provided⁴².

2.26.5 A schedule to the PIA SLA sets out detailed performance standards and reporting requirements relating to the different functions of a SRO. In relation to “Supervision”, the FSA’s general responsibilities are:

³⁸ Rule 7.2 PIA Rules.

³⁹ See paragraph 2.27 below.

⁴⁰ By paragraph 4(1) of Schedule 2 to the FSAct 1986 the PIA is required to have adequate arrangements and resources for the effective monitoring and enforcement of compliance with its rules and by paragraph 4(2) of Schedule 2 to the FSAct 1986 the PIA may provide for its monitoring functions, but not its enforcement functions, to be performed on its behalf (without affecting its responsibilities for such functions) by any other body or person who is able and willing to perform them.

⁴¹ Section 3.1.

⁴² Section 3.6.

- (a) “To monitor the operations of member firms, in accordance with the plans agreed with the PIA Board, to ensure they are complying with PIA regulations and highlight cases requiring enforcement action;
- (b) To provide advice to member firms and FSA staff on the application of the [FSAct 1986], the PIA Rules and other regulations which apply;
- (c) Carry out desk based monitoring including reviewing returns from regulated firms...[and] assessing complaints⁴³; and
- (d) Visit all newly admitted firms within six months of admittance to the PIA.”

2.27 Conduct of Business Regulation - The Regulator

- 2.27.1 During the Review Period, the functions of the various SROs for which the FSA is responsible under the service level agreements were carried out by the Investment Business Division of the FSA. This division (known as (“**IBD**”)) was headed by a FSA director and was divided into 4 departments, 3 of which dealt with the business of the SROs for which the FSA was responsible. The department responsible for carrying out the functions of the PIA under the PIA SLA was known as “**IB-PIA**”. The fourth department was “**IB-Policy**” which dealt with the policy development issues relating to the three SROs, including homogenising the different conduct of business rulebooks. IB-Policy also contained a team with some actuarial expertise.
- 2.27.2 IB-PIA contained 13 supervision teams and responsibility for monitoring member firms was divided among these teams. Each supervision team, headed by a Team Manager, comprised desk and field based officers and was given responsibility for monitoring approximately 350 to 400 firms each including a mixture of product providers (such as Equitable Life) and IFAs. The majority of the time of a field based officer was spent conducting visits to the member firms for which the relevant team was responsible, whilst the desk based officers conducted follow-up work such as responding to queries on the visit report and monitoring the firm’s on-going compliance. The team responsible for Equitable Life was Supervision Team 4.
- 2.27.3 IB-PIA also contained some “stand-alone” specialist teams including the Supervision Practice Team (“**IB-PIA (Supervision)**”) and the Advertising Supervision Team (“**IB-PIA (Advertising)**”). IB-PIA (Supervision) started life as a helpline answering queries regarding the PIA Rules from both member firms and arising within the FSA. In summer 1999, it ceased to answer external queries (which became the responsibility of the particular supervision teams) but it continued to provide a support service internally. IB-PIA (Advertising) was responsible for monitoring advertising by member firms as well as dealing with complaints about advertising and assisting the field supervision teams where necessary.
- 2.27.4 IBD and IB-PIA also had access to:
- (a) lawyers within GCD; and

⁴³ Schedule 1, part 2.

- (b) a department known as Regulatory Enforcement (PIA firms/Bank Investigations) (“**Enforcement**”) within a separate Enforcement Division, headed by a FSA director.

2.28 Conduct of Business Regulation - The Approach

- 2.28.1 Consistent with the team structure, the way in which the conduct of business regulator managed its responsibilities in respect of life insurance companies during the Review Period falls broadly into the following five areas:
- (a) It subjected new members to an authorisation process;
 - (b) It supervised its members on a proactive basis by deploying field based officers to carry out supervision visits to check that the member firm’s processes and the advice being given to investors were compliant. Desk based co-ordinators handled correspondence with the member firms following field supervision visits and dealt with miscellaneous correspondence;
 - (c) It monitored advertising and dealt with complaints about advertising within IB-PIA (Advertising);
 - (d) It referred consumer complaints to the PIA Ombudsman; and
 - (e) It referred alleged Rule breaches to Enforcement for investigation and, if appropriate, disciplinary action. Rule breaches were referred either by the supervision teams following a visit or came to light as a result of consumer complaints or notifications made by the member firms themselves.
- 2.28.2 The principal way in which the PIA monitored compliance with its Rules during the Review Period was by carrying out supervision visits to its member firms. The number of member firms for which each team was responsible means that visits were not a frequent occurrence. The regularity with which they took place depended on the risk evaluation of each firm but the interval between visits generally varied between 12 months and 36 months.
- 2.28.3 Prior to and during the Review Period, the FSA was moving towards a more flexible approach to supervision visits which was much more risk-based and sought to direct resources to the areas that needed most attention, based on the intelligence obtained in relation to particular firms from various sources including returns, comments in the press and consumers. In other words, IB-PIA was engaged in a constant process of identifying risks and intelligence to determine where to focus its supervisory effort to best effect.
- 2.28.4 IB-PIA described this new approach to us:
- “Post the service level agreement in 1998, in IB-PIA we introduced a new approach to supervision which basically sought to be much more risk-based, risk-focused, more targeted and more resource and cost efficient. What we were trying to do was to get away from a rigid .. sort of approach to an approach that actually tried to direct resources to the areas where it looked as though they were needed.”

- 2.28.5 As a result of this approach, it was intended that IB-PIA should have a closer relationship with the bigger firms or those whose risk profile gave cause for particular concern whilst the smaller firms would only be visited if there was a particular reason to do so.
- 2.28.6 Accordingly, whilst IB-PIA continues to conduct routine “monitoring” visits encompassing a whole range of different areas⁴⁴ (particularly in relation to large firms) there has been a move towards:
- (a) “focused” visits to particular firms concentrating on particular issues rather than on the whole spectrum of the firm’s activities; and
 - (b) “themed” visits to a number of firms concentrating on issues that have application across a particular industry (such as the insurance industry), or which affect consumers of a certain type (such as people who have purchased a particular product).

2.29 The Conduct of Business Regulator - Enforcement

- 2.29.1 As set out above, the PIA SLA provides that the FSA will second staff to the PIA for the purpose of enforcing compliance with the PIA Rules. In practice, this function is carried out by a department known as “Enforcement”.
- 2.29.2 This department investigates particular cases referred to it by IB-PIA and carries out disciplinary action against member firms as required under the PIA SLA (which requires the FSA to investigate cases which suggest significant Rule breaches, investor losses or unwarranted risks to investors and to undertake such disciplinary action as may be required in a fair and timely manner).
- 2.29.3 The PIA’s formal powers of intervention include prohibiting a member from entering into specified types of transactions or soliciting business from persons of a specified kind or carrying on business in a specified manner. These powers may be exercised where it appears necessary or desirable in the interests of investors or where the company has contravened PIA Rules or provisions of the FSAct 1986⁴⁵.
- 2.29.4 The PIA also has a number of disciplinary powers which include issuing reprimand orders, imposing fines and ordering the expulsion of a member from the PIA⁴⁶. These powers can be exercised in respect of a failure to comply with the PIA Rules.
- 2.29.5 However, the exercise of the powers is subject to the following provisos:
- (a) pursuant to provisions of the ICA 1982, the PIA may not intervene in relation to a regulated insurance company on any of those grounds which relate to the ability of the company to meet its liabilities to policyholders; this is a matter for the prudential regulator under the ICA 1982⁴⁷; and

⁴⁴Particularly in relation to large firms which the PIA may visit in order to get to know the firm and gather information.

⁴⁵ PIA Rule 9.

⁴⁶ PIA Rule 10.4.3.

⁴⁷ Schedule 10(6) FSAct 1986.

- (b) before exercising certain powers, (such as restriction of business, restriction on dealing with assets and vesting of assets in a trustee⁴⁸) the PIA must first notify the prudential regulator who has a power of veto⁴⁹.

2.30 The Role of the PIA

2.30.1 The following documents describe IB-PIA's objective:

- (a) the Overall Assessment and Co-ordinated Supervisory Programme ("OA-CSP") drafted by IFSD towards the end of 1999:

"to identify instances of investor risk, establish what range of procedures the firm has for its sales force and how robust they subsequently are, together with ensuring that they comply with PIA Rules."

- (b) A document setting out IB-PIA's objectives for the year 2000/01 indicates that IB-PIA's high level objective is to:

"be proactive in identifying regulatory threats and respond effectively to new regulatory responsibilities" and "continue to develop the regulatory approach to become less mechanical, rigid and reactive; and more judgmental, proactive & relevant for firms' business."

2.30.2 The FSA has described the role and approach of the PIA in the following terms:

- (a) "The PIA tradition is at the more passive end of the supervisory process, by which I mean that they have an enormous number of firms. The nature of their supervision, I would say, is much more reactive than proactive - has been traditionally - partly in the face of this huge number of firms, partly in the nature of the staff that they had, but also in the nature of the Board they have had, Lautro and FIMBRA, we are all prisoners of our history. Their history of supervision has been rather reactive rather than proactive. I think the second point to make is that I think they have been comforted in that, by the fact that the compensation scheme exists, the Ombudsman scheme and the compensation schemes exist to provide ex-post protection, a safety net and clearly, if you have that, the importance of taking an early proactive decision is less if- as far as the consumer is concerned - any detriment can be addressed after the event."
- (b) "A key point is that a typical field team is responsible for supervising perhaps 350 - 400 firms. [The SRO approach] puts the responsibility for delivering compliance clearly on the regulated firms. They (in particular larger product provider firms) have specialist resources and processes to ensure that they meet the required standards. The regulator's job is to check the application of those processes in practice and to handle problems it identifies through its visit or other supervisory processes, or through other intelligence."
- (c) "Where we are moving to, I think, is...an environment whereby we actually spend more time with the bigger players and try and get more proactive with

⁴⁸ ss 65-67.

⁴⁹ Schedule 10(6)(3) FSAct 1986.

them. So the relationship would be not just with the compliance people, where it predominantly is now, but also with the chief executive, marketing director ... So we understand much better, we get closer to the business strategies of these firms, we understand what makes them tick better and then we can assess what risk management needs to be around that sort of fundamental business value and strategy and make sure the risk management people in the firm, compliance people are dealing with that. The intention there being that you get to the heart, you understand what is going on earlier and you can nip issues in the bud before they become problems.”

2.31 The PIA Ombudsman and Complaints

- 2.31.1 Under the PIA Rules, member firms have an obligation to establish and maintain a proper procedure for handling complaints and a firm applying for membership of the PIA will not be admitted unless its complaints system complies with the framework set out in the PIA Rules. The firm is also required to explain to the complainant that if he or she is not happy with the outcome of the firm’s investigation, the complaint may be referred to the PIA Ombudsman and is obliged to co-operate with the PIA Ombudsman in relation to any on-going investigation and to comply promptly with any awards made by the PIA Ombudsman in due course.
- 2.31.2 The PIA Ombudsman is a subsidiary of the PIA and its Terms of Reference are issued by the Board of the PIA in accordance with the PIA’s Articles of Association. Under the Terms of Reference, the PIA Ombudsman has jurisdiction to resolve complaints made against firms regulated by the PIA. The Terms of Reference also cover procedure, settlements, awards and recommendations, limitations and test cases. On receipt of a complaint, the PIA Ombudsman must investigate and facilitate the satisfaction, settlement or withdrawal of the complaint by whatever process seems expedient.
- 2.31.3 This service is available to consumers without charge. However, the complainant is not bound by the PIA Ombudsman’s determination and may subsequently choose to bring court proceedings against the particular firm. In addition, the PIA Ombudsman may relinquish jurisdiction over a complaint if the firm which is the subject of the complaint serves a notice containing a statement that the complaint involves an issue which may have important consequences for firms generally, or an important, or novel, point of law. This occurred at the beginning of the Review Period when Equitable Life decided to initiate the Court proceedings to test the lawfulness of its terminal bonus practice.
- 2.31.4 Any complaints against firms received by the PIA or IB-PIA are simply referred to the PIA Ombudsman, unless there is a particular issue relating to the firm’s practices that needs to be considered by the PIA or there are compliance implications.
- 2.31.5 Under the Terms of Reference, the PIA Ombudsman is required to submit an annual report to the PIA Board containing a general review of its activities and to inform the PIA of any failure by a firm to provide information to the PIA Ombudsman during the course of an investigation. In addition to this formal communication there is also some informal contact between IB-PIA and the PIA Ombudsman but, essentially, IB-

PIA relies on the PIA Ombudsman to bring to its attention particular complaints or a series of complaints in relation to a particular issue.⁵⁰ We understand that IB-PIA regards the PIA Ombudsman as a convenient source of information in relation to the activities of member firms and that information from the PIA Ombudsman can trigger action by IB-PIA. For example, if IB-PIA became aware of a large number of complaints in relation to a particular issue, a “focused” visit or “themed” visit might be triggered. Information about complaints would also be relevant to the assessment of the risk rating of a particular firm and its compliance with the PIA Rules.

Interaction: Prudential and Conduct of Business Regulation

2.32 Introduction

- 2.32.1 The jurisdictional boundaries between prudential and conduct of investment business regulators are prescribed by the ICA 1982 and the FSAct 1986. Certain of the provisions of the ICA 1982 are disapplied in respect of insurance contracts which constitute investment business and to which the FSAct 1986 applies⁵¹. Similarly, the application of some of the provisions of the FSAct 1986 is restricted in the case of insurance companies in recognition of the fact that these companies are subject to certain provisions of the ICA 1982⁵².
- 2.32.2 The FSAct 1986 provides that, where an insurance company is regulated by a SRO (such as the PIA), that organisation must take proper account of the regulation applied under the ICA 1982⁵³. The only aspects of an insurance company’s business which are subject to conduct of business Rules are:
- (a) procuring proposals for policies which constitute investment business and advising persons on such policies and the exercise of the rights conferred by them;
 - (b) managing the investments of pension funds, procuring persons to enter into contracts for the management of such investments and advising persons on such contracts and the exercise of the rights conferred by them; and
 - (c) matters incidental to (a) and (b) above⁵⁴.
- 2.32.3 The regulations under section 72 of the ICA 1982 (insurance advertisements) are disapplied to the extent that any advertisement relates to a contract of insurance the rights under which constitute an investment for the purpose of the FSAct 1986. Similarly, the requirements under sections 74 to 77 of the ICA 1982 are disapplied in respect of long-term insurance business which is investment business (intermediaries in insurance transactions, statutory notice by insurer in relation to long-term policy,

⁵⁰ IB-PIA (Supervision) did provide occasional support to the PIA Ombudsman in relation to PIA and Lautro Rule interpretation, complainants that the PIA Ombudsman could not help and where the complainant wanted to discuss issues with somebody else.

⁵¹ Sections 72, 74 - 77 ICA 1982 are disapplied in respect of long-term insurance contracts which are investment business Schedule 10(5) FSAct 1986.

⁵² Sections 65 -67 - see Schedule 10 paragraphs 6(3) and (4) FSAct 1986.

⁵³ Schedule 10(3).

⁵⁴ Schedule 10(4).

right to withdraw). This is in recognition of the fact that the conduct of business Rules in respect of this business which apply are those prescribed by the FSAct 1986.

- 2.32.4 As outlined above, the enforcement powers under the FSAct 1986 are also modified in respect of regulated insurance companies to ensure that decisions which impact on the prudential aspects of an insurance company's business are referred to the prudential regulator. Powers of intervention under the FSAct 1986 may not be exercised for reasons relating to the ability of an insurance company to meet its liabilities to policyholders or potential policyholders (as this is a matter for prudential regulation under the ICA 1982). The PIA may not exercise powers under sections 65 (restriction of business), 66 (restriction on dealing with assets) and 67 (vesting of assets in trustee) if HMT has served a notice directing it not to do so. Similarly, where a SRO (such as PIA) proposes to exercise any powers corresponding to those above (for example, restricting the scope of business an insurance company can carry out under its rules) it must notify its intention to HMT and HMT may direct it not to do so.

2.33 Co-ordination of Work

- 2.33.1 Prior to 1 January 1999 the two regulators were, and operated as, entirely separate entities and there was no formal or structured channel of communication between them.
- 2.33.2 After 1 January 1999, reporting arrangements were put in place so as to encourage bilateral interaction:
- (a) "ChairCo" Meetings: These were attended by the two Managing Directors of the FSA, the Chief Operating Officer and Howard Davies. The meetings concentrated primarily on management issues such as staffing and cost control. Quarterly Reports from each of the divisions of the FSA (including IBD and IFSD) were directed to Chairco.
 - (b) "ExCo" (later "DirCo") Meetings: These were attended by directors of the FSA including the directors of IBD, IFSD and Enforcement. They were held on a weekly basis. The purpose of these meetings was to discuss key policy development and broad regulatory issues.
 - (c) Firms and Markets Committee ("FMC"): This was established in mid-2000 and met weekly. It was chaired by Howard Davies (or one of the Managing Directors, if he was not available) and was principally attended by members of ChairCo and those directors with direct regulatory responsibility. It focused on firm and market related issues.
 - (d) Bilateral Liaison Meetings: These were held bi-monthly between IFSD and IB-PIA and were instituted in early 1999. Typically, these were attended by representatives from group and senior management and by staff who had firm-specific issues to raise. The meetings would involve discussion on current regulatory issues, industry developments and specific issues on firms.

- (e) Financial Supervision and Management meetings: (chaired by Michael Foot) which “would concentrate on management type issues - but it was a forum for people to mention hot issues in their area”.
- (f) Supervisory Co-ordination Meetings were set up as a pilot scheme to allow IB-PIA staff to get a better understanding of how IFSD staff operated, the issues they considered and the sort of intelligence it held on different firms.

2.34 Lead Supervision

- 2.34.1 In addition, the creation of a single national regulator gave rise to the opportunity to develop a formal system of co-ordination between the different regulators. The system that was adopted by the FSA from banking supervision practice was known as “lead supervision”. Essentially, lead supervision is intended to promote the sharing of information between and co-ordination of all the different regulators which supervise a particular entity. This is facilitated by the appointment of one of the regulatory bodies to be a “lead supervisor”. The lead supervisor is chosen according to the “predominant business test”. Since the business of Equitable Life is predominantly insurance-based, the lead supervisor for Equitable Life was IFSD.
- 2.34.2 Lead supervision was implemented in two stages. The main objective of the first stage was to improve information flows amongst all the regulators who supervise a particular entity. The second stage aimed to build the responsibilities of the lead supervisor by assigning to it three key responsibilities:
- (a) acting as a central point of supervisory contact;
 - (b) maintaining an overall assessment of the group in those areas which are most likely to affect the risks that the group as a whole faces; and
 - (c) co-ordinating the preparation and implementation of a prioritised supervisory programme drawn up in co-operation with all the group’s FSA supervisors.
- 2.34.3 In practice, the lead supervisor co-ordinated the preparation of a OA-CSP which set out the risk rating and the action planned by each regulatory body in respect of the particular entity, including the timing of any visits.
- 2.34.4 The group of individuals with responsibility for a particular entity, comprising one person from each regulator, was known as the “college” and college meetings were instituted as part of the implementation of lead supervision. The purpose of the college meetings was to enable the college members to gain an understanding of the way each division worked and to build working relationships within the FSA to exchange information regarding the particular entity and to co-ordinate the scheduling of visits. The meetings also provided an opportunity for members to discuss particular issues that would influence the regulator’s perception of a firm and how it should be regulated.
- 2.34.5 The first lead supervision training for FSA staff took place in early March 1999 and this laid the foundations for an increased level of co-ordination between IB-PIA and IFSD. The training involved information about how to find counterparts in other regulators, the different regulatory systems, the general basis for exchanging information and the purpose of lead supervision. A list of the individuals assigned to

particular entities from each of the regulatory bodies was generated enabling direct liaison between the appropriate individuals across the FSA departments. In June 1999, IFSD and IB-PIA agreed to pilot supervisory co-operation in respect of 11 firms including Equitable Life.

Chapter Three

Guaranteed Annuities and Solvency of Insurance Companies

Part 1

Guaranteed Annuities

3.1 Introduction

- 3.1.1 The origin of the problem which was eventually to lead to Equitable Life's closure to new business was a guarantee which had been included in a significant number of with-profits pensions policies issued by Equitable Life between 1957 and June 1988. In order to understand how these guarantees had such a substantial impact on Equitable Life and to put the events described in Chapters 4 and 5 in context, it is necessary to describe the nature of these guarantees. This Chapter also describes how the guarantees became increasingly valuable during the 1990s and the approach which was adopted by the Board of Equitable Life to deal with this problem. In Chapter 2 we described the elements of the regulatory regime applicable to insurance companies. The latter part of this Chapter describes the way in which the solvency regime set out in the ICA 1982 operates and the way it applied to these guaranteed annuity policies.

3.2 Equitable Life

- 3.2.1 As a mutual society, Equitable Life has no shareholders. The members are its with-profits policyholders who, in signing a policy proposal form, agree, once the relevant policy is effected, to become a member subject to the Articles of Association. Until the House of Lords' decision in July 2000, Equitable Life was committed to retaining its mutual status.
- 3.2.2 At 31 December 1998 Equitable Life's funds under management exceeded £28billion. Of that sum over £21billion represented the funds backing with-profits policies.

3.3 Long-Term Insurance

- 3.3.1 Insurance policies provide a significant part of the long-term savings market in the UK. In 1999 funds invested in long-term insurance policies in companies and friendly societies amounted to £992billion.
- 3.3.2 Long-term insurance (or "life insurance") policies are of various types including pure protection policies (for example, term insurance), savings policies (for example, endowments) and policies for the provision of an income (for example, annuities). The policies may be paid for by regular defined premiums, a single premium or a succession of "recurrent single premiums" which can vary as the policyholder chooses. If an insurance policy meets certain requirements set by the Inland Revenue, it can be regarded as a pension policy and investors can obtain tax relief on the premiums paid into such a policy.

- 3.3.3 If a policyholder stops paying (regular) premiums before the maturity date specified in the policy, the policy may remain in-force but become “paid up”, although reduced benefits may be paid. Alternatively, the policy may be surrendered or, in the case of pension policies which may not be surrendered for tax reasons, the policy may be transferred to another insurance company.
- 3.3.4 These policies divide between with-profits policies and non-profit policies. Non-profit policies are either “traditional” policies (where the policyholder pays a defined premium for a defined benefit) or unit-linked policies (where the premiums are invested and the policyholder receives the value of his investment).

3.4 With-profits Policies

- 3.4.1 The key feature of a “conventional” with-profits policy is that the premiums paid by the policyholder are greater than required to pay the sum assured. Any profits made (from the extra premiums or elsewhere) allow bonuses to be declared, effectively increasing the sum assured. With a “unitised with-profits” policy, the policyholder’s with-profits account starts with a zero balance and is increased by the premiums paid and by bonuses (which are expressed as percentages of the value of the account). It is the unitised with-profits pension policies sold by Equitable Life which are most relevant to this Report.
- 3.4.2 Typically, two types of bonus are paid:
- (a) A “reversionary” bonus which is declared regularly (usually each year) during the life of the policy. Once allocated to the policy, these bonuses are guaranteed and cannot be taken away even if the value of the underlying investments falls.
 - (b) A “terminal” (or “final”) bonus which is determined only when a claim is paid and is not guaranteed. As set out in more detail below, the discretionary nature of the terminal bonus means that it does not have to be backed by prudent reserves (i.e. provisions made by an insurance company to cover liabilities arising under or in connection with contracts for long-term business).
- 3.4.3 Since terminal bonuses were introduced in the late 1960s, the balance between reversionary and terminal bonuses has changed so that terminal bonus now represents an increasingly higher proportion of the benefits paid to the policyholder. In recent years at Equitable Life, terminal bonus has risen to about 40% of total policy proceeds.
- 3.4.4 Each year the policyholder receives a bonus notice which gives details of the reversionary bonus for the year and sets out the bonuses which have been allocated to the policy to date.
- 3.4.5 One of the advantages of with-profits policies is that they are generally considered to provide investors with the opportunity to benefit from stock market growth without taking the direct risk of investing in equities. The policyholder receives a combination of a growing level of guaranteed benefits over the life of the policy, a lower risk of exposure to stock market down turns and the potential of higher returns at maturity. Although it is not possible to be certain of the final value of a policy

until it matures, the value is less volatile than that of an equivalent unit trust or unit-linked policy.

- 3.4.6 The principal disadvantage of with-profits policies is considered to be lack of transparency. The lack of transparency arises for two reasons: firstly, a wide discretion is given to the directors of life insurance companies in setting bonus levels and secondly, the policyholder is only given details of the bonuses which have been declared to date and does not know how much the terminal bonus will be until the policy matures. A recent report of a Working Party of the Institute entitled "Transparent with-profits - Freedom with Publicity", which was presented in February 2001, noted:

"The over-arching criticism levelled specifically at with-profits investment (rather than at insurance or investment products in general) is the lack of transparency in its operation, particularly in the information presented to customers, which could conceal unfair treatment of policyholders."

- 3.4.7 With-profits policies may include guarantees. An example is that the maturity value of a policy will be at least the sum assured and reversionary bonuses. Depending on the terms of the policy and the practice of the insurance company, the cost of these guarantees might fall on the with-profits fund backing the policy or, in the case of a proprietary company, on shareholders' funds. Alternatively, the expected cost of these guarantees might be included in the premium, with any residual cost (or profit) being charged more generally.

3.5 Asset shares

- 3.5.1 In order to ensure that the total payout to a with-profits policyholder is fair relative to other policyholders, most insurance companies maintain an internal record of the income (being the premiums received and investment return) and outgoings (being expenses, commission, tax and expected cost of claims) relating to each policy. This record is referred to as an 'asset share'.
- 3.5.2 There is no formal definition of an asset share in any regulations. In most life insurance companies, further additions and deductions are considered appropriate; examples include profits on non-profit business, costs of capital and transfers to shareholders. In particular, some life insurance companies may make some adjustment to a policyholder's asset share in respect of any guarantees enjoyed by the policyholder over the lifetime of the policy.
- 3.5.3 By comparing the total asset share for a policy at maturity with the basic sum assured and reversionary bonuses declared to date in respect of the policy, the Appointed Actuary is able to calculate the amount of the terminal bonus so that the total paid out equals the total asset share¹. However, in practice, absolute equality is rarely achieved. The basic calculation of asset share will be the same for all classes of policyholder but the different benefits which are provided by different policies mean that the terminal bonus may differ between the classes of policy. Other factors which mean that absolute equality is rarely achieved include consistency between

¹ Similar comparisons are carried out when a policy is surrendered.

generations of policyholders and competitive pressures. All these factors taken together form a foundation for assessing PRE.

- 3.5.4 Asset shares may be calculated by crediting each policyholder with the actual investment gain (or loss) achieved by the with-profits fund in each year. This type of asset share is known as an “unsmoothed asset share” and its value will vary with the underlying investments. A bonus policy that paid out unsmoothed asset shares would not normally meet the usual policyholder expectation of a smoothed return.
- 3.5.5 Therefore, life insurance companies often calculate an asset share value that is more stable over time, i.e. a “smoothed asset share”. This allows for a hypothetical, rather than actual, investment return. This hypothetical return will not include every “peak and trough” of the stockmarket and could be calculated, for instance, by using a rolling average of the last 5 years actual returns, or the Appointed Actuary’s estimate of the long-term rate of growth adjusted in the light of actual experience.
- 3.5.6 Equitable Life used the term “policy value” to describe smoothed asset share in its bonus notices.

3.6 Annuities

- 3.6.1 In exchange for tax concessions on pension contributions, on maturity (or “vesting”) of a pension policy, Inland Revenue rules require a policyholder to purchase either an annuity or a pension fund withdrawal contract (“**PFW**”)². At its most basic level, an annuity is a contract with an insurance company by which the insurance company agrees to pay a defined amount on a regular basis during the remainder of a person’s lifetime. The annuity may be purchased from the company with which the fund has been accumulated or from another pension provider.
- 3.6.2 There are a variety of different types of annuity and other pension products available on the market. An “immediate” annuity is an annuity which is in payment (i.e. it is being paid to the policyholder). A “deferred” annuity is where the policyholder pays premiums and an annuity is not payable until a number of years later. Most annuities are “level” or increase at a particular rate; some others are with-profits or unit-linked.
- 3.6.3 Each company may offer a different annuity rate (i.e. the level of annuity that is paid for a particular premium). Current annuity rates are based on what an insurance company regards as the expected investment return on a portfolio of medium term fixed interest securities purchased using the proceeds of the policyholder’s pension fund and the anticipated period of payment of the annuity which is dependent on the expected mortality of the policyholder.

3.7 Pension fund withdrawals

- 3.7.1 Another type of pension product which is relevant to this Report is a PFW (or “income drawdown”). In May 1995, legislation was introduced which allowed a policyholder to draw income directly from a personal pension from age 50 with no compulsion to purchase an annuity until age 75. The idea behind a PFW is that the policyholder defers the purchase of an annuity but, in the meantime, draws an

² These are described below.

income direct from the pension fund, which remains invested until an annuity is purchased. Equitable Life had already developed a product along these lines and it became the principal provider in this market. By October 2000, it was estimated to have sold approximately 22,000 contracts.

3.7.2 One of the perceived advantages of a PFW is that it allows the investor to maintain his funds in equities rather than the fixed interest investments usually backing immediate annuities. Although equity prices are more volatile, it is generally believed that they will outperform fixed interest securities over time. However, a PFW is a complicated product and the charges are considered by some to be high. In addition, opting for a PFW involves two particular risks:

(a) that, by the time an annuity is purchased, current annuity rates will have decreased; and

(b) that the pension fund will be reduced by the withdrawal of an income and may be eroded by poor investment performance.

3.7.3 A PFW may only be bought by an investor who has a personal pension plan. An investor with an older pension policy ("section 226 retirement annuity") may only purchase a PFW if the section 226 retirement annuity is first converted to a personal pension before the PFW is purchased. For those policyholders whose policies contain a GAO, this means that the GAO is lost.

3.8 Guaranteed annuities

3.8.1 Some pension contracts contain GAOs. A GAO allows the policyholder, at retirement, to opt to exchange some or all of the amount provided by the pension policy for an annuity at a fixed rate which is set out in the policy. A GAR is the fixed rate at which the cash amount provided by a pension policy is converted to an annuity at the option of the policyholder on retirement.

3.8.2 The GARs provided for under Equitable Life's with-profits policies varied depending on their type as well as the age and sex of the policyholder. Until 1975 the interest rate underlying the guarantee was 4%; after 1975 until 1988 (a period of high inflation) the rate increased to 7%.

3.9 Equitable Life's with-profits GAO policies

3.9.1 Equitable Life issued with-profits policies containing GAR provisions between 1957 and June 1988. No explicit or implicit charge was ever made for the inclusion in the policies of the GARs. The GAR was simply one of the contractual benefits obtained by the payment of the premium by which the policy was effected.

3.9.2 In the evidence which was presented in the Court case, Equitable Life provided details of the numbers of with-profits policies containing GAR provisions which it had issued. Ignoring group policies, there were said to be approximately 116,000 with-profits policies containing GAR provisions in issue which were held by approximately 90,000 persons. Ignoring group policies, Equitable Life stated that there were approximately 300,000 with-profits policies which did not contain provision for GARs in issue which were held by approximately 290,000 persons.

3.9.3 The GAOs offered varied considerably between different insurance companies. At one end of the spectrum some options were specific and inflexible, for example, the GAO applied at a specific date and only if the annuity was taken in a specific form. At the other end of the spectrum, the GAO could be taken at a wide range of dates and for any style of annuity. The GAOs contained in the policies issued by Equitable Life were among the more flexible - policyholders could retire at any time within the permitted age range of 60 to 75 and receive the same benefits as if they had selected that retirement date at the outset.

3.9.4 Although GARs were not included in policies sold by Equitable Life after June 1988, policies sold with GARs before that date remain in force. A policyholder can continue to pay recurrent single premiums into these policies and obtain the benefit of the GAR in respect of such premiums³.

3.10 The emergence of the GAR problem

3.10.1 For many years, current annuity rates exceeded the GARs provided for in Equitable Life's with-profits policies. However, during the 1990s, current annuity rates fell significantly. Two factors are largely responsible for this:

- (a) The yield on government gilts with a 15 year term to maturity fell from nearly 11% at the end of 1990 to just over 4.5%⁴ at the end of 1998. These securities reflect the main investments bought by life insurance companies to provide for annuity income payments. As the interest rate dropped, the level of annuity income that life insurance companies can provide reduced accordingly.

Appendix 7 is a graph which shows the yield on 15 year high coupon gilts between 1976 and 1998.

- (b) Over recent decades mortality rates for individuals purchasing annuities have decreased. The life expectancy for a male purchasing a retirement annuity has increased from 14.9 years in 1975 to 17.6 years in 2000⁵. It is now common practice to allow for further improvements in mortality when calculating annuity rates.

Appendix 8 is a chart which shows at 5 year intervals from 1975 to 2000 the life expectancy of a 65 year old male holder of a retirement annuity in the course of payment.

3.10.2 The combination of both these factors has had a significant impact on current annuity rates during the last 10 years. In May 1990 the annuity rate for a male aged 65 was approximately 15%; by June 1999 it had fallen to approximately 9%. In other words, a typical annuity bought by a 65 year old male in mid-1999 bought an income for life of approximately 60% of the income for life that could have been secured by a man of the same age in the spring of 1990.

³ Following inception of such policies, recurrent single premiums are also known as "top-ups".

⁴ Source: Datastream.

⁵ Source: Actuarial Mortality Tables, standard in 1975 and 2000 published by Continuous Mortality Investigations Bureau.

3.10.3 As a report of the Working Party of the Life Board of the Faculty and Institute in November 1997 (referred to below) noted:

“At the time many of the GAO rates were introduced, during the 1960s and 1970s, it was considered appropriate to use a mortality table with no explicit allowance for future improvement ...and what must have seemed a relatively conservative rate of interest.”

3.10.4 As current annuity rates fell, the GARs became increasingly valuable. For Equitable Life, the GARs began to exceed its current annuity rates between late October 1993 and mid-May 1994. Between mid-May 1994 and mid-May 1995 the position reversed and Equitable Life’s current annuity rates generally began to exceed the GARs by a small margin. However, since mid-May 1995 the GARs have generally exceeded Equitable Life’s current annuity rates; further, the extent to which they have done so has generally increased over time.

3.10.5 Appendix 9 is a graph illustrating the fall in current annuity rates and how the GARs have become increasingly valuable.

3.10.6 The emergence of the GAR problem led to the adoption of a variety of different approaches by insurance companies. Some insurance companies had made an implicit charge for the expected cost of the guarantee against the asset share of a policyholder whose policy contained a GAO. The charge was held in a contingency reserve which was contributed towards the actual cost of the guarantees as they emerged. Policyholders with GAOs at insurance companies which had adopted this approach received lower final payouts because the insurance company had made a charge against the policyholder’s asset share. However, these insurance companies applied the GAR to the total payout received by the policyholder.

3.10.7 Other life insurance companies did not make a specific charge against the policyholder’s asset share. Some of these insurance companies were able to meet the cost of the guarantees from an “estate” held within their with-profits funds. (It can be argued that the estate has arisen from general deductions from, or under-distributions of the asset shares of, previous policyholders, which makes this approach somewhat similar to the first approach except that the charging is more arbitrary.)

3.10.8 Equitable Life had not charged for the GAOs and had not established specific contingency reserves in respect of them. Furthermore, Equitable Life only had a modest estate from which it could meet the cost of the guarantees because of the approach which it had adopted to the distribution of surplus arising in its with-profits fund.

3.11 Equitable Life’s approach to distribution of surplus

3.11.1 Since its incorporation and until the House of Lords’ decision in July 2000, the Board of Equitable Life had adopted a policy which it described as “full and fair” distribution of its surplus to with-profits policyholders. The approach was described in a paper entitled “With Profits Without Mystery” which was presented to the Institute in March 1989 by Mr Roy Ranson (then the Deputy General Manager & Appointed Actuary of Equitable Life) and Mr Headdon:

“The essence of the concept is that we regard with-profits policyholders as participating in a “managed fund”. The premiums they pay, after meeting expenses and the cost of life cover and other benefits and options, are invested in the managed fund. The benefits a policyholder ultimately receives will reflect the value of the assets in the fund attributable to his policy, i.e. that policyholder’s asset share.

...

It may be instructive to consider briefly how the concept has developed. In many ways it is the explicit expression of an attitude which has prevailed in the office for many years. Put simply, that is that the business belongs to the current generations of with-profits policyholders. Those policyholders participate in a pooled fund and, when they leave, should take “full value” from the fund. The fund is continually open to new members. In particular, we do not believe in the concept of an “estate” in the sense of a body of assets passed from generation to generation and which belongs to no-one.”

3.11.2 Equitable Life’s practice meant that there was no holding back of profits from one generation of policyholders to the next. This practice had the effect of increasing the returns paid to policyholders and it was a strong selling point for Equitable Life. IFSD told us it was a “source of pride” to Equitable Life which had claimed that it had always sought to pay out the highest possible amounts when policies became claims (whether at maturity, death or surrender).

3.11.3 However, an inevitable consequence of the policy of “full and fair” distribution was that Equitable Life did not build up any substantial free assets (or “estate”) which would be available to meet unexpected demands on its capital resources. The absence of a substantial estate was well known; indeed, it was promoted by Equitable Life as a virtue. It argued that:

“if part of the surplus otherwise available for distribution to policyholders was set aside for future emergencies, this would have been at the expense of policyholders whose policies were in force or maturing when those surpluses arose. In the view of the Board, such an approach would have been inconsistent with full and fair distribution.”

3.11.4 However, Equitable Life’s approach of operating without an estate did attract comment. The discussion at the Institute which took place at the time Mr Ranson and Mr Headdon presented their paper reflected concerns at the absence of an estate. One actuary suggested that one of the advantages of financial strength was that it gave the insurance company freedom of manoeuvre; another suggested that “it was in consideration of the improbable” that insurance companies retained an estate. These comments were reflected by some of the individuals whom we interviewed. For example, GAD told us:

“We knew that it wasn’t a strong office, but it was seeking to distribute the whole of the surplus arising to the existing policyholders. It was also paying out relatively - perhaps not relatively high, but a significant proportion of that surplus in the way of guaranteed bonuses, so it’s very dependent upon there being no investment shocks.”

3.11.5 In our interviews with individuals from IFSD and GAD we asked whether the absence of a large estate affected the way in which Equitable Life was regulated. IFSD told us that it was necessary “to monitor and regulate bearing in mind the fact they have not got one” but there were limited opportunities for the regulator to affect the size of the estate. GAD told us:

“There’s not a lot you can do about it if the company chooses to operate its business in that way; we would keep a close eye on it, and we have expressed the view to the company, over at least ten years, that we weren’t exactly comfortable with the way that they operated, but the company, I suppose, were arrogant in that respect, and felt that they knew best.”

3.11.6 IFSD told us:

“It is sort of self-evident that the less surplus you have got, the more exposed you are to accidents, surprises, or...shocks...I think the question was, was it a reasonable approach for the company to take, or was it so unreasonable that the Regulator should have done something about it? I think our judgement was that it was clearly a factor and, if you like, a risk, but the company were aware of it; the company took a judgement of how much to pay out each year, and that was...a big bonus for the policyholders, the fact that the funds were paid out, the surplus was paid out so fully. Against that has to be set the risk that unexpected shocks would leave them with less fat. But that is a judgement every company has to make. The Equitable were perhaps at one extreme, or near one extreme, in terms of the way that judgement was exercised.”

3.12 Equitable Life’s terminal bonus practice

3.12.1 The emergence of the GAR problem had a particularly significant impact on Equitable Life. IFSD explained part of the reason:

“Equitable had got a lot of these guaranteed annuity contracts, and a lot of the guarantees were quite valuable relative to the guarantees that others in the industry had got. Also, the contracts were very flexible. They allowed people to retire at any date, typically after 60, and to take the benefit of the guarantee, whereas a lot of other companies’ contracts weren’t that flexible: you could only take the guarantee if you retired at either, say, the date you had chosen for your retirement when you took out the policy, or possibly you might have two or three dates, but that was all; if you retired at 65, or 70, or 75, you could take the guarantee, but otherwise you weren’t entitled to it. Because of the flexibility of Equitable’s guarantees, the chance of them being taken up was greater, in their case; whenever you decided that you wanted to retire, you would be eligible for the guarantee. Also the form of the guarantee was reasonably attractive in that, typically, they were monthly or quarterly in advance, whereas other companies were annually in arrears, which was not an attractive form of payment for an annuity.”

3.12.2 When the GARs under Equitable Life’s with-profits policies began to exceed its current annuity rates and in the absence of any contingency reserve or sizeable estate, Equitable Life had to decide which group of policyholders should bear the emerging cost of the guarantees.

3.12.3 The response of the Equitable Life Board was to adopt a “differential terminal bonus practice”. In December 1993 (the first occasion when the GARs exceeded Equitable Life’s current annuity rates) the Board of Equitable Life resolved to allocate to a GAO policyholder a different terminal bonus according to whether the policyholder elected to take:

- (a) an annuity at the GAR pursuant to the terms of the policy; or
- (b) an alternative benefit (such as an annuity at the current rate from Equitable Life or from another provider).

3.12.4 The Board allocated a larger terminal bonus to those GAR policyholders who elected to take an annuity at current rates than the terminal bonus which was allocated to those policyholders who elected to exercise the GAO. The reduction in the terminal bonus which the Board made had the effect of making the total annuity which was available to a GAR policyholder who exercised the GAO identical (in virtually all cases) to the amount available to a policyholder who did not exercise the GAO or a non-GAR policyholder.

3.12.5 Two examples will help to illustrate how this approach operated in practice. For the purposes of these examples, the following assumptions have been made:

- (a) A current annuity rate of £8.30 per annum per £100 of fund;
- (b) A GAR of £10 per annum per £100 of fund; and
- (c) All of the fund is taken in annuity form.

Guaranteed fund (i.e. basic sum assured plus declared reversionary bonuses)	£ 75,000
Terminal bonus	<u>25,000</u>
Total fund	100,000

On current annuity rates the annuity payable would be £100,000 x (8.30/100) = £8,300 per annum.

Equitable Life’s approach was to apply the GAR only to the guaranteed fund giving a guaranteed minimum annuity of: £75,000 x (10/100) = £7,500. The terminal bonus allocated to a policyholder opting to take an annuity in GAR form would therefore be reduced from £25,000 to £8,000:

Guaranteed fund	£ 75,000
Terminal bonus	<u>8,000</u>
Total fund	83,000

£83,000 x (10/100) = £8,300 per annum.

3.12.6 There were situations in which the exercise of the GAO would result in the policyholder receiving a higher annuity:

Guaranteed fund (i.e. basic sum assured plus declared reversionary bonuses)	£ 85,000
Terminal bonus	<u>15,000</u>
Total fund	100,000

On current annuity rates, the annuity payable would be £100,000 x (8.30/100) = £8,300 per annum.

However, Equitable Life's approach of applying the GAR only to the guaranteed fund would give a higher annuity of £85,000 x (10/100) = £8,500. In these circumstances, the terminal bonus would be reduced to nil but the GAR policyholder has obtained a higher annuity by exercising the GAO.

3.12.7 The Board considered that it was able to adopt this differential terminal bonus practice under Article 65 of the Articles of Association. That Article provided as follows:

- “65(1) The Directors shall, at such intervals as they may deem expedient, but at least once in every three years, cause an investigation to be made into the financial condition of the Society, including a valuation of its assets and liabilities, by the [Appointed Actuary]. Provided that in the valuation of the assets the values thereof be not estimated beyond the market prices (if any) of the same, unless for reasons to be set out in the Directors' report to the Members upon the results of the valuation. After making such provision as they may think sufficient for such liabilities, and any special or other reserve they may think fit, the Directors shall, at a Special Board Meeting, declare what amount of the surplus (if any) shown by such valuation may, in their opinion, be divided by way of bonus, and *they shall apportion the amount of such declared surplus by way of bonus among the holders of the participating policies on such principles, and by such methods, as they may from time to time determine.* The Directors may pay or apply the bonus so apportioned to each participating policyholder, either by way of reversionary bonus (that is to say, by way of addition to the sum assured when it shall become a claim), cash payment, reduction of premium for the whole of life or any less period, or in any other way they and any participating policyholder may agree.
- (2) The Directors (after obtaining such report or reports from the [Appointed Actuary] as they may in their discretion consider to be necessary or desirable in the circumstances) may, in cases where participating policies become claims in the interval between two valuations, pay such interim or additional or special bonuses as they shall think fit.
- (3) The amount of any bonus which may be declared or paid pursuant to paragraph (1) or paragraph (2) of this Regulation and the amount (if any) to which any participating policyholder may become entitled under any mode of payment or application of any such bonus, shall be

matters within the absolute discretion of the Directors, whose decision thereon shall be final and conclusive.” [emphasis added]

3.12.8 It was Equitable Life’s belief that this Article conferred an “absolute discretion on the Board as regards whether and to what extent surplus is allocated for the provision of bonuses; and that subject to such discretion being exercised *bona fide* and with a proper appreciation of the relevant facts, the Board is free to divide up surplus as it thinks fit.”

3.13 The Court case

3.13.1 The differential terminal bonus practice adopted by Equitable Life led to complaints from a number of its policyholders. The thrust of the complaints was that the Board was reneging on the contractual obligations under the policies or that it was exercising its discretion improperly. Policyholders with GARs in their contracts argued that Equitable Life had not made its procedures clear at the outset and that their expectation was that the GAR should be applied to the total fund (including the terminal bonus) in order to calculate the guaranteed annuity.

3.13.2 By mid-December 1998 at least 15 complaints had been made to the PIA Ombudsman by individual policyholders about Equitable Life’s approach. Equitable Life decided to initiate a Court case rather than allow the cases to proceed before the PIA Ombudsman. IFSD explained the reasons for Equitable Life’s decision:

“The problem with the Ombudsman was he was going to decide on individual cases and it was going to be “death by a thousand cuts”. Potentially, the first case the Ombudsman decided, well it could have been very much on the individual circumstances of that case, maybe that policyholder could say the salesman told me this, and it would be very difficult for Equitable to disprove that. If that then sets precedent for the Ombudsman for future cases. Effectively Equitable would lose the principle potentially without having had a fair hearing on that principle.”

3.13.3 Equitable Life informed HMT-ID of its decision to initiate the Court case in a letter dated 18 December 1998.

Part 2

Solvency of Insurance Companies

3.14 Introduction

- 3.14.1 In Chapter Two we explained that insurance companies were subject to a specific statutory solvency regime which is designed to ensure that insurance companies are able to meet their obligations to policyholders. This section explains how this regime operates including the role the Appointed Actuary plays in it. The background to the debate which took place between HMT-ID and Equitable Life as to how Equitable Life should reserve for GAOs is also explained.

3.15 Statutory solvency requirements

- 3.15.1 The ICA 1982, and the regulations made under it, set out the requirements concerning the solvency of life insurance companies. The two principal provisions in the ICA1982 relating to solvency are sections 32 and 33.
- 3.15.2 Section 32 of the ICA 1982 requires all insurance companies to maintain a margin of solvency of such amount as may be prescribed from time to time by regulations. In effect, this means that insurance companies are required to hold assets which exceed the company's liabilities by a specified amount. This amount, which is known as the "Required Minimum Margin" ("RMM"), must be maintained throughout the year and not just at the year end.
- 3.15.3 In the event that a life insurance company fails to maintain sufficient assets to cover the RMM, section 32 of the ICA 1982 provides that it may be required to submit "a plan for the restoration of a sound financial position" to the FSA. IFSD told us that:
- "for a plan to be acceptable, it would need to provide for cover for the RMM to be restored within a reasonable timescale. The timescale considered reasonable would depend on the circumstances. For example, a longer timescale would typically be allowed to effect a substantial change in investment policy; a shorter period would be allowed for a capital injection from a parent company."
- 3.15.4 Section 33 provides that if the excess of a company's assets over its liabilities falls below the minimum margin of solvency, the insurance company may be required to submit "a short-term financial scheme" to the FSA.
- 3.15.5 The valuation of assets and liabilities for the purposes of calculating the excess of assets over liabilities available to cover the RMM must be in accordance with the applicable valuation regulations. The principal regulations dealing with the valuation of assets and liabilities are the 1994 Regulations.

3.16 Required Minimum Margin

- 3.16.1 The RMM of a company carrying on long-term business is the greater of:

- (a) the Minimum Guaranteed Fund (which, in the case of a mutual life insurance company, is 600,000 euros); and
- (b) the Required Margin of Solvency (“RMS”).

3.16.2 The Minimum Guaranteed Fund for all but the smallest and newest companies will be much lower than the RMS. As a result, in the majority of cases (including that of Equitable Life), the RMM equates to the RMS.

3.16.3 The rules for determining the RMS of a life insurance company depend upon the classes of long-term business which it carries on.

3.16.4 Paragraph (3) of Regulation 22 of the 1994 Regulations requires that, of the assets covering a company’s RMM, at least 50% of the Guarantee Fund⁶ (or, if greater, 100% of the Minimum Guaranteed Fund) be covered by “explicit assets”. Explicit assets are all types of assets other than implicit items (which are described below). For most life insurance companies (including Equitable Life), the Guarantee Fund is equivalent to 1/3rd of the RMS. Consequently, the effect of Regulation 22 is that 1/6th of the RMS (and hence 1/6th of the RMM) must be covered by explicit assets. Such assets are referred to as “explicit available assets” and the 1/6th of the RMM that must be covered by them as the “explicit RMM”.

3.16.5 The remaining 5/6th of the RMM may be covered by implicit items. These are assets of a long-term fund which are intangible and relate, for example, to future profits, Zillmerising (which is explained below) or hidden reserves resulting from the underestimation of assets or the overestimation of liabilities. In order to include implicit items such as these in the calculation of the margin of solvency, an order under section 68 of the ICA 1982 must first be obtained.

3.17 Section 68 Orders

3.17.1 Under section 68 of the ICA 1982 a direction may be made that certain provisions of the ICA 1982 and the regulations made under it, including those relating to the regulatory returns, shall not apply to a company, or shall apply to it with specific modifications. The direction takes the form of an Order. Currently, such Orders may be issued by the HMT on advice from the FSA.

3.17.2 Prudential guidance issued by the then prudential regulator, the DTI, states that:

“Orders in respect of future profits and Zillmerising will be readily available, provided that the relevant requirements set out in this Guidance Note have been satisfied. Orders in respect of hidden reserves will only exceptionally be given.”

3.17.3 Equitable Life had the benefit of Section 68 Orders in relation to future profits implicit items and to a subordinated loan. These are considered below.

⁶ Regulation 22 of the 1994 Regulations sets out how the Guarantee Fund is to be calculated.

3.18 Valuation of explicit assets

- 3.18.1 Broadly speaking, section 35A of the ICA 1982 requires a UK insurance company to ensure that its liabilities in respect of its insurance contracts are covered by assets of appropriate safety, yield and marketability. The assets must be appropriately diversified and adequately spread so that excessive reliance is not placed on investments of any particular category or description.
- 3.18.2 Assets which fulfil the relevant criteria specified in the regulations are referred to as “admissible assets”.
- 3.18.3 In very general terms, the valuation regulations are designed to arrive at the amount a company could expect to realise from its assets in the short term if it were to cease operations. Part VIII of the 1994 Regulations specifies the basis of valuation to be applied to each category of asset. The main principle behind the valuation regulations is that assets are valued at market value where this is ascertainable. Some types of asset are required to be valued on a more conservative basis than normal accountancy rules permit. For example, investments in, and debts owed by, subsidiaries are valued on the basis that the subsidiary is about to go into liquidation (“break up basis”) and not on a going concern basis, thus eliminating the value of goodwill and other intangible assets.
- 3.18.4 The maximum value of each type of asset that can be taken into the calculation of the value of assets is set as a percentage of the “long-term business amount” which is, approximately, the total policy liabilities excluding unit-linked business. These percentages are set out in Schedule 12 Part II of the 1994 Regulations and vary according to the risk inherent in holding the relevant asset. For example, any value of listed equities of any one company above 2.5% of the long-term business amount is disregarded.
- 3.18.5 Any asset not mentioned in the valuation regulations (for example, gold or commodities) must be excluded from the calculations. In other words, with the exception of cash, the asset is treated as having no value if there is no valuation rule for that particular type of asset.

3.19 Implicit items - future profits

- 3.19.1 EU directives and UK legislation permit a value to be placed on the future profits of an insurance company. This is referred to as a “future profits implicit item”. If such an implicit item is permitted, it represents an intangible asset which can be included in the calculation of assets for the purpose of determining whether the RMM is being covered.
- 3.19.2 GAD explained to us the background to such items:

“The background legislation...stems from the European Directives, particularly the First Life Directive going back to 1979. This says that at the discretion of the supervisory authority, the company may be allowed to count such items against 5/6ths of its margin of solvency, to its future profits calculation. The future profits calculation is then specified in the same Directive as being, in effect, 50%

of the average profits earned over the last five years multiplied by the expected duration of the policy in force. The Directive just said that the supervisor could exercise their discretion, and it may be allowed as a solvency margin.”

3.19.3 GAD also explained the economic rationale for such items:

“the economic rationale is that in calculating the liabilities, the valuation regulations specify that the Appointed Actuary must make a prudent and conservative assumption about future rates of investment return, and it is then recognised that there is a degree of conservatism or prudence that is built into the system, and it is then permissible that companies may take some of this into account as an item that is available to cover the solvency margin. In effect, what we are saying is that if adverse contingency or experience should arise, then any such losses arising from that adverse experience would be offset against those future profits in the first instance.”

3.19.4 Regulation 24 of the 1994 Regulations sets out the requirements in relation to future profits implicit items. In order to obtain a Section 68 Order in respect of a future profits implicit item, the Appointed Actuary must certify that the amount applied for is less than the present value of the profits actually anticipated to arise in the future on the in-force business. The Appointed Actuary is not required in the application to state the assumptions he has used in this prospective calculation, or the results of this calculation. However, the 1984 DTI Guidance Note on Implicit Items (which is still current) states that the Appointed Actuary should use “cautious assumptions in regard to the future experience, in many respects similar to those required for the minimum basis for calculating mathematical reserves”.

3.19.5 Since 1994 Equitable Life has applied for on an annual basis, and been granted, a Section 68 Order permitting a proportion of future profits to be included as an implicit item in the calculation of its solvency margin. The table in Appendix 10 provides details of these applications and orders.

3.20 Implicit items - Zillmerising

3.20.1 A number of life insurance companies reduce the calculated reserves for liabilities by an adjustment referred to as a “Zillmer adjustment”. The Zillmer adjustment allows for the uneven incidence of expenses incurred by a life insurance company writing new business and effectively spreads the acquisition costs of writing the policy over the lifetime of the policy in proportion to the premiums receivable. Consequently, Zillmer adjustments are only applied to regular premium policies and not to single premium (or recurrent single premium) policies.

3.20.2 If a life insurance company does not explicitly reduce its liabilities in this way, it is possible that it could apply for a Section 68 Order to allow this reduction as an implicit item.

3.21 Valuation of liabilities

3.21.1 The overriding principles for valuing the amount of the liabilities are set out in Regulation 64 of the 1994 Regulations. Paragraph (1) of Regulation 64 requires:

“The determination of the amount of long-term liabilities.....shall be made on actuarial principles which have due regard to the reasonable expectations of policyholders and shall make proper provision for all liabilities on prudent assumptions that shall include appropriate margins for adverse deviation of the relevant factors.”

3.21.2 Paragraphs (2) and (3) of Regulation 64 require that:

- “(2) The determination shall take account of all prospective liabilities as determined by the policy conditions for each existing contract, taking credit for premiums payable after the valuation date.
- (3) Without prejudice to the generality of paragraph (1) above, the amount of the long-term liabilities shall be determined in compliance with each of the regulations 65 to 75 below and shall take into account, inter alia, the following factors:
- (a) all guaranteed benefits, including guaranteed surrender values;
 - (b) vested, declared or allotted bonuses to which policyholders are already either collectively or individually contractually entitled;
 - (c) all options available to the policyholder under the terms of the contract;
 - (d) expenses, including commissions;
 - (e) any rights under contracts of reinsurance in respect of long-term business; and
 - (f) discretionary charges and deductions, in so far as they do not exceed the reasonable expectations of policyholders.”⁷

3.22 Valuation of liabilities - The Appointed Actuary’s obligations

3.22.1 The “actuarial principles” referred to in Regulation 64 are set out in two Guidance Notes prepared by the Faculty and Institute, GN1 and GN8. As set out in Chapter 2, both GN1 and GN8 are designated as “practice standard” which means that they are, in effect, mandatory for Appointed Actuaries. The Appointed Actuary is required to certify whether he has fully complied with them in his certificate to the FSA as part of the regulatory returns.

3.22.2 GN1 deals with general matters. It states:

“It is incumbent upon all Appointed Actuaries to ensure, so far as is within their authority, that the long-term business of the company is operated on sound financial lines and with regard to its policyholders’ reasonable expectations.”⁸

⁷ This sub-paragraph was added by the 2000 Regulations.

⁸ Paragraph 1.1.

3.22.3 GN1 sets out in paragraph 4.1 the broad duties of the Appointed Actuary. The Guidance Note goes on to set out the extent of the Appointed Actuary's responsibility and the duties of the Appointed Actuary. Paragraph 8.1 states:

“The Appointed Actuary is required as part of the Appointed Actuary's statutory duties to report to the Supervisory Authority in a prescribed form on actuarial investigations carried out under section 18 of the ICA 1982. It is the Appointed Actuary's professional duty first to report in writing to the directors on the results and implications of any such investigation, whether or not an allocation of profits is involved. In the Section 18 Report to the Supervisory Authority, the Appointed Actuary should use best endeavours to ensure the financial results are presented in a way that demonstrates the true underlying position of the company and that these results are not distorted by any undisclosed valuation methods or assumptions.”

3.22.4 GN8, which is supplementary to GN1, draws the attention of the Appointed Actuary to certain aspects of Regulations 64 to 75 and their implications for the manner in which the valuation is carried out. In particular, it states that:

“Regulation 64 is paramount. The Appointed Actuary must use prudent bases determined according to actuarial principles, and which have regard to the professional considerations set out in GN1...”

3.22.5 Paragraphs 65 to 75 of the 1994 Regulations impose further requirements in relation to determining the liabilities. In particular, Regulation 72 requires provision to be made for options as follows:

- “(1) Provision shall be made on prudent assumptions to cover any increase in liabilities caused by policyholders exercising options under their contracts.
- (2) Where a contract includes an option whereby the policyholder could secure a guaranteed cash payment within twelve months following the valuation date, the provision for that option shall be such as to ensure that the value placed on the contract is not less than the amount required to provide for the payments that would have to be made if the option were exercised.”

It was the interpretation of Regulation 72 which was at the heart of the debate on reserving which took place between HMT-ID (later IFSD) and Equitable Life.

3.22.6 The effect of the 1994 Regulations and the professional obligations imposed on the Appointed Actuary is to require all life insurance companies to reserve on “prudent assumptions” for all guaranteed benefits and options exercisable by the policyholder which could secure guaranteed benefits. Prudent assumptions are a matter of actuarial judgement and are not defined in the legislation.

3.23 Reserving

3.23.1 In broad terms, the reserves for life insurance policies are calculated as the expected value of any future contractual benefits to the policyholder discounted to the valuation date, offset against the expected value of that part of any future premiums which are required to provide the basic benefit, again discounted to the valuation date. Any premiums not required (on the valuation basis) to provide the basic

benefit, together with the actual investment return in excess of that expected (on the valuation basis) is available to fund future expenses and provide future bonuses.

- 3.23.2 The expected values of the future benefits and premiums are assessed taking into account the likelihood of the policyholder dying or surviving over the duration of the policy. In calculating the reserves, it is generally assumed that policies will not lapse unless this increases the liability.
- 3.23.3 The rate of interest used to discount the expected values has a maximum value less than the interest earned on the assets. This ensures that the valuation basis remains prudent.
- 3.23.4 Future benefits to policyholders which are given at the discretion of the insurance company do not need to be explicitly reserved for, provided that policyholders would not reasonably expect that some level of discretionary benefit would be paid if the prudent valuation assumptions occur in practice.
- 3.23.5 In particular, the 1994 Regulations require that reversionary bonuses which have already been declared are reserved for, as these are contractual benefits, but future reversionary bonuses and terminal bonuses do not generally require explicit additional reserves.

3.24 Resilience reserves

- 3.24.1 A number of different assumptions are made when calculating the value of liabilities of a life insurance company. These include economic assumptions (for example, about future investment returns) and demographic assumptions (for example, about future mortality). However, if the value of the assets change, the value of the liabilities will generally not change by the same amount. The result might be that after a change in asset values, the assets may be insufficient to cover the policy liabilities.
- 3.24.2 To protect against this risk, the 1994 Regulations require the company to demonstrate that it would have sufficient assets to meet the value of liabilities, even if there were to be a significant change in investment conditions. This is known as the resilience test. Its purpose is to ensure that the company would remain solvent without relying on its free assets if a change in financial conditions were to occur. The reserves which are required to satisfy the resilience test are known as the resilience reserves.
- 3.24.3 Regulation 75 provides:
- “The determination of the amount of long-term liabilities shall take into account the nature and term of the assets representing those liabilities and the value placed upon them and shall include prudent provision against the effects of possible future changes in the value of the assets on:
- (a) the ability of the company to meet its obligations arising under contracts for long-term business as they arise; and
 - (b) the adequacy of the assets to meet the liabilities as determined in accordance with regulations 65 to 74...”

3.24.4 The main professional guidance is set out in GN 8. Paragraph 3.9.2 of GN8 states:

“Regulation 75 gives no indication of the range of possible future changes in the value of the assets which is to be allowed for. In determining an appropriate range, the Appointed Actuary must use professional judgement as an experienced financial practitioner. The essential point is that if changes, for example in market yield or currency values, would result in a change in the aggregate liability that is not matched by a change in the market value of the corresponding assets, then Regulation 75 requires the Appointed Actuary to consider what provision is required as a contingency margin, having regard to the consequences should the provision prove to be insufficient. In particular the Appointed Actuary needs to exercise special care with regard to any investments presenting novel or unorthodox features, derivatives (whether assets or liabilities) and any contracts containing substantial options.”

3.24.5 GAD, as part of its responsibility to review the regulatory returns, developed internal working guidelines as to the changes in market yields and equity prices which it might be considered prudent to take into account. The Government Actuary publishes these internal guidelines as “Dear Appointed Actuary” letters which are the *de facto* standard for testing the resilience of the reserving basis. It is relevant to note that these are guidelines and are not mandatory.

3.24.6 In a letter in September 1993 the Government Actuary stated:

“For with-profits offices, we consider that the valuation should be tested for three different scenarios. Our benchmark at the present time would be:

- (1) a reduction in fixed-interest yields by 20% combined with a fall in value of equities of 10%;
- (2) a reduction in fixed-interest yields by 10% combined with a fall in equity values of 25%; and
- (3) a rise in fixed-interest yields of 3% combined with a fall in equity values of 25%.”

3.24.7 These scenarios were used until November 1998 when GAD wrote to Appointed Actuaries setting out a more complex version of the second scenario which allowed a modification of the test if the FTSE Index fell below 4500. Tests (1) and (3) remained unaltered.

3.24.8 Test (2) was changed again in September 1999. The test comprised a combination of:

- (a) a 10% fall in fixed interest yields; and
- (b) a fall in the value of equities of the greater of:

- (i) 25%, subject to the fall being restricted to such as would not produce a P/E ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long-term gilt yield⁹ before the assumed fall in paragraph (a); and
- (ii) 10%.

3.24.9

On 15 May 2000 the Government Actuary wrote again to Appointed Actuaries. He noted that the recent revisions to the 1994 Regulations had made two of the three scenario tests unnecessarily severe and he therefore considered that revisions to the resilience tests were appropriate in the then current conditions¹⁰. In particular, the second scenario became a combination of:

- (a) a fall in the value of equities of the greater of:
 - (i) 25%, subject to the fall being restricted to such as would not produce a P/E ratio on the FTSE Actuaries All Share Index lower than 75% of the inverse of the long-term gilt yield before the assumed fall in paragraph (b); and
 - (ii) 10%;
- (b) for fixed interest securities:
 - (i) a fall in the yields on risk free securities of less than 5 years outstanding term to redemption and on short term deposits to the level which is calculated under Regulation 69(9) of the 1994 Regulations for future investments (or remain constant if already at or below this level);
 - (ii) the yields on risk free securities of at least 15 years duration remaining constant;
 - (iii) a fall in the yields on risk free securities of more than 5 but less than 15 years outstanding term to redemption to levels obtained by interpolating between the figures given by (i) above and the 15 year gilt index yield (or remain constant if already at or below this level);
- (c) a fall in property values of 20%; and
- (d) a rise in the real yields on indexed gilts of 10% (for example, from 2% to 2.2%)

3.24.10

Where the nature and terms of assets and liabilities are well matched, then changes in investment conditions, as described in the above resilience tests, may require little additional reserves. However, when assets and liabilities are not well matched or the liabilities include onerous options or guarantees, then the resilience test may require significant reserves.

3.24.11

The test described in the letter of 15 May 2000 had a significant effect on the resilience reserves required by Equitable Life. On 11 August 2000, the Appointed Actuary estimated that this would reduce net explicit assets by some £600million.

⁹ As defined in Regulation 69(9).

¹⁰ The letter foreshadowed the provisions of the Insurance Companies (Amendment) Regulations 2000 which were to come into effect on 29 May 2000.

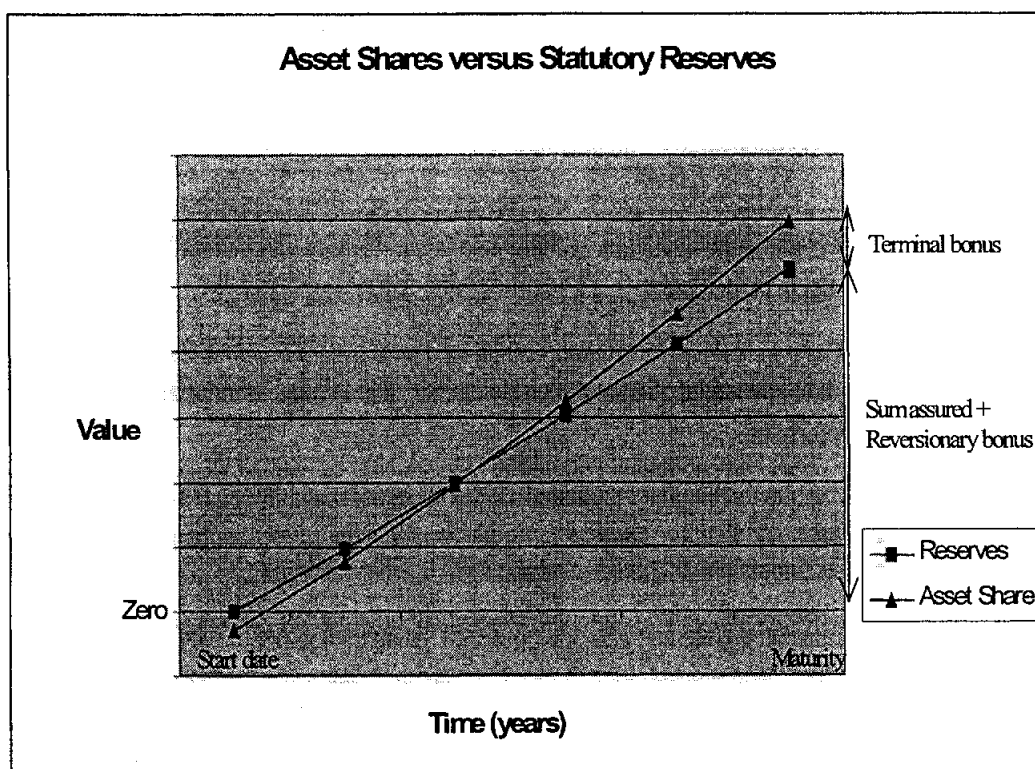
3.25 Subordinated loan

- 3.25.1 Equitable Life used a subordinated loan and, for the years ended 1998 and 1999, reinsurance to strengthen the financial position which was reported in its regulatory returns.
- 3.25.2 Under the 1994 Regulations, funds raised from the issue of loan capital do not count toward the RMM because the value of the money received would be offset by a corresponding liability to repay the loan with interest. However, the 1994 Regulations provide that subordinated capital may be counted if the obligation to repay the loan is subordinated to the rights of policyholders and a Section 68 Order is obtained.
- 3.25.3 If granted, the Section 68 Order, in effect, varies the terms of the 1994 Regulations to provide that the liability to repay the value of the loan capital may be excluded from the calculation of the company's liabilities up to (in the case of Equitable Life) 50% of the RMM.
- 3.25.4 In August 1997 Equitable Life entered into a £346million subordinated loan with a specially created subsidiary which had floated corresponding bonds on the market.

3.26 The interaction of asset shares and statutory reserving

- 3.26.1 As noted above, the unsmoothed asset share for a with-profits policy is internal management information which is used to monitor the accumulated "value" of a policy. The total of all the asset shares for each policy compared with the tangible and intangible assets available is a measure of the ability of the insurance company to meet PRE.
- 3.26.2 Once the policy reaches maturity, the Appointed Actuary must decide whether an appropriate claim value is simply the asset share (generally with the investment return smoothed in some way) or something more or less than the asset share so that the payout meets PRE. One aspect of meeting PRE entails the maturity value being consistent with previous maturity values on similar policies, taking into account contractual commitments and reflecting relevant marketing literature.
- 3.26.3 Further, the claim value is made up of the sum assured, previously declared reversionary bonuses and a terminal bonus declared at the maturity date. A major part of the Appointed Actuary's role, in managing the finances of a with-profits policy, is deciding how much of the asset share the company should recognise from time to time by way of guaranteed reversionary bonus.
- 3.26.4 In setting the reversionary bonuses, the Appointed Actuary will have regard to the statutory valuation. The reversionary bonus affects the statutory valuation in two ways. Firstly, there must be enough surplus assets, assessed on the prudent statutory basis, to be able to finance the cost of the reversionary bonus. Secondly, once a reversionary bonus has been declared, it becomes a guaranteed benefit and hence must be provided for. This, in turn, limits the investment freedom of the insurance company because prudence requires that the higher the proportion of benefits that are guaranteed, the more that assets should be invested in lower risk investments, such as Government stocks.

- 3.26.5 Terminal bonuses are not guaranteed, but there must be sufficient surplus available to pay them.
- 3.26.6 Against these pressures to keep bonuses (particularly guaranteed reversionary bonuses) low, there are obvious commercial pressures from policyholders and intermediaries to make payments (and guarantees) as high as possible.
- 3.26.7 In balancing the pressures between financial prudence and the need to be competitive, the Appointed Actuary uses the unsmoothed asset share as a benchmark from which he can depart, but not by too much and not for too long.
- 3.26.8 The relative amounts of the asset share and statutory valuation reserves over the life of a policy are set out in the diagram below:



- 3.26.9 As can be seen from the diagram, the unadjusted asset share is less than the statutory reserves at the outset of the policy, principally because of the high level of acquisition costs, which the unadjusted asset share recognises (but the statutory valuation does not). At this stage of a policy's life, it is a net absorber of capital. Later, the asset share exceeds the statutory reserves, with the result that the policy is effectively providing capital to the insurance company. The capital base of the insurance company, and hence its investment freedom, depends heavily on the amount of the excess of the capital provided by 'older' policies over the capital absorbed by the 'newer' policies.

3.27 Reinsurance

3.27.1 Reinsurance is the process by which a life insurance company transfers part of its risk under a contract to another life insurance company (which may be a professional reinsurance company). Reinsurance is a powerful portfolio management tool that enables insurance companies to accept large or unusual risks and reduce the effect of variations in claims experience from year to year.

3.27.2 Certain types of reinsurance also have financial objectives over and above simple transfer of risk. For example, some financial reinsurance can be used to improve the disclosed statutory solvency position of an insurance company, by obtaining reinsurance from a reinsurer located overseas, and not subject to the same requirements as a UK regulated insurance company. In interview, GAD referred to this as “regulatory arbitrage” and told us:

“We have always expressed our discomfort with these types of regulatory arbitrage arrangements and suggested to the companies that, if possible, the regulator may well seek to limit the benefits that can be derived from these arrangements. It is unsatisfactory, to the extent that the liability is going down a black hole, because you are taking it off one company’s books and somebody else is taking up a liability but not making any provision for it.”

3.27.3 This type of financial reinsurance takes account of the value of future surpluses that are expected to emerge from a portfolio of business. Possible forms of financial reinsurance include:

- (a) The insurance company receives a payment from the reinsurer in advance of the emergence of future surplus, in exchange for the reinsurer being granted the right to a proportion of that surplus when it emerges;
- (b) The reinsurer agrees to pay the cost of future claims, in exchange for the right to repayment from any surplus emerging after the claim is made under the reinsurance treaty. The insurance company is thereby able to reduce reserves without any substantial premium being paid to the reinsurer.

3.27.4 In both cases, it is key that the repayment to the reinsurer is subordinate to the rights of policyholders. It is usual for some premium to be paid to the reinsurer for the agreement and this premium will reflect the reinsurer’s assessment of the risks that future surpluses may not emerge.

3.27.5 As described in Chapter 4, Equitable Life entered into a reinsurance agreement with Irish European Reinsurance Company Limited (“IERC”). This agreement fell into the second category described above. The risk premium paid at the outset of the agreement was £400,000 payable in two instalments, one of £150,000 payable on commencement and one of £250,000 on 1 April 1999. IERC agreed to pay for the additional costs of GAOs should they be exercised on more than 25% of the value of funds retiring in any one year. If this occurred, IERC would be liable to pay Equitable Life an amount which equalled the additional cost of providing an annuity at the GAR, over the cost of an annuity at current annuity rates. However, IERC

would then have “call” on the surplus emerging after the date of the claim on the reinsurance.

3.27.6 The agreement also provided that IERC would recover, in instalments, any sums it had paid to Equitable Life. The size of the instalments was limited so that payment would not make Equitable Life insolvent.

3.27.7 GAD explained to us the purpose of the agreement:

“The purpose of the treaty was to enable Equitable Life to reserve on a basis which was more akin to their view as to what a prudent reserving basis should be, because they felt that it required quite a significant change in the practice of policyholders for the take-up rate to get anywhere near 25%, which was the level which they felt was prudent. They negotiated with the reinsurer that the reinsurer should take the commercial risk that the take-up rate might exceed 25%, which the reinsurer was happy to do because it wasn’t under the control of the UK supervisory regime. If it was a UK-regulated reinsurer, we would require the reinsurer to set up the balance of the liability under the 75% that it was taking.”

3.27.8 The agreement was conditional on there being no change to Equitable Life’s terminal bonus practice; in the event, Equitable Life was able to renegotiate the reinsurance agreement following the House of Lords’ judgment. In the new agreement, the take-up assumption was increased to 60% which Equitable Life believed to be a prudent estimate of the additional take-up rate following the judgment.

3.28 Reserving for annuity guarantees

3.28.1 As annuity rates declined during the 1990s the actuarial profession began to appreciate the consequent increase in the value of GARs. A report of the Working Party of the Life Board of the Faculty and Institute, which was published in November 1997, identified a number of possible approaches to reserving for GARs in relation to with-profits business. Three possible approaches were set out “for consideration”:

- (a) “Allow for guarantees in the same way as for unit-linked business by setting aside additional reserves related to prudent estimates of cost over and above existing, unadjusted with-profits reserves;
- (b) Recognise the cost of guarantees as effectively increasing the guaranteed sum assured on some prudent basis. Net premium reserves are then recalculated on this basis;
- (c) Review whether and to what extent the guarantee will be covered by terminal bonus adjustments. Providing that terminal bonus adjustments will be used and are sufficient to cover guarantees in all circumstances, there is an argument for not reserving for such guarantees - no explicit provision is made for terminal bonuses and hence the provision for guarantees is simply part of this implicit provision subject to the existence of appropriate terminal bonus margins.”

3.28.2 None of these approaches was considered entirely satisfactory. The first approach was described as the “most prudent” so would have an adverse effect on the solvency

margin and would therefore be unattractive to a company using it in isolation. The second approach was arbitrary in its effect. The report stated that the third approach, which was the approach which Equitable Life adopted up to and including the 1997 year end valuation, “could be viewed as being unsound because no explicit provision is made for an explicit guarantee”. The report concluded that because of low interest rates and improving life expectancy, companies would need to work out how to reserve for guarantees.

3.28.3 GAD explained some of the background to us in the context of a letter written by a senior actuary, Professor David Wilkie, to an actuarial publication:

“He [David Wilkie] wrote a letter saying that actuaries are using a stupid assumption, or a stupid approach to valuing these sort of options. He was suggesting they should use stochastic methods. The problem is that, whilst interest rates are high and well above the strike price of the option, you don’t set up any provision. Even though you do a resilience test, the resilience test might not cause you to set up a provision. But, as interest rates come down, you start to expose the option and you start to need a provision. Unfortunately, in this particular case, interest rates sort-of collapsed in 1997, end of 1997, and fell from 6.5% at the end of 1996, I think it was, or even 7%, and ended up being of the order of 4.5%. So really, quite a dramatic fall, and it suddenly exposed these options on the basis, the way in which actuaries reserve for these sorts of options...Actuaries generally probably were caught out by this. Most offices don’t have the facility to do stochastic modelling and stochastic approaches to reserving.”¹¹

3.29 Equitable Life’s approach to reserving for GAOs

3.29.1 Prior to the decision of the House of Lords in July 2000, Equitable Life established reserves for GAR policies in reliance on its terminal bonus practice. Equitable Life took the view that there was only a very remote chance that this practice might be overturned and it did not therefore set up a reserve against this contingency.

3.29.2 In assessing the reserves required for GAOs in the context of Equitable Life’s terminal bonus practice, Equitable Life’s Appointed Actuary sought to rely on Regulation 72(1) of the 1994 Regulations (which is referred to above). Equitable Life maintained that, as a first step, a prudent assessment should be made of the proportion of retiring policyholders that would exercise the GAO based on a comparison of the income that would be available if the policyholder chose to exercise the GAO with the income that would be available if the policyholder elected to take an annuity at current annuity rates. In a letter from Equitable Life to GAD dated 30 October 1998, the Appointed Actuary wrote:

“All retirement cases are checked to determine whether, if a conventional non-profit annuity is required, the guaranteed annuity rate will produce a higher level of income. Currently that is so in around 30% of cases and clients are advised accordingly, even if their intention is known to be to take some other form of annuity. Interestingly, to date no such clients have actually chosen to take

¹¹ Appendix 7 contains a graph showing the levels of 15 year high coupon gilt yields from 1976 to 1998.

advantage of the guaranteed annuity rate - all have preferred a more modern form of annuity.”

- 3.29.3 Nevertheless, the Appointed Actuary felt it was prudent to establish reserves on the assumption that 30% of the vesting policyholders would exercise the GAO, based on this experience, and that the remainder would not.
- 3.29.4 Having made this assumption, Equitable Life valued the two groups of policyholders on different bases. For those exercising the GAO, Equitable Life made provision for the full value of the GAR, applied to the guaranteed value of the fund expected; for the others, it made provision merely for the guaranteed value of the fund without terminal bonus. In line with general reserving practice, Equitable Life did not reserve for terminal bonus as terminal bonus was not guaranteed. The result of applying this approach at previous valuation dates was that the additional reserves required for the GAOs were small in the overall context of Equitable Life’s funds, and therefore were regarded as immaterial.
- 3.29.5 HMT-ID and, after 1 January 1999, IFSD, advised by GAD, took a different view. Their view was that the policyholder’s decision not to exercise the GAO was based on there being sufficient terminal bonus to outweigh the value of the guarantee. This being the case, the terminal bonus was not “discretionary” and reserves should be established at least up to a level sufficient to cover the GAO.
- 3.29.6 Equitable Life’s response was that this was tantamount to setting the proportion of vesting policyholders taking GARs to 100%, which was, in its view, excessively prudent. The regulator accepted that this was tantamount to a 100% proportion, but that this was the logical consequence of assuming that terminal bonus could fall to zero. This was because if the open market cash fund used in the initial comparison fell below the value of the GAR, the proportion of policyholders accepting the GAR would rise to 100%. The regulator also relied on Regulation 64(3)(c) of the 1994 Regulations (which requires all options available to the policyholder under the terms of his contract to be taken into account when determining the liabilities).
- 3.29.7 The subsequent debate, which is described in further detail in Chapter 4, was then conducted in terms of the appropriate proportion of policyholders accepting the GAR option, with Equitable Life eventually accepting that the proportion accepting GARs should be increased significantly. In the 1998 regulatory returns, Equitable Life adopted a proportion of between 70% and 82.5% depending on policy class. GAD subsequently pushed for the proportion to be increased to 95% or greater¹².

3.30 January 1999 guidance on reserving for GAOs

- 3.30.1 In early January 1999 the FSA prepared draft guidance to be sent out by the Government Actuary to all Appointed Actuaries of companies authorised to carry out long-term insurance business relating to reserving requirements for GAOs. The guidance was considered and commented upon by GCD.
- 3.30.2 The guidance asked Appointed Actuaries to reserve for GAOs on prudent assumptions. The guidance noted that it would not be prudent to assume that

¹² See 3.31 below and Appendix 3.

policyholders would choose to take a benefit of significantly lower nominal value than the guaranteed annuity. However, some limited allowance, of “a few percentage points” of the reserve could be allowed for the possibility that some policyholders might prefer to take their benefit in some other form, such as the perceived flexibility of a different type of pension arrangement.

3.30.3 IFSD explained the background to the inclusion of the reference to “a few percentage points” in the letter:

“The question was, were we going to put a number on it?, and it may well have started off originally as being 5%, and –but, I suppose, as with all good things, there would be a spread of actuarial opinion about how much flexibility you should allow, and I suppose that, rather than settle on a number, in the end, as I say, I think it was the Government Actuary’s suggestion that we go for “a few percentage points of the reserve”. I suppose people felt that you have got to have – there was even a question about do you leave it at the point of saying that you have to be very close to the full value of the guaranteed annuity, very close to 100%; what does that mean?, and in the end, yes, it was thought that we needed to clarify in some way what “very close to” meant. Certainly, I suppose that everybody could agree that “very close to” meant a few percentage points.”

3.30.4 The guidance was sent out under cover of a letter dated 13 January 1999 to managing directors of companies authorised to carry out long-term insurance business. The covering letter asked the managing directors to consider whether their 1997 regulatory returns had been prepared in a way which was consistent with the guidance, and that if not (and if, as a consequence, they would have shown a materially different financial position if they had been so prepared), they were asked to submit their 1998 regulatory returns by 31 March 1999 (three months early).

3.30.5 A copy of the January 1999 guidance on reserving for GAOs is in Appendix 2.

3.31 December 1999 guidance on reserving for GAOs

3.31.1 In the 1998 year end regulatory returns, a small number of companies had interpreted the words “within a few percentage points” of 100% in the January 1999 guidance to mean a range of percentage points that went as low as 70%.

3.31.2 In mid-December 1999 GAD prepared amended guidance in relation to reserving for GAOs which, among other matters, referred to the meaning of “a few percentage points”. The guidance was reviewed by IFSD and GCD. The guidance was issued on 22 December 1999 by way of a letter to managing directors of all life insurance companies enclosing a guidance letter from the Government Actuary. The reference to “a few percentage points” was clarified to mean the total aggregate allowance that might prudently be made for all other benefit forms (whether cash or other forms of annuity) and that an allowance in excess of 5% would not be considered to represent “a few percentage points”. The letter also reported that the Government Actuary was reviewing the level of disclosure of the assumptions made in the regulatory returns. On the same day, the guidance was sent separately by GAD to Appointed Actuaries of insurance companies authorised to write long-term business.

3.31.3 A copy of the December 1999 guidance on reserving for GAOs is in Appendix 3.

Chapter Four

Description of the prudential regulation of Equitable Life

Part 1

The Inheritance Period

4.1 Introduction

- 4.1.1 As far as the prudential regulation of Equitable Life was concerned, much of the focus of IFSD's attention during the Review Period was directed at matters arising out of the Society's exposure to GAOs. A number of significant decisions and actions in respect of this issue had occurred during the Inheritance Period. In order therefore to make sense of the description of the course of the regulation of Equitable Life during the Review Period, it is necessary (and a requirement of our Terms of Reference) for this Report to look in some detail at the Inheritance Period.
- 4.1.2 It should also be understood that although the responsibility for the prudential regulation of the life insurance industry passed to the FSA on 1 January 1999, the team most directly concerned with the prudential regulation of Equitable Life remained substantially the same.
- 4.1.3 There are two principal strands concerning Equitable Life's management of its GAO exposure which run through this narrative. They are:
- (a) the debate between Equitable Life and the regulator as to the level of reserves required to be held in respect of the guarantees; and
 - (b) the question of whether Equitable Life's terminal bonus practice:
 - (i) was lawful in terms of the contractual relationships between the Society and its policyholders; and
 - (ii) gave rise to a risk that Equitable Life was unable to meet PRE.
- 4.1.4 During the Inheritance Period it was recognised that there were wider industry implications concerning these matters, which were also the subject of general guidance issued to the industry, which itself was a matter for discussions between the regulator and the EST. These are also described in the narrative which follows.

4.2 Equitable Life's decision to adopt a differential bonus practice

- 4.2.1 As explained in **Chapter 3**, for many years current annuity rates exceeded the GARs which had been included in certain policies issued by Equitable Life between 1957 and 1988. However, during the 1990s current annuity rates fell significantly. Equitable Life's GARs began to exceed current annuity rates between October 1993 and May 1994. From May 1994 to May 1995, the trend reversed but only temporarily and in May 1995 current annuity rates fell again and the extent to which they have done so has generally increased substantially with the continued fall in interest rates generally.

4.2.2 In December 1993 the Board of Equitable Life recognised the potential liability arising as a result of current annuity rates falling below GARs. Accordingly, the Board resolved to adopt a practice of making a different terminal bonus award to each policyholder depending on whether the policyholder elected to take:

- (a) an annuity at the GAR set out in the contract; or
- (b) an alternative benefit (such as an annuity at the current annuity rate from Equitable Life or from another provider).

4.2.3 Terminal bonuses were calculated so as to ensure that the total benefits received by those who elected to take the GAR were equal to those which the policyholder would have received if he had elected to take the alternative, non-GAR-based, benefit. The effect of the decision was that a larger terminal bonus was awarded to policyholders who elected to take the alternative benefit.

4.3 Equitable Life's financial position as disclosed at the end of 1996

4.3.1 The regulator's view of Equitable Life's financial position at the end of December 1996 is evident from the scrutiny report dated 8 December 1997 prepared by GAD in respect of Equitable Life's 1996 regulatory returns.

4.3.2 The report noted that:

“about 65% of its liabilities relate to unitised with-profits business, for which it endeavours to show competitive annual accumulations of benefits reflecting the total investment returns achieved, but because guaranteed bonuses include credit for a measure of asset appreciation, future bonus declarations of the Society would seem to be vulnerable to any sustained stockmarket downturn. It has a modest free estate. Some questions have been raised about the strength of the reserves established.”¹

4.3.3 These and other questions were set out in a letter to the Appointed Actuary,² requesting further information, about the provisions made for resilience reserves and questioning whether total accumulated asset shares for policies in force were less than assets available.³

4.3.4 GAD's summary of “key features” showed that Equitable Life had cover for RMM of 2.53 and a priority rating of 3. As set out in **Chapter 2**, this priority rating relates to the company's financial strength, taking into account a number of indicators, and a rating of 3 denotes a company where there are sufficient concerns to warrant early attention or other reasons to require GAD to carry out its scrutiny early in the cycle.

4.3.5 Among other matters, the scrutiny report noted that:

¹ GAD was emphasising that Equitable Life takes into account unrealised gains (“asset appreciation”) in its assessment of the statutory assets available to fund reversionary bonuses and that if there was a stockmarket fall future reversionary bonuses would be difficult to fund.

² The role of the Appointed Actuary is explained in **Chapter 2**.

³ The relative amounts of total accumulated asset shares for policies in-force as compared with “assets available” would provide GAD with an indication as to whether or not Equitable Life was able to meet PRE. This is explained in more detail in **Chapter 3**.

- (a) Equitable Life was determined to provide fair bonuses to policyholders, “with no deliberate holding back of profits from one generation to another”;
- (b) Equitable Life had applied for a Section 68 Order for a future profits implicit item each year but used this order for the first time in 1994; the current Section 68 Order for the year ending 31 December 1996 was for £600million, of which about 50% had been used;
- (c) in 1997 the Society had taken a subordinated loan for £350million from a specially created subsidiary, which had floated corresponding bonds on the market; and
- (d) it seemed likely that the current asset shares exceeded the admissible assets.

4.3.6 The Appointed Actuary’s response to GAD’s questions on, among other matters, resilience reserving and the difference between total accumulated asset share for policies in-force and available assets confirmed that GAD was correct:

“in deducing that at 31.12.96 the total face value of policies including accrued final bonus was in excess of the value of the assets attributable to with-profits business. Those assets will include items like the accumulated new business strains and so are higher than a pure share of the Form 9 admissible assets”.

4.3.7 The Appointed Actuary also said:

“I am not clear whether you are asking about unsmoothed or smoothed asset shares. Because of the flexibility of our contracts we do not calculate unsmoothed asset shares for every policy. However, given the way we operate the business the totality of unsmoothed asset shares will be close to the value of the assets attributable to with profits business. If, however, you are asking about smoothed asset shares, then our bonus system means that the policy value, including final bonus, is effectively a smoothed asset share. Thus the total of such asset shares will be the total face value of the policies including accrued final bonus, as discussed above.”⁴

4.3.8 GAD’s response to the Appointed Actuary’s letter was that the fact that the total face value of the policies was higher than Equitable Life’s admissible assets did not necessarily cause GAD any concern, but, as set out in a letter to the Appointed Actuary dated 16 January 1998, GAD considered that:

“the lack of any ... free estate does bring to prominence the importance of not building up policyholder expectations too far - with the implication that it might then be considered necessary to hold reserves for anticipated final bonus additions. I am sure that you are acutely aware of this.”

4.3.9 A meeting between GAD and Equitable Life took place in May 1998. GAD subsequently confirmed to HMT-ID that it considered the scrutiny of the 1996 regulatory returns to be closed and noted:

⁴ Form 9 admissible assets and the concepts of smoothed and unsmoothed asset shares are explained in Chapter 3.

“I am happy to confirm that our discussions did not conclude that any particular strengthening of their reserves was needed in relation to accumulating with-profits business, although I remain concerned that not all holders of such contracts (with this and other offices) appreciate what could happen at future bonus declarations if we saw a sudden downturn in the market values of assets. The whole industry is relying on a soft landing, so that reductions can be achieved gradually and without trauma.”

4.3.10 Following the meeting GAD wrote to Equitable Life confirming the discussions:

“it is clear that we are agreed that great restraint should be exercised in relation to the setting of guaranteed bonus levels at a time when a large part of the investment returns is being derived from capital gains.

We appreciate the openness of your current bonus structure for this business, and the clarity of the notes included in your Bonus Notices, but we remain wary that some of your policyholders may still not appreciate that levels of non-guaranteed final bonus might actually be reduced from one declaration to the next.”

4.4 Equitable Life’s disclosure of the guarantees in its regulatory returns

4.4.1 The Appointed Actuary was required to include in his valuation report in Schedule 4 of the regulatory returns a description of, among other matters, any material options.⁵

4.4.2 In Schedule 4 of Equitable Life’s regulatory returns for the years ending 1993, 1994 and 1995 the Appointed Actuary stated:

“Pensions business with profits contracts described as retirement annuity, transfer plan, individual or group business are deferred annuities, the premiums being of the recurrent premium (or variable premium) type. The premiums provide a cash fund at the pension date, to which (for policies issued prior to 1 July 1988) a guaranteed annuity rate is applicable.”

4.4.3 In the regulatory returns for 1996, 1997, 1998 and 1999 the wording was changed to the following:

“Some older contracts contain minimum guaranteed rates for annuity purchase at retirement.”

4.4.4 At a separate paragraph in the regulatory returns for 1993, 1994, 1995, 1996 and 1997, dealing with the basis of the reserve made for guarantees and options referred to above, Equitable Life stated:

“It was considered unnecessary in current conditions to make explicit provision for the other guarantees and options described [above].”

4.4.5 Save for the reference to terminal bonus practice set out below, there was no other reference to GAO policies in the regulatory returns between 1993 and 1997.

⁵ 1996 Regulations, Schedule 4, paragraph 4(1).

4.5 Survey by the Faculty and Institute - 1997

- 4.5.1 In late 1996 the actuarial profession identified GAOs as an issue to be addressed, and in January 1997, the Life Board of the Faculty and Institute appointed a Working Party to review the issue and carry out a survey of life companies' practices in relation to guaranteed annuities.⁶ The Working Party reported to the profession in November 1997. One of the members of the Working Party was an actuary employed by GAD and a copy of the Working Party's report appears on the GAD files.

4.6 Disclosure by Equitable Life of its terminal bonus practice

- 4.6.1 As far as its differential terminal bonus practice was concerned, from 1993 to 1997, Equitable Life's regulatory returns disclosed that practice as follows:

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

4.7 Equitable Life's disclosure of its resilience test in its regulatory returns

- 4.7.1 In Schedule 4 of the regulatory returns for 1996, 1997, 1998 and 1999 the following statement was included in Equitable Life's description of the basis for the resilience test:

"For all accumulating with profits business, an annual loading of [0.25%⁷] increasing by 4% per annum compound of the basic benefit was reserved which is considered to be a prudent allowance for ongoing expenses: for accumulating with profits pensions business, ½% pa of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses."

- 4.7.2 No questions were asked of Equitable Life by the regulator about the charge referred to in the second part of the sentence set out above until late 2000. The charge was later described by the Appointed Actuary as being in the nature of a "Zillmer" adjustment.⁸ The effect of the charge was to weaken the net premium reserve. The charge was not connected with GAOs, but became a matter of debate between GAD and the Appointed Actuary in late 2000 in relation to Equitable Life's disclosure of its statutory solvency position.

⁶ Reference is made to this survey in Chapter 3.

⁷ This figure varied from year to year.

⁸ "Zillmer" adjustments are described in Chapter 3.

4.8 Press articles

- 4.8.1 From early August 1998 articles began to appear in the press concerning the costs to insurance companies of guaranteed annuities. At the end of August 1998 an article was published in the *Sunday Telegraph* which referred to Equitable Life informing policyholders that it was “trimming the final bonus which it pays ... in order to pay for the guarantees” and that Equitable Life was the only insurance company which had taken the step of adjusting bonus rates to pay for the guarantees.

4.9 GAD’s 1998 survey on reserving for annuity guarantees

- 4.9.1 Following the publication of the report of the Working Party of the Life Board of the Faculty and Institute and, we were told in interview, because GAD was unable to access the confidential working papers, GAD initiated its own survey of life companies’ approach to reserving for annuity guarantees. The survey was initiated in June 1998. We have been told that the reason why the survey was initiated more than six months after publication of the Working Party’s report was that GAD wished to obtain full details of GAO policies and the valuation basis for those policies as included in the 31 December 1997 regulatory returns. Most insurance companies have a year end of 31 December. The regulatory returns are presented to the regulator and published on or around 30 June of the following year. Accordingly, by sending out the survey in June 1998, GAD sought to ensure that the information in the responses to the survey would be as up to date as possible and would also reflect how actuaries had reacted to the profession’s survey and subsequent discussions. The survey responses would also be able to be reconciled, by GAD, with the information contained in the latest regulatory returns.
- 4.9.2 On 29 July 1998 the Appointed Actuary, on behalf of Equitable Life, submitted a response to the GAD survey. A copy of that response appears on HMT-ID’s files and we were told at interview that HMT-ID first saw this in September 1998. The response showed that Equitable Life had made no explicit provision for annuity guarantees in setting its resilience or mathematical reserves⁹ and that Equitable Life’s investment policy did not take account of the guarantees. The response also showed that the Appointed Actuary had seen the Working Party’s report on reserving for annuity guarantees and that Equitable Life’s approach had not been modified by the “recent debate” on annuity guarantees in the actuarial profession.
- 4.9.3 In the response to the survey the Appointed Actuary stated that Equitable Life’s approach to setting terminal bonus rates for a cohort of policies was influenced by whether or not an annuity guarantee was biting. The Appointed Actuary described how the terminal bonus was adjusted as follows:

“For any policy for which the annuity guarantee is biting, the amount of terminal bonus is reduced to pay for the cost of the guarantee. For all but a few small policies the “cost” of the annuity guarantee is covered by this adjustment.”

- 4.9.4 Under “any other comments”, the Appointed Actuary wrote:

⁹ Resilience reserves and mathematical reserves are explained in Chapter 3.

“The cost of annuity guarantees has more than adequately been covered by the terminal bonus cushion to date for all but a few small policies... As the business to which annuity guarantees apply ages, the increasing terminal bonus cushion will make it increasingly unlikely that guarantees will actually bite.”

- 4.9.5 In response to the question “Are policyholders advised when they reach retirement of the existence of any available options to receive a guaranteed annuity?”, the Appointed Actuary answered “no.”¹⁰
- 4.9.6 In relation to all but one type of contract disclosed by Equitable Life as including a guarantee, in response to the question “Is the guarantee given to: (a) regular premiums paid at initial level (b) increments (c) single premiums (d) new members?” Equitable Life answered “yes” to each question (save for (d)). This was a matter which became very significant following the House of Lords’ judgment when the difficulties of quantifying and predicting the level of increments which might be paid by GAR policyholders was raised as an issue by bidders for Equitable Life.
- 4.9.7 None of the information in response to the survey was passed on by HMT-ID to IB-PIA, the conduct of business regulator. At that time these were separate regulatory bodies with no formal mechanism for the co-ordination of their respective duties. IBD was subsequently told, in a memorandum of 3 September 1998, which referred to the GAD survey, that PIA would no doubt have an interest in the issue such as the extent to which companies are informing policyholders about the existence of a GAO at vesting.

4.10 GAD’s advice to HMT-ID on guaranteed annuities following the survey

- 4.10.1 Following receipt of the responses to its survey, in mid-August and early September 1998 GAD provided HMT-ID with written advice on GAOs. GAD prepared a paper with some suggestions on derivative strategies which might assist life companies with their GAO liabilities. That advice included a section on PRE. The advice noted:

“There is an argument prevalent in the industry which runs something like this.

Terminal bonus is determined as the amount necessary to raise policy proceeds to asset share (plus or minus a bit). If a GAO applies, then the policy proceeds can be measured as the cost of an annuity of that amount (on a realistic not a prudent basis). Therefore terminal bonus can be restricted to keep the cost of GAO down. This cannot justify a lower reserve, however, as the terminal bonus is not itself reserved for.

Alternatively, the terminal bonus has been described, and therefore a policyholder’s reasonable expectation created, based upon the open market option, and to the extent that a GAO applies to the full sum, the full pain must be borne.

¹⁰ Subsequently HMT-ID asked Equitable Life further questions on this aspect at a meeting on 13 November 1998 and were told that “policyholders had a dialogue with the sales force and an illustration was given...The GAO option was covered in the illustrations only if it was more attractive to the policyholder.”

There is probably no solution to this issue on an industry basis, as it probably is a function of policy wordings, marketing material, with profits guides and similar items.”

4.10.2 The advice also noted as “overriding considerations” that “whatever is the technical position, it must be remembered [that] these GAOs exist in large numbers, and threaten solvency in many cases and policyholders’ actual, if not necessarily reasonable, expectations in more” and that “there is a risk of these becoming the regulator’s problem.”

4.11 GAD advice on action to be taken by HMT-ID on GAOs

4.11.1 On 1 September 1998, GAD provided HMT-ID with written advice in relation to GAOs. The advice noted that following substantial improvements in projected mortality and with falling long-term interest rates, many of the guarantees were becoming valuable rights. The note considered various issues including:

- (a) the circumstances in which the company was obliged to tell a policyholder if the guarantee was valuable;
- (b) that the PIA was the only authority with jurisdiction to “police” the requirement of companies offering advice on maturity to offer “best advice”, although if there was a breach of the requirement to manage the business in a sound and prudent manner by failing to conduct the business with due regard to PRE, then HMT-ID may have a role;
- (c) that if companies were avoiding contractual obligations, this was potentially a matter for HMT-ID;
- (d) the action which HMT-ID should take, noting that:

“HMT would appear to have a number of options, but the best course of action would seem to be along the following lines:

- circulate all insurance companies referring to the issue of annuity options and guarantees and identifying the avoiding of these obligations as unacceptable behaviour;
- all companies should be asked to report on the procedures in place to ensure guaranteed rates are applied in maturity option quotations, and that the existence of the options is made known (*is this going a step too far?*);
- any policyholder or IFA complaint should be the trigger for a visit to review the procedures;
- any subsequent failures should result in a section 43A investigation, to include a sample review of files;
- identification of a substantial problem would necessitate action, including a review of cases and “fit and proper” action.”

4.12 Consideration by HMT-ID of the use of derivatives in relation to GAOs

4.12.1 One industry-wide solution involving the use of derivatives was brought to HMT-ID's attention in October 1998. On 19 October 1998 the Debt Management Office¹¹ wrote to HMT-ID concerning the possibility of issuing a gilt that included an option designed to cover potential liabilities for GAOs. The letter enclosed a copy of an article published in *The Actuary* concerning the various forms of hedging the interest rate exposure, and estimating the cost of guarantees at between £5billion and £12billion.

4.12.2 On 2 November 1998 HMT-ID wrote to the Debt Management Office referring to direct discussions which had taken place between HMT-ID and the author of the article published in *The Actuary*, in respect of which HMT-ID considered that there was nothing appropriate for the Debt Management Office to follow up. The letter stated:

“We are, of course, monitoring companies' exposure to this issue very closely and discussing with them how they plan to handle this... Our present impression is that [the author of the article in *The Actuary*] is somewhat overstating both the size of the problem and the difficulties posed for companies by the application of the admissibility rules to derivatives. However these are early days...”

4.12.3 The regulator's view at that stage, we were told, was that a derivative solution, at least for Equitable Life, might have been unsuitable. As set out in a Board paper dated March 1999, the Appointed Actuary considered that the cost of buying protection which might in the event prove unnecessary would reduce the level of payouts for policyholders and, accordingly, this course of action was not one of the measures that the Appointed Actuary identified as sensible for Equitable Life to pursue.¹²

4.13 Scrutiny Report

4.13.1 For a company such as Equitable Life which had been given a priority rating of 3 in relation to its 1996 regulatory returns, in the normal course of prudential regulation GAD would produce a detailed scrutiny of its 1997 regulatory returns within 6 months of receipt by the regulator. However, no detailed scrutiny was produced by GAD in 1998 in respect of its 1997 regulatory returns. GAD's scrutiny of those regulatory returns was combined with its scrutiny of Equitable Life's 1998 regulatory returns, which were submitted to the FSA in May 1999. We were told in interview that this was because Equitable Life was given a priority rating of 4 in 1997, and its regulatory returns would have been scrutinised in March 1998, although because of the ongoing dialogue with the regulator, GAD knew “where all the issues” were and scrutinised the 1997 returns, with the 1998 returns, in 1999. It is clear from the

¹¹ The Debt Management Office was established in 1998 and is an executive agency of HMT. Its brief is to carry out the Government's debt management policy of minimising financing costs over the long term, taking account of risks and to manage the aggregate cash needs of the Exchequer in the most cost-effective way, in both cases consistently with the objectives of monetary and any wider policy considerations. Its strategic objectives include conducting market operations, liaising as necessary with the relevant bodies, with a view to maintaining or promoting an orderly, efficient and liquid market for gilts.

¹² The Equitable Life Board paper was received by the FSA in early 1999 and is referred to in the description of the events of the Review Period, below.

documents that the 1997 regulatory returns were considered, at least in part, prior to May 1999, because it is referred to in a briefing note given by HMT-ID to the FSA in December 1998, which is referred to in more detail below.

4.14 Dialogue between Equitable Life and HMT-ID in relation to GAO issues

- 4.14.1 The exchanges between the regulator and Equitable Life in relation to GAO issues opened with an exchange of letters in September 1998. On 21 September 1998 HMT-ID wrote to Equitable Life referring to its responses to the GAD survey, in particular, in relation to the terminal bonus practice. HMT-ID asked Equitable Life to supply copies of relevant marketing literature or other evidence in support of its approach of reducing terminal bonuses "as we will wish to be satisfied that policyholders' reasonable expectations are being met."
- 4.14.2 In response, by a letter dated 29 September 1998, Equitable Life sought to explain its approach by reference to the following points:
- (a) Equitable Life "guarantees full value benefits" whenever retirement occurs which was described by Equitable Life as an "unusual" approach;
 - (b) It had always been clear to Equitable Life that because of its wide-ranging nature the guarantee could become valuable in a period of sustained low interest rates;
 - (c) That if Equitable Life had tried to set rates for the GAR policyholders as a class so that the same terminal bonus was awarded whether benefits were taken in cash or annuity form, bonus rates for the whole class would have been lower. This would have been to the material disadvantage of those electing to take their benefits in cash form. Additionally there would have been difficulty in estimating the allowance to be made for GAOs through the bonus system and this would be more likely to result in a material inequity between business containing GAOs and more recent products which contained no such options;
 - (d) That accordingly, Equitable Life had decided to deploy its terminal bonus practice;
 - (e) That the Society had always described its approach to bonuses "in the most general terms" in marketing literature because in its experience bonus systems needed to be flexible and capable of changing with evolving financial conditions;
 - (f) That such comments as it had made "focused on principles such as fair treatment between different classes of business, that bonuses are primarily determined by the level of investment returns over a contract's lifetime and that our aim is to pass on the smoothed earnings achieved on the contributions made during a policy's term";
 - (g) That these messages had been reinforced at each declaration in the bonus notices and that Equitable Life had been at pains to make clear in all its illustrations that terminal bonuses were allotted only at the point of retirement, could vary, and were not guaranteed; and

(h) That for “several years now” the presentation of results for all pension contracts had focused on the open market option cash fund because that is what the vast majority of its clients had been interested in.

4.14.3 Equitable Life also explained that it had disclosed its terminal bonus practice in its regulatory returns since 1993.

4.14.4 With the letter, Equitable Life enclosed various items of literature about bonuses and policies.

4.14.5 On 1 October 1998 Equitable Life sent HMT-ID a facsimile enclosing a copy of the retirement annuity policy document which was used in the 1980s prior to withdrawal of the sale of contracts containing GAOs and a copy of Article 65 of the Society’s Articles of Association. As set out in **Chapter 3**, Article 65 gives the directors of Equitable Life discretion to make decisions in relation to the declaration and payment of bonuses.

4.14.6 On 2 October 1998 a meeting took place between Equitable Life, HMT-ID and GAD to discuss Equitable Life’s approach to terminal bonus and its reserving practice.

4.14.7 As to the terminal bonus practice, GAD expressed some doubts as to the clarity of the literature provided by Equitable Life and commented that a GAR policyholder could interpret it as indicative of entitlement to whichever of the current and guaranteed rates produced the higher figure. Equitable Life stated that it had been advised by Counsel that the Society was acting fully within its rights and that other offices were raising expectations by paying GARs on the full fund value.

4.14.8 As to the reserving practice, Equitable Life confirmed that no provision had been made for GAOs as at 31 December 1997 as it had only recently been the case that guarantees were biting on the guaranteed fund. Equitable Life argued that two-thirds of policyholders chose to take a cash benefit and so it would not be appropriate to reserve fully for all the guarantees. HMT-ID argued that Equitable Life needed to look at all guarantees and options throughout its policy base and make appropriate reserves. Equitable Life stated that the need to reserve for GAOs at the level required by the regulator could have severe consequences for the Society and that it might have to switch to investing in gilts to maintain solvency, but agreed to assess the need to provide reserves for GAOs along the basis outlined by HMT-ID and to make a reassessment of solvency.

4.14.9 There was also a discussion of reserving for increments. Equitable Life had disclosed in its response to the GAD survey in July 1998 that GARs did apply in most contracts to increments to existing policies. At the meeting Equitable Life agreed:

“that many of their policies allowed the payment of additional premiums, but this was not seen as a risk because of the treatment taken with respect to asset shares. However, switches of policies into the Equitable were currently a risk but the company was looking to impose endorsements on any switches in to stop these policyholders gaining disproportionate benefits.”

- 4.14.10 The difficulties associated with quantifying the liability for and therefore reserving for increments was a matter the implications and significance of which were to emerge after the House of Lords' judgment.
- 4.14.11 Thereafter, and until the end of the Inheritance Period, HMT-ID and GAD, in the course of correspondence and meetings, sought to ensure both that Equitable Life applied an appropriate level of reserves in respect of the GAOs and began to consider whether the terminal bonus practice was in accordance with PRE. The next sections dealing with the Inheritance Period set out each of these strands separately. The reader should be careful not to form an impression as a result that these two issues were being dealt with separately. Correspondence and meetings often covered both topics.

4.15 Reserving for GAOs

- 4.15.1 During the autumn of 1998, following receipt of the response to the GAD survey, HMT-ID initiated a debate with Equitable Life and gradually imposed its view in relation to Equitable Life's reserving practice. HMT-ID conferred closely with GAD in the process and followed GAD's advice and lead on the interpretation of the relevant regulations. HMT-ID also sought advice from TAD, particularly in relation to its consideration of the options for intervention.
- 4.15.2 On 19 October 1998 HMT-ID sent a memorandum to the EST about the position of Equitable Life. Among other matters, the memorandum stated:
- “Meeting the cost of the guarantees is putting a significant strain on the company's resources and, as a mutual, it does not have the option of obtaining a capital injection from shareholders to relieve this strain. We have discussed the situation with the company and it has been agreed that it will submit to HMT updated information regarding its liabilities for GAOs and its resulting financial position in order that we can monitor this and take any action that becomes necessary to protect policyholders' interest. It is feasible that the company could have to consider some form of demutualisation, for instance through merger with another company, depending on how serious the financial situation proves to be.”
- 4.15.3 On 30 October 1998 Equitable Life wrote to GAD setting out the costs of various approaches to reserving. Equitable Life argued that the “commercial” cost of its guarantees was highly unlikely to exceed £50million. As to reserving, Equitable Life estimated that a reserve of £170million would cover all benefits taken in annuity form, assuming that policyholders would only choose the guaranteed annuity when it would produce a higher income than the cash fund at the current annuity rate.
- 4.15.4 GAD forwarded Equitable Life's letter to HMT-ID on 3 November 1998 noting that “it is not acceptable in this context to regard these guarantees as covered by a ‘First charge’ against a final bonus for which no provision is made. This has clearly not yet been recognised by Equitable Life (and they have not even attempted as we requested at the meeting [on 2 October 1998] to quantify the reserves on this basis).”
- 4.15.5 On 6 November 1998, HMT-ID wrote to Equitable Life setting out GAD's arguments and requesting further information and a meeting.

- 4.15.6 Equitable Life replied on 11 November 1998 stating that the basic additional reserve at 31 December 1997, on the basis requested by GAD, would have been around £675million, and gave estimates of the reserves based on various different valuation interest rates. The range given was estimated for the year ending 31 December 1998 and was £955million and £1375million. Equitable Life said that these figures should be increased by 10% and 20% in respect of the resilience reserves.
- 4.15.7 On 13 November 1998, GAD and HMT-ID met Equitable Life. Despite arguments from Equitable Life that policyholders taking the GAO were very much in the minority (because in many cases the margin of any GAO benefit was small), GAD and HMT-ID “argued that it was a statutory requirement to reserve on [the 100% take-up] basis and unless the Equitable could put up a compelling argument to the contrary we would expect the company to reserve on this basis.”
- 4.15.8 Equitable Life was concerned about the timing of the potential need to reserve on the basis of 100% take-up rate and the potential commercial implications. Equitable Life agreed that thought would have to be given to reducing bonus declarations and agreed to provide an update on its latest free asset position.
- 4.15.9 Equitable Life wrote to GAD on 24 November 1998 setting out an explanation of how the GAO worked and arguing at length against GAD’s position. Equitable Life estimated surplus assets as at 30 October 1998, as £1164million and quantified the cost of GAO reserves on the basis which GAD was requiring as £1794million. Equitable Life pointed out that it had obtained a Section 68 Order allowing implicit items of up to £850million to be brought into account and that it would “not necessarily consider [a resilience reserve in accordance with the normal GAD guidelines to be] appropriate, if very substantial additional reserves were also required for guaranteed annuity rates.”
- 4.15.10 The letter identified choices available if reserving were required at the onerous end of the spectrum, including passing the bonus declaration, and indicated that the Appointed Actuary would “need to consider what steps to take in terms of consulting with the profession”.
- 4.15.11 There was a meeting on 3 December 1998 to discuss reserving matters, as well as PRE issues (the latter are referred to in more detail below). The Appointed Actuary reiterated Equitable Life’s arguments and noted that the Society’s reserving policy was not new, that GAD should have been aware from the regulatory returns that it was writing GAO business and that GAD had tacitly accepted its reserving basis. GAD rejected this argument. HMT-ID argued that there was at least a possibility that dissident policyholders might win a case in Court that they should be paid a guaranteed annuity on unadjusted terminal bonus. Equitable Life admitted that there was at least a potential contingent liability here. Equitable Life asked if there was any scope for HMT-ID to give any concession on this issue and what would be the consequences of not following this requirement. HMT-ID indicated that it could not see any scope for a concession in the circumstances. HMT-ID said that it would take appropriate measures to ensure compliance and when Equitable Life asked if there would be any way to appeal the matter, HMT-ID said that this would be limited to judicial review. Equitable Life said that it might have to take up that option. GAD expressed the opinion that “if the company had not been mistaken in its interpretation

of the regulations it would not have been in the past so generous in its bonus declarations. Questions were also raised regarding the prudence of trying to operate a company without an estate.” Equitable Life said that they had not taken any legal advice on the issue of reserving. There was discussion about the bonus declaration and the possibility of using reinsurance as an option for “protecting the balance sheet”. The meeting note records that the Appointed Actuary “was concerned from a professional point of view that he was being forced to adopt a reserving approach that was ‘wildly prudent’ and he thought he would need to consult professionally regarding this.”

- 4.15.12 Following this meeting, intervention action was actively considered by HMT-ID.
- 4.15.13 On 7 December 1998, HMT-ID wrote to Equitable Life setting out its views in full and rebutting the arguments which had been raised by Equitable Life. In particular, HMT-ID did not accept that assuming a GAO take-up rate of 35% (as had been proposed by Equitable Life) was prudent, nor that a reserve based on the cash option should exclude terminal bonus. HMT-ID indicated that it would be willing to consider the possibility of treating a reinsurance arrangement as effective from the year end provided that at least the broad terms of the agreement were in place by that date and that a firm intention to enter into the agreement could be shown.
- 4.15.14 In view of Equitable Life’s continued resistance to HMT-ID’s reserving arguments, GAD suggested, by way of internal memorandum to HMT-ID dated 8 December 1998 that it may be appropriate for the Government Actuary to discuss Equitable Life’s approach to reserving with the Appointed Actuary if HMT-ID was proposing to take issue with Equitable Life’s stance. Equitable Life told HMT-ID on 10 December 1998 that it had obtained “favourable” legal advice on the reserving question and that it was willing to take the matter to judicial review.
- 4.15.15 On 18 December 1998, Equitable Life sent HMT-ID a copy of a Joint Opinion of Leading Counsel. The Joint Opinion set out Counsel’s view that Equitable Life’s terminal bonus practice was wholly within the directors’ discretion, that policyholders had no contractual right to have terminal bonus allocated to them, that the literature made it “abundantly clear” that terminal bonus was not guaranteed prior to actual allocation to the policy, that HMT-ID had been aware of the existence of the GAO policies from 1993 onwards and had not previously taken the point now being taken against the Society. HMT-ID’s current requirement for reserving was manifestly unfair and would be open to judicial review on the basis that HMT-ID’s current attitude was a breach of Equitable Life’s legitimate expectations.
- 4.15.16 HMT-ID maintained its stance that Equitable Life was required to reserve fully for the GAOs. Internal legal advice was obtained by HMT-ID in relation to possible intervention action.
- 4.15.17 At a meeting on 22 December 1998 the debate on reserving continued. HMT-ID said that it would respond formally to the Joint Opinion on reserving when it had had an opportunity to consider it in detail. HMT-ID said that it was for Equitable Life to reserve as it saw fit, but it would take regulatory action if the reserves were inappropriate or Equitable Life’s actions imperilled solvency margin cover. Among other matters, HMT-ID rejected the arguments raised in the Joint Opinion that HMT-

ID had tacitly accepted Equitable Life's reserving practice. HMT-ID said that the information disclosed in the regulatory returns was limited and gave them no reason to question the validity of the reserving basis. GAD added that the report of the Working Party of the Faculty and Institute had concluded that holding no reserve for GAOs and assuming that the cost could be met from terminal bonus was "imprudent"¹³. Equitable Life argued that the requirement to reserve at 100% would disadvantage policyholders because it would constrain investment strategy. Equitable Life said that the consequent low solvency margin would threaten the Society's future and could put immense pressure on the Society to look for a buyer. HMT-ID agreed to consider any proposals which were transitional measures to soften the blow in relation to reserving. Equitable Life indicated that it was considering obtaining reinsurance for the reserves for guaranteed annuities.

4.15.18 On the same day, Equitable Life applied for a Section 68 Order for a future profits implicit item of £1900million. This was granted and a copy of the Order was sent to Equitable Life at the end of the year. On 31 December 1998 Equitable Life confirmed to HMT-ID that it had received an offer from an offshore reinsurer to enter into a reinsurance agreement.

4.16 Equitable Life's terminal bonus practice and PRE

4.16.1 During the Inheritance Period the activity and correspondence relating to Equitable Life's terminal bonus practice and PRE was principally directed at HMT-ID informing itself in order to be able to form a view on whether this practice was consistent with PRE.

4.16.2 Following the meeting on 2 October 1998 it was agreed at an internal meeting in early November 1998 that a meeting with Equitable Life should be arranged urgently in order to make it clear to Equitable Life that HMT-ID wished to satisfy itself that, *inter alia*, Equitable Life was conducting its business with due regard to the interests of policyholders¹⁴ and, more generally, whether Equitable Life's terminal bonus practice "accords with PRE".

4.16.3 On 12 November 1998 GAD provided HMT-ID with a background note for a meeting with Equitable Life which was due to take place on the following day. GAD suggested various questions should be raised relating to PRE and the terms of Equitable Life's contracts. The memorandum from GAD also listed certain documents which Equitable Life should be asked to provide, including copies of Board papers relating to the decision to grant lower bonuses to policyholders electing to take the GARs, copies of any communications prior to the 1995 bonus notice which might have indicated that a two-tier bonus system could apply and copies of any documents which supported the adoption of a two-tier terminal bonus system as a modification of policyholders' previous expectations.

4.16.4 At the meeting on 13 November, HMT-ID told Equitable Life that to understand the PRE implications it would want to see a selection of documents sent to policyholders

¹³ As described in Chapter 3, the Working Party's report described this approach as "unsound".

¹⁴ As required by section 7 of Schedule 2A ICA 1982, referred to in more detail in Chapter 2.

and prospective policyholders. Equitable Life explained to HMT-ID that the Society had obtained a legal opinion from Leading Counsel which endorsed its position and Equitable Life agreed to provide copies of the Opinion and the instructions sent to Counsel as well as any Board papers required concerning Board discussions of the issue. HMT-ID asked Equitable Life about press reports which alleged that projections had been given to policyholders showing that the guaranteed rate was applied to unadjusted terminal bonus. Equitable Life said that, even if that had been the case, the level of terminal bonus had not been guaranteed, that the Society's principle was to pay out on the basis of asset share and that some policyholders had written in supporting its stance. HMT-ID explained to Equitable Life that in order to understand the PRE implications it would want to "get a feel for what impression had been given to policyholders over the years" and said that it would be writing to ask for a selection of documents. Equitable Life was asked about information given to policyholders on vesting:

"[HMT-ID] felt that it was necessary to understand what information was given to clients on the GAO option for policies which were close to maturity. [Equitable Life] said that policyholders had a dialogue with the sales force and an illustration was given. It was added that the sales force tended to be in favour of the client rather than the company. The GAO option was covered in the illustrations only if it was more attractive to the policyholder."

4.16.5 On 16 November 1998 HMT-ID wrote to Equitable Life what action was required following the meeting on 13 November 1998. HMT-ID requested copies of literature provided to policyholders, Leading Counsel's Opinion and copies of the instructions which had been sent to Leading Counsel. The letter stated:

"We are concerned that a policyholder with a policy where the GAO is biting to the extent that there would be no terminal bonus if the option is exercised will receive lower benefits if he/she chooses the cash option (no credit being given under the cash option for the additional value of the GAO). From our initial reading of the specimen contract received prior to our meeting on 2 October, it appears that it could possibly be interpreted as entitling the policyholder to cash to the same value as the GAO in such cases. You agreed to provide some worked examples covering situations where some or all of the policy proceeds are to be taken in cash."

4.16.6 On 23 November 1998 Equitable Life wrote to HMT-ID enclosing the following:

- (a) a list of items supplied to clients during the lifetime of a contract;
- (b) Instructions to Leading Counsel and documents, a Settled Note of a Consultation and an Opinion;
- (c) a listing of retirement annuity policies under which benefits had been taken since 1996;
- (d) illustrations provided where the exercise of a GAO would and would not produce a higher level of retirement income; and

(e) a leaflet which Equitable Life was issuing to all retiring policyholders.

4.16.7 The Settled Note of Consultation and the Opinion of Leading Counsel were circulated to GAD and TAD for comment. The Settled Note of Consultation confirmed that Counsel's view was that as long as the directors of Equitable Life had exercised their discretion:

“with a view to ensuring (so far as possible) that those [policies] which were producing less advantageous benefits because of the terms on which they were written and economic experience did not suffer by comparison with others which were producing more advantageous benefits having regard to the impact of economic experience on their terms; then that would be defensible.

If, however, the rationale for the use of the discretion was to reduce bonuses on the more expensive policies on the basis that the Society had in some sense made a bad bargain in writing policies on such terms, and honouring the Society's contractual obligations was regarded as too costly, this could not be defended.”

4.16.8 In his Opinion, Counsel advised that:

“The Board's decision to seek to achieve a result under which all persons holding similar policies achieve the same investment return, irrespective of whether some policyholders had the benefit of guaranteed annuity rates applicable to guaranteed benefits, is perfectly legitimate.”

4.16.9 Counsel advised that Equitable Life's problems stemmed less from the documentation issued to policyholders and more from the way in which the Society had presented the differential allocation of terminal bonuses when undertaken and subsequently when the present story had broken in the press. In this connection Counsel noted the need to redraft the bonus notices.

4.16.10 Counsel also advised that if a policyholder challenged the differential treatment of policyholders he ought not to succeed, but that retrospective defence of the Society's action would be harder than it would have been if Equitable Life's presentation of the position had been different. He advised that:

“the Society would have to overcome a “credibility gap” arising out of (i) its being unable to point to any past communication to guaranteed annuity policyholders indicating that terminal bonuses would be utilised for the purposes of adjusting overall returns and (ii) the fact that over the several weeks since the present story had broken the Society had failed to get its message across generally, or in the particular manner suggested and developed in the present consultation. Nevertheless, Counsel considered that the Society's past actions would be vindicated if the matter came to Court - for which purpose it would be essential that the Society's witnesses came up to proof and there were no bombshells lurking in other documents.”

4.16.11 In his Opinion, Counsel stated that the “abbreviated nature of the annual statement tends to obscure the fact that a number of different things are being stated in a single

table which tends to create an impression that one is comparing like with like at all stages, when one is not (or may not be) doing so.”

- 4.16.12 Counsel advised that Equitable Life’s Board had discretion to award an extra allocation of terminal bonus to those policyholders who chose not to exercise their GAO although he also advised that the literature should reflect this practice, which should be adopted in future (in substitution for the current practice of reducing terminal bonus to policyholders who chose the GAR).
- 4.16.13 Leading Counsel made further detailed comments on the presentation and explanation in the bonus notices which he considered would “best serve the Society’s interests in the present circumstances.”
- 4.16.14 Equitable Life had also asked Counsel’s advice in relation to (a) increments paid by GAO policyholders and (b) transfers into the with-profits fund by GAO policyholders of the proceeds of a pension from another pension provider. In relation to increments, Counsel advised that if Equitable Life wanted to impose amended terms on such premiums it would have to do so:
- “at or prior to the time of accepting any further premiums ... and would clearly have to consider the commercial implications of doing so before acting. What was clear, however, was that the possibility of imposing new terms prospectively prior to acceptance of an overdue premium could not now be relied upon in order to validate otherwise indefensible conduct in those cases where overdue premiums had been accepted in the past without the Society applying different terms at that time.”
- 4.16.15 As far as transferring funds into the with-profits fund was concerned, Counsel agreed that the current document used by Equitable Life to effect the transfer:
- “did permit the Society to apply whatever terms it thought fit on transfers into the Society’s retirement policies, assuming the Society was otherwise permitted to refuse to accept such transfers. It was noted, however, that the Society would have to specifically impose the particular terms and that the current form of endorsement did not do that. The endorsement was being revised accordingly.”
- 4.16.16 The Settled Note of Consultation recorded that Counsel had advised that it:
- “would be feasible but not tactically desirable (at this stage at least), to obtain a test case ruling on the matter. Better to sort matters out quietly, and to attempt to undo any damage done to date by getting a clear message across by correspondence, than to risk the publicity, cost and serious potentially adverse result of a court hearing.”
- 4.16.17 The advice disclosed that Counsel had prepared wording for a new form of bonus notice.
- 4.16.18 GAD’s reaction to the advice in a memorandum dated 1 December 1998 was that it did “not wholeheartedly support the actions taken thus far by the Society”. GAD stated:

“The question remains as to whether past vesting policyholders have been treated fairly, and Counsel advises that the Society ought to be able to defend its position in Court. *We do not feel sufficiently competent to offer an opinion on this legal question. The presentation adopted by the Society in its bonus notices, of the benefits available at maturity, does not appear to have been in strict accordance with the policy conditions, but it is difficult to see how this might have created a breach of contract. It remains possible that policyholders could successfully argue that they were not led to expect a differential terminal bonus rate dependent on the benefit they chose at vesting.*”

4.16.19 GAD also noted that:

“Other items of advice given by Counsel give little comfort to the Society in seeking to limit its exposures to the guaranteed annuity rate. In particular the Society appears to be unable to avoid the exposure in respect of past transfers in and where premiums have been intermittent because they have not specifically imposed special terms when they accepted those premiums. They are modifying their approach to this in future in order to limit their future commitments.”

4.16.20 In a manuscript note of late November or early December 1998, HMT-ID commented under the heading “PRE”:

“Need to be clear how new documentation will be drafted

Risk that their past practice could be found to be unacceptable so could be liable to pay guarantee on top of full fund.

Need to make an approp. accounting provision (contingent liabilities).”

4.16.21 As referred to above, on 3 December 1998 a meeting was held with Equitable Life to discuss GAO issues. As far as PRE was concerned, the minute of the meeting recorded that HMT-ID had stated that it considered that if the advice given by Counsel was followed in relation to the revision of annual statements “there would be relatively little doubt that PRE would in future be met”. The principal question was whether PRE had been met in respect of policies which had already matured, since the way in which the contracts and the company’s bonus policy had been described did not appear to HMT-ID to be fully in line with the approach adopted by the company. HMT-ID said that it wished to consider this issue further and more material was requested from Equitable Life, including copies of documents given to potential policyholders, documents supplied during the lifetime of the policy and literature supplied and records of discussions with policyholders at maturity.

4.16.22 On 2 December 1998 an internal memorandum within IB-PIA recorded that HMT-ID intended to look at the literature used by Equitable Life when policies were issued and also at the wording used on bonus notices and other materials issued during the term of the policy. This was stated to be to allow them to take a view on what reasonable expectations a policyholder might have had from reading the literature. In the second half of December 1998 HMT-ID received, in two stages, two boxes of materials from Equitable Life containing the documents which had been requested at the meeting on 3 December 1998. The documents were reviewed by HMT-ID (and,

in January 1999, by IFSD). According to an internal note, IB-PIA asked to be kept informed about this review and decided to await its outcome before considering what, if any, action it should take. The information which we have received regarding the review of Equitable Life's product and marketing literature and decisions taken in relation to it are set out in the description of events during the Review Period, below.

- 4.16.23 On 4 December 1998 TAD gave some advice to HMT-ID. The advice, which expressly stated that it was not intended to be final or complete, dealt in part with Equitable Life's reserving position and possible intervention action. As regards Leading Counsel's advice, TAD advised that it found it hard to take issue with what Leading Counsel had said: "He...concluded that on balance a Court would accept that Equitable's practices were valid in terms of contract and trust law." The advice went on to say:

"However, I understand it to be your view that considerations of PRE may go beyond determining what is a legally acceptable construction of the contract or exercise of a discretion under or in conjunction with the contract. If so, then [Leading Counsel's] opinions (even if you accept them) are not an end to the matter."

- 4.16.24 On 7 December 1998 HMT-ID wrote to Equitable Life summarising the meeting on 3 December and went on to deal with, among other matters, PRE. On the issue of PRE HMT-ID stated that "if the advice given by Counsel ... was followed in relation to the revision of annual statements there would be relatively little doubt that PRE would in future be met" and the principal question was in relation to policies which had already matured. HMT-ID also said that at the meeting it had indicated that it:

"expected an appropriate statement on contingent liabilities to appear in [Equitable Life's] regulatory returns, related to the risk of a successful challenge to the Equitable Life's bonus practice with regard to guaranteed annuities."¹⁵

- 4.16.25 On 18 December 1998 Equitable Life wrote to HMT-ID and informed it that, on the advice of Leading Counsel, Equitable Life had decided to take one or more test cases to the High Court in relation to its practice in respect of terminal bonuses. We were told in interview that Equitable Life had not given HMT-ID "any inkling or warning" of this. The letter provided no detail about the proposed test cases.

4.17 Other matters during the Inheritance Period

- 4.17.1 Concurrently with HMT-ID's correspondence with Equitable Life concerning reserving and its terminal bonus practice, HMT-ID was also engaged in the related

¹⁵ At the meeting on 3 December 1998 HMT-ID had argued that "there was the possibility that dissident policyholders (who were arguing that when GAOs are biting they should be paid a guarantee annuity on unadjusted terminal bonus) could win their case in court and this could lead to the need for even higher reserves. [The Managing Director of Equitable Life] accepted that there was at least a potential contingent liability here and he would be considering with his auditors whether any mention of this needed to be made in the accounts and returns. He said that the auditors would inevitably be involved in coming to an opinion on the overall reserving approach taken. Although they will not audit Schedule 4, they would need to sign off the Form 9 position."

matter of preparing guidance to the industry on GAOs. As a consequence of the emergence of GAOs as an industry-wide issue, it had been decided by GAD and HMT-ID to issue guidance on the question of charging for GAOs and PRE. The EST had requested a “read out” on the position of Equitable Life and its exposure to GAOs. At the same time as responding to that request, HMT-ID sent the EST draft guidance on the handling of GAOs to be sent out by HMT-ID to long-term insurance companies. There was a series of exchanges, both internal, and with the EST, which shed some light on the thinking at that time within HMT-ID and GAD on the PRE aspects of charging for the guarantees and, in that context, Equitable Life’s terminal bonus practice.

4.17.2 In addition, in preparation for the handover of the responsibility for the prudential regulation of the insurance industry to the FSA and in anticipation of the ultimate merger of conduct of business regulation with prudential regulation, there was communication with the FSA and IBD regarding the current status of views on Equitable Life.

4.17.3 Each of these two issues is dealt with below.

4.18 Communications with the EST and the 1998 Guidance

4.18.1 On 9 October 1998 GAD sent a memorandum to HMT-ID advising that some guidance to companies over HMT-ID’s interpretation of PRE in the context of GAOs was needed. The memorandum stated:

“As a starting point, I believe we could say that policyholders with such annuity guarantees or options on guaranteed terms could reasonably expect to pay some premium, or charge, towards the cost of these options and guarantees.

For linked contracts, this would have to be provided out of the normal explicit charges levied under the terms of the contract. Any cost arising to the office in respect of meeting these guarantees over and above these accumulated charges, would therefore have to be covered by the insurer from alternative available resources.

For participating policies this charge could be deemed to be met out of each premium received (or the investment return to be credited by way of bonus) and hence would impact on the assessment of bonuses, including in particular any final bonus that would be normally payable to these policyholders.

The level of the charge deemed to be payable by participating policyholders for the annuity options and guarantees (applicable normally under the terms of the contract to at least the guaranteed initial benefit and attaching declared bonuses) would we understand generally be assessed by reference to their perceived value over the duration of the contract. The selected treatment by each office would though depend on the wording of their contracts and how these are presented to policyholders.

This could therefore result in some reduction of the final bonus that would otherwise be payable if there were no such options or guarantees in the policy.

As a consequence of the above, we would expect that for most companies the present guaranteed cash benefits (including declared bonuses) would be converted, as a contractual minimum, to annuity on the guaranteed terms. However the appropriate final (or terminal) bonus may be somewhat lower than for contracts without such options or guarantees, and could be converted at current annuity rates.

Any residual cost for the insurer in respect of the annuity options and guarantees on all types of contract, will therefore fall to be apportioned among the available resources within the long-term fund. ...

The appropriateness of any such adjustments to bonus allocations for participating policyholders would need to be assessed by each office in the context of the reasonable expectations of all their policyholders which will be influenced by their policy documents and any representations made through marketing literature, bonus statements or elsewhere. This would be particularly relevant where a significant part of the current costs of annuity options and guarantees is to be charged by adjustments to the final bonuses, and hence to the benefits payable under those same policies that contain such options and guarantees.” [emphasis added]

4.18.2 The guidance which was ultimately issued closely followed this note.

4.18.3 On 19 October 1998 HMT-ID sent a memorandum to the EST commenting on the position of Equitable Life and its handling of its exposure to GAOs. The memorandum concluded that HMT-ID took the view that it was reasonable for policyholders to be required to pay some premium or charge towards the cost of a GAO provided that this possibility was allowed for in the terms of the contract. The memorandum also informed the EST that HMT-ID was drafting some guidance which would be sent to the EST for approval shortly. The note also stated the following:

“Equitable Life has recently been heavily criticised in the press for the approach it is taking to fulfilling the guarantee contained in its pension contracts - adjusting levels of terminal bonus paid to policyholders to take account of the cost of the guarantee.”

4.18.4 As far as PRE was concerned, HMT-ID told the EST:

“We have discussed the situation with [Equitable Life], and our initial view, on the evidence we have seen to date, is that [Equitable Life’s] approach appears to be consistent with the terms of the contracts sold, and that [Equitable Life] is endeavouring to fulfil the reasonable expectations of all its policyholders.”

4.18.5 It is not clear from the evidence provided to the Review Team which documents had been received and which had been reviewed at this stage to form this “initial view”.

4.18.6 Draft guidance was prepared by HMT-ID between 9 and 26 October 1998. On 26 October 1998, following a short telephone consultation with TAD about matters of form only (TAD had no industry experience to comment on the substance of the

guidance), HMT-ID sent EST a memorandum seeking approval of the issuance of guidance on meeting the costs of GAOs. The covering note to the draft guidance stated that:

“In the case of holders of with-profits policies the guarantee costs might be met through a reduction in the level of benefits payable under the contract. Equitable Life’s approach of reducing the terminal bonus received by with-profit policyholders entitled to a guaranteed annuity rate has been criticised in the press, but is in line with this general guidance.

In addition, the draft letter indicates that where charges to policyholders are insufficient to meet the full cost of the guarantee, other resources will need to be used. In line with the guidance issued on how insurers may meet the costs of pension mis-selling, it is indicated that, where appropriate, surpluses within the policyholder funds may be used provided this does not result in a failure to meet the reasonable benefit expectations of policyholders. Corresponding to the arguments used in the case of pension mis-selling, it appears reasonable that with-profit policyholders who stood to share in any profits made from the sale of contracts carrying guaranteed annuity options should also be expected to meet their share of any loss associated with that business.”

4.18.7 On 19 November 1998 HMT-ID received a note from the Assistant Private Secretary to the EST in response to HMT-ID’s request for ministerial approval of the draft guidance. The note records the following:

“The Economic Secretary is not at all happy with the proposal. The Minister has commented that surely if people bought a contract, it is a guarantee and they should not now expect to pay for the guarantee themselves. The Minister is minded to think that the shareholder should bear some/all? of the costs themselves.

The Minister has asked about Orphan Assets asking if some appropriate use could be made where they exist. The Minister would welcome a fuller justification and consideration of other issues before she is prepared to agree a way forward.”

4.18.8 HMT-ID did not amend the guidance in the light of the EST’s reaction. It provided the EST, as requested, with a “fuller justification of the proposed line on how insurers may meet the costs arising from guaranteed annuity options.”

4.18.9 On 24 November 1998 GAD prepared a note intended to assist HMT-ID to explain the position more fully to the EST. The memorandum noted that preparing the explanation to the EST “may then help us to identify more clearly where the draft letter may need to be modified.”

4.18.10 The memorandum stated that policyholders could reasonably be expected to pay some “premium” in advance for the GAO. GAD noted that in view of present investment conditions (with low yields on fixed interest securities) there may be a residual cost to the insurer of providing the guarantee over and above the accumulated charges received over the duration of the contract. Accordingly the guidance was suggesting that those residual costs could be met from either orphan

assets or by the shareholders and that this was a legitimate expense to be charged to the long-term fund. The memorandum noted the particular difficulty for insurers without orphan assets or shareholders, such as Equitable Life. GAD stated:

“In this situation, the ultimate residual cost of annuity guarantees falls to be met by either the policyholders who benefit from this guarantee or the remaining with-profit policyholders who share in the overall profits or losses for this business.

Unfortunately, Equitable Life has given these guarantees on a substantial portfolio of its policies (with an associated policy liability equal to around 40% of the value of all with-profit contracts). Consequently, the residual cost of the guarantee is relatively large and will necessarily impact the total amount of bonuses that can be paid to policyholders.

Contractually it is arguable whether it is obliged to spread the cost more evenly across all their policyholders, and we are seeking more specific information from them in this context.

Nevertheless, the policyholders with these guarantees will have to meet at least part of the residual cost of these guarantees, even if this cost is shared across all policyholders. Moreover the remaining policyholders will undoubtedly complain if their bonuses are now reduced on this account.”

4.18.11 On 9 December 1998, HMT-ID provided the EST with more detailed background to the proposed further draft of the guidance letter and requested ministerial approval. The note included the following comments:

“In my earlier submission I indicated that, subject to the terms of the contract and the reasonable expectations engendered in policyholders, we considered it reasonable for policyholders whose contract contains a guarantee to pay some additional charge for that guarantee. This was on the grounds that it was reasonable for policyholders to expect to pay in advance some ‘premium’ for the guaranteed annuity option as the option provides an additional benefit to the policyholder. In the case of with-profits policies, the consequence of charging some premium for the guarantee will be that the accumulated premiums after the deduction of charges ... will be lower than for similar policies that do not contain the guaranteed annuity option. It then follows that a lower final bonus ... commensurate with the lower net value of the premiums paid, may reasonably be offered on these contracts...

We consider that it would be acceptable in certain circumstances for insurers to adjust at maturity the level of final bonus paid to policyholders according to the form in which the benefits are to be taken. This would apply where the insurer has an established policy of setting final bonus so that the benefits paid to policyholders are in line with their “asset share” (an “asset share” is the value achieved when the premiums paid net of costs are simply rolled up at the average rate of investment return achieved by the with-profits fund) and this policy has been clearly communicated to policyholders. In this circumstance, there would be no failure to meet policyholders’ reasonable expectations; setting a reduced final bonus where the guaranteed annuity option applied in order to bring the total

value of the benefits into line with the asset share would simply be a specific example of the operation of the company's general policy. It then would be open to the company to enhance bonuses where a cash alternative was taken, to bring the benefits back into line with the asset share.

In practice it is unlikely to be immediately apparent whether a company has adopted the approach of charging a premium in advance for the cost of the guarantee or has reduced final bonus at maturity so as to bring the benefits into line with asset shares. In both cases the effect is likely to be a reduction in the level of final bonus paid to policyholders where the guaranteed annuity option applies.

Under present investment conditions with low yields on fixed-interest securities, the additional premium charge for the guarantee over the duration of the contract (or the scope for reducing final bonus) may not be sufficient to meet the full cost of that guarantee (or to bring the benefits back in line with asset shares). In this scenario there will be a residual cost to the insurer in providing the guaranteed annuity and policyholders will receive additional benefits by exercising their guarantee. ...

A particular difficulty arises for mutual insurers (such as Equitable Life) that do not have any 'orphan assets' or 'estate' from which the residual costs of guaranteed annuity options can be met. In this situation, the ultimate residual cost of the guarantees must either be met by the policyholders who benefit from the guarantee or be spread across all with-profit policyholders who share in the overall profits and losses of the relevant business. Unfortunately Equitable Life has given these guarantees on a substantial portfolio of its policies (approximately 25% of its with-profits business by liability value) and the level of the guarantee is comparatively high. Consequently, the residual costs of the guarantee is relatively large and will necessarily impact on the total amount of bonuses that can be paid to policyholders."

4.18.12 On 15 December 1998 the Assistant Private Secretary to the EST confirmed the EST's agreement to the issue of the guidance letter which had first been proposed in early October 1998.

4.18.13 Following a briefing meeting on Equitable Life which had taken place on 15 December 1998 between HMT-ID and the FSA, a facsimile was sent to Michael Foot, Managing Director of the FSA, dated 17 December 1998 to brief the FSA in relation to the proposed guidance. In the facsimile, HMT-ID stated that:

"While the letter deliberately sets out general principles, application of which will produce different results depending on the individual offices' circumstances, but should ensure a consistent and fair approach overall, commentators are likely to see it as relating primarily to the Equitable. Some will see it as support for the Equitable's position; some will see it as a shot across their bows."

4.18.14 On 18 December 1998 the guidance was issued by HMT-ID and sent to managing directors of life insurance companies. A copy of the guidance appears in full at **Appendix 1**.

4.18.15 Among other matters the guidance stated as follows:

“Generally we consider that it would be appropriate for the level of the charge deemed to be payable by participating policyholders for their guarantee (or annuity option) to reflect the perceived value of that guarantee (or option) over the duration of the contract. This could be achieved in some cases through some reduction in the terminal bonus that would be payable if there were no such guarantee (or option) attached to the policy. However the selected treatment by each office would need to depend on the wording of the contract involved and how it had been presented to policyholders.”

4.18.16 The guidance also contained two important caveats. The first was that the treatment of the cost of GAOs by each firm “would need to depend on the wording of the contract involved and how it had been presented to policyholders.” The second was that “The above is the Treasury’s considered view and is without prejudice to any decision of the courts that may affect it.”

4.19 Briefings to the FSA and IBD

4.19.1 In anticipation of the transfer of responsibility for the prudential regulation of insurance companies from HMT-ID to the FSA, a memorandum was sent by HMT-ID to Michael Foot on 3 September 1998. HMT-ID referred to the recent press interest in the issue of GAOs and informed the FSA about the GAD survey, the analysis of the responses which GAD was then carrying out and that HMT-ID was considering the implications for PRE. The note was also copied to IBD on the basis that that division would no doubt have an interest in some aspects of the issue, such as “the extent to which companies are informing policyholders of the existence of a guarantee at the time when they come to make choices about annuities on retirement”. The memorandum noted that this was “an example of an issue on which we will need to work together to ensure a seamless regulatory approach.”

4.19.2 A further briefing memorandum was sent by HMT-ID to the FSA and IBD on 5 November 1998 attaching the draft guidance letter referred to above relating to HMT-ID’s interpretation of PRE in relation to GAOs and how companies could charge for the costs of GAOs. In the covering memorandum, HMT-ID expressed its concern as to Equitable Life’s ability to reserve adequately: “The information received to date is unconvincing, and raises serious questions about the company’s solvency.” HMT-ID stated: “our preliminary view is that the Equitable Life is entitled to [pay the GAR only on the guaranteed sum not on the discretionary terminal bonus] though we are seeking further information to test the position further.” Michael Foot responded by a note stating that he thought that it was critical that HMT-ID seek further information for such purpose.

4.19.3 As part of a series of briefing meetings in anticipation of the transfer of the prudential regulation of insurance companies from HMT-ID to the FSA, a meeting was arranged between representatives of HMT-ID and Howard Davies and Michael Foot to discuss the position regarding Equitable Life. This was the only pre-handover briefing given to Howard Davies and Michael Foot relating to the problems of a particular company. A briefing note was prepared by HMT-ID and sent to the FSA setting out the free asset position if Equitable Life reserved for 100% or 25% of

GAOs. The note stated that Equitable Life was just solvent if it reserved fully for its GAOs and, for the FSA's information, set out the arguments on reserving.

4.19.4 The briefing note also stated:

“However, it should be noted that the free assets figure makes no allowance for the declaration of bonuses. The costs of annual bonuses, assuming they are maintained at their current level is £500m, so the company would appear to have insufficient assets to declare a bonus in 1999. Also it should be noted that £850m of the assets available to cover the RMM are implicit items (allowance for future profits). Only 5/6th of the RMM can be covered by implicit items. The company is therefore close to breaching this requirement when GAOs are fully reserved for. A relatively small fall in equities or gilt yields could wipe out the company's explicit free assets.”

4.19.5 The note set out a strategy for regulatory action. At a meeting before Christmas, Equitable Life was to be told that :

- (a) HMT-ID was not minded to take action against Equitable Life for its failure to reserve fully for GAOs in its 1997 regulatory returns;
- (b) Equitable Life's proposed reserving approach was not acceptable to HMT-ID; and
- (c) it was for Equitable Life to decide the reserving approach which it intended to adopt in its 1998 returns but if the FSA decided that the regulatory returns were not compliant with the Regulations, the FSA would take action.

4.19.6 In addition, it was intended to seek an undertaking from Equitable Life that it would not declare any further bonuses without prior discussion with HMT-ID.

4.19.7 The note contemplated closing Equitable Life to new business and the steps which would be taken if Equitable Life indicated it was going to declare a bonus which would have the effect of making the company breach its RMM if full reserves were made for the GAOs.

4.19.8 The section on “other regulatory action to be taken” stated that in December 1998/January 1999 HMT-ID would analyse the policyholder documentation issued by Equitable Life in order to reach a view on whether the reduction of terminal bonuses to meet the cost of GAOs was consistent with PRE for all policies maturing before the 1998 year end. It also stated that in January 1999 HMT-ID would seek to issue a “Dear Director” letter to all life insurance companies setting out its interpretation of the reserving requirements for GAOs (that full reserving was required) and stipulating that adequate disclosure was required in the regulatory returns of the reserving basis used for GAOs.

4.19.9 On 15 December 1998 the briefing meeting took place attended by HMT-ID, Howard Davies and Michael Foot. According to the minute of the meeting the following points, among others, were discussed:

- (a) it was considered vital from HMT-ID's perspective that the company was not permitted to make itself insolvent (assuming 100% reserving for GAOs) by declaring further bonuses but to pass a bonus declaration would be commercially very damaging;
- (b) HMT-ID had received a copy of Equitable Life's Counsel's Opinion which it considered provided "reasonable comfort" that the approach taken by Equitable Life to terminal bonus was consistent with PRE. We have subsequently been told that the minute was not accurate since Counsel's opinion related to the consistency of Equitable Life's terminal bonus practice with the terms of the contracts and did not directly address the issue of PRE, although "in undertaking the analysis of the terms of the company's contracts Counsel had looked at some of the points that would also need to be assessed in reaching a view on whether PRE was being met";
- (c) HMT-ID told the FSA that it had also given Equitable Life a list of further documents which it required so as to make its own assessment of PRE; and
- (d) there was concern to ensure that HMT-ID's approach was defensible - any reserving at less than 100% would be arbitrary.

4.19.10 The note of the meeting stated that: "It was concluded that the situation was not a happy one but in the circumstances HMT[-ID] appeared to be taking the only sensible approach."

4.19.11 As referred to above, shortly after the meeting, on 17 December 1998, HMT-ID sent a note to Michael Foot (copied to Howard Davies) alerting him to the fact that guidance to the life insurance industry on PRE in the context of GAOs would be issued shortly, enclosing a copy.

4.20 The position on handover to the FSA

4.20.1 At the end of the Inheritance Period, as far as reserving was concerned, HMT-ID was resolute in holding its line on reserving and Equitable Life appeared to be beginning to bow to the pressure. As regards Equitable Life's terminal bonus practice, guidance to the industry had been issued and in reliance on Leading Counsel's Opinion obtained by Equitable Life, HMT-ID believed that Equitable Life's approach was defensible in contract. As far as PRE was concerned, HMT-ID was not convinced that Equitable Life's past conduct was consistent with PRE, although it appeared more comfortable with the PRE aspects of the Society's current practice.

Part 2

The Review Period Prudential regulation before the House of Lords' Judgment

4.21 Introduction

- 4.21.1 During the Review Period and until the judgment of the House of Lords on 20 July 2000, the debate between the regulator and Equitable Life which had begun in late 1998 on the issue of reserving for guaranteed annuities continued, as did the consideration of the question of whether Equitable Life's terminal bonus practice was lawful in terms of the contractual relationship between the Society and the policyholder and whether or not that practice had a bearing on the ability of Equitable Life to meet PRE.

4.22 Regulation of statutory solvency and reserving

- 4.22.1 On 4 January 1999 GAD provided advice to IFSD following its review of Equitable Life's Counsel's Joint Opinion on reserving. GAD advised that IFSD needed to:
- (a) set out in writing to Equitable Life that the FSA was not satisfied with its level of reserving for GAOs;
 - (b) respond to Equitable Life's Joint Counsel's opinion on reserving; and
 - (c) request information (which GAD listed) to help GAD form a better understanding of Equitable Life's current financial condition and resilience to changing investment conditions.

4.23 GAD advice on the Joint Opinion of Counsel

- 4.23.1 As far as the Joint Opinion was concerned, GAD noted that Counsel had overlooked the key point that the prudent assumption about the proportions of policyholders who may exercise each option ought to depend on the relative value of the benefits. GAD considered that recent experience of take-up rates was irrelevant because an additional (discretionary) cash sum was being paid to those who chose the cash benefit rather than the guaranteed annuity. Therefore, in GAD's view, Equitable Life could not sensibly take account of the increased proportion who were taking the cash benefit, since Equitable Life did not propose to maintain any provision on the balance sheet for that additional cash bonus.
- 4.23.2 The Joint Opinion asserted that an insurer may take account of the existence of options to reduce the level of mathematical reserves. GAD questioned this interpretation of Regulation 72 (1) of the 1994 Regulations¹⁶. GAD said that if this had been intended, then the wording in Regulation 72 would have been "variation in liabilities" not "increase in liabilities."

¹⁶ "Provision shall be made on prudent assumptions to cover any increase in liabilities caused by policyholders exercising options under their contracts."

- 4.23.3 GAD accepted that Equitable Life could make an allowance for mortality prior to policyholders attaining 60. However, no allowance could be made for transfers to other pension arrangements, because Regulation 74 of the 1994 Regulations prohibits any reduction in liabilities in respect of possible future voluntary discontinuance.
- 4.23.4 GAD also stated:
- “On the subject of the earlier 1993 - 1996 returns, I accept with hindsight that we might have addressed the issue rather earlier by asking some pointed questions about their guaranteed annuities. However, the presentation of their valuation methodology in their returns was somewhat obscure, and required the reader to pick up comments in three quite separate parts of the return and draw certain inferences from them. There was nothing said to indicate that the level or extent of these guaranteed annuities were regarded as significant.”
- 4.23.5 Equitable Life’s presentation in the regulatory returns is set out in **Part 1 of Chapter 4**.
- 4.23.6 The Opinion alleged, as Equitable Life had done at the meeting on 3 December 1998, that the regulator had “tacitly” accepted the reserving basis in the 1997 returns. GAD denied this: it said that there had not been any direct communication between GAD and Equitable Life about those regulatory returns.
- 4.23.7 GAD questioned Counsel’s comments that if the additional reserve had been required for GAOs at the end of 1996 or earlier that would have prevented the declaration of bonuses. GAD also noted that Equitable Life did not at any time seek to discuss the reserving basis with GAD or HMT-ID even when this had become a material issue for the Society.
- 4.23.8 GAD had some sympathy with the points made by Counsel regarding the size of the one-off reserve (£1.5billion) and the fact that to make it would affect all policyholders in the form of reduced bonuses in future years. GAD said that it could consider some phasing-in of higher provisions when it had seen some of the information which it had asked IFSD to request from Equitable Life, which should help them consider the ramifications of the increased provision in the context of PRE.

4.24 FSA response to the Joint Opinion

- 4.24.1 On 11 January 1999 IFSD assisted by GCD and following the advice from GAD referred to above, replied to Equitable Life’s letters of 18 and 31 December 1998 and set out some matters relating to the discussions which had taken place on 22 December 1998 regarding the standard of reserving required for the contracts containing GAOs.
- 4.24.2 In its letter, IFSD stated that the Joint Opinion had not changed IFSD’s view on reserving as set out in HMT-ID’s letter to Equitable Life dated 7 December 1998, and, most importantly, did not appear even to address IFSD’s position. IFSD’s main points are set out below.

- (a) IFSD made clear that the issue was not the contractual right to bonus (or lack of it) or any representation about bonuses. The issue was the reality that bonuses had to be adjusted in order to ensure that the value of benefits, if taken in guaranteed annuity form, was no greater than the cash fund available to provide for an annuity on current rates and that that practice would need to continue if policyholders were to be expected to opt for the cash fund; so the company's discretion not to pay additional bonuses was substantially fettered.
- (b) As far as cash commutation was concerned, evidence that most policyholders currently took this did not address the real issue.
- (c) The letter repeated the points in GAD's advice relating to allowances for mortality and the prohibition on reducing liabilities in respect of voluntary discontinuance. IFSD also noted that "it would not in any event appear prudent to assume that policyholders would easily be persuaded to surrender their rights to a valuable annuity guarantee."
- (d) IFSD responded to Equitable Life's allegations that DTI and/or HMT-ID had been on notice of Equitable Life's reserving practice since submission of its 1993 regulatory returns. This was denied, on the basis that the statements in the regulatory returns were "brief in the extreme and do not disclose the reserving method, the rate of guarantee or the volume of business affected." IFSD noted that it would be raising the issue of reserving for GAOs with the industry shortly. IFSD did not consider that "the text of resolutions of the Society's Board reveals that GARs actually exceeded CARs ... [and] DTI/HMT was not aware from 1994 that the GARs referred to were higher than CARs", as asserted in the Joint Opinion.

4.24.3 IFSD said that its view:

"remains that guaranteed annuities must, as a matter of prudence, be fully reserved. It is a consequence of the changing economic circumstances that the quantum of reserves required has increased significantly over the last year or two. The Equitable has so far presented us with no reasonable argument as to why, on suitably prudent assumptions, reserves should be established at a level significantly less than 100% of the value of the guaranteed annuities."

4.24.4 The letter also stated that in the event that Equitable Life wished to argue that reserving at 100% would unduly prejudice policyholders and should not be enforced by intervention in the short term, IFSD would have to receive clear and convincing arguments from Equitable Life to that effect (and, among other matters, that there was no real risk that Equitable Life was unable to meet its liabilities) and any arrangement which fell short of the normal reserving requirement would have to be disclosed in the regulatory returns so that potential policyholders were not materially misled as to the overall financial position of the Society.

4.25 Early submission of 1998 regulatory returns

4.25.1 On 7 January 1999 IFSD sent a briefing note to Howard Davies relating to the proposal to issue guidance to the insurance industry on reserving requirements for

GAOs. The memorandum recommended that Howard Davies should consider, amongst other matters, the general industry draft guidance and that IFSD proposed to ask companies to submit their 1998 regulatory returns early where their 1997 regulatory returns were not prepared in compliance with the line set out in the guidance and where they presented a materially misleading impression as a result. The note stated:

“The industry letter has the potential to lead to difficult questions being asked about whether some companies’ 1997 returns were not prepared in accordance with the guidance now being issued and whether the FSA will take action against these companies. We are clear that action to prosecute the companies for supplying improper returns would be a disproportionate response and in any event very unlikely to succeed. We have considered the options available in terms of other intervention action, none of which is attractive, and concluded that the least bad approach is to ask those companies whose 1997 returns were not prepared in accordance with the guidance, and would have shown a materially different financial position if they had been so prepared, to accelerate submission of their 1998 returns.”

4.25.2 The note set out the advantages and disadvantages of the following three options available to the FSA:

- (a) take no action in relation to the past regulatory returns;
- (b) require correction of misleading 1997 regulatory returns; or
- (c) require accelerated 1998 regulatory returns from companies who submitted “misleading” 1997 regulatory returns.

4.25.3 The decision was subsequently taken to proceed with the last of the three options, as recommended in the briefing note.

4.26 January 1999 guidance on reserving for GAOs

4.26.1 By a letter dated 13 January 1999 the Government Actuary issued guidance to all Appointed Actuaries of companies authorised to carry on long-term insurance business relating to reserving for GAOs. A copy of the guidance appears at **Appendix 2** to this Report. It is also explained in **Chapter 3**.

4.26.2 On 29 January 1999 GAD telephoned the Appointed Actuary to discuss matters arising out of a paper dated 22 January 1999 which the Appointed Actuary had produced for Equitable Life’s January Board meeting headed “Valuation and bonus declaration as at 31 December 1998”. The paper showed that the Appointed Actuary considered that the lowest proportions of benefits which he could assume would be taken in GAR form without, in his opinion, being found to be in contravention of the Government Actuary’s guidance, were between 65% and 80%.

4.26.3 In a file note of the telephone conversation, GAD recorded that “[the Appointed Actuary] was, in truth, rather vague as to how he justified the percentages of the total liabilities for which he assumed retirement benefits were taken in GAR form.”

4.26.4 GAD indicated that there would need to be further discussion of the adjustments which the Appointed Actuary was seeking to make in calculating the GAR liability before he could expect IFSD to accept those adjustments as producing acceptably prudent reserves.

4.26.5 In response to GAD's questions, the Appointed Actuary advised that the GAR reserve included an allowance of £450million in respect of future premiums. Therefore the additional reserve held for existing GAR liabilities was actually in the region of £1billion:

“Under questioning about the effect of moving to 90% of full GAR reserves, he suggested that perhaps another £150m might be needed - but, perhaps, he would then lower the allowance for future premiums to £300m at this time.”

4.26.6 GAD noted:

“He seemed to be gradually accepting the ultimate need for establishing full provisions but appeared to be hoping that HMT would look kindly on the idea of phasing-in, which he suggested had received a favourable mention at an earlier meeting.”

4.26.7 In response to the guidance and IFSD's covering letter regarding early submission of the 1998 regulatory returns, Equitable Life conceded that the reserving included in its 1997 regulatory returns had not been consistent with the guidance, but argued that early submission of the 1998 regulatory returns was unnecessary. IFSD did not agree and threatened that regulatory action would be taken to require Equitable Life to make such early submissions if it did not do so voluntarily. On 26 February 1999 Equitable Life agreed to submit its returns early.

4.27 Monitoring Equitable Life's 1998 bonus declaration and request for Financial Condition Report

4.27.1 Following up on GAD's advice on Equitable Life's reserving provided to IFSD in January 1999, and in preparation for discussions with Equitable Life about its proposed bonus declaration for the year end 1998, IFSD requested the following information from Equitable Life on 18 January 1999 which GAD had stated would help them to form a “better understanding of their current financial condition, and resilience to changing investment conditions”:

“Total Mathematical Reserves (before allowance for value of annuity guarantees) as at 30/12/98 in respect of all contracts with GARs (before and after resilience test);

Aggregate Asset Shares as at 30/12/98 in respect of all contracts with GARs;

Mathematical reserves (as in (a) above, but before resilience test) analysed by attained age of policyholder;

Total Mathematical Reserves in respect of all with-profit contracts (before and after resilience test (before allowance for value of annuity guarantees));

Aggregate Asset Shares as at 30/12/98 in respect of all with-profit contracts; and

A copy of the most recent Financial Condition Report produced by the Actuary in accordance with professional guidance note GN2.”

4.27.2 Equitable Life provided items (a) to (e) under cover of a letter dated 26 January 1999 and in a letter dated 21 January 1999 Equitable Life informed IFSD that the initial view of the directors was that it would be appropriate to make a substantial reduction in declared bonuses for 1998 (5% compared to 6.5% in 1997) to reflect current and prospective financial conditions. In response to the FSA’s request for a copy of the most recent Financial Condition Report, Equitable Life said that since the Appointed Actuary had always been fully involved in all Board and Investment Committee meetings, the Society had taken the view that Financial Condition Reporting was most usefully dealt with as a continuing process throughout the year, rather than being covered in a single annual report.

4.27.3 By a memorandum dated 29 January 1999 GAD gave advice to the FSA on various Board papers which Equitable Life had supplied to IFSD relating to the proposed declaration of bonus. The advice noted that Equitable Life was sensibly seeking to balance the considerations of reducing progressively the amount of additional guaranteed benefits added each year with maintaining a reasonably competitive position and smoothing bonus declarations from year to year in line with the perceived expectations of policyholders.

4.27.4 The advice further stated:

“The cost of the declared bonus for 1998 would be some £365 Million (compared with £508M in 1997). This would leave the overall financial position of the company as shown in their draft 1998 returns as showing cover of 250% for the solvency margin (ie similar to 31/12/97) assuming that the reinsurance with ERC is completed (and accepted by FSA as allowing a significant reduction in the reserves for GARs), or 110% if the ERC reinsurance is not taken into account. In the latter situation, they would though be able to take credit for a larger future profits implicit item which could boost the apparent solvency margin cover to around 200%, though the explicit cover for the guarantee fund would be very thin.

Therefore the financial position shown in their 1998 supervisory returns is likely to appear as reasonably satisfactory following their proposed declaration of bonus, though they would be potentially close to regulatory action under Section 33 [of the ICA 1982]¹⁷ if their proposed reinsurance is not completed satisfactorily. Accordingly, I believe that it would be difficult to object formally to their proposed course of action, though we would need to continue to monitor their position carefully.

Indeed, we are very conscious of their financial sensitivity to changing investment conditions. ...

¹⁷ As set out in more detail in Chapter 3, section 33 of the ICA 1982 requires an insurance company to maintain a minimum margin of solvency, failing which the company is required to submit to the regulator a short term financial plan.

Their liability profile also shows that they will continue to have a significant number of policies in-force with GARs (and guaranteed future bonuses of 3.5%pa) for another 15-20 years. There are also a fairly substantial level of guarantees on most of their other policies. Meanwhile, they continue to issue annual notices to policyholders showing a high level of projected benefits and thereby generating future expectations.

Therefore, in writing to them to say that we have no objection to their current proposed rate of declared bonus, I believe that we should voice our concerns about their apparent vulnerability to changing investment conditions. We should certainly ask them to repeat for 1999 (and provide us with a copy of) the type of 12-month projection shown in their February 1998 paper, and ideally extend this to a period of 3-5 years on plausible investment scenarios. They should also be asked to produce some contingency plans for how they would react if an adverse investment return were to appear over the next 1-2 year period, which reduced their solvency margin cover to close to or even below 100% of the required minimum level.”

4.27.5 As set out below, these views were communicated by IFSD to Equitable Life in a telephone call and confirmed subsequently by letter.

4.28 The reinsurance agreement

4.28.1 In a letter to IFSD dated 21 January 1999 (referred to above) Equitable Life also noted that it had entered into a reinsurance agreement with effect from 31 December 1998 and enclosed a copy of the draft terms of the reinsurance agreement. The use of reinsurance agreements by life companies is set out in more detail in **Chapter 3**. The draft terms of the agreement were sent to GAD who reviewed them in detail and gave IFSD a summary and some advice on the effect of the reinsurance. Among other matters, GAD made the points set out below:

- (a) The reinsurer was a Dublin-based subsidiary of ERC Frankona. GAD noted that it had no details of the financial strength of that subsidiary, IERC, or of the extent, if any, of any support which ERC Frankona might be prepared to guarantee IERC in respect of its potential liability.
- (b) The reinsurance was a financing arrangement which provided support to Equitable Life in any year when more than 25% by value of the guaranteed business vesting in that year select the GAO.
- (c) The cost of the reinsurance was £150,000 (increasing by RPI) for each year that the agreement remained in force.¹⁸

¹⁸ This was correct according to the draft agreement which GAD had been sent at that time. In the final version of the reinsurance agreement signed by Equitable Life on 11 October 1999 the annual deposit premium was stated to be £400,000, payable, for the first year, in two instalments, the first on the Commencement Date of the reinsurance agreement in the sum of £150,000 and the second on 1 April 1999 in the sum of £250,000.

- (d) The reinsurance could be cancelled if Equitable Life changed its practice on GAOs “presumably including if it lost its Court case.” The terms of the cancellation clause in the final form of agreement were as follows:

“The reinsurance will apply so long as the Reinsured makes no change to its current practice regarding the exercising of guaranteed annuity options as represented to the reinsurer in the attached schedule (Appendix III). Should any change occur, either at the choice of the Reinsured or as a result of any legal action brought against the Reinsured, then no further Reinsurance Claims Events will be admissible. In that event, the reinsurance will be terminated at the earliest date at which no Recovery Amount is due.”

- (e) The intention of the reinsurance was to enable Equitable Life to maintain a reserve, in respect of policies with GARs, equivalent to providing for the additional cost of the guarantees on only 25% of the business rather than the near 100% which the regulator was requiring. GAD advised that it believed the reinsurance would not achieve the intended reserving effect. GAD set out its reasons, in particular that on cancellation: “the Equitable would be required to immediately repay any outstanding finance and increase its mathematical reserves.” GAD pointed out that this seemed to negate the benefit of the arrangement to Equitable Life, particularly where the reinsurer had an option to cancel the reinsurance, although GAD noted that there were various ways in which this might be resolved.

4.28.2 On 28 January 1999, there was a meeting to discuss the draft reinsurance agreement at which GAD provided various comments to Equitable Life on the terms of the agreement. In the minutes of the meeting, which record a discussion regarding the presentation of the reinsurance and the additional reserves for GAOs in the regulatory returns, IFSD noted that “any presentation which did not show separately the gross liability and reinsurance cover would be artificial and hence potentially misleading. In view of the significance of the reinsurance agreement to the company’s solvency position it was important that the level of dependence on the reinsurance was clear to readers of the returns.” As set out below, this was done.

4.28.3 The 1996 Regulations¹⁹ require, *inter alia*, disclosure of an indication of the nature and extent of the cover given under a reinsurance agreement. In its 1998 regulatory returns, Equitable Life made disclosure of the reinsurance agreement pursuant to that requirement in the following terms:

“The reinsurer provides surplus cover for the costs arising from the exercise of guaranteed annuity rates in respect of Retirement Annuity policies, Individual Pension Plans and Transfer Plans issued before 1 July 1988. If, in any calendar year, the proportion of terminations due to retirements exercising the guaranteed annuity option exceeds 25% of the total retirements in that calendar year, as measured by the guaranteed funds for those policies, the reinsurer’s gross liability is the value of the guaranteed annuity in excess of the guaranteed policy funds for

¹⁹ Regulation 12(2).

that proportion of retirements effecting the guaranteed annuity option which is in excess of 25%.”

- 4.28.4 The fact that the reinsurance agreement would apply as long as Equitable Life made no change to its terminal bonus practice was not disclosed in the regulatory returns.
- 4.28.5 GAD’s advice dated 29 January 1999 on Equitable Life’s proposed bonus declaration formed the basis of a telephone call in late January 1999 and a letter from IFSD to Equitable Life dated 1 February 1999. GAD’s advice stated that Equitable Life’s financial position shown in its 1998 regulatory returns:
- “is likely to appear as reasonably satisfactory following their proposed declaration of bonus, though they would be potentially close to regulatory action under section 33 [of the ICA 1982²⁰] if their proposed reinsurance is not completed satisfactorily.”
- 4.28.6 IFSD advised Equitable Life that, in the absence of a robust reinsurance agreement along the lines which had been discussed, IFSD would not consider it prudent for Equitable Life to declare any bonus for 1998. IFSD noted that in the absence of reinsurance, the cover for the solvency margin would appear so low that it could easily be eliminated by a small move in market conditions.
- 4.28.7 IFSD told Equitable Life that even with the reinsurance, the Society needed to consider carefully the scope for declaring a bonus because of the uncertainties surrounding the financial implications of the Court case:
- “In particular it would appear necessary for Equitable Life to consider the prudence of declaring a bonus in the light of the risk of losing the Court case and the potential costs that might be incurred as a result. We also consider it necessary for the company to take account of the risk, even after the terms of the reinsurance treaty have been revised as discussed with GAD, of the treaty being cancelled by the reinsurer (whether as a result of Equitable losing the Court case and having to change its payment policy, or for some other reason) because of the heavy dependence of the company on the reinsurance treaty in order to be able to show more than marginal solvency coverage. We consider these points to be, in the first instance, a matter of judgement for Equitable Life, on which the company must satisfy itself appropriately.”
- 4.28.8 IFSD confirmed that, on the basis of the information received and assuming the reinsurance agreement was revised to resolve GAD’s concerns, it was not minded to object to the proposed bonus declaration. IFSD asked to be kept informed on progress relating to the revision of the terms of the reinsurance agreement in order to take this into account in reaching “a final view” on the bonus declaration. The letter stated that any decision by the FSA not to intervene over the bonus declaration was not the end of the matter, and that the regulator remained concerned about the ongoing financial health of Equitable Life because of the relatively low level of

²⁰ See Chapter 3.

explicit free assets²¹ and the apparent sensitivity of free assets to future rates of investment return. In order better to understand the key factors influencing Equitable Life's longer term solvency position, IFSD requested various projections and contingency plans as suggested by GAD in its advice on 29 January 1999, referred to above.

4.28.9 The negotiation of the reinsurance agreement continued during most of 1999. GAD gave Equitable Life the benefit of its experience on such matters and suggested various revisions to the terms of the agreement. The reinsurance agreement was not signed by Equitable Life until 11 October 1999. The consequences of the House of Lords' judgment in respect of the agreement are set out in **Part 3** below.

4.29 Equitable Life issues proceedings

4.29.1 In January 1999, while discussions between Equitable Life and IFSD in relation to reserving, reinsurance and the 1998 bonus declaration were taking place, Equitable Life prepared to issue Court proceedings in relation to its terminal bonus practice.

4.29.2 On 15 January 1999 Equitable Life issued an Originating Summons in the High Court seeking declarations from the Court affirming the validity of the decisions of the directors to apply differential terminal bonuses to GAR policyholders.

4.29.3 In its Originating Summons Equitable Life sought the following relief from the Court:

“ (1) A declaration that [Equitable Life's] Board is entitled to exercise the discretion conferred by Article 65 so as to allot or otherwise make available different amounts of final bonus to Policyholders whose benefits become payable at a time when guaranteed annuity rates applicable to them under their Policies are higher than current annuity rates, so as (so far as is possible having regard to the amount of the surplus available for the provision of final bonuses in respect of such Policies and to [Equitable Life's] obligation to equalise the total value of the benefits taken by any given Policyholder interested under a Policy which contains provision for guaranteed annuity rates irrespective of whether such Policyholder elects to take an annuity to which such guaranteed annuity rates apply.”

4.29.4 A second declaration sought confirmation from the Court that, if the Board of Equitable Life was entitled to exercise its discretion in allotting differential terminal bonuses, it had done so validly.

4.29.5 The Summons also requested that, in the event that the Court found that the Board of Equitable Life was entitled to exercise, but had not (in the past) validly exercised, its discretion, the Court make an alternative declaration, that the Board may now exercise its discretion so as to equalise the total value of benefits taken by GAR policyholders.

²¹ Explicit free assets means the amount of net assets, excluding implicit items, available to an insurance company in excess of its required minimum margin of solvency.

- 4.29.6 On 23 February 1999 the Court had ordered that Mr Hyman was to represent the interests of all policyholders or former policyholders of Equitable Life who had an interest in a policy containing a provision for GARs. The Court also ordered that Equitable Life was to represent the interests of all other with-profits policyholders. The Court Order expressly stated that it did not preclude any policyholder from seeking relief based on allegations as to the way in which policies were sold to him individually if those allegations were based on facts which were not before the Court. The FSA saw this Court Order for the first time in mid-June 1999.
- 4.29.7 Equitable Life did not send IFSD a copy of the Originating Summons or evidence in support until mid-June 1999. The evidence in the case was finalised in March and May 1999. Copies were requested by IFSD in mid-June 1999, shortly before the First Instance hearing, although GCD had indicated internally in late January 1999 that it would be helpful to see the Court papers.

4.30 PRE

- 4.30.1 In late December 1998 and early January 1999 there had been some internal consideration of whether Equitable Life's terminal bonus practice was in accordance with PRE.
- 4.30.2 In an exchange of e-mails with GCD on 26 and 27 January 1999, whilst advising on whether it was appropriate to disclose the 1998 guidance letter to the public, GCD enquired whether IFSD would be continuing to consider "the PRE issue" while the matter was also before the Courts. GCD remarked that it was:
- "becoming increasingly clear that any decision by the FSA on the PRE issue (to intervene or not) is likely to be viewed by the Courts as unfair if policyholders are not first formally invited to make submissions on the matter to the FSA (although not necessarily on an individual basis). We are concerned with the PRE issue because complaints have been made. We have so far considered the views of and the material provided by, but only by, the Equitable. Although we have asked for extensive information from the Equitable, there is nevertheless a reasonable possibility that something will be missed or misconstrued by the FSA and which might be corrected, or at least challenged, by policyholders. Hence there is a real risk that any decision would be overturned by a Court on fairness grounds (or because a relevant consideration had not been taken into account)."
- 4.30.3 GCD considered that if IFSD continued to examine the documents and submissions from Equitable Life, but held back from any decision or tentative decision on PRE until judgment was handed down, considerations of the fairness issue could be postponed until then. This prompted IFSD to conclude, as recorded in an e-mail dated 26 January 1999, that:

"As a matter of policy, [our] strong preference is not to reach a decision on PRE until after the Court case. ([We] understand that the Court decision will not in principle preclude FSA taking a view on whether to intervene on PRE grounds; but in practice, the judgement as to whether PRE has been met or not will depend crucially on the precise nature of the individual contracts, as well as what

policyholders were told; so that it would be sensible to await the Court's decision on the legal position)."

- 4.30.4 IFSD agreed that while it would be best to wait for the result of the case before taking a view on the PRE issue, it considered that it "should do some of the ground work in the interim." In interview, Michael Foot told us that he was privy to this decision to defer consideration of PRE.
- 4.30.5 IB-PIA, who had been told by HMT-ID in late 1998 that it was considering the matter and who had asked to be kept informed about HMT-ID's work on this matter, was not party to the decision and was not informed about it by IFSD.

4.31 FSA perception of Court case

- 4.31.1 At the "start" of the litigation it was the expectation of at least one IFSD executive that the issues in the case would be dealt with "fairly quickly" and that IFSD did not envisage "three rounds. Our hope or expectation was that ... it would be settled 'once and for all' at the Court of first instance." There was no written advice on file from GCD regarding legal procedure, timing, such as the potential length of time which the Courts might take to resolve the issue if the matter were to be appealed to the House of Lords. No written advice was given as to the chances of an appeal to the House of Lords and there was no meeting specifically to discuss the Court case until late June 1999. In interview we were told that following a meeting at which Equitable Life had been very positive about the Court outcome (which we believe to have been on 29 June 1999), GCD gave oral advice to IFSD and GAD along the following lines:

"if the Court takes a Chancery approach to this matter, it will favour the Equitable's position, but, make no mistake, this is very high risk for the Equitable. You can never predict judicial outcomes. At the High Court level, they are more likely to get a judge who would take a Chancery approach, but we can't be certain about that. Courts are more and more inclined now to take a wider policy approach to these matters ... If Equitable get the wrong panel or the wrong judge, they could find themselves on the receiving end of a change in judicial approach. The Court might ... not like what the Equitable has done and might be influenced for that reason. Don't jump to conclusions about this."

- 4.31.2 IFSD has also confirmed that no detailed consideration was given to the FSA being involved or intervening in the Court action. It was considered briefly, as far as could be recalled, in an informal conversation following a meeting with Equitable Life, between GCD and IFSD and possibly GAD. In interview, GCD said:

"it's hard to imagine on what basis we would have become involved. Clearly we couldn't become involved as Amicus²² because as a Regulator it would have been completely inappropriate. ... To have intervened on a public interest basis ... would also have been very difficult to justify and the courts actually do look very

²² An Amicus Curiae ("friend of the Court") is a third party to Court proceedings and usually a barrister, who calls to the attention of the Court a point of law or decision or fact which the parties have not raised or on which the Judge is doubtful or mistaken.

hard at whether there is a real reason for a public sector body to intervene on public interest grounds ... Here, the Court was simply looking at the contract and the exercise of discretion in terms of contract - private law terms - and although maybe there was a bit of debate around the margins about the extent to which PRE would be relevant to the issues, it is pretty hard to imagine how we would have had anything to offer on issues of contract and issues of exercise of directors' discretion, when we have got no particular expertise."

- 4.31.3 Having decided to defer consideration on the PRE issue until after the outcome of the Court case was known, the regulator's attention was focused on the provision by GAD of advice on the reinsurance agreement and scrutiny of the regulatory returns. The scrutiny included both the 1997 regulatory returns and the 1998 regulatory returns which Equitable Life agreed to submit early following receipt of confirmation that IFSD would not object to Equitable Life's proposed bonus declaration as long as the reinsurance agreement had the desired effect.

4.32 Report to FSA Board

- 4.32.1 On 18 March 1999, Mr Foot provided a report to the FSA Board as part of the monthly update on recent developments within financial supervision. Equitable Life was mentioned. The report stated that:

"after setting aside reserves consistently with the guidance, its free assets were so low that the prudence of paying a bonus this year was questionable. Equitable have now put in place a reinsurance treaty to cover the additional liability for guaranteed annuities, and will declare a reduced bonus of 5% ... Equitable Life have also ... agreed to submit their next set of regulatory returns early, so that a comprehensive and up to date picture of their financial position is available to policyholders."

4.33 IFSD Report on potential risk from GAO exposure

- 4.33.1 In mid-March 1999 a note was circulated within IFSD which, among other matters, reported on the effect of GAOs on Equitable Life's statutory solvency position. The attachment to the note stated:

"The company's financial position has been very severely affected. Its policy is to distribute as much of its profits to policyholders as possible, consequently it has not built up an estate which can be used to meet unexpected costs such as those arising from GAOs and as a mutual it has no ready mechanism for raising additional capital."

- 4.33.2 The summary attached to the note also suggested that a reserve of the order of £2.9billion would be required at the end of 1998 but that Equitable Life was seeking to finalise a reinsurance agreement which would reduce its net reserving requirement by some £2billion and thereby increase its solvency margin coverage to a more acceptable level. The note also stated:

"We remain concerned about the financial viability of the company in the longer term. It has declared high levels of guaranteed bonuses in the past and its ability

to honour these guaranteed bonuses appears heavily dependent on the company continuing to achieve high investment return. The company's liabilities for GAOs could also increase significantly if the yields on long gilts fall further."

4.34 Submission by Equitable Life of its 1998 regulatory returns

- 4.34.1 On 30 March 1999 Equitable Life submitted its 1998 regulatory returns. On the same date, the Appointed Actuary wrote to IFSD applying for a future profits implicit item for 1999 of £1 billion. In December 1998 HMT-ID had requested an appropriate statement on contingent liabilities to appear in Equitable Life's regulatory returns relating to the risk of a successful challenge to Equitable Life's terminal bonus practice with regard to guaranteed annuities. The Court case was not mentioned in the 1998 (or 1999) regulatory returns, although the 1998 Companies Act Report and Accounts did state that for the purposes of establishing accounting provisions, a specific provision of £200 million in respect of guaranteed annuities had been included as at 31 December 1998 and a supplementary report was published with the 1999 Companies Act Accounts which referred to the litigation. Section 1402 of the 1998 regulatory returns relating to charges, contingent liabilities, guarantees and contractual commitments disclosed a number of guarantees and obligations unrelated to the litigation. This section of the report concluded that as at 31 December 1998:

"there were no charges over any Society assets, no contingent liabilities connected to the Society, and in relation to any related company: no guarantees, indemnities or contractual commitments other than detailed above."

4.35 Initial scrutiny of Equitable Life's 1998 regulatory returns

- 4.35.1 On 9 April 1999 GAD provided IFSD with a memorandum reporting on GAD's initial scrutiny of the Society's 1998 regulatory returns. It was noted that the gross reserve for GARs was "lower than we would have hoped for" and that "[the Appointed Actuary] appears to have made allowances for non-take up of [GARs] ... to a greater extent than we thought he should, in the light of the [Government Actuary's] guidance", as he had indicated on the telephone to GAD on 29 January 1999 that he would. GAD stated:

"We will need to consider further the implications for other companies if we accept the arguments of [the Appointed Actuary] - but the solvency implications for Equitable are negligible (except for raising somewhat the RMM), since the reinsurance treaty with Irish ERC should largely cancel out any increase in their gross provision which would arise from raising the assumed take-up rate. We can only presume that the company was reluctant to disclose any higher figures for its gross liability, or for the extent of its consequent reliance on reinsurance."

- 4.35.2 GAD pointed out that it had not seen a copy of the finalised reinsurance agreement so that the appropriateness of the value given to the reinsured liability in the regulatory returns could be assessed. GAD informed IFSD that the target date for completion of a combined detailed scrutiny of the 1997 and 1998 regulatory returns was the end of June 1999.

- 4.35.3 Accordingly, IFSD wrote to Equitable Life on 15 April 1999 requesting a copy of the finalised reinsurance agreement and also seeking a note of Equitable Life's revenue and solvency projections and contingency plans which had previously been requested by the FSA in a letter dated 1 February 1999.
- 4.35.4 Equitable Life responded on 20 April 1999 confirming that the reinsurance agreement had not been finalised and enclosing a copy of the term sheet on which the agreement would be based. The letter stated that the solvency projections, which had been requested on 1 February 1999, were not yet available. Equitable Life did, however, enclose a copy of an Equitable Life Board paper dated 18 March 1999 setting out the measures open to Equitable Life to protect its statutory solvency position. In that paper, the Appointed Actuary identified a number of measures which he considered that "it would seem sensible for the Society to pursue":
- "(i) Take on further subordinated debt.
 - (ii) Use reinsurance to alleviate the capital strain caused by certain products, particularly the managed pension.
 - (iii) Make some shift in the equity portfolio from lower-yielding to higher-yielding stocks.
 - (iv) Limit the extent of exposure to development property situations.
 - (v) Investigate the merits of introducing a new bonus class for business incorporating GARs and actively encouraging policyholders to give up their GARs.
 - (vi) Gradually introduce new products with no entitlement to declared bonuses."
- 4.35.5 On 21 April 1999 GAD advised IFSD, in response to their question on the point, that although the reinsurance agreement had not been signed, the intention to enter into it was sufficient for Equitable Life to rely upon it in its regulatory returns because GAD believed the ISC had agreed in principle that where there was a letter of intent in place then credit may be taken for a reinsurance agreement.
- 4.35.6 On 27 April 1999 GAD provided its comments to IFSD on the Equitable Life Board paper dated 18 March 1999, relating to measures available to Equitable Life to protect its statutory solvency position. GAD commented that the possibilities of increasing subordinated debt, sustaining a future profits implicit item at about 5/6ths of RMM and to seek to raise further financial reassurance (on specific products with onerous capital requirements) looked fairly plausible, but "may only have marginal financial impact, bearing in mind the existence now of the overarching treaty with ERC Francona." GAD also commented that Equitable Life's suggestion of strictly applying policy conditions to limit the impact of existing GAOs would have a strong adverse impact on the image of the Society, while the idea of "threatening" GAO policyholders with a 1% reduction in credited annual rate of return, with the option of giving up their GAO in exchange for receiving bonuses at a higher rate, might be in conflict with statements made in product and marketing literature. GAD

commented that the idea of designing a new participating product with no entitlement to declared bonuses was imaginative.

4.36 Equitable Life's letter to the EST- April 1999

- 4.36.1 In early May 1999 the FSA received a copy of a letter which Equitable Life had sent to the EST protesting about the FSA's approach to reserving for GAOs. Equitable Life complained about the likely effect of the reserving requirements on the industry and suggested that the FSA had little room for manoeuvre and that Ministerial intervention might be required to secure a more commercial and satisfactory outcome. A response was prepared with input from IFSD and sent to Equitable Life on 14 June 1999 explaining the purpose behind the onerous requirements of the regulatory returns and indicating that the Minister was not willing to get involved where there was already a dialogue between an individual company and its regulator.

4.37 Dialogue with Equitable Life on solvency issues - May 1999

- 4.37.1 On 4 May 1999 Equitable Life wrote to IFSD enclosing information on the projected solvency position which had initially been requested on 1 February 1999. The information was in the form of a paper by the Appointed Actuary that had been presented to the Equitable Life Board dated 23 April 1999 and entitled "Projections of the Society's Financial Position". The paper showed the projected solvency position as at 31 December 1999 on three different scenarios, which were characterised as follows:

"17. 'Central' - a modest rise in gilt yields to 5% coupled with broadly unchanged equity values

'High' - a more significant rise in yields with gilt yields rising above 6% and equity prices falling around 5%

'Low' - further reductions in yields with gilts falling to around 3.5% and equity prices rising by around 8% ...

18. The 31.12.99 projected solvency position arising from these scenarios are as follows (figures related to non linked business only):

	High	Central	Low	Actual 31.12.98
Available assets /minimum margin	1.7	2.6	1.3	2.5"

- 4.37.2 The Appointed Actuary then projected how the solvency position might develop after 31 December 1999 on the assumption that:

"21. ... the implied total returns on the assets in 2000 and beyond in all three scenarios is between 6% and 7% p.a.

22. The progression of the ratio of available assets to minimum margin (actual value at 31.12.98 of 2.5) is as follows:

	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>
'High'	1.7	1.9	2.1	2.4	2.7
'Central'	2.6	2.8	3.0	3.3	3.6
'Low'	1.3	1.6	1.8	2.2	2.5

4.37.3

The Appointed Actuary thereafter noted:

- “27. Finally, I have attempted to project the impact of losing the Court case. This is extremely difficult to do because there are a number of different components, the position on each of which could have an impact on solvency. For example, if it was ruled that a common rate of final bonus must apply but that it could be equalised at a level at or near that currently applicable when benefits are taken in GAR form, then there is little additional cost to impact on the solvency position.
28. To form a picture of a less favourable (but not the worst possible) outcome I have made the following assumptions:
- (i) that a revised or replacement reinsurance arrangement is put in place with a similar reserving effect;
 - (ii) that final bonus has to be paid initially at the level applicable to cash fund benefits for PRE reasons but that it can be smoothed down to the realistic level over 3 years;
 - (iii) that the rate of retirements under policies with GARs increase by 25% in that 3 year period;
 - (iv) that an immediate provision of £400m has to be made to compensate past retirements in the period 1995-8;
 - (v) no premium increases in 1999-2003.
29. The impact on the ratios in the 'central' projections, compared with those projected in paragraph 22 above is as follows:

	1999	2000	2001	2002	2003
Central conditions [a modest rise in gilt yields to 5% coupled with broadly unchanged equity values]	2.6	2.8	3.0	3.3	3.6

Alternative scenario (per 2.1 2.2 2.5 2.9 3.3 paragraph 28)

30. The reduction in the 1999 cover ratio from 2.6x to 2.1x is predominantly due to the allowance of £400m for the compensation of past retirements with the position worsened by the claims in 1999 where the benefits provided exceed the asset shares due to the assumed revised operation of GARs as described in paragraph 27. The position does not really start to improve until 2002 by which time final bonus levels have been reduced to again reflect asset shares. All the cover ratios under this 'central' scenario are acceptable but if coupled with investment scenarios such as those shown under the 'low' projection [assuming gilt yields at 3.5%, equity yields at 2.7% and a total return on equities of just over 7% per annum], the position would become unacceptably tight."

4.37.4 The paper was sent to GAD for review. GAD and IFSD did not ask Equitable Life to prepare projections on the basis of the "worst possible" outcome.

4.38 Detailed Scrutiny Report on Equitable Life's 1997 and 1998 regulatory returns

4.38.1 On 20 May 1999 GAD submitted its detailed scrutiny report on Equitable Life's 1997 and 1998 regulatory returns.

4.38.2 The report noted that:

"the Actuary has made assumptions about the maximum percentage of maturity benefits that would be taken in guaranteed annuity form, and in doing so has somewhat stretched the concessions offered by the [Government Actuary] in his guidance letter of 13 January 1999. It is necessary to consider whether the Actuary's reserving assumptions for annuity guarantees should be challenged.

...

It is noted that the proportions of benefits assumed to be taken in guaranteed annuity form are somewhat higher than were used in a January Board paper, and which were discussed with the Actuary by GAD on the 29th of that month, but they might still be thought to stretch the guidance given by the Government Actuary."

4.38.3 The report recorded the following "Action Points":

- (a) there remained a need for the FSA and GAD to consider the final terms of the reinsurance agreement; and
- (b) a "policy decision needs to be taken about whether to challenge some of the assumptions made by the Actuary" in setting the level of the required reserves for GAOs.

4.38.4 The report also referred to the Court case:

“A test case is being brought before the Courts in July 1999 to try to obtain legal clearance for [Equitable Life’s terminal bonus practice]. (Loss of the case would result in a need for the Society to reduce its level of terminal bonus additions to a wider group of policyholders - maybe all!)”

4.38.5 On 25 May 1999 there was an exchange of e-mails between IFSD and GAD which record that IFSD had agreed internally that a “low profile” approach to obtaining clarification of the basis for Equitable Life’s level of reserving for GAOs was the best way forward and that GAD should write to Equitable Life accordingly. In interview it was explained to us that a “low profile” approach meant, in the first instance, finding out why the reserve had been set at that level, which would be appropriate for GAD to do by raising it as a detailed point arising out of the scrutiny of the regulatory returns. An approach by GAD would be seen as a technical matter, whereas if the matter was raised by IFSD, Equitable Life would have thought that IFSD had already concluded that the level of reserving was inappropriate. In interview GCD told us that it would have been difficult to justify intervention if Equitable Life had reserved at 80% or higher, since Regulation 64 of the 1994 Regulations required valuation of liabilities on “prudent assumptions” and prudence was a matter of actuarial judgement in each case.

4.38.6 In order to clarify the position, GAD wrote to the Appointed Actuary on 27 May 1999 seeking an explanation of the assumptions used to arrive at the expected proportion of policyholders taking their benefits in guaranteed annuity form. The letter also sought clarification as to how the reinsurance offset had been calculated in the regulatory returns including an explanation of how allowance was made in the returns for the premiums payable to IERC if the reinsurance was called on. GAD also requested supplementary information in support of the projected solvency information provided on 4 May 1999.

4.38.7 The Appointed Actuary replied to GAD on 25 June 1999 explaining how the level of the reserve for guaranteed annuities had been calculated and specific reductions had been made for a range of factors considered likely to reduce the proportion of policyholders who would actually exercise their GAO:

- (a) for all types of contract - a 5% reduction in the proportion assumed to take the guaranteed option because of the bonus system operated by the Society;
- (b) for perceived flexibility and other perceived advantages of alternative forms of benefit: for group pension business and for retirement annuities, a 10% reduction and for individual pensions and transfer plans, a reduction of 5%;
- (c) for cash commutation options:²³ retirement annuity 15%; individual pension/transfer plan 7.5%; for group pensions 2.5%.

4.38.8 As regards the reinsurance offset, the Appointed Actuary stated:

²³ Policyholders may, subject to limits established by the Inland Revenue, “commute” part of their pension fund, i.e., receive a cash lump sum and a consequently reduced annuity.

“The reinsurance offset has been calculated assuming that any guaranteed benefits taken in guaranteed annuity form above 25% are covered by the reinsurer to be paid back from future surpluses. The value of the deposit premium of £400,000 p.a. has been calculated assuming it increases in line with RPI and has been deducted from the reinsurance offset. The risk premium of 2% of any outstanding claim amount should the reinsurance be called on is payable out of future surpluses and therefore, as discussed on previous occasions, has not been included in the reserves for guarantees.”

4.38.9 The Appointed Actuary answered the other points in GAD’s letter including confirmation that the 1.4 times cover for the Society’s solvency margin was projected at the end of 1999 assuming gilt yields remained static, equities fell by 10% over the year and a bonus ½% below that for 1998 was declared.

4.38.10 On 15 July 1999, when judgment in the Court case (which was in fact given in September 1999) was expected within a few days, GAD replied to the Appointed Actuary’s letter of 25 June 1999 and stated:

“As you might appreciate, we intend to defer formal consideration of your justifications of the proportions assumed to take the benefits in guaranteed annuity form until we see the outcome of the court case. However, I would say that we do still have some difficulty in accepting that reductions of between 17½% and 30% are consistent with the “few percentage points” quoted by the Government Actuary in paragraph 6 of his letter dated 13th January 1999.”

4.38.11 In interview we were told that one of the reasons for the decision to defer formal consideration of the Appointed Actuary’s reserving decisions was that IFSD was not in a position to require reserving at a higher level because the regulations required reserving at a “prudent” level, which did not mean that reserving for 100% of the liability was mandatory. We were also told in interview that the letter would have the effect of strengthening the FSA’s hand in the event that the Court case went against Equitable Life, because in that event the FSA would be able to object more strongly to the Society’s reserving position.

4.38.12 In a letter dated 19 July 1999 the Appointed Actuary disputed GAD’s interpretation of the Government Actuary’s guidance letter and argued that the guidance contained references to some relaxation of the 100% reserving requirement and “does not imply that the combined effect of all relevant factors should be “a few percentage points” but that each factor should be considered individually”. In particular the Appointed Actuary stated that the letter referred to the allowance being “a few percentage points of the reserve” rather than of the assumed take-up rate:

“Looked at in that way, even for the retirement annuities, where I have assumed the lowest take-up rate of 70%, the effective reduction in the overall reserve is less than 10%. That would seem to put a rather different light on the reserving assumptions.”

4.38.13 There was no further correspondence on this issue between the regulator and Equitable Life, save for the publication by the Government Actuary of reserving guidance, which was sent to all life insurance companies in December 1999, until

GAD raised the matter again during its scrutiny of the 1999 regulatory returns in late November 2000. The issue was raised with IFSD by GAD in September 1999, when GAD stated that it was not inclined to pursue the matter with Equitable Life at that time because, while the reinsurance agreement was effective, reserving at the higher level would not affect Equitable Life's net liability.

4.39 The FSA's scenario planning for the First Instance judgment

4.39.1 The Court case had been listed for hearing on 5 July 1999.

4.39.2 IFSD considered what action it might have to take depending on the outcome of the case and on 8 June 1999, prior to receiving copies of any of the Court papers, draft scenarios were circulated internally at the FSA relating to the potential outcomes of the Court case and their regulatory implications and these were discussed at an internal meeting on 9 June 1999 attended by IFSD, GAD and GCD. The draft paper analysed the following possibilities:

1. Equitable Life win totally;
2. Equitable Life win in part, its past practice being found unacceptable, but current practice acceptable;
3. Equitable Life win (in total or in part) but the PRE perspective referred to the FSA; and
4. Equitable Life loses, it being found that to reduce terminal bonus where a GAO is exercised was unacceptable.

4.39.3 Under Scenario 3 one of the implications for the FSA was that the FSA would have to "reach a public view on PRE in the context of GAOs" and the FSA:

"Expect to conclude Equitable current bonus practice is consistent with PRE but more doubtful about whether same could be said of past practice (because bonus notices of dubious clarity in the past)."

4.39.4 It was also noted that IFSD needed to try and define some more detailed criteria for determining when a reduction in terminal bonus was/was not consistent with PRE. In the final draft, Scenario 3 was removed because, we were told in interview, it was decided that the FSA would need to review the consistency of Equitable Life's bonus practice with PRE irrespective of whether or not the Court specifically referred the matter to the FSA.

4.39.5 One of the implications of Scenario 3, of the draft scenarios circulated on 8 June 1999, was stated to be that:

"Company would need to look at reducing substantially terminal bonus payable to all policyholders (*or those with a GAO irrespective of whether it was exercised?*)"

4.39.6 The draft scenarios were amended after a meeting with Equitable Life on 29 June 1999 and were sent to Michael Foot and IB-PIA on 5 July 1999. We have been told that at that meeting Equitable Life told IFSD that if the Society lost the Court case it

would look at meeting the cost of GAOs from GAO policyholders as a class. This was reflected in the amended version of the scenarios:

“Company would need to look at reducing substantially terminal bonus payable to policyholders with a GAO irrespective of whether it was exercised (or all WP pension policyholders if this was not accepted by the Court).”

4.39.7 The draft scenarios also set out various steps that would need to be taken in the event of a takeover bid, the likely effect of a fall in new business and the need to monitor Equitable Life’s surrender values to ensure that they were not so generous as to increase the lapse rate and thereby adversely affect Equitable Life’s solvency.

4.39.8 GAD’s view of the draft scenarios was that they should be considered alongside the projections which had been presented to the Equitable Life Board at the end of April 1999. GAD noted that the paper provided projections which included the possibility of losing the Court case together with various other assumptions. GAD advised that all the projections made by Equitable Life assumed that from the end 1999 position future annual investment returns were in the region of 6% to 7% and were adequate to generate fairly high levels of annually emerging surplus (probably in the region of £1billion).

4.39.9 GAD’s note continued:

“By modifying future payout levels, and also by restraining levels of reversionary bonus declaration, the Society is then able to steadily recover a reasonably strong disclosed financial position - although [the Appointed Actuary] does admit that in the ‘low’ investment yield scenario ‘the position would become impossibly tight’.

We also believe that worse results could arise if further tweaks are given to the ‘high’ investment yield scenario, such that equity market values suffer a sustained fall, and await with interest [the Appointed Actuary’s] response regarding the potential end 1999 position in the modified investment scenario as postulated in my letter of 27 May.”

4.39.10 The letter of 27 May 1999 had requested that the Appointed Actuary indicate the projected end 1999 result of a scenario where gilt yields remained in the current region of about 5%, while equity values fell by 10% over the year. The information was provided by the Appointed Actuary on 25 June 1999. In his letter of that date the Appointed Actuary explained:

“The projected end-1999 result of a scenario where gilt yields stay in the region of about 5% while equity values fall by 10% over the year (that is, about 20% from current values) would indicated a ratio of available assets to minimum margin of approximately 1.4x. As with the other projections in the paper [presented to the Board of Equitable Life in April 1999], that projection assumes a declared bonus at a level ½% p.a. below those allocated for 1998.”

4.39.11 On 16 June 1999, following a telephone call from IFSD to Equitable Life, the Society’s solicitors sent certain papers which had been submitted to Court to IFSD.

These were reviewed separately by IFSD and GAD and “skimmed” by GCD. GAD prepared a note commenting on the papers on 22 June 1999.

4.40 Equitable Life’s scenario planning for the First Instance judgment

4.40.1 Equitable Life wrote to IFSD on 21 June 1999. The letter explained that its lawyers advised the Society against preparing a fully documented contingency plan on the grounds that it could be unhelpful if such a plan became discoverable in some future legal action. Equitable Life said that despite this it had been giving considerable thought to the ramifications of the various possible outcomes and to assist these considerations it had identified six possible scenarios for the outcome of the Court case including the possibility that the Court ruled that Equitable Life’s approach was invalid. Equitable Life noted that the scenarios were “described in the attached note together with brief comments on the client servicing implications.” All but the first two were described as thought to be “highly unlikely” by Equitable Life’s lawyers. The scenarios were as follows:

- “1. Complete success...
2. Success but some adverse comment in the judgment...
3. Directors have discretion but have incorrectly executed it on technical grounds...
4. Directors have discretion but have not given sufficient weight to or considered the right PRE...
5. Ruling that the Society’s approach was invalid and that final bonus rates on cash and annuity benefits must be equal but that Board still has discretion to set rates at a level they deem appropriate...
6. Ruling that the Society’s approach was invalid and that final bonus rates on cash and annuity benefits must be equal but due to PRE it must be at the cash levels.”

4.40.2 For each of these scenarios Equitable Life set out its intended plan of action. These did not include reference to the financial implications of each scenario.

4.40.3 IFSD prepared a paper on or about 22 June 1999 after reviewing the Court papers sent by Equitable Life. This paper stated that:

“Equitable have indicated that if they lose the case they would look at spreading the costs of GAOs just across policyholders with a GAO (irrespective of whether it was exercised) ie they would seek to ensure that payments to other WP pension and life policyholders were unaffected. The policyholder’s solicitors have asked the Court to consider the acceptability of this intention if it becomes relevant.”

4.40.4 One of the affidavits in the Court proceedings sworn on 3 March 1999 on behalf of Equitable Life (and received by IFSD on 16 June 1999) set out the consequences if the declarations which the Board of Equitable Life sought were not granted by the

Court. One of the relevant variables affecting future bonuses was how the costs of providing “higher” benefits to the GAR policyholders would be spread among other with-profits policyholders. The affidavit stated as follows:

“There is only one cake to be divided up amongst all with-profits policyholders, and if the Society is obliged to allot the same proportionate final bonuses to all GAR with-profits policyholders irrespective of whether or not benefits are taken in guaranteed annuity form or not [sic], then the level of final bonuses must necessarily be adjusted downwards so as to enable this to take place. This would require the Society to review all bonuses for all with-profits policyholders, particularly those policyholders having GARs in their policies. The Society’s directors, in the exercise of their discretion as to bonuses, would have to decide whether the cost of any increased final bonus for policyholders taking their benefits in guaranteed annuity form should be borne by all with-profits policyholders, or simply those with GAR policies whether or not they take benefits in guaranteed annuity form. The directors have made no decision yet, although they have sympathy with the argument that providing benefits at a higher level to GAR policyholders should not be at the expense of policyholders who have no GARs.”

4.40.5 The evidence served on behalf of Mr Hyman in the Court case, sworn on 28 May 1999, which was sent to IFSD on 16 June 1999, included the following statement:

“Another particular concern raised by many policyholders has been Equitable’s assertion (made in correspondence to policyholders as well as in [Equitable Life’s] affidavit) that in the event of Equitable succeeding in this action, they intend to adopt a policy of greatly reducing or eliminating the final bonus for all holders of Guaranteed Annuity Rate policies, rather than spreading the cost throughout the with-profits fund. The policyholders who are aware of this assertion have expressed the hope that this stated intention should be considered in this action along with the decisions already implemented by Equitable.”

4.41 Further consideration of PRE by the FSA and liaison with IB-PIA and IBD

4.41.1 On or around 24 June 1999 IFSD sent copies of Equitable Life’s bonus notices for 1996 and 1997 to IB-PIA for its views as to whether the bonus notices were potentially misleading and whether IB-PIA had powers to take any action in relation to them. IB-PIA was not sent a copy of Counsel’s Opinion which was on IFSD’s files and which advised that Equitable Life should change the format of the bonus notices from the 1998 notice onwards.

4.41.2 Following discussions with GCD about PRE, a memorandum dated 25 June 1999 was prepared by IFSD which dealt with the type of action which IFSD might need to take on PRE in the event that the Court decided that PRE was not relevant to the case. We have been told in interview that IFSD’s doubts about the consistency of Equitable Life’s terminal bonus practice with PRE remained “significant” at this time. The memorandum (which was not copied to IB-PIA or IBD) also reported that the format of Equitable Life’s bonus notices had been raised with the PIA and that it was considered by IFSD that the bonus notices were the main factor in support of the argument that Equitable Life’s approach was not consistent with PRE. The

memorandum records that the format of the bonus notices had been raised with Equitable Life in the past, before the GAO issue arose, but that no progress had been made in persuading Equitable Life to change them. IB-PIA provided its views in September 1999, as set out below.

4.42 Meeting with Equitable Life on 29 June 1999

4.42.1 On 29 June 1999 Messrs Nash and Headdon met IFSD, GAD and GCD to discuss the implications of the pending Court case. This was the first meeting held between IFSD and Equitable Life to discuss this matter since Equitable Life's announcement of its intention to bring a test case in mid-December 1998.

4.42.2 A number of points were discussed, as set out below:

- (a) Equitable Life explained that its lawyers expected the Society to win the case and that it was "inconceivable" that the Court would require GARs to be paid on top of full terminal bonus at the same level which had been paid to GAR policyholders taking the cash benefits because it was thought that a judge could not totally discount the scope for directors to exercise discretion over bonus levels.
- (b) It was only in what were considered the "highly unlikely" scenarios (5 and 6) that Equitable Life's reinsurance contract would be invalidated. The meeting note recorded that Equitable Life said:

"As a contingency against losing the case the company had been in discussion with reinsurers about increasing the scope of reinsurance cover. [One reinsurer] had been prepared to offer a form of surplus relief reinsurance and even offered to take over the company's existing reinsurance with ERC. However at the eleventh hour [that reinsurer's] Head Office backed off from the proposal claiming "capacity problems."

Following this the company had decided to wait until the outcome of the Court case before talking to other reinsurers, they did not want to tout around the reinsurance market at such a sensitive time. [Equitable Life] believed that there was room to extend the scope of the existing reinsurance contract if Equitable were to lose the case and that premium rates would be practical and consistent with the existing treaty. GAD made the point that any extension in the scope of these treaties could have implications for the size of the company's future profits implicit item."

- (c) Equitable Life expected to appeal if the outcome was that its approach was ruled invalid and would ask the Court for approval not to change its bonus practice or pay compensation pending the outcome of the appeal.
- (d) It was confirmed that none of the measures described in the Board paper supplied on 20 April 1999 had been implemented but were being retained as contingency plans. Those measures included:

- (i) subordinated debt;
 - (ii) future profits implicit items;
 - (iii) financial reassurance;
 - (iv) protecting the GAR exposure;
 - (v) making changes to the investment mix;
 - (vi) use policy conditions to restrict growth in guarantees;
 - (vii) product design; and
 - (viii) business mix.
- (e) IFSD made it clear that even if Equitable Life won the Court case it would still need to consider whether the bonus practice was consistent with PRE. Equitable Life was told that IFSD had some concerns about what policyholders had actually been told in bonus notices and that IFSD had not yet reached a view on this.
- (f) Equitable Life confirmed to IFSD that it had adopted the new approach to bonus payments which had been recommended by its legal advisers. This was to award an additional cash sum to policyholders who did not exercise a GAO. IFSD asked to be sent a copy of the current form of bonus notice and other literature sent to policyholders.
- (g) Equitable Life confirmed that new business levels were holding up well and turnover of sales staff remained low. The Society would continue to follow its philosophy of paying out as much as possible in bonuses and not building up an estate. The absence of an estate was seen by Equitable Life as a good deterrent to predators.
- (h) Arrangements were made to co-ordinate any press handling issues that might arise from the case.

4.42.3 IFSD have told us that it did not consider it necessary to quantify in numerical terms the financial implications for Equitable Life in the event that it lost the case along the lines of the Scenario 4 of IFSD's draft scenarios dated 8 June 1999. There is no evidence that GAD carried out, or was asked to carry out, any analysis of the financial implications to Equitable Life of such a scenario. In interview we were told that such a scenario was considered by Equitable Life and by IFSD to be unlikely: "I don't think we had, until the end of the House of Lords' judgment, really thought that the eventual outcome was a serious runner ..."

4.42.4 We have subsequently been told that "what was considered important was the overall financial implication for the company in terms of its subsequent action eg would it be weakened to the point of becoming statutorily insolvent or a takeover target or needing to demutualise."

4.42.5 On 30 June 1999 the Appointed Actuary wrote to IFSD enclosing a typical bonus notice for 1998 as requested at the previous day's meeting for the purpose of assisting in the assessment of PRE. IFSD sent this to IB-PIA for its views as to whether or not it was misleading. IB-PIA's views on the bonus notices and communications between different teams within IBD are set out in **Chapter 5**.

4.43 Monitoring the High Court hearings

4.43.1 On 5 July 1999 the hearings in the case of *Equitable Life v Hyman* commenced in the High Court in London. IFSD received a copy of the transcripts. On the first day of the proceedings Equitable Life's solicitors sent the FSA a copy of the skeleton arguments of both parties in the proceedings.

4.43.2 On 5 July 1999 an internal memorandum was sent by IFSD to Michael Foot (copied to IB-PIA and others) setting out the background to the Court case and enclosing a copy of the paper setting out the possible outcomes to the case and draft press lines which had been considered internally in June 1999. The memorandum stated:

"The issue before the court is whether under the company's articles of association the board has the discretion to set differential levels of terminal bonus according to whether or not a guaranteed annuity option is exercised. The company considers it has the necessary discretion, the policyholders' main argument is that this discretion is limited by policyholders' reasonable expectations (PRE) and that the directors should have exercised their discretion so as to meet the reasonable expectation that policyholders would be entitled to the guarantee on top of terminal bonus.

We have undertaken some simple scenario planning in order to be ready to react to the outcome of the court case. The attached paper sets out the three basic scenarios that we envisage, their implications for Equitable Life and hence the actions FSA might need to take. The impact of the judgment on the company's financial position will need to be monitored and unless the judgment definitively settles the matter, we will need to undertake a significant exercise to determine whether we should intervene to ensure that Equitable Life's approach is consistent with PRE pursuant to our powers under the Insurance Companies Act 1982."

4.43.3 The memorandum then set out the questions which the FSA would have to consider in reviewing the question of PRE and stated:

"Some initial work on the PRE question has already been done and more will be undertaken ahead of the judgment (which may not be issued for some time after the court hearing and may in any event be appealed) so that we are in a position to reach a preliminary view within a reasonable time period after the judgment is released. We will have to consider whether it is necessary to invite representations and additional evidence from policyholders before we reach a final view on the issue in order that we can demonstrate that we have made reasonable efforts to obtain and take into account all relevant evidence."

- 4.43.4 The memorandum noted that Equitable Life was co-operating “fully” over the issue and would be providing IFSD with transcripts of the hearing so that IFSD could monitor developments.
- 4.43.5 The memorandum also reported that PIA was considering the presentation of Equitable Life’s bonus notices: “It appears to us that the notices may be misleading to policyholders because of the emphasis they place on the projected total fund value which includes terminal bonus although it is not guaranteed.”
- 4.43.6 The scenarios which were attached to the memorandum were as set out below.
- 4.43.7 Scenario 1 was described as follows: “Equitable win totally (past and current practice of reducing terminal bonus is acceptable within the terms of the contract).”
- 4.43.8 Scenario 2 was described as “Equitable win in part (current practice of reducing terminal bonus acceptable but past practice unacceptable).” The implications for Equitable Life were stated to be:
- (a) Equitable Life would continue its current terminal bonus practice;
 - (b) the reinsurance agreement would provide the anticipated GAO reserving cover;
 - (c) some compensation would have to be paid to some policyholders but the cost was unlikely to be substantial relative to Equitable Life’s reserves (possibly £400million);
 - (d) possible further downgraded credit rating which may cause significant reputational damage;
 - (e) Equitable Life would remain in a solvent but relatively weak financial position for a with-profits office;
 - (f) the judgment might be appealed by either side; and
 - (g) there may be a surge in surrenders and retirements.
- 4.43.9 The implications of Scenario 2 for the FSA were as follows:
- (a) FSA would need to continue to monitor solvency closely and the effect on surrender/retirement rates;
 - (b) the PIA Ombudsman would need to resolve complaints cases;
 - (c) IFSD would need to consider whether PRE warranted intervention or whether the court ruling should be considered definitive on policyholder interest; and
 - (d) IFSD would need to review the 1998 guidance and to discuss the implications of the judgment with other firms.

4.43.10 Scenario 3 was described as “Equitable lose (reducing terminal bonus where GAO exercised is unacceptable)” and the implications for Equitable Life were considered to be as follows:

- (a) GAO reinsurance invalidated if Equitable Life’s terminal bonus practice changes (although this may not be immediate if there is an appeal);
- (b) without the reinsurance Equitable Life is likely to only just be able to cover its RMM after taking full account of future profits implicit items;
- (c) Equitable Life would need to look at reducing substantially terminal bonus payable to policyholders with a GAO irrespective of whether it was exercised (or all with-profits pension policyholders if this was not accepted by the Court);
- (d) Equitable Life would aim to cut bonuses gradually over 3 years in order to meet PRE - (this might precipitate a takeover bid, a significant reduction in new business, an increase in lapse rates and policyholders retiring early to beat terminal bonus cuts);
- (e) Equitable Life would need to consider switching from equities to gilts to protect its solvency position;
- (f) Equitable Life would need to pay compensation to policyholders who had exercised GAOs and suffered reduced terminal bonus payouts as a result; and
- (g) Equitable Life’s credit rating is likely to be reduced further which may cause significant reputational damage.

4.43.11 The implications of Scenario 3 for the FSA were as set out below:

- (a) It was likely that IFSD would not need to form a judgement on whether intervention action was warranted on the grounds of PRE.
- (b) IFSD would need to determine the solvency of Equitable Life. If it was in breach of RMM then IFSD would need to issue a section 32²⁴ notice requesting a short term financial scheme for restoration of a sound financial position. If RMM was not breached, IFSD would still need to obtain financial projections to see how Equitable Life intended to increase its financial strength in the short to medium term.
- (c) If there was a significant risk that the company would be unable to meet its liabilities to policyholders or PRE then IFSD would need to consider closing the company to new business or suspending its authorisation.

²⁴ This is a reference to section 32 of the ICA 1982, which requires an insurance company to maintain a margin of solvency. This is referred to in more detail in Chapter 3.

- (d) Close monitoring of the company's business against the scheme/projections would be needed.
- (e) IFSD would need to assess the consistency of speed of bonus reductions with PRE and the practical effect on payouts.
- (f) Equitable Life might need to be encouraged by IFSD to reduce surrender values relative to maturity values.
- (g) IFSD would need to be alert to the potential wider loss of confidence in the industry.
- (h) If there was a takeover bid, the FSA would have no authority to protect Equitable Life from it. The FSA and Independent Actuary and the Court would scrutinise the terms of the transfer to check that they were fair to policyholders.
- (i) If there was a fall in new business then this would reduce new business strain and help bolster the financial position in the short to medium term.
- (j) IFSD would need to monitor the lapse rate to ensure that it is not so high as to affect the solvency position. IFSD would also need to address the concern that policyholders might be losing out through early surrenders. There would be a potential for an allegation that the FSA should have prevented Equitable Life from writing new business earlier so that lapses could have been avoided.

4.43.12 On 15 July 1999 Michael Foot reported to the FSA Board that the case had begun and that IFSD was undertaking some "contingency planning".

4.43.13 At this time the judgment was expected to be handed down in July before the Court vacation. However, in the event, judgment was given in September. Following receipt of copies of the transcripts of all three days of Court hearings, a summary was prepared and distributed internally on 12 August 1999. The overall conclusion set out in the summary was that the decision could go "either way" (GCD commented in manuscript that it agreed that it was "impossible to call") but the note stated that the most likely outcome was that Equitable Life would win but would be criticised for not making its approach clearer. It was noted that both sides played down the PRE issue.

4.43.14 On 8 September 1999 at a meeting of ExCo, it was reported that judgment was due in the case of *Equitable Life v Hyman* on the following day. The minutes record that "It needed to be considered how the FSA would respond."

4.44 Judgment of the High Court

4.44.1 On 9 September 1999 judgment was given in favour of Equitable Life by the (then) Vice-Chancellor, the Rt Hon Sir Richard Scott. The main finding of the judgment was that Equitable Life had not acted in breach of contract and its directors were entitled to exercise their discretion so as to declare differential terminal bonuses to

GAR policyholders who exercised their GAO. The precise meaning of the Vice-Chancellor's comments about PRE were not clear to the FSA and were considered internally by some to be critical of Equitable Life. Mr Hyman, the representative policyholder, was granted permission to appeal to the Court of Appeal.

4.44.2 The headnote to the Vice-Chancellor's judgment appears at **Appendix 4**.

4.45 Reactions to the High Court judgment

4.45.1 On 9 September 1999 GAD sent an e-mail to IFSD, copying in GCD with comments on the judgment and GAD's understanding of the Vice-Chancellor's conclusions on PRE. GAD noted that it had not seen anything in the judgment which was clearly inconsistent with the general guidance on the application of GARs and terminal bonus, "albeit that the Equitable's GAR policyholders are effectively being charged for this option according to its value at the vesting date of the contract rather than over the duration of the contract, though there is nothing to indicate that another office might not operate some other fair basis of charging". GAD also noted that the Vice-Chancellor also seemed to endorse the regulator's stance on the need to reserve additional amounts for GARs.

4.45.2 On the following day GCD sent a five page note to IFSD and Michael Foot summarising the judgment. The note was also circulated to IBD and was subsequently sent to IB-PIA and Enforcement on 14 September 1999. The note referred to the Vice-Chancellor's reference to the concept of PRE and his statement that the statutory provisions: "recognise that policyholders may have a reasonable expectation of benefits over and above their contractually guaranteed benefits." GCD noted that this was very significant and was the first real judicial support which the regulator had had for this principle.

4.45.3 GCD referred to the issue of breach of contract and commented on the Vice-Chancellor's finding that there was nothing in the contract to prevent Equitable Life's terminal bonus practice:

"This on its face seems right, but I understand that the FSA has some evidence that, on maturity and when options were being discussed with policyholders, the Equitable did not tell policyholders in terms that terminal bonus was conditional. This is not a matter for IFSD however and is before the PIA."

4.45.4 The Vice-Chancellor found that:

"a reasonable expectation does not become a contractual right. PRE was no more than one of the factors to be taken into account by the Directors. Its effective weight in the balance would depend upon all other factors taken into account. And the balance was, and is, one for the Directors, and not the Court, to strike."

4.45.5 GCD went on to comment that the Vice-Chancellor found that GAR policyholders had a reasonable expectation that they would receive full terminal bonus with a GAR annuity and said:

“I understand that, based on the evidence we have examined so far, we would be likely to come to the same conclusion. In any event, it would be very difficult to come to a different conclusion, in the face of a relatively authoritative judgement, without some compelling reason (and probably good evidence) to do so. The next step then, would be for us to consider whether, under section 45 of the Insurance Companies Act 1982, action should be taken to ensure that the criteria of sound and prudent management are fulfilled... The VC concluded that the directors of the Equitable had properly had regard to PRE; the question for us goes beyond that and is whether sufficient or due regard was had to PRE.”

4.45.6 The note continued:

“As we have already discussed, if we were to take the view that due regard was not had to PRE, there is real awkwardness in taking action against the Equitable for all sorts of reasons (which I won't go into here) including the need to rely on grounds which are primarily directed at good management, soundness and prudence, rather than conduct of business as such. There is also a PIA “ring” to this case...”

4.45.7 The note recorded that “Given that the Court of Appeal may overturn the judgment or in effect alter its contents, including the findings on PRE, [the FSA] have decided to defer reaching a decision on whether to take action until the appeal is concluded.” Finally, GCD suggested that it might be appropriate to contact the PIA Ombudsman and find out whether he was adopting the same approach.

4.45.8 On 14 September 1999 IFSD prepared a one page memorandum summarising the case. On 14 and 15 September 1999 there were e-mail exchanges between members of IFSD, IBD and IB-PIA regarding the need for all parts of FSA to consider the implications of the judgment and a copy of GCD's summary of the judgment was attached to the e-mail. IFSD and IBD agreed that each regulator should do some analysis in advance of the outcome of the Court of Appeal and IFSD stated as follows:

“You phoned to discuss the next steps. As I explained I think it is important that we review the situation in the light of the judgment, including whether the judgment throws any light on the PIA's (and the PIA Ombudsman's) interests and responsibilities. Although it seems clear that the judgment will be appealed (the appeal may not be heard until early next year) there is no reason why our analysis should be delayed until after the appeal - and, indeed very good reasons why it should not.

That said I am keen that we should look at the issues from the perspective of all the FSA constituent bodies and that we should consider any possible action in the same way. I think that will probably mean that we should not decide on, or initiate, any action until the appeal court's decision is known. If the judgment is overturned, particularly if the actions of the Equitable's directors are heavily criticised, it is possible that it would be appropriate for us to take action under the Insurance Companies Act. I would not wish to be in a position where our room for action had been constrained, or possibly prejudiced, by earlier actions by others.

But we can, of course, consider this further in the light of the analysis which I think we are agreed should now be undertaken.”

- 4.45.9 On 16 September 1999 Equitable Life wrote to all policyholders setting out the positive approval the Society considered it had been given by the Court for its bonus practice. There is no evidence that the FSA saw this letter before it was sent out.
- 4.45.10 On the same day, the FSA Board held its regular monthly meeting. The written report to the Board had been prepared before the judgment had been given and therefore merely notified the Board that judgment was expected on 9 September and that the FSA would need to study the judgment and report again to the Board in due course. The Board was informed that the ruling might have wider consequences for the interpretation of PRE.
- 4.45.11 On 23 September 1999 IB-PIA completed its review of the bonus notices which IFSD had sent in June 1999 and advised IFSD that its initial view was that IB-PIA believed that it did not have jurisdiction to take any action in relation to bonus notices, but that in any event it did not consider the bonus notices to be poorly presented or inaccurate. IFSD described PIA’s response as a “surprisingly unqualified endorsement” of the bonus notices, but did not revert to IB-PIA.
- 4.45.12 On 1 October 1999 GAD sent a memorandum to IFSD setting out why GAD considered that the judgment was more favourable to Equitable Life on the question of PRE than was implied by the GCD summary.
- 4.45.13 There remained small differences within IFSD and GAD about what the Vice-Chancellor had said about PRE and its potential impact, but since the whole issue was going to appeal it was not thought necessary to address these for the time being.
- 4.45.14 On 11 October 1999 there was a meeting between IFSD and IB-PIA at which IFSD reported that “Although the [First Instance] judgment was in favour of the Equitable, IFSD view [sic] is that although Equitable had regard to PRE they did not meet it so there is the possibility of intervention.”

4.46 Initial risk assessment - August 1999

- 4.46.1 At the end of August 1999 IFSD prepared an Initial Risk Assessment of Equitable Life as part of piloting a new FSA assessment methodology. In interview we were told that this was part of a pilot for the introduction of risk assessment for all companies. It was produced for the supervisors to review the format and was based on information “to hand”. The overall summary stated that Equitable Life was seen as a “high financial risk because of the level of benefits guaranteed to policyholders, the relatively low free asset position and the difficulty it would face in raising external finance. Equitable would be particularly vulnerable to a sustained and significant fall in equity prices.”
- 4.46.2 Under the section headed “Cultural Attitude”, were the following comments:

“A tendency to arrogant superiority regarding the efficiency of their operations and the high priority given to the interests of policyholders. This can blind them to the financial risks that can arise as a result of guaranteeing high benefit levels.”

- 4.46.3 We have been told that the reference to “high benefit levels” was a reference to the generous rates of reversionary bonus which Equitable Life paid to its policyholders, not to its GAO contracts.
- 4.46.4 It was noted below the heading “Corporate Governance” that there was no particular reason to believe there were problems in this area although little evidence was available. IFSD noted that the Board papers which it had seen relating to bonuses suggested that the Board was presented with the information which was necessary in order to make a decision. The note recorded that more information was needed about reporting lines into the Board and the frequency of Board meetings in order to be able to assess the extent to which an appropriate degree of control was being exercised by the Board.
- 4.46.5 Under the heading “Internal Controls and Risk Management” IFSD noted that it required more information before it could form a judgement.
- 4.46.6 As far as solvency issues were concerned, IFSD noted that the relatively low free asset position together with Equitable Life’s mutual status (making the raising of external capital difficult) and the high levels of reversionary bonus which had traditionally been declared meant that the company was potentially highly vulnerable to a change in economic circumstances. A sustained period of low investment returns - particularly if it was associated with a substantial fall in equity prices - could be particularly damaging. It was noted that Equitable Life had taken heed of the regulator’s concerns about the level of reversionary bonuses and had made some effort to reduce them that year. Further reductions would be needed in future years if the risk was to be significantly reduced.
- 4.46.7 Below the heading “Financial” and the sub-heading “Reserving/Capital” it was noted:
- “Equitable has a high exposure to guaranteed annuity options. It had to establish reserves for GAOs in excess of £1.5b in 1998 and it is arguable that a higher reserve should have been set. Approximately half the reserve is covered by a reinsurance arrangement. It is dependent on the reinsurance to be able to demonstrate a reasonably healthy level of free assets. Also potential risk that Equitable could need to pay compensation to GAO policyholders if it loses the current court case.”
- 4.46.8 In summary, the note recorded that more information was needed on internal controls and risk management and audit and compliance. This information, and more information about Board meetings and reporting lines, was sought by a letter dated 15 November 1999, in advance of the company visit which the FSA made to Equitable Life’s offices in Aylesbury in December 1999.

4.47 Reserving - late 1999

- 4.47.1 On 20 September 1999 there was an exchange of e-mails between IFSD and GAD concerning finalisation of GAD's scrutiny of Equitable Life's regulatory returns for 1998. GAD confirmed that the detailed scrutiny had been submitted to the FSA on 20 May 1999, but reminded IFSD that there were two outstanding matters: the further consideration of the final terms of the reinsurance agreement and a policy decision on whether to challenge some of the assumptions made in setting the reserves for GAOs. GAD asked whether the final wording of the reinsurance agreement had been received and noted that the dialogue on the second issue (reserving) was continuing and that no formal consideration had been given to the Appointed Actuary's "observations" in his letter to GAD of 19 July 1999.
- 4.47.2 On 24 September 1999 GAD sent a memorandum to IFSD stating that GAD was not inclined to pursue the issue of the level of Equitable Life's reserves for guaranteed annuities any further at this point even though GAD remained "somewhat uncomfortable that [the Appointed Actuary's] assumptions are not fully in line with expectations based on our interpretation of the GA's letter on this subject." Since the reinsurance agreement provided protection for losses in excess of a 25% take-up rate for GAOs, any required increase in gross reserves arising from an amendment to Equitable Life's assumptions as to take-up rate would be matched by an equivalent increase in reinsurance recoveries. There would therefore be no net effect on Equitable Life's overall financial position. However, GAD suggested that the topic could be raised at the forthcoming company visit and confirmed that detailed scrutiny of the 1998 regulatory returns was now considered to be closed.
- 4.47.3 The memorandum from GAD also stated that Equitable Life's calculations for its future profits implicit item requested by Equitable Life on 30 March 1999 were in line with the guidance but suggested that IFSD should ask the Appointed Actuary to certify that the amount used must not exceed the present value of future profits expected to emerge and that the Appointed Actuary would need to make allowance for the potential effect of the reinsurance agreement in reducing future profits. GAD also reminded IFSD that a copy of the reinsurance agreement as signed should be requested from Equitable Life.
- 4.47.4 Accordingly, on 28 September 1999 IFSD wrote to the Appointed Actuary confirming that before recommending Equitable Life's application for a future profits implicit item be approved, confirmation was required as to the effect the reinsurance agreement would have on future profits. IFSD also renewed the request for a copy of the final version of the reinsurance agreement.
- 4.47.5 The reinsurance agreement was signed by IERC on 30 September 1999 and by Equitable Life on 11 October 1999 and was sent to the FSA on 14 October 1999, together with a revised application for a future profits implicit item of £1 billion. In the covering letter the Appointed Actuary confirmed that in making the calculations supporting the application he had not "double counted" future profits which might be required to make repayments to the reinsurer if claims arose under the reinsurance agreement.

4.47.6 On 22 October 1999 GAD sent a note to the FSA advising that Equitable Life's revised application for a future profits implicit item of £1000million was acceptable. On 8 November 1999 the ISC approved the application for the future profits implicit item, according to the minutes, "without further discussion" and on 9 November 1999 HMT issued the Section 68 Order granting formal approval.

4.48 Meeting attended by all regulators

4.48.1 A meeting of both conduct of business and prudential regulators, to discuss what action IB-PIA should be taking in relation to GAO issues and Equitable Life in particular, was convened on 21 October 1999. This was the first meeting to take place which was dedicated to Equitable Life and GAOs which was attended by representatives of each of IFSD, IB-PIA, IB-Policy and the internal lawyers advising IBD. We have not seen any minutes of this meeting, but it was referred to in an e-mail from IFSD to GAD in which IFSD noted that it would be writing to Equitable Life to obtain information for IB-PIA in relation to sales of GAO policies after "A" Day and in relation to top-ups sold since June 1988 (which was the date on which Equitable Life ceased to sell GAR policies). The meeting is also described in **Chapter 5**.

4.49 Company visit

4.49.1 HMT-ID, and subsequently IFSD, sought to visit insurance companies once every three years, although the aim was to increase the frequency of visits. A company visit to Equitable Life had taken place in November 1996. In September 1999 IFSD arranged to visit Equitable Life on 6 December 1999. In advance of the visit, it had been agreed that its purpose was to talk about "the broader picture rather than just GAOs" and to discuss the Society's overall position and future plans to ensure that IFSD had a more rounded picture of the company's operations. On 15 November 1999 in preparation for the visit, IFSD requested a number of items of information from Equitable Life including the latest financial condition report, structure charts, details of board sub-committees, copies of the latest business plans and papers on future strategy, details of investment policy, the latest report from the investment manager, the internal audit programme for 1998 and 1999 and internal audit's most recent report to the Board or to senior management.

4.49.2 On 25 November 1999 the Appointed Actuary sent IFSD a substantial volume of the background material which had been requested. That material included copies of reports to the Board of Equitable Life, financial projections and internal audit documents. In lieu of a financial condition report Equitable Life sent a copy of the latest set of financial projections dated 23 April 1999 (a copy of which had been sent to IFSD on 4 May 1999) and the latest report to the Board on revenue and solvency matters dated 22 October 1999.

4.49.3 The visit was referred to at a college meeting²⁵ on 26 November 1999, attended by, among others, IFSD and IB-PIA, at which various assurances as to information exchange were given by IFSD to IB-PIA, following IFSD's agreement to pilot lead

²⁵ As explained in **Chapter 2** and described in **Chapter 5**.

supervision for various firms including Equitable Life in June 1999. IFSD explained that it would be visiting Equitable Life and that although the focus of its recent regulatory activity had been on solvency and the GAO issue, it was hoping to fill in some of the gaps in its knowledge of the Society as a result of the visit.

4.49.4 According to the note of the company visit by IFSD to Equitable Life, among the topics covered were:

- (a) overview of corporate management structure;
- (b) general market outlook and business strategy;
- (c) investment policy and asset management;
- (d) systems and controls; and
- (e) financial position/role of Appointed Actuary.

4.49.5 In the note of the visit, under the heading "Investment Policy and Asset Management" it is noted that GAD felt that "Chris Headdon's future projections ... did not fully take into account the scenario of a long term stock market depression - which could have severe implications for the Society".

4.49.6 As far as systems and controls were concerned, Equitable Life told IFSD that the Society had recently reviewed the control systems in conjunction with consultants. The consultants had concluded that Equitable Life's processes were satisfactory but could be improved if they were more formalised and had recommended that the Society considered creating a traditional internal audit function. The Board agreed to do so and were recruiting an internal auditor from outside Equitable Life. Equitable Life told the FSA that it expected that the new internal auditor and a new internal audit function would lead to a more structured formalised approach to risk management that would look across the business and not just be "top down."

4.49.7 The discussion about GAOs was limited. The Appointed Actuary told IFSD that the reinsurance agreement had been extended to cover group business whereas previously it had covered only individual business. This would improve the reported solvency. The gross GAO reserve was £1.56billion, this reduced to £760million net after the reinsurance. The extension to the reinsurance agreement to include group schemes had further reduced the net GAO exposure to £560million. The Appointed Actuary reported that next year all of these figures would further decrease since about 10% of GAO business would come off the books. There was also a short discussion about reserves and Equitable Life was warned that the FSA and the Government Actuary would be setting out more clearly the approach to be taken with respect to reserving for GAOs. This could mean that Equitable Life would have to increase its gross reserves for GAOs.

4.50 December 1999 guidance on reserving for GAOs

4.50.1 The guidance which had been issued in January 1999 requiring full reserves for GAOs had stated as follows:

“It is likely that close to 100% of policyholders will exercise the annuity guarantee unless the company maintains terminal bonus at a level which ensures that the value to the policyholder of the alternative benefit is at least equal to the value of the guaranteed annuity. Accordingly, this constraint will need to be reflected in the valuation assumptions made about either the proportion of policyholders opting for the alternative benefit or the value of that alternative benefit. Consequently any reduction in the reserves held by the insurer by more than a few percentage points below the full value of the guaranteed annuity for this reason would require very careful justification by the actuary.”

4.50.2 As GAD had noted in its scrutiny of Equitable Life’s 1998 regulatory returns, the Society had interpreted “a few percentage points below the full value of the guaranteed annuity” as about 80% of the full value. As part of the scrutiny exercise, GAD had asked Equitable Life how it had reached this figure but, as at 24 November 1999, had not expressed a view on the acceptability of Equitable Life’s argument on this point. In an e-mail of that date, IFSD noted that it had intended the phrase “a few percentage points below the full value of the guaranteed annuity” in the January 1999 guidance on reserving for GAOs to mean around 95% of the full value, in total.

4.50.3 The FSA was concerned that a number of companies had interpreted the guidance as meaning 10% and two companies had gone beyond this. As a result, IFSD considered it should set out for companies the intention of the guidance when it referred to “a few percentage points”.

4.50.4 Clarification of the guidance on reserving for GAOs was issued on 22 December 1999 in a letter from the Government Actuary. A copy of this guidance appears at **Appendix 3** to this Report. The letter was also sent to managing directors of all life insurance companies under cover of a letter from IFSD. The reference to “a few percentage points” was clarified to mean the total aggregate allowance that might prudently be made for all other benefit forms (whether cash or other forms of annuity) and that, in the FSA’s view, an allowance in excess of 5% would not be considered to represent “a few percentage points.” The Government Actuary explained that in his view:

“in determining the reserve for a contract containing a guaranteed annuity it would not generally be prudent to assume that policyholders will choose a benefit form that is of significantly lower nominal value to them than the guaranteed annuity. I indicated previously that I would expect any allowance for the reduction in the liability on the basis of policyholders making such choices to be limited to “a few percentage points” of the reserve. I would like to clarify that I was referring here to the total aggregate allowance that might prudently be made for all other benefit forms (whether cash or other forms of annuity) and that in my view an allowance in excess of 5% would not be considered to represent ‘a few percentage points’.”

4.50.5 The letter also reported that the Government Actuary was reviewing the level of disclosure of the assumptions made by each company in the 1998 regulatory returns.

4.51 Hearings in the Court of Appeal

- 4.51.1 As far as the Court case was concerned, on 21 October 1999, Michael Foot's report on recent developments within financial supervision was sent to the FSA Board noting the outcome of the First Instance hearing and stating that "The judgment is subject to appeal; we shall await the outcome of the appeal before considering whether any further action by FSA is called for."
- 4.51.2 On 28 October 1999 IFSD was informed by the Appointed Actuary that the appeal was listed to be heard at the end of November 1999. Equitable Life said that it would send the FSA copies of the skeleton arguments to be lodged by Mr Hyman.
- 4.51.3 Michael Foot's November report on developments within financial supervision was sent to the FSA Board on 18 November 1999 and reported that the Court had given permission to appeal to the representative policyholder in the Court case and that the hearing of the appeal had been set down for hearing in late November 1999.
- 4.51.4 The appeal hearing opened on 29 November 1999.
- 4.51.5 The Court of Appeal's judgment was given on 21 January 2000. By a majority of 2 to 1 the Court allowed the appeal of the representative policyholder. Lord Woolf MR, now Lord Chief Justice, gave the leading judgment. The following passage contains the essential reasons for his decision:

"[Equitable Life's directors' decision to adopt the terminal bonus practice] was an exercise of discretion reducing the policy-holder's reasonable expectation that he would receive his asset share irrespective of how he exercised his rights under the policy. The purposes for which the powers contained in Article 65 are conferred on the Society do not include treating a policy-holder differently depending on the manner in which he seeks to exercise his rights under the policy which he has been granted by the Society in return for his premium. This is precisely the result of the policy adopted by the Society and it is a collateral purpose designed to negative a benefit to which the policy-holder would otherwise be entitled."

- 4.51.6 Waller LJ, who also gave judgment in favour of Mr Hyman, held that on a proper construction of the policy Equitable Life had not been entitled to allot a final bonus which was conditional upon the form in which the benefits under the policy were taken. However, he commented at the end of his judgment (a comment which does not form part of his reasoned decision):

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

of their equivalent asset share. What the correct final bonus is in relation to GAR policies could only be worked out by the Board on the advice of the actuary.”

4.51.7 The headnote to the Court of Appeal’s judgment appears at **Appendix 5**.

4.52 Reactions to the Court of Appeal judgment

4.52.1 On 21 January 2000 Equitable Life sent a facsimile to IFSD, enclosing Equitable Life’s solicitors’ summary of the Court of Appeal’s judgment. Based on the document prepared by Equitable Life’s solicitors only, which IFSD had sent on to GAD, GAD sent its initial assessment of the judgment to IFSD on the same day. GAD’s view was that most of the advice in the guidance issued by HMT-ID in December 1998 would still be relevant and that the judgment vindicated IFSD’s stance on the reserving levels required. GAD also noted that it was not clear how the judgment was intended to be applied to Equitable Life’s existing policies but suggested that the costs to the Society should be fairly marginal. It also suggested that Equitable Life be asked to confirm that the reinsurance agreement would be unaffected by the judgment.

4.52.2 Shortly after the judgment had been given, IFSD informed IB-PIA that it was no cause for panic; Equitable Life had been given permission to maintain its payment practice pending an appeal to the House of Lords; the financial position of the company was “largely unaltered by the judgment as Equitable Life already has to fully reserve in the Annual Returns for biting GAOs.”

4.52.3 On 24 January 2000 Howard Davies asked IFSD whether there was any substance in the claim which he had seen in the press that “others in the industry think we have been indulgent towards the Equitable”. The article, which appeared in *The Independent* on 22 January 2000, stated that: “Competitors said that the decision had taken not just the Society by surprise but also insurance regulators at the Financial Services Authority who are widely believed in the industry to have offered Equitable a high degree of latitude in dealing with the issue.”

4.52.4 IFSD’s response to Howard Davies was that no concern had been heard to that effect in the industry and that a number of companies, including Equitable Life, believed that the FSA had taken a very tough line on reserving standards in respect of GAOs. It was suggested that the comment by one of the Appeal Court Judges that the 1998 guidance letter to life offices “endorsed” Equitable Life’s position may have been picked up by the press as an indication of “indulgence”.

4.52.5 Following the judgment, on 24 January 2000, IFSD was requested to provide a summary of the general implications for the insurance industry for HMT. IFSD considered this might be premature because:

“The company have been given leave to appeal. Even if the Court of Appeal’s decision is upheld the implications, both for the Equitable and the industry will depend on the terms of the Lords judgment. As an instance of this, the implication of the CoA judgment seems to be that the Equitable is entitled to declare bonus on a differential basis as between policies with GAOs and those without, but not between policies with GAOs where the option is exercised and

those where it is not. The House of Lords might, presumably reach a different view on this which could have implications for the company/industry which are different from, though of the same or greater order than, those which would flow if the CoA decision was not appealed.”

4.52.6 In a memorandum dated 28 January 2000 prepared by IFSD and circulated internally, which stated that it had been prepared without considered legal advice, it was noted under the heading “Implications for the industry (if the judgment stands)”:

“Equitable would need to revise its bonus policy for future years, but potentially the new approach need not lead to any significant additional costs for the company. The question of whether any compensation might be payable in respect of policies vesting in the last five years could only be assessed in the light of the HoL judgment. However our assessment remains that any compensation cost would be unlikely to have a material impact on the company’s financial position. The reputational damage to the company would only become apparent at a later date.”

4.52.7 On 31 January 2000 GCD circulated a summary of the Court of Appeal judgment to IFSD and GAD. The summary focused on the leading judgment because in GCD’s view “it was the most interesting” but GCD made it clear that for a non-lawyer the only matter of real interest was that each judge made his findings for different reasons. The summary quoted Lord Woolf’s reasons extensively. It referred to Lord Justice Waller’s judgment by simply stating that he:

“concluded that while different bonuses might be awarded to different types of policyholder (eg GAR policyholders), and the award of differential bonuses was within the wide discretion of the Directors, differential bonuses were not permissible under the terms of the policy.”

4.52.8 The note also stated:

“In the result, it is impossible to predict which way the House of Lords will jump. Much will depend on the panel which is selected to hear the appeal. It seems reasonably likely as well that the Judges on the panel (like those in the Court of Appeal) will have different reasons for their decision. Accordingly, any attempt to divine the implications of this judgment or to guess the contents of the decision of the House of Lords (apart from recognising that the Equitable might win or lose) would probably not be of much benefit. In addition neither the Vice-Chancellor nor the Court of Appeal dealt with mechanisms of compliance with its judgment (partly because argument was not made on this issue and partly because they might in any event be agreed by the parties, hopefully in consultation with the FSA). If the Court of Appeal is upheld, how compliance is or may be achieved by the Equitable (there may be more than one way) could significantly affect any implications for ‘the industry’.”

4.52.9 This summary was interpreted by Michael Foot as meaning that the House of Lords would either “jump” to the Court of Appeal decision (meaning the *obiter* comment of Lord Justice Waller) or to the decision of the Vice-Chancellor at first instance, not to what he saw as “an extreme third option”. In interview IFSD said “I think we felt

after the Court of Appeal that we were entitled to take a reasonable assessment of what the worst likely outcome was, as being effectively the Waller outcome”.

4.53 Letter from Equitable Life to policyholders following the Court of Appeal decision

4.53.1 On 1 February 2000 the Equitable Life wrote to all policyholders updating them on the latest situation in respect of the Court case. The letter stated:

“Contrary to many of the reports which have appeared in the press, there would be no significant costs imposed on the Society if the Court of Appeal’s decision were upheld in the House of Lords. The speculation regarding financial difficulties and costs to be borne by with-profits policyholders is therefore unfounded. Your Society remains, and will continue to remain, financially secure.”

4.53.2 A copy of the letter was given to IFSD by an employee of the FSA who was an Equitable Life policyholder. The letter was only seen by the FSA after it was sent out by Equitable Life. It was not forwarded by IFSD to IB-PIA.

4.53.3 On 17 February 2000 the FSA Board was updated on recent developments within financial supervision. The report stated as follows:

“Equitable does not appear to face any immediate financial risk or any additional threat to its independence. If the appeal judgment was upheld, Equitable would need to revise its bonus policy, but potentially the new approach need not lead to significant additional costs. The reputational damage from the court case will only become apparent at a later date, but interestingly the judgment did not spark a significant surge in calls to the company’s policyholder helpline.”

4.53.4 On 2 March 2000 GCD sent an e-mail to one IFSD executive querying whether there was an argument that to impose the costs of the guarantees only on GAO policyholders “would be [a] breach of PRE and might fall foul” of the judgment of Lord Woolf in the Court of Appeal.

4.53.5 From the documents seen by the Review Team, there was no communication between IFSD and Equitable Life between mid-January 2000 and late May 2000 relating to the Court case, save for the summary of the judgment prepared by Equitable Life’s lawyers which was sent by facsimile to IFSD on the day of the Court of Appeal judgment.

4.54 Meeting between IFSD and Enforcement

4.54.1 On 8 March 2000 IFSD had a meeting with Enforcement relating to PFWs. IFSD was concerned about any impact on Equitable Life’s solvency which might result from Enforcement’s activities. This is referred to in **Chapter 5**.

4.55 House of Lords hearing - June 2000

4.55.1 On 31 May 2000 IFSD received copies of the Agreed Statement of Facts and Issues and the document setting out Equitable Life’s Case for the House of Lords hearing which was due to take place on 12 June 2000. IFSD circulated copies of those

documents to GAD and GCD. Equitable Life's lawyers said that they were unable to obtain consent from Mr Hyman's lawyers to release a copy of his Case for the House of Lords. IFSD noted that it was not intending to request a copy of Mr Hyman's Case for the House of Lords because it did not wish to suggest or to create an expectation that the FSA "would/could do something depending on the outcome of the case."

- 4.55.2 On 12 June 2000 the hearing of the case of *Equitable Life v Hyman* commenced in the House of Lords. The hearing lasted for four days. Copies of the transcripts were sent to the FSA, although it is not clear on what date they were received.
- 4.55.3 Shortly after the House of Lords' hearing, on 27 June 2000, Equitable Life made an application for a future profits implicit item of £1.1billion for use in its year end regulatory returns. The regulatory returns for year end 31 December 1999 were received by IFSD on 30 June 2000. On 7 July 2000 GAD recommended to IFSD the granting of the future profits implicit item. GAD stated "We have reviewed the Actuary's calculations in the light of the 1999 returns and are satisfied that they are consistent with the relevant Regulations and Guidance Note." GAD noted, amongst other things, that there was a significant margin between the £1.1billion amount applied for and the maximum £3.3billion amount that the company could have applied for based on the information provided. GAD concluded "We therefore recommend that FSA grant their consent for the society to use an implicit item of £1.1bn in their 2000 FSA Returns." The application was considered by the ISC in September 2000 and is referred to in more detail in Part 3 below.
- 4.55.4 On 4 July 2000 Michael Foot received a call from Equitable Life. Equitable Life informed Michael Foot that the Equitable Life Board was considering what ought to be done if Equitable Life lost in the House of Lords. Although Equitable Life had no firm idea of the likely judgment, Michael Foot was told that there were "straws in the wind" that the House of Lords would "like to find against the Society."
- 4.55.5 Equitable Life wanted to see what thoughts the FSA had about whether it was necessary for there to be resignations at a senior level in the event of such a Court decision. Michael Foot sent a note of the telephone conversation to Howard Davies, with a single copy to IFSD suggesting that the FSA should emphasise the importance of retaining an adequate executive relationship and that it depended on the presence or absence of detailed criticism in the judgment.
- 4.55.6 On 5 July 2000 Michael Foot recorded in a note to Howard Davies (a single copy of which was sent to IFSD) that he had told Equitable Life that the FSA wished to ensure continuity amongst the executives at Equitable Life and suggested that any resignations could take place at the year end. He also said that it depended on the judgment, but "on what we knew so far it was unlikely that the FSA would be throwing brickbats at Equitable Life."
- 4.55.7 A meeting between Equitable Life and IFSD took place at Equitable Life's request on 18 July 2000. The meeting was to discuss contingency planning for the House of Lords' judgment which was due to be given on 20 July 2000.

- 4.55.8 The note of the meeting does not refer to the telephone call from Equitable Life on 4 July 2000, although it does refer to new arguments raised in the House of Lords. The meeting note records that the possibility of losing in the House of Lords “was thought unlikely” but if it did, on the basis of scenario 3, set out below, it would have severe consequences for the Society. Equitable Life outlined three scenarios. The third (a ruling which required Equitable Life to pay GARs on top of full terminal bonus) is stated in the meeting note not to have been seen as a potential option before but followed arguments which the House of Lords had heard. The note also recorded that Equitable Life considered that this new third scenario was now in play:
- “A ruling that did not allow the Society to alter the rate of bonus for policies that contain GARs - the Society would need to declare a rate of bonus as if the policies did not contain GARs. This would mean that the Equitable would have to pay a GA on top of unadjusted asset share; the directors of the Society would not be able to adjust bonus rates downwards because GAR benefits gave an additional benefit to the policyholder.”
- 4.55.9 Although this outcome was still considered unlikely, if Equitable Life had to pay GARs on top of the value of unadjusted asset share, it would have a profound effect on solvency. The reinsurance agreement would no longer be valid and Equitable Life would need to find assets to fund the additional benefits payable to GAR policyholders from its own resources. It was estimated that this could be in the region of £1billion to £1.5billion depending on the precise nature of the judgment. The note records that the reinsurance would remain in effect for 3 months covering policies vesting during that 3 month period, but would not protect Equitable Life’s balance sheet position for all the relevant GAO policies²⁶. The note recorded that Equitable Life “had not sought to renegotiate [the] treaty to cover the Society’s GAR liability if this scenario occurred. The Appointed Actuary did not think this was likely to be a viable proposition in any case.”
- 4.55.10 The meeting note records that Equitable Life told IFSD that it would need to find the assets for funding the additional benefits from its own resources. Equitable Life proposed to announce immediately that it would seek a partner if this third scenario occurred. Equitable Life “was keen to avoid any precipitous action from the FSA in the light of this adverse judgment. Mainly because this could have a detrimental effect on the value of the business, for example stopping the company writing new business could lead to losses in the field force and this was a valuable asset for the Society.”
- 4.55.11 IFSD indicated that it would not “rush to take remedial action in these circumstances and understood the importance of maintaining the value of the society.” The FSA would however need to be convinced that there was a prospect of a suitable buyer being found quickly. This approach was based on IFSD’s view that there was no reason to take any hasty regulatory action in circumstances where a solvent firm was seeking to put itself up for sale and any such action would be carefully considered, including the impact of such action on the interests of policyholders.

²⁶ The agreement was terminable on 3 months’ notice given by Equitable Life. In the event of a change in Equitable Life’s terminal bonus practice, no further claims would be possible and the agreement would be terminated.

4.55.12 The Appointed Actuary reported that he was conducting some scenario modelling to see if the company would be insolvent if scenario 3 occurred and GAD asked to receive these details when complete, which it was told would be the following week.

4.55.13 The Appointed Actuary said that if the House of Lords upheld the Court of Appeal judgment, Equitable Life expected to reduce the bonuses of GAR policyholders as a class. On 2 March 2000 GCD had queried whether this might “fall foul” of Lord Woolf’s judgment. The meeting note recorded that:

“If the Lords basically upheld the Court of Appeal judgment this would prohibit the Society from paying differential bonus levels according to the form of benefit that a GAR policyholder takes. However, the Society believed it would then be within its rights to offer a reduced rate of bonus for all GAR policies whether or not the policyholder elected to take the open market option. In these circumstances as things stood GAR policyholders would get a larger slice of the pot for this class of policyholders. (Although this pot would be smaller since the Society would have dropped bonus rates and would leave the Society open to criticism from aggrieved GAR policyholders that having won the argument they are no better off). It could also lead to arguments that the Society has ignored the spirit of the Lords judgment.”

4.55.14 On 19 July 2000 an internal note was prepared by IFSD setting out the possible outcomes of the House of Lords case, taking account of Equitable Life’s views which had been expressed at the meeting on the previous day, and the regulatory action that was likely to be appropriate in each case. It was circulated to Howard Davies, Michael Foot and IFSD. It was not sent to IB-PIA. We have subsequently been told that this was because it was circulated on a “need to know” basis. In the introductory section the note states as follows:

“It should be noted that Option 3 is not something that has been considered previously. It would involve the court opining on the apportionment of bonuses between different classes of policyholders (GAR and non-GAR policyholders) rather than just on the bonus entitlements of GAR policyholders. Previous court hearings focussed on the narrow issue of the rights of GAR policyholders. However, the hearings in the House of Lords suggest they may consider the issue in its broader context. Although Option 3 now appears to be a possibility, we still consider it much less likely than the other two potential outcomes.

As indicated below the implications of Option 3 would be much more serious for Equitable, and potentially have much wider implications for the industry and the FSA.”

4.55.15 The three broad scenarios were:

- 1 “Equitable Life win” - different levels of terminal bonus may be paid to policyholders depending on whether they exercise their right to take an annuity at guaranteed rates.
- 2 “Equitable Life lose” - different levels of terminal bonus may not be paid according to whether a policyholder opts to take advantage of his

guaranteed annuity rate but a guaranteed annuity rate policyholder need not receive the same level of bonus as a policyholder whose contract does not include a GAR.

- 3 “Equitable lose very badly” - different levels of terminal bonus may not be paid and the existence of GARs in a class of contract should not influence the level of bonuses paid to that class of contract.

4.55.16 The implications of Scenario 3 for Equitable Life were set out as follows:

“The judgment would require the company to declare one level of terminal bonus, effectively at the higher of the two levels currently available. This would lead to a substantial increase in costs in honouring the GARs and also raise the issue of compensation for policyholders who have already taken their retirement benefits. The compensation costs would be relatively modest (estimated at up to £200m) but the overall financial implications of the judgment would be very serious. The reinsurance treaty put in place to cover some £1billion of the reserving costs of the GARs would fall away (it is conditional on Equitable maintaining its current bonus practice or something equivalent in cost terms). This would have knock on effects elsewhere in its reserving and Equitable estimates that it would only just be able to cover its solvency margin (year end position was assets of £3.8b to cover a solvency margin of £1.1b).

In this scenario, Equitable could adjust its investment portfolio (match its assets and liabilities more closely) in order to improve its statutory solvency position. However, this could be expected to reduce the investment return to policyholders and the resulting financial position would still not be expected to be sufficiently strong for market confidence in the company to be maintained. Therefore Equitable’s board has reached the view that in these circumstances they should seek a partner as this would be the approach that was in the best interests of their policyholders. It is expected that there would be no shortage of potential partners.”

4.55.17 The implications of Scenario 3 for the FSA were also set out. These included keeping closely in touch with Equitable Life over its financial position and plans to sell. The note also commented that in the event that its solvency margin was breached, it was “unlikely FSA would need to take any public regulatory action since the company would already be taking steps to ensure its financial position was repaired.” IFSD noted that it would need to discuss with Equitable Life compensation arrangements for policies which had vested and that IFSD would need to consider the wider implications of the judgment.

4.55.18 GAD was not asked to carry out any financial assessment of the implications of Scenario 3.

4.55.19 On 20 July 2000 the House of Lords handed down its judgment. The unanimous decision went against Equitable Life’s practice of differential terminal bonuses and ruled out the possibility of any lawful “ring fencing” by Equitable Life, such as by paying lower bonuses to GAR policyholders as a class. Within hours, Equitable Life

issued a press release saying that its Board had concluded that members' interests would be best served by:

“the sale of the business to an organisation capable of providing capital support and therefore ensuring continued investment freedom. The proceeds of sale to such a parent will mitigate the reduction in benefits that with profits policyholders not taking GAR benefits would otherwise suffer.”

4.55.20 When asked in interview whether Equitable Life should have been allowed to continue to write business after the House of Lords' judgment, Howard Davies told us:

“we thought that was likely to produce the best outcome for policyholders, in that closing it to new business at the time would have significantly reduced the value of the company and would have significantly reduced the likelihood of a successful sale, which filled the hole.”

4.55.21 Howard Davies also told us in interview (and we believe that he is referring to meetings on 20 July 2000):

“I can't say that there was a lengthy meeting on the subject. But there were a lot of ... corridor discussions at the time because this was a pretty chaotic day because it happened to be our annual meeting. I can remember asking whether we were really confident there were going to be lots of bidders, and at that time we were so confident, and therefore the issue of closure did not seem to be a very likely option to address. I can't say that there was a lengthy consideration of this, but given the promptness of Equitable's response to put themselves up for sale, that, we felt, sort of held the position ... I think if they had shilly shalied about the future, we would have had time to consider the options much more carefully at that time. But we didn't really.”

4.55.22 The headnote to the House of Lords' judgment appears at **Appendix 6**. The reactions to the judgment and the events which followed it are set out in **Part 3** below.

Part 3

The Review Period Prudential regulation after the House of Lords' Judgment

4.56 Introduction

- 4.56.1 The House of Lords decided unanimously against Equitable Life in a judgment which was handed down on 20 July 2000. The House of Lords held that Equitable Life was in breach of contract because the general discretion in Article 65 of its Articles of Association was not sufficiently wide to permit the adjustment of policy values. Lord Steyn, whose decision and reasons the other four Judges agreed with, said that his decision was in substantial agreement with Lord Woolf. Lord Woolf had given the leading judgment in the Court of Appeal, in which he found against Equitable Life both in contract and in relation to directors' discretion.
- 4.56.2 Following the judgment in the House of Lords, six main issues arose which are dealt with in the sections which follow:
- (a) The immediate impact of the judgment;
 - (b) Amending the reinsurance agreement;
 - (c) Monitoring the solvency of Equitable Life;
 - (d) The bid process;
 - (e) Compensation; and
 - (f) Closure to new business.

4.57 Immediate impact of the judgment

- 4.57.1 A brief summary of the judgment was circulated by GCD on 20 July 2000, followed by a longer summary on the next day.
- 4.57.2 The longer summary prepared by GCD identified the main issue, namely, whether the Society was entitled to declare a differential terminal bonus because current annuity rates had fallen below GARs. The critical question in the absence of any express provision was whether it was appropriate to imply any restriction in the exercise of the directors' discretion from the language of Article 65 read in its particular commercial setting:

“The Court noted that final bonuses are not bounty. They are a significant part of the consideration for the premiums paid. The directors' discretion as to the amount and distribution of bonuses was conferred for the benefit of the policyholders. In this context the self-evident commercial object of the inclusion of guaranteed rates in the policy is to protect the policyholder against a fall in market annuity rates by ensuring that if the fall occurs he or she will be better off than would have been the case with market rates. The provision for guaranteed

annuity rates was a good selling point in the marketing by the Society of the GAR policies. It was also obvious that it would have been a significant attraction for purchasers of GAR policies. The supposition of the parties was therefore presumed to have been that the directors would not exercise their discretion in conflict with contractual rights. An implication precluding the use of the directors' discretion in this way is strictly necessary. The implication is essential to give effect to the reasonable expectations of the parties."

- 4.57.3 GCD's note included reference to Lord Justice Waller's suggestion in the Court of Appeal that the Society could lawfully have declared a differential terminal bonus which varied according to whether or not the policy included a GAR. The note also pointed out that Lord Steyn in the House of Lords took the view that the route suggested by Lord Justice Waller was not open to Equitable Life and its directors could not declare a differential terminal bonus to GAR policyholders because to do so would be to erode the value of the guarantee by another means.
- 4.57.4 GCD's summary concluded that while it was the worst possible outcome for Equitable Life, it was by no means clear what its wider implications would be for other companies with GAOs. It was recognised that the HMT-ID guidance letter of 18 December 1998 would need to be amended in the light of the House of Lords' judgment "to make its tone less positive [but] it is not yet clear whether it will require substantial amendment."
- 4.57.5 On 20 July 2000 IFSD spoke to the Appointed Actuary who said that he would try to send a rough calculation of the statutory solvency position in the next couple of days. The Appointed Actuary also warned IFSD that Equitable Life planned an immediate across the board cut in with-profits policy values of 5%. The Appointed Actuary said that the intention was that once a sale had been completed and bonus levels restored, those policyholders whose policies had matured in the intervening period would be eligible for a top-up "so nobody should lose out irrespective of when they took their benefits". According to the documents, IFSD did not comment on this decision. We have been told by IFSD that it now thinks the decision was taken in order to manage policyholders' expectations: "The company wanted to show a cost to policyholders arising from the judgment in order that they could subsequently show that same cost being met out of the proceeds of the expected sale."
- 4.57.6 On 24 July 2000 an action plan was circulated internally within IFSD and to GCD and GAD (but not to IB-PIA) for dealing with the judgment. The action plan included the points set out below:
- (a) Obtaining confirmation about the solvency position of the Society and reviewing its financial projections of future solvency (it was noted that the Appointed Actuary had confirmed "that he has no reason to believe that the company is in breach of its solvency margin", however, IFSD commented in the note, "the financial position is tight").
 - (b) Considering the implications of the judgment for other companies by writing to them and asking for their assessment of the implications of the judgment for their business.

(c) Reviewing the 1998 guidance issued to firms by HMT-ID.

(d) Arranging discussions with Equitable Life about the bid process and the regulatory issues that might arise.

4.57.7 Under the heading “sales process” it was noted that IFSD intended to hold a meeting with Equitable Life to “encourage it to maintain a close dialogue with us and to highlight the regulatory processes that will need to run alongside the sale/demutualisation”.

4.57.8 IFSD decided that while the 1998 guidance letter was subject to review, life companies should be told not to rely on it. By letters dated 27 July 2000 IFSD wrote to managing directors of with-profits offices asking for their assessment of the implications of the House of Lords’ judgment for their firm.

4.57.9 On 26 July 2000 Equitable Life announced changes to its bonus rates in response to the House of Lords’ judgment. With-profits policies would be credited with no growth for the first seven months of the year but the previous growth rates would apply from 31 July 2000. Arrangements would be put in place to compensate those with GAR policies that had already matured. Equitable Life also stated that in selecting a purchaser it would be looking to obtain the maximum benefit for policyholders, and in particular to secure funds so that the lost growth for the first part of the year could be replaced.

4.57.10 On 2 August 2000 Equitable Life wrote to all policyholders explaining the implications of the House of Lords’ judgment and explaining the change to bonus rates set out in its 26 July 2000 announcement.

4.57.11 Shortly after the House of Lords’ judgment internal consideration was given as to whether or not to revise the guidance which had been issued in 1998 regarding charging for the costs of GAOs. The proposed new guidance was the matter of extensive internal consultation and a seminar was arranged and was attended by various external specialists to discuss the implications of the House of Lords’ judgment for the preparation of any future guidance. GCD provided advice, counselling IFSD to be clear not to confuse or “conflate” the impact of the decision in the case with PRE:

“These two are clearly different. The case is about giving effect to the rights of a policyholder against its insurance company. It is about the nature of the bargain between the company and the policyholder, with unstated parts filled in by what the court concludes must have been the shared mutual expectation of the parties.

In contrast to this, there is the concept of ‘policyholders reasonable expectations’. This is a power given to us, rather than to every policyholder. It is exercised like any other discretionary power on the basis of a range of considerations, including the seriousness of the conduct concerned, likelihood of its repetition, and so on.”

4.57.12 External Counsel was also consulted regarding the drafting of proposed revised guidance. In the event, no revised guidance was issued because the FSA ultimately took the view that there were two possible dangers in issuing it: either it would be

“content-free” or it risked judging the circumstances of individual contracts in a way which the FSA could not be certain was correct.

- 4.57.13 As far as briefing IB-PIA following the House of Lords’ judgment was concerned, at a bilateral meeting between IB-PIA and IFSD on 24 August 2000, IFSD reported that the House of Lords’ judgment against Equitable Life would have implications for the industry more widely, that the process of finding a buyer for Equitable Life was underway and it was hoped that a buyer would be identified by December 2000, with demutualisation taking place in August 2001. IFSD also told IB-PIA that, in the meantime, Equitable Life was just covering its solvency margin. This meeting is referred to in more detail in **Chapter 5**.

4.58 Amending the reinsurance agreement

- 4.58.1 As a consequence of the House of Lords’ judgment, Equitable Life was required to re-negotiate the reinsurance agreement. As explained earlier, the reinsurance was conditional on Equitable Life continuing its terminal bonus practice. The House of Lords’ judgment required Equitable Life to change its bonus practice and accordingly reinsurance on new terms had to be negotiated.
- 4.58.2 Without the reinsurance agreement, as far as the statutory financial position was concerned, IFSD believed that Equitable Life continued to cover its RMM.
- 4.58.3 Equitable Life updated IFSD by letter on 4 August 2000 confirming that the negotiations for an amended reinsurance agreement were going well. At a meeting on 11 August 2000 Equitable Life confirmed that a revised reinsurance agreement had been negotiated with IERC assuming a greater level of anticipated GAR take-up. This was close to completion and gave cover when over 60% of policyholders chose to take the GAR. The total annual deposit premium would be £700,000. In a letter dated 1 September 2000 Equitable Life sent to IFSD copies of the signed addenda to the reinsurance agreement. These were reviewed and approved by GAD on 22 September 2000.

4.59 Monitoring the solvency of Equitable Life

- 4.59.1 As set out in **Chapter 3**, there had also been changes in the valuation regulations which affected Equitable Life in the course of 2000 and required certain insurance companies to increase their reserves. The FSA believed that the resulting increase in reserves required by Equitable Life was in the region of £200-400million. In addition, during 2000, the Government Actuary updated his recommendations regarding the resilience test in the reserves.²⁷
- 4.59.2 On 26 July 2000 the Appointed Actuary wrote to IFSD as had been requested immediately following the judgment, setting out Equitable Life’s estimated solvency position following the House of Lords’ judgment. Based on the application of “old

²⁷ See Chapter 3.

resilience test 2”²⁸ the Society had free assets of £225million. The Appointed Actuary stated:

“On a continuing basis the position would be unacceptably weak. However, as you said last week, we have effectively implemented a plan to strengthen the position by taking the course of action which we have. Meanwhile I believe it is reasonable to regard the Society as continuing to meet its required minimum margin.”

- 4.59.3 On 4 August 2000 the Appointed Actuary wrote to IFSD with information on the impact of new business on the solvency position of Equitable Life. He reminded IFSD that in his letter of 26 July 2000 excess assets as at the end of June 2000 were shown to be £225million. The equivalent figure at the year end, based on various assumptions including an assumption of no new business, would be £200million and including new business would be £210million. These figures did not take credit for the revised reinsurance agreement which was then being negotiated. The letter projected an improvement in solvency with the passage of time assuming reasonably favourable investment conditions.
- 4.59.4 On 4 August 2000, the Appointed Actuary wrote a separate letter to IFSD commenting on the effect of the recent changes in the resilience test (Test 2), which he considered to be more stringent than the old version and noting that he would be sending some short-term projections incorporating new business.
- 4.59.5 At a meeting between Equitable Life and IFSD, also attended by GAD, on 11 August 2000, primarily to discuss regulatory aspects of the bid process, and described in more detail below, a number of other matters arose. There was a discussion about the charges to policyholders for transferring their pensions out of Equitable Life’s with-profits fund and the possibility of hedging the GAO exposure. In addition, there was some discussion of the compensation arrangements which Equitable Life was putting in place.
- 4.59.6 At the meeting Equitable Life agreed to provide IFSD with monthly solvency figures, solvency scenario planning and sensitivity information regarding the possible 2000 and 2001 year end financial positions. Between July and the end of the Review Period, Equitable Life’s monthly solvency position was monitored by GAD.
- 4.59.7 On 1 September 2000 a paper was prepared by IFSD for the ISC to assist them in deciding whether or not to grant Equitable Life a future profits implicit item of £1.1billion for use in its year end 2000 accounts. The Appointed Actuary had first made the application for this item on 27 June 2000 and GAD had, on 7 July 2000 (before the House of Lords’ judgment), recommended that it be granted. The paper for the ISC set out the particular circumstances of Equitable Life and noted that the Society had lost its case in the House of Lords, which had led to “significant financial costs for the society.” It noted that Equitable Life was still solvent but had been “weakened to the extent that the directors have decided that in the interests of

²⁸ See Chapter 3.

policyholders it should seek a buyer to strengthen its financial position.” The briefing for the ISC also stated “we have routinely given Section 68 Orders to companies for future profit implicit items provided that we have been satisfied that the basis of calculation provided for in Regulation 24²⁹ has been correctly carried out.” It was noted that, based on Equitable Life’s calculations, the application was for one-third of the amount of the total implicit items to which the Society was entitled and the solvency position of Equitable Life at the end of June 2000 was set out, expressed to be “re-stated post judgment”:

Net explicit assets	£1580million
Current future profits item	<u>£1000million</u>
Total assets to meet RMM	£2580million
RMM	<u>£1190million</u>
Excess Assets	<u>£1390million</u>

- 4.59.8 The source of these numbers is not given but is most likely to be the Appointed Actuary’s updated monthly solvency statement provided at the meeting with IFSD on 11 August 2000. The figures set out above were based on the new reinsurance agreement and on the ‘old resilience test’. If the figures had been adjusted to the new resilience test the net explicit assets would be reduced by some £600million, as noted by the Appointed Actuary in the meeting of 11 August 2000. This would have led to Equitable Life showing significantly lower excess assets.
- 4.59.9 The paper noted that “Equitable is unlikely to be dependent on the implicit item for coverage of its RMM” and “we would expect the company’s financial position to improve during the rest of the year (as profits emerge).”
- 4.59.10 The paper warned that “in the particular circumstances faced by Equitable it is important to carefully consider any request from this company that affects the form 9 position.” It also stated that “whilst there are a number of uncertainties that could affect the balance sheet (such as a reduction in long-term interest rates) these should not significantly affect the future profits calculation.”
- 4.59.11 The paper also noted that “the Society have provided the detailed calculations in relation to Regulation 24, these have been reviewed and approved by GAD who are fully aware of the context in which this concession would be granted.” The note does not record that, in fact, GAD’s opinion was prepared on 7 July 2000, before the House of Lords’ judgment.
- 4.59.12 On 11 September 2000, the day of the ISC meeting, the chairman of the ISC sent an e-mail to the ISC members stating that he had “not had time to put questions to individual supervisors bilaterally; but subject to the comments below, it may be that we will not need a meeting.” Regarding Equitable Life’s application, he stated that it “involves a fairly standard request for a concession for a future profits item.” He

²⁹ Of the 1994 Regulations

referred to the paper prepared by IFSD stating that it “makes clear that the Equitable’s request is well within normal parameters” and, as a result, he did not think there was any difficulty with the ISC agreeing to the recommendation. He then went on to state that “nevertheless, this implicit item is an important aspect of the Equitable’s overall financial position, and given the high profile of this company at present, some members may wish to discuss the paper.” He asked that members let him know by noon that day if they would like a discussion.

4.59.13 One member of ISC responded to the chairman’s e-mail, noting two points but stating that neither of them “would suggest that agreement should be withheld.”

4.59.14 The ISC approved the request on 11 September 2000 without meeting.

4.59.15 In interview, IFSD explained the role and involvement of the ISC in this application for a future profits implicit item as follows:

“I think it is fair to say that the full background, in the way that we have just discussed it, was not set out. It will of course have been very much in the supervisor’s mind and the GAD’s mind. It may be a weakness of the way the ISC operates at the moment; that sometimes the narrow issue, which requires the formal approval is focused on. It is a matter of judgement ... there is a balance to be struck between how much paper you put before the committee and how much detail you go into. And on the whole, the committee bristles if the papers are too long. However, I accept that if the ISC is the only, as it were, decision maker, then it should have a rounded picture put to it, and basically that is what we tried to do. It may be that in this instance ... that it was fair, but it didn’t necessarily tell the wider picture that you have outlined. However, don’t forget that the Equitable was already a case which everyone up the hierarchy in the FSA, was taking a close interest in, so although this was a technical issue, the wider issues were already under scrutiny by Michael Foot and others. So to that extent, the ISC was only a cog in the wheel, and I think what I would say in, as it were, in defence of what we did, having accepted we might have done it better, is that that is how we saw the ISC.”

4.59.16 When asked in interview whether GAD looked at the wider circumstances of a company applying for implicit items, GAD said that it did not “think that that there would be any sort of basis for us to advise that an application, that met with the relevant guidance and regulations, shouldn’t be accepted.”

4.59.17 On 12 September 2000 a letter was sent to the Appointed Actuary granting the approval of the application. The letter commented that “the amount of the implicit item actually shown in Form 9 of the 31 December 2000 Annual Return cannot exceed the amount that could be supported by a new application submitted with that return (bringing in the financial performance of the company in 2000).” The letter made a second point that “if the society does demutualise, the company to which the business is transferred would not be able to take advantage of the surplus that has arisen in the Equitable in earlier years to generate an implicit item for itself.”

4.59.18 The Appointed Actuary wrote to IFSD on 1 September 2000 with a monthly solvency update to 31 July 2000 showing excess assets of £1300million.

- 4.59.19 On 21 September 2000 Michael Foot produced a note to the FSA Board to update them on recent developments within financial supervision. The Board was informed about the House of Lords' judgment and, in particular, that "ring fencing" had been ruled out, that reports to the FSA from industry showed considerable uncertainty and confusion as to how it should respond and that the FSA planned to issue guidance to the industry, after consultation.
- 4.59.20 GAD confirmed to IFSD on 22 September 2000 that, although the solvency cover remained thin, it had no questions to raise at that time with Equitable Life about its solvency position.
- 4.59.21 On 9 October 2000 the Appointed Actuary wrote to IFSD providing an estimated solvency position as at 31 August 2000 showing excess assets of £2165million (an improvement which the Appointed Actuary explained by reference to relative strength of the markets) and some sensitivity analysis of the solvency to equity and gilt yield movements.
- 4.59.22 Following a review of the Appointed Actuary's letter of 9 October, GAD sent a memorandum to IFSD on 17 October 2000 noting that a 15% fall in equities would lead to the RMM being uncovered. GAD pointed out that this corresponded to a fall in the FTSE 100 index to around 5700, from the end of August level of 6672. Since the index had recently been around 6200, GAD reminded IFSD that this needed close monitoring.
- 4.59.23 The Appointed Actuary wrote to IFSD on 30 October 2000 enclosing the end September solvency figures. He stated that they were broadly comparable with the June and July position. Excess assets were shown as £1140million (the end June excess assets were shown as £1390million).
- 4.59.24 On 31 October 2000 the FSA was informed by one potential bidder about concerns that GAR policyholders could pay incremental premiums into the fund to which the guarantee would attach, thereby increasing the fund's liabilities to the detriment of non-GAR policyholders. By an e-mail dated 2 November 2000 from GAD to IFSD, the suggestion was raised that IFSD might issue an order preventing Equitable Life from accepting more than a specified sum of incremental premiums on GAO policies. GAD also suggested that Equitable Life could possibly seek a court order to limit the liability on such policies. IFSD subsequently found out that Equitable Life had received legal advice that it could not seek to limit top-ups by invoking an apparent right in the contracts to change the terms of the contracts if no premium was paid in any one year and IFSD obtained internal legal advice from GCD along similar lines.
- 4.59.25 On 3 November 2000 a meeting between Equitable Life and its advisers and IFSD and GAD took place at the request of IFSD and GAD to discuss reserving issues. The points arising at this meeting, according to IFSD's note, included those set out below:
- (a) Equitable Life was close to finalising a rectification scheme "allowing relevant GAR policyholders from 1 January 1994 to this year the ability to re-choose a scheme based on a higher level of GAO."

- (b) Equitable Life explained that Ernst & Young, who were assisting the Society in the bid process had “confirmed that [Ernst & Young] had looked at the sensitivities involved concerning the likelihood of GAR policyholders increasing their benefits and felt comfortable with Equitable Life’s figures. [Ernst & Young] understood why potential purchasers would be worried by this potential exposure but thought that once the basis for the reserving was further explained some re-assurance had been given to bidders.” This issue, which had been raised with the FSA by one bidder as a real concern, a few days before the meeting, is dealt with in the bid process section below.
- (c) IFSD requested greater involvement in the bid process and a copy of the Ernst & Young valuation report. The FSA had already seen reference to this report in a letter sent to them by Equitable Life on 1 September 2000 and had heard of the existence of this report from bidders in the bid process. Copies of three reports prepared by Ernst & Young were received by the FSA on 16 November 2000. The first report from Ernst & Young had been prepared on 25 August 2000. The contents of the reports is described in more detail below.
- (d) The Appointed Actuary said he was not aware of any concerns about reserving issues being raised by any of the bidders.

4.59.26 GAD also prepared a note immediately following the meeting entitled “Conclusions following meeting with Appointed Actuary”. The note referred to the possibility of closing Equitable Life to new business.

4.59.27 The note concluded that GAD believed that Equitable Life was covering its minimum capital requirement at present, but had very little room for manoeuvre in the event of a modest fall in equity values. The note stated:

“The management seem to accept therefore that they have no alternative other than to arrange a sale and demutualisation if they are to remain open to new business. With the recent cut in bonus rates (and assuming that this is not reversed), new policyholders should not have to meet any of the cost of GARs, as indeed is likely to be their expectation. However, they will be joining a very weak fund.

“If the sale does not take place, then we shall almost certainly have to lean on them to stop writing new business, and they will very probably also need to rearrange their investment portfolio to a more defensive position. Otherwise, a full liquidation could be envisaged in the event of a substantial fall in equity values.”

4.59.28 On 16 November 2000 the Appointed Actuary wrote to GAD following the meeting on 3 November 2000. The letter confirmed that Equitable Life’s 1999 regulatory returns assumed only 85% take-up of the GARs. The Appointed Actuary stated that the GAO reserve was attributable between paid-up benefits and future premiums in the ratio of $\frac{3}{4}$: $\frac{1}{4}$. The Appointed Actuary enclosed the three actuarial reports produced by Ernst & Young on Equitable Life.

4.59.29 In his letter, the Appointed Actuary referred to various queries which had been raised in the bid process about Equitable Life’s approach to resilience reserving, in

particular, the inclusion of a charge of ½% on accumulating with-profits pensions business:

“As I mentioned when we met, the Society’s recurrent single premium contract is somewhat unusual, being effectively a unitised contract which is neither true single premium (like bonds) nor having a unit-linked style nil allocation period, and has never fitted the valuation regulations, which have been essentially based on a net premium valuation of level premium contracts, particularly well. As such, over the years, a certain amount of interpretation has been needed to determine minimum reserving requirements, particularly in resilience test conditions.

In particular we have included an allowance for unrecouped acquisition costs consistent with the spirit of regulation 68, which necessarily takes the form of a reduction in benefits. It has been my understanding that that was something discussed with GAD when my predecessor, R H Ranson, introduced the practice in the early 1990s. From the files I have inherited I cannot find specific correspondence on the topic but note that meetings were held in September 1992 and November 1993 when detailed discussion of the approach to resilience testing was a major item on the agendas. From the 1996 Returns onwards, following the new regulations requiring greater disclosure of the approach to resilience testing, the approach has been described in Schedule 4 each year - see, for example, paragraph 7(8)(a)(ii) of the 1999 Returns. For clarity I should confirm that the approach is only taken on contracts where future premiums are payable. True single premium products such as bonds and income drawdown products are excluded.

Because the approach is non-standard some of the prospective purchasers would like to see some more explicit confirmation that GAD feels the approach is reasonable and, accordingly, would not put pressure on the Appointed Actuary of the new entity to change the approach.”

- 4.59.30 The Appointed Actuary then set out his detailed justification for the approach.
- 4.59.31 The three actuarial reports which had been prepared by Ernst & Young for Equitable Life and were enclosed with the Appointed Actuary’s letter were as follows:
- (a) Components of an Actuarial Appraisal of Equitable Life as at 31 December 1999 dated 25 August 2000;
 - (b) Financial Projections of Equitable Life dated October 2000; and
 - (c) Stochastic Financial Projections of the with-profits business of Equitable Life dated 8 November 2000.
- 4.59.32 The reports had been prepared for Equitable Life as part of a package of information to be provided to bidders in the bid process. The report setting out financial projections stated that the projections had been based on Equitable Life’s reserving practice at year end 1999:

“Naturally, in some respects, this will differ from a purchaser’s reserving practice. A different approach might lead to higher reserves, or lower reserves.”

4.59.33 Ernst & Young then provided four examples, three of which led to increased reserves and one of which led to a reduction. Ernst & Young also commented that there were some possible effects which they had not quantified, namely:

- “- Equitable could adopt a more efficient allocation of assets in the resilience tests;
- Equitable could calculate non profit reserves using a gross premium methodology; and
- Reserves could be based on the maximum of the discounted guaranteed amount, and a percentage of policy value.”

4.59.34 The reports were reviewed by GAD. GAD was concerned by a number of items. The debate with Equitable Life relating to these items continued beyond the Review Period.

4.59.35 On 22 November 2000 the Appointed Actuary sent IFSD the estimated solvency position at end October 2000. Excess assets were shown as £1080million. The Appointed Actuary commented that the position was broadly similar to the previous month.

4.59.36 On 23 November 2000 GAD wrote to the Appointed Actuary in response to his letter of 16 November 2000. The letter also followed up certain points arising from the scrutiny of the 1999 regulatory returns. Amongst other matters, the letter questioned and sought explanations for the issues set out below:

- (a) The consistency of Equitable Life’s approach to its GAR reserve with the Government Actuary’s 1999 guidance.
- (b) The method and the assumptions used by Equitable Life in assessing the GAR liability on future premiums. The Ernst & Young report stated that a change in assumptions from assuming a 20% decrement per annum in future premiums to assuming no decrements in future premiums would lead to an increase in the GAR reserve of £360million. GAD asked the Appointed Actuary to justify the assumption of a 20% per annum reduction in future premiums on GAO contracts.
- (c) The effect on the resilience reserve of a number of modifications in its method of calculation.
- (d) The appropriateness of the ½% charge on accumulating with-profits business used by the Society. Ernst & Young had stated that the removal of the ½% charge had the effect of increasing liabilities by £950million.

4.59.37 On 24 November 2000 GAD submitted its detailed scrutiny report on Equitable Life’s 1999 regulatory returns. The format of the report was different from that used

in previous years. In interview we were told that, in the preceding year, GAD had become increasingly aware that the FSA was adopting a risk-based approach to its regulation of life insurance companies. Accordingly, GAD considered it would be helpful, at least for the case of Equitable Life, to express the concerns which GAD had in that way, so that it would “mesh” with the way IFSD was monitoring companies.

4.59.38 The following categories were included in the scrutiny report: (a) capital risk; (b) reserve risk; (c) asset risk; (d) strategy risk; and (e) control risk.

4.59.39 GAD assessed that the Society was exposed to a number of risks - principally reserve risks (there were questions about adequacy of the reserving approach used in a number of places in the report) and asset risk (it would be particularly vulnerable to a fall in the equity market). The scrutiny report stated that, as far as capital risk was concerned, at first sight the solvency position looked reasonable, but the available assets of £3,861million to cover RMM of £1114million included a future profits implicit item of £925million, disregarded the liability to repay a subordinated loan of £346million and benefited from a reduction of almost £1.1billion in the GAO reserve from the reinsurance agreement. Without these items, the available assets would be just £1511million, “a less satisfactory picture for this large fund.”

4.59.40 The report also noted that the aggregate asset shares were close to the value of the fund, that is, there was no estate. The £1.5billion ‘saved’ from the cut in reversionary bonuses after the House of Lords’ judgment had been re-allocated to finance future GAO support and the likely costs of the rectification scheme.

4.59.41 Under the heading “Reserve risk”, GAD noted that there appeared to be a wide range of ages over which benefits could be taken on accumulating with-profits pensions contracts at the option of the policyholder, without any market value adjustment being applied to the guaranteed benefits, and with the full value of any GAR (provided this attaches to their policy) being available. It was unclear to GAD whether the reserves were adequate to provide fully for this flexibility, and GAD questioned this in its letter to the Appointed Actuary dated 23 November 2000.

4.59.42 GAD made the following additional points in relation to reserve risks:

“In the resilience scenario, the Society effectively takes credit for an additional ½% p.a. on the investment return. This appears to be justified as a ‘Zillmer’ adjustment to enable the Society to recoup unrelieved acquisition expenses. We are questioning this also.

Inter alia, the Insurance Companies (Amendment) Regulations 2000 are likely to lead to increased reserves on accumulating with profits business. We are asking the Appointed Actuary in our letter to confirm the impact on this Society, which we understand from our recent meeting to be much lower than is being suggested in the market.

The Society utilises a reinsurance treaty with Irish European which provides protection to the Society should more than 60% (formerly 25%) of the benefits in any calendar year on the contracts which incorporate guaranteed annuity options

be taken in guaranteed form. This is not wholly satisfactory from a regulatory perspective as it relies on regulatory arbitrage to achieve the desired result, and would not be available in the event of insolvency. It removes over £1billion of liabilities from Equitable's balance sheet.

When setting GAO reserves, the Appointed Actuary assumes that 85% of benefits are taken in GAO form. This is a weaker assumption than that specified in the guidance of DAA13, although currently any assumption over 60% would be negated by the offset gained from the reinsurance treaty above."

4.59.43 Under the heading "Asset risk", GAD noted:

"The Society is exposed to falls in the equity market. A sensitivity matrix supplied by the Society to FSA on 09.10.2000 shows the Society would be unable to cover its RMM if the FTSE-100 Index fell to around 5750 (a fall of 15% from end-August levels), though they are not particularly sensitive to movements in fixed interest yields."

4.59.44 Under the heading "Strategy risk", GAD noted:

"Without capital support from a prospective purchaser, the Society will be unable to reinstate the 7 months bonus foregone this year on the accumulating with profits pensions business. There are PRE issues here for both GAR and non-GAR policyholders. Indeed, the related question of whether the Society should be continuing to sell non-GAR policies in the same fund as that where the GAR policies reside could be considered to be an environment risk."

4.59.45 On 29 November 2000 the Appointed Actuary wrote to GAD in response to the letter of 23 November 2000. The Appointed Actuary stated that the ½% per annum allowance was justified, as it could be allowed for in the ways set out below:

- (a) Premiums for Equitable Life with-profits pension policies have a standard explicit charge of 4.5%. Part of that charge has been rebated by Equitable Life in recent years, but there was no guarantee of that practice continuing.
- (b) The future profits calculation supporting applications for a section 68 implicit items order have for a number of years shown future profits of at least £2billion. The actual implicit items used have been £1billion or less.
- (c) If the FSA proposals to use price earning ratios instead of dividend yields as a measure of the return on equities were adopted in the future, the Appointed Actuary stated that it would have a similar effect as to allow for the unrecouped acquisition costs.
- (d) The Appointed Actuary suggested that the allowance could be recouped by applying a more sophisticated approach to the hypothecation of assets in the resilience test scenario.

4.59.46 The Appointed Actuary sought to justify the assumption of a 20% annual decrement in future premiums on GAO contracts by stating that "the premium income on this

portfolio declined by 25% p.a. over the years 1997-1999 and not all premiums on the relevant classes are entitled to GARs.”

- 4.59.47 On 29 November 2000 IFSD requested a meeting with Equitable Life to discuss the main issues raised in the FSA’s discussions with potential bidders. This meeting is referred to in more detail in the section below dealing with the bid process. However, other matters which related to Equitable Life’s reserving and solvency were to be discussed at the meeting.
- 4.59.48 On 30 November 2000 IFSD circulated an e-mail internally and to GAD (though not to IB-PIA) suggesting an agenda for the meeting, including the following matters:
- (a) Equitable Life’s views on the bidding process;
 - (b) what contingency plans Equitable Life was making;
 - (c) Equitable Life’s response to GAD letter on reserving;
 - (d) PIA issues; and
 - (e) Equitable Life’s GAO rectification scheme.
- 4.59.49 The meeting took place between FSA and Equitable Life on 1 December 2000. IB-PIA was not invited to the meeting. The Appointed Actuary “agreed that the use of the 20% rate of decrement in assessing future premiums that secure GAR benefits had to be reviewed. This rate reflected experience prior to the [House of Lords’] judgment, not after.”
- 4.59.50 IFSD’s conversations with two potential bidders on 1 December 2000, were recorded in an internal memorandum, indicating that it was possible that all bidders were about to pull out of the bidding and IFSD noted accordingly:
- “Thus we may face a position, as early as Friday, where it is clear that no bid will be made by either party. We (and the Equitable Life) will need to be ready to respond quickly to that. My preference in that situation would be a very early announcement by the Company that they are closing to new business. In this case we would need to be ready to explain:
- (a) the regulatory implications
 - (b) why we had not closed the company immediately after the House of Lords’ judgment (or possibly even before that).”
- 4.59.51 On 4 December 2000 GAD wrote to the Appointed Actuary following up some points raised at the meeting on 1 December 2000. GAD confirmed the views expressed at the meeting.
- (a) On the issue of reserving, GAD commented:
- “We accept that, by assuming a GAR take-up rate of 85%, you have satisfied the requirements of the third paragraph of [the December 1999 reserving

guidance], insofar as the reserves held on accumulating with profits pensions business have not thereby been reduced by more than 5%.

However, it is not intended that DAA13 should result in all offices assuming the same GAR take-up rate. In particular, the third paragraph of DAA13 says that 'it would not generally be prudent to assume that policyholders will chose a benefit form that is of significantly lower nominal value to them than the guaranteed annuity' ... whilst we accept that a reduction of 5% in the proportion electing to take the GAR on account of cash commutation is justified, any further reduction on account of perceived flexibility (which we take to be the reasoning behind the further reduction in the assumed take-up rate to 85%) needs to be viewed against the thinking above.

In our opinion, to achieve consistency with DAA13, in the context of GARs worth 30% more than current annuity rates, it would not be prudent to assume that more than 10% of policyholders would take cash or alternative benefits. This leads to a minimum assumed take-up rate of 90%.

We also note that Section 8 of DAA11 says that past experience alone should not be used when setting the proportions assumed to exercise the GAR in the future. Hence the recent experience of just 44% taking up the option does not of itself justify the use of 85% as a prudent assumption going forwards.

We recognise that whilst the current reinsurance arrangement remains in place, there would be no effect at the net level of strengthening the reserving assumption."

- (b) On the rate of decrement on recurrent single premium business GAD noted that Ernst & Young had used a 10% annual decrement as a "realistic" assumption, that policyholders could elect to increase their premiums in future years (subject to Inland Revenue constraints) and that GAD "would therefore be looking for a somewhat stronger assumption in this respect at the coming year end."
- (c) The use of the ½% charge caused GAD particular concern and it told Equitable Life that "we do not believe that this valuation assumption would be acceptable in an insurer's return as at 31 December 2000."

4.59.52 The events leading up to the decision by Equitable Life to close to new business are set out below.

4.60 The bid process

4.60.1 We were told that when Equitable Life announced that it was putting itself up for sale the FSA considered, on the basis of information given to it by Equitable Life, that the Society was very saleable. There is no documentary evidence that the FSA analysed the consequences, at this stage, of the Equitable Life failing to find a buyer or requested any information from Equitable Life on this "worst case" scenario.

4.60.2 At the FSA's request, on 11 August 2000 Equitable Life attended a meeting at the FSA with IFSD, GAD and GCD to discuss the bid process. Equitable Life had

engaged a firm of investment bankers (Schroder Salomon Smith Barney (“Schroders”)) and appointed legal advisers and Ernst & Young to assist them in the bid process. Equitable Life informed the FSA that the Society intended to provide sales information to interested parties by the end of August 2000. Under cover of a letter from the Appointed Actuary dated 1 September 2000, IFSD received a copy of a draft letter from Schroders to potential bidders dated 25 August 2000 which referred to the Information Memorandum and to an actuarial report which had been prepared by Ernst & Young. The Schroders letter also appears on the GAD files. It was not, however, until a meeting on 3 November 2000, that IFSD requested a copy of the Ernst & Young actuarial reports from Equitable Life. The purpose of the meeting on 11 August 2000, the minutes of which are in a note dated 17 August 2000, was to discuss the regulatory aspects of the bid process.

- 4.60.3 The FSA outlined the regulatory processes which would be required for the sale to proceed and the likely timescales. The sale was likely to require a Schedule 2C scheme³⁰. The present timetable was for the sale to be completed by June 2001. It was pointed out that this was “extremely tight” and given that the purchaser would not be identified until the end of the year it was “very optimistic.”
- 4.60.4 On 1 September 2000 Equitable Life wrote to IFSD informing them that the Information Memorandum had just been issued and that the Managing Director would be telephoning IFSD with an update on the position. There was then no documented contact with Equitable Life regarding the bid process until a meeting on 3 November 2000 when IFSD requested a greater involvement in the bidding process.
- 4.60.5 In mid to late October and early November, IFSD met or spoke on the telephone to three potential bidders discussing mainly regulatory issues which might arise out of an acquisition. IFSD have noted in interview that comments made by the bidders to the FSA may have had the ulterior motive of “talking down the price.”
- 4.60.6 The FSA Board met on 19 October 2000. Michael Foot’s report to the Board contained an update on the preparation of revised guidance following the House of Lords’ judgment and an update on the bid process. The report noted that Equitable Life had had three serious offers and the Appointed Actuary of the Society had indicated to the FSA that the bids currently on the table were high enough to enable with-profits policyholders to gain restitution for the investment growth the Society had lost for the period 1 January 2000 to 31 July 2000 with additional goodwill on top.
- 4.60.7 By 25 October 2000 IFSD was aware that Equitable Life had asked for final bids by about 20 November 2000.
- 4.60.8 According to a note which was sent to Howard Davies and copied to Michael Foot, on 31 October 2000 IFSD was informed by one potential bidder that it was interested

³⁰ This is a statutory scheme under the ICA 1982 for the transfer of long-term insurance business from one body to another. Such a scheme has to be approved by the Court, because it affects, or may affect, the interests of policyholders.

but it was becoming increasingly concerned about the financial implications of the deal:

“The more work they do in the data room the more they become convinced that the scale of the shortfall in the Equitable’s funds is greater than the Equitable Life themselves estimate. Moreover they are concerned that the wording of the Equitable’s policies would allow policyholders with guaranteed annuity options to increase the scale of their contributions (and hence the scale of the GAO liability) to the detriment of other policyholders in the fund.”

4.60.9 The potential bidder stated that it was “investigating whether this liability can be capped and if so how but again are more pessimistic than the Equitable directors of this issue.”

4.60.10 Howard Davies commented, by way of a manuscript note on the memorandum reporting this information: “Thanks. A useful communication. It does not lower my worry level about the Equitable. I think an early discussion with them is very much indicated.”

4.60.11 At a meeting with another bidder on 6 November 2000 mention was made of Ernst & Young’s actuarial appraisal of Equitable Life which had not, at that time, been seen by IFSD. Questions were raised by the bidder about Equitable Life’s reserving basis. Concern was expressed that Equitable Life’s current implicit items might be invalidated in any Schedule 2C scheme subsequent to the purchase. The bidder asked about the regulator’s attitude to financial reinsurance and, according to the note of the meeting, was told that the regulator did not support such arrangements which take advantage of regulatory arbitrage. The bidder pointed out that Equitable Life’s GAO reinsurance agreement fell into this category³¹. The bidder also asked the FSA to explain why in its resilience reserve Equitable Life was able to include a Zillmer adjustment which effectively added ½% to the investment return.

4.60.12 Shortly after the meeting on 6 November 2000, that same bidder expressed its concerns about Equitable Life’s financial position to Howard Davies:

“They had reached the view that the Equitable’s financial position was considerably worse than they had first thought. The hole was significantly larger than they had expected ... And he said his main motive in telling me this was to alert me to the fact that the Equitable’s position might be rather more doubtful than we had been led to believe.”

4.60.13 On 14 November 2000 an internal memorandum was circulated at the FSA setting out how the possible outcomes of the bidding process might be handled. The note considered various possible outcomes to the bid process including the possibility of no bid at all. In that event, it was proposed that:

“we would need to consider carefully whether we would wish to exercise any powers of intervention (if indeed the powers for us to do so exist in particular

³¹ Chapter 3 refers to GAD’s view of “regulatory arbitrage” in more detail.

circumstances) ... We would in particular need to carry out a fairly robust analysis of the company's financial position, for example to check the basis on which the accounts and financial statements have been prepared, so as to ensure that assumptions and projections remain valid for a radically different business model."

4.60.14 The note continued:

"It is evident from the comments that have been made to the FSA by potential bidders that they have serious concerns about their potential exposure to the seemingly unlimited exposure of Equitable to certain liabilities, including the apparent rights of GAO policyholders to top up their cover. Equitable have indicated that the exposure is not as significant as some may have us believe and that in fact the liabilities are subject to a *de facto* cap, for example, by virtue of pensions/tax legislation."

4.60.15 The concerns then being expressed about the financial condition of Equitable Life had led to some suggestions being made by the bidders as to possible forms of protection if the shareholders of any acquiring company were not to face an unacceptable degree of risk. The note examined the regulatory implications of this.

4.60.16 In mid-November 2000 there were further discussions between IFSD and the bidders. One of the bidders said that due diligence "had left [it] feeling that it wouldn't be worth taking the Equitable at any price." One of this bidder's concerns was that there would be disgruntled policyholders at the end of the day because they would not be compensated for the loss of bonuses for the first seven months of 2000.

4.60.17 On 16 November 2000 GAD sent an e-mail to the FSA and GCD commenting on the memorandum of 14 November 2000. GAD's view was that if no bidder was found Equitable Life would be in a very difficult position because it had stated publicly that it needed to find a partner with capital. Further:

"from a regulatory perspective, we know that their financial position remains very close to the edge of not covering their margin of solvency, there are a number of uncertainties (e.g. in the viability of their financial reinsurance and resilience to changes in financial markets - they are unable at present to satisfy one of the recommended resilience tests which they argue is quite strong and they point to a known anomaly in Regulation 69) and we would then also know that it would be difficult to arrange a rescue by another insurer in the event of technical insolvency arising."

4.60.18 The e-mail concluded that the FSA would have to require Equitable Life to commission an independent investigation of its viability to write further business if it intended not to close to new business.

4.60.19 On 16 November 2000 Michael Foot prepared a report to update the FSA Board on recent developments within financial supervision. The report contained an update on issuing guidance on the implications of the House of Lords' judgment and reported that a seminar had recently taken place with leading legal and actuarial experts. On

the issue of the sale, his report stated that there were three potential bidders. It also stated:

“The due diligence process has revealed some concerns about how far liability for guarantees can be capped, since the guarantees appear also to apply to some future premiums. We are exploring with the Equitable the implications of this, both for the sale process and for the expectations of future policyholders if they continue to sell new business.”

4.60.20 On the same day an internal FSA memorandum, sent to Howard Davies and Michael Foot, among others, recorded that two of the bidders had “some reservations about continuing liabilities.” A main concern of one of the bidders was the open ended nature of the GAR liabilities. Howard Davies commented: “The bid [from one bidder] looks more promising, though I confess I don’t understand how they make the sums add up. The proposition [from another bidder] looks fraught with difficulty for us.”

4.60.21 On 17 November 2000 IFSD referred a point raised by one of the bidders to IB-PIA. This matter is described in **Chapter 5**. The bidder was intending, after acquisition, to close the with-profits fund to new business. IFSD considered that policyholders would be able to continue to “top-up” their existing policies. For those with GAR policies this was likely to be an attractive option and other policyholders in the Equitable Life with-profits fund would have to meet the additional GAR costs. The bidder had asked if this would be regarded as mis-selling to those policyholders who do not have GARs. IFSD received the response that the key issue was:

“whether the reasonable expectations for the new sales to existing policyholders is greater or less than asset share given that the firm knows about a possible strain on the funds. If it is less then the firm has serious problems, since, I would suggest, the minimum PRE is asset share. If it cannot “promise” asset share then the warning that you could get back less must be disclosed and I suspect would make [it] unsellable.”

4.60.22 In late November 2000 various technical points raised by the bidders were considered by IFSD. IFSD considered whether eligibility to a future profits implicit item could be transferred and how the EC Directives impinged on this. Views tended towards a conclusion that a future profits implicit item could be granted to an acquiring company and these views, without confirmation that such an order would necessarily be granted, were confirmed to Equitable Life by letter dated 27 November 2000.

4.60.23 Further meetings took place with one of the bidders to discuss the structure of the proposed purchase, reserving issues and potential compliance issues. A further issue was raised relating to PIA Rule waivers. PIA responded to this query in early December 2000.

4.60.24 On 23 November 2000 in an internal memorandum to Michael Foot it was reported that one of the bidders was putting together a bid which was likely to be attractive to the Equitable Life Board. There were two points, relating to the structure of the Equitable Life funds after the acquisition and the preservation of the value of the

business between the bid being recommended to Equitable Life's members and their vote on it, on which that bidder required comfort from IFSD. In respect of the first, IFSD had suggested a variation on the proposal which appeared acceptable in regulatory terms. The second raised issues relating to PIA Rules and an urgent meeting was to be set up with the relevant people in IB-PIA. This matter is described in **Chapter 5**.

4.60.25 In late November 2000 GAD provided advice to IFSD on the structure which was being proposed by one of the bidders and the implications of that structure for PRE and reserving.

4.60.26 On 23 November 2000 IFSD received a call from Equitable Life who wished to keep IFSD in touch with Equitable Life's views on progress towards a sale. Two bidders were discussed and the note records:

“We did not talk about the possible price that either ... bidder might offer but, from what he said, I had the impression that [Equitable Life's Managing Director has] much more realistic expectations now than he did a few weeks ago.”

4.60.27 In late November 2000 there were further meetings with one of the bidders.

4.60.28 On 1 December 2000 an internal e-mail was circulated within IFSD. The concern was expressed that if a sale was to proceed, Equitable Life would need to obtain separate votes from GAR and non-GAR policyholders. It was suggested that IFSD request scenario testing of the adequacy of a GAR sub-fund in different economic scenarios.

4.60.29 A meeting with Equitable Life was held on 1 December 2000. The meeting had been arranged to obtain an update on the bid process and to discuss reserving issues. According to the note of the meeting prepared on 4 December 2000, Equitable Life confirmed that there remained only two bids, one of which involved a very small offer price with no goodwill element for policyholders and, as regards the second, Equitable Life had real concerns that the bidder was not offering sufficient cash “to allow the Society to proceed with this option in any case” in which case Equitable Life would close to new business and sell the infrastructure and sales force.

4.60.30 IFSD decided to prepare a paper looking at possible outcomes of the bid process - closed fund and acquisition by each of the two remaining bidders (each of which proposed different structures) against the relevant FSA objectives of protection of consumers and market confidence. The paper was also intended to consider the compensation scheme and interim arrangements including a “pre-emptive” sale of the sales force which was contemplated by one of the bidders.

4.60.31 On 4 December 2000 one of the bidders pulled out. The other (last) bidder told the FSA that it was “increasingly concerned” that acquisition of Equitable Life would not be economic and the aim was that the bid would be considered by its Board on 7 December 2000 and that there was no way of predicting the recommendation which would be made. That bidder decided not to proceed with an acquisition on 7 December 2000.

4.61 Equitable Life's GAO Rectification Scheme

4.61.1 On 11 August 2000, at a meeting between Equitable Life, IFSD and GAD, Equitable Life told the FSA that:

“compensation would be due for policyholders. The latest estimate of this cost was £150m - the Appointed Actuary said that the worst case scenario for compensation was £350m. Compensation would be a difficult exercise evaluating the consequence of the directors re-exercising their discretion. For those that had remained with the Society this would be more straight forward process. But for those who had left the Society and for example, taken an open market option, compensation would be much more difficult to assess. As previously proposed an independent claims assessor would be responsible for assessing entitlement to compensation for cases where it could be argued that a policyholder would have chosen an Equitable GAR policy rather than another option if he had been given the improved offer at vesting.”

4.61.2 Equitable Life asked whether the FSA would be able to give a view on the Society's compensation proposals so that they could be said to be “approved by the FSA.” IFSD was non-committal on this point but thought it sensible to have a look at what the Society intended to do.

4.61.3 On 9 October 2000 the Appointed Actuary sent IFSD a copy of the letter sent to policyholders regarding the compensation scheme and noted that Equitable Life was at an advanced stage in obtaining the endorsement of the independent experts.

4.61.4 At a meeting on 3 November 2000 Equitable Life reported that it was close to finalising the compensation scheme:

“allowing relevant GAR policyholders from 1 Jan 1994 to this year the ability to re-choose a scheme based on a higher level of GAO. The scope of the review will cover 26,000 cases and some 20,000 AVC schemes. For some of the earlier years - when interests rates were higher - the additional GAR benefits are marginal, (and for part of 1994-95 the GAR rate is non beneficial) greater benefits are concentrated in the later years when interest rates were low. The Appointed Actuary thought that general inertia and concern over changing pension arrangements would mean that policyholders would not change their arrangements unless there was a reasonable additional benefit of say at least 10%.”

4.61.5 Equitable Life also reported that the aggregate value of the compensation scheme was £200million and that Lord Browne-Wilkinson was involved in the construction of the scheme and an independent actuary was reviewing its terms.

4.61.6 At a meeting on 3 December 2000 attended by Equitable Life, IFSD and GAD, the Managing Director of Equitable Life confirmed that the compensation scheme had recently been “signed off” would be put before its Board on 7 December 2000 and affected policyholders would be contacted shortly afterwards. We understand that Equitable Life's rectification scheme has not yet been finalised.

4.62 Decision to close to new business

- 4.62.1 On 1 December 2000 a meeting took place between Equitable Life, IFSD and GAD. According to the minutes of the meeting, Equitable Life:
- “did not appear to be unduly concerned about WP policyholders who joined the Society after the House of Lords’ judgment. Although it was conceded that the Board had to make a decision on whether to carry on writing this business within a couple of weeks depending on the outcome of the sale process. The Society had not considered whether post 20 July WP policyholders could be excessively disadvantaged in a closed fund. This is because after this date the preferential treatment of GAR policyholders was known. Going forward if GAR policyholders had a greater propensity to top up their benefits than previously this will be to the detriment of non GAR policyholders.”
- 4.62.2 Equitable Life confirmed that the sales force were adequately briefed and instructed to advise potential with-profits policyholders on the Society’s particular circumstances prior to sale. Equitable Life also reported that its Board had taken legal advice on whether it should continue to write new business.
- 4.62.3 IB-PIA was not invited to, and did not attend, this meeting. IB-PIA was not sent a copy of the minutes.
- 4.62.4 On 3 December 2000 GAD prepared a note on the options available if no sale of Equitable Life was achieved. The note had three sections - closure to new business, means to improve statutory financial position and means to improve realistic financial position. The note stated that Equitable Life was “almost certainly too vulnerable to continue writing business” if the sale fell through and, in that event, it would “need to close or commission an independent report to show that they were indeed viable to continue as an open fund.”
- 4.62.5 On 5 December 2000 IFSD held an internal meeting to deal with matters which might arise on closure. This included arranging a meeting of the Tripartite Standing Committee³² and contacting overseas regulators, the press office, the ABI and discussing with GAD the solvency position and possible use of formal powers.
- 4.62.6 On 5 December 2000 IFSD sent a memorandum to Michael Foot in advance of a meeting with Equitable Life. Equitable Life’s end of October 2000 solvency figures showed free assets of £1080million. IFSD noted that the latest estimate was that:
- “Equitable has free assets of £70m above the required minimum margin of solvency. (This margin has built into it the “resilience test”, which allows for a 25% fall in equities; but even so this margin is uncomfortably tight). This estimate

³² The Tripartite Standing Committee is a committee of representatives of HM Treasury, the Bank of England and the FSA which meets on a monthly basis to discuss cases of significance and other developments relevant to financial stability. Meetings can also be called at other times by one of the participating institutions if it considers there to be an issue which needs to be addressed urgently. In exceptional circumstances, the Bank may implement an operation beyond its routine activity in the money market to implement its interest rate objectives. Such a support operation is expected to happen very rarely and would normally only be undertaken in the case of a genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy. If the Bank or the FSA identified a problem where such a support operation might be necessary, they would immediately inform and consult with each other.

is £1010million less than the Equitable's own estimate; the reason for the difference is that GAD have made adjustments to a variety of assumptions in the reserving basis, to bring them into line with what they would normally expect."

4.62.7 The note stated that in the absence of a bid:

"it is very difficult to see how the Equitable Life could justify continuing as a going concern ... We believe we would have grounds for closing the company to new business under the Insurance Companies Act (either for failing to meet its required minimum margin of solvency, or because of the risk that PRE would not be met). But we would prefer that the Equitable Life's directors took this decision for themselves."

4.62.8 On 5 and 6 December 2000 there was an exchange of e-mails between Michael Foot and IFSD in advance of the meeting with Equitable Life on 6 December 2000.

4.62.9 In his e-mail, Michael Foot highlighted three areas which he considered were likely to arise:

- (a) the powers which the FSA has if there are no bidders for Equitable Life and it was not willing to voluntarily suspend business;
- (b) what policyholders should be told about the implications of a cessation to new business; and
- (c) what should be said in answer to questions about other firms' exposure.

4.62.10 IFSD responded to these points later that evening. IFSD commented that its view was that because GAD had clarified how thin and fragile the company's margin was, the FSA could be reasonably robust. This would entail telling the company that the FSA could not allow Equitable Life to continue to write new business. IFSD understood that this was consistent with the advice which Equitable Life's directors had already received. There might be some debate about whether Equitable Life should have a period of grace to enable there to be a "fire sale." So far as the implications of cessation were concerned, IFSD noted that it agreed:

"that the company and the ABI should so far as possible take the heat... We need to be careful over top-ups. Initial (but firm) legal advice is that our intervention powers do not allow us to interfere in contracts (and the right to top-up is a contractual one). I suspect that our emphasis should be on ensuring that there is proper transparency and information so that those who wish to top-up do so advisedly and in full knowledge of the situation. This will be particularly so where the E is an AVC provider and we will need to consider getting the E to write to the relevant trustees urgently to draw their attention to the issue and to suggest that they consider carefully whether they (the trustees) wish to continue assisting

members to put their funds with them. We should perhaps also consider talking to OPRA³³ tomorrow.”

- 4.62.11 GCD advice on 6 December 2000 specified the statutory powers under which intervention action could be taken:
- (a) section 12A of the ICA 1982 (suspension of authorisation in urgent cases) where it appears that any of the criteria of sound and prudent management is not or has not been fulfilled, or may not be or may not have been fulfilled, or that an obligation under the ICA 1982 has not been satisfied; and
 - (b) section 45(1) of the ICA 1982.
- 4.62.12 On 6 December 2000 Equitable Life met IFSD and GAD to discuss the prospects for the Society. Michael Foot chaired the meeting. IB-PIA were not invited to, and did not attend, this meeting.
- 4.62.13 The note of the meeting records that Equitable Life was aware that the one remaining bidder was unlikely to make a bid. Equitable Life had during the past five to six weeks considered the options if no bid emerged and had decided that “in these circumstances the with-profits fund would have to close and very likely the unit linked business.” IFSD pointed out that the FSA would have a problem allowing Equitable Life to write unit-linked business because it appeared that these contracts contained provisions whereby the value of the policies could be reduced to pay for the wider liabilities of Equitable Life. The Society accepted this point and agreed that if the last interested bidder did not make a bid, Equitable Life would close to all new business.
- 4.62.14 It was agreed that press handling of the situation should be co-ordinated and that certain overseas regulators where Equitable Life carried on business would need to be briefed.
- 4.62.15 On the financial side, the Appointed Actuary stated that the investment strategy would need to move to a more conservative position.
- 4.62.16 It was confirmed that the status of the subordinated loan was safe if the Society closed to new business. Similarly, the reinsurance agreement still held good if the company stopped writing new business. Surrenders would have to be monitored closely “so as to deter excess surrenders which could further jeopardise the Society.”
- 4.62.17 Equitable Life mentioned the possibility that there might be claims for mis-selling based on the much lower estimated cost of the GAR liability represented to potential policyholders prior to the House of Lords’ judgment.
- 4.62.18 On the same day the last potential bidder informally indicated its withdrawal from the bidding process.

³³ OPRA, the Occupational Pensions Regulatory Authority, was established by Parliament under the Pensions Act 1995 to help ensure that occupational pension schemes are safe and well run.

- 4.62.19 On 7 December 2000 an internal meeting was held at the FSA attended by IFSD and GCD to discuss potential timing and press releases in advance of any announcement that the last bidder had withdrawn.
- 4.62.20 On 8 December 2000, by way of a co-ordinated announcement by the FSA and Equitable Life at 7:30 am on the London Stock Exchange Reuters News System, the Society declared that it was closed to new business.

Chapter Five

Description of the conduct of business regulation of Equitable Life

5.1 Introduction

- 5.1.1 The Terms of Reference require the Report to cover the PIA's discharge of its functions. As set out in **Chapter 2**, with effect from 1 June 1998, the PIA delegated the task of monitoring compliance with PIA Rules by its member firms to the FSA and agreed to provide staff for the purposes of carrying out other regulatory functions, including enforcing compliance with the Rules (under the PIA SLA). Accordingly, this Chapter focuses on the teams within the FSA who were involved in the regulation of Equitable Life on behalf of the PIA.
- 5.1.2 The Terms of Reference also state that the Report will:
- (a) describe the background and events leading up to the FSA's assumption of responsibility for the prudential regulation of the Equitable Life on 1 January 1999; and
 - (b) describe the course of supervisory work from then until the Society's closure to new business on 8 December 2000.
- 5.1.3 In contrast with the prudential regulator, the FSA (on behalf of the PIA) was tasked with conduct of business regulation from 1 June 1998. Accordingly, this Chapter tells the story of conduct of business regulation from the point, after 1 June 1998, when the relevant teams within the FSA first became aware of GAO-related issues. These teams are explained in **Chapter 2**.
- 5.1.4 The conduct of business narrative chronicles the consideration of various issues arising in connection with GAOs which were considered on different occasions by different teams within the FSA. To deal with each issue as it arises in chronological sequence, but in a way which makes it easier to follow, the Chapter makes use of headings to denote where consideration of particular issues begins and ends.
- 5.1.5 The following paragraphs seek to introduce the issues that arose to be considered by the conduct of business regulator.

5.2 Issues arising for the conduct of business regulator

- 5.2.1 There were two classes of customer of Equitable Life which were of particular significance during the Review Period:
- (a) GAR policyholders; and
 - (b) Investors in the with-profits fund.
- 5.2.2 In relation to GAR policyholders, the Review Team accepts that there was nothing that the conduct of business regulator could have done, prior to the House of Lords' judgment, to pre-empt that decision and its potential adverse implications on existing GAR policyholders. (In fact as it turned out, there were no such adverse

repercussions; indeed quite the reverse.) In relation to these policyholders, therefore, the focus of the Review Team's attention has been on the process by which IBD and IB-PIA assessed the issues as they arose. The principal issue concerned the advice and information given to GAR policyholders either:

- (a) at the point of sale of the GAO policy; or
- (b) when, during the lifetime of the GAO policy, incremental payments ("top-ups") were made; or
- (c) when, on maturity of the policy (also referred to as "vesting"), a GAR policyholder purchased an annuity or "switched" from a GAO policy to another product without a GAR, such as a PFW (described in **Chapter 3**).

5.2.3 In relation to investors, the issue for the conduct of business regulator to consider was the impact of GAO issues on the advice and information that should be given to those who were considering investing in Equitable Life's with-profits fund (including not only by way of a new sale but also top-up business).

5.2.4 For both GAR and non-GAR policyholders as well as potential investors, the decision of the House of Lords was a watershed in that it represented the moment at which doubts about Equitable Life's terminal bonus practice were finally resolved and the GAOs acquired a value which had not previously been recognised. In this Chapter therefore we deal with these issues by reference to the period before and after the judgment of the House of Lords as different considerations apply.

5.3 When did IBD first become aware of GAO issues?

5.3.1 In 1998, IBD became aware of different GAO-related issues at a number of levels:

- (a) referral of PFWs to Enforcement;
- (b) IB-Policy;
- (c) IBD; and
- (d) IB-PIA.

5.4 Referral of PFWs to Enforcement

5.4.1 In June and July 1998, IB-PIA conducted a series of "pension-focused" visits to regulated firms to examine records in relation to the sales of a number of pension products, including PFWs. These visits were the first "themed" visits conducted by IB-PIA.

5.4.2 One of the issues identified by IB-PIA was that, as a result of the poor quality of some firms' records of PFW business, no definite conclusions could be reached on whether or not firms were providing an adequate explanation to investors of the inherent risks of opting for withdrawals rather than an annuity or other options available. The issues arising from the visits were subsequently reported to the PIA Board and, in March 1999, were referred to Enforcement.

5.5 Awareness of GAOs: IB-Policy

5.5.1 In August 1998, an article appeared in the *Sunday Times* making reference to GAO policies that had been sold up to 1988, and in some cases until 1993, and stating that, since some insurers might not be able to identify which policies contained a guarantee and as policyholders might not be aware of their entitlement, some policyholders might have received pension incomes lower than their due. The article included the following comment:

“Pensioners out of pocket could have problems seeking redress. The Personal Investment Authority (PIA), the industry watchdog, said, ‘Pension plans taken out before 1988 do not come under our remit as the sales occurred before the Financial Services Act came into force.’”

5.5.2 On 28 August 1998, IB-Policy prepared a memorandum that was copied to the FSA’s Media Relations Department (“**Media Relations**”) and to IFSD referring to numerous press enquiries relating to GAOs and attaching, as an example, a copy of the *Sunday Times* article. The memorandum stated that Media Relations had received several enquiries asking what the PIA or the FSA were doing about this issue and that IB-Policy had advised Media Relations that the issue related to policies sold “before our time” and to “after sale administration” which was outside the PIA’s scope. IB-Policy expressed the view in the memorandum that, at the extreme, it could breach the principles of fair dealing or high standards of market conduct but that “we would be most unlikely to want to invoke those rules”.

5.5.3 The memorandum states:

“If we were to issue guidance, the most we might do would be to remind product provider firms about their responsibilities and the need to check each maturing policy itself. It seems almost unbelievable that firms do not know what they have guaranteed. This probably stems from the remote prospect (or so it seemed back in the 60’s when these guaranteed rates were set) that the guarantee could ever be called into use.”

5.5.4 The memorandum concludes by noting that, as the subject of GARs raised the question of solvency, HMT-ID was also investigating.

5.5.5 There is no evidence that IB-Policy copied this memorandum to IBD or IB-PIA or that the FSA took any steps at this stage to investigate whether any policies were sold after “A” Day¹ or that any further consideration was given to reminding product providers of the need to check policyholders’ entitlement to a GAO.

5.6 Awareness of GAOs: IBD

5.6.1 On 3 September 1998, HMT-ID sent a memorandum to Michael Foot which was copied to IBD, amongst others, and which referred to a survey of all the Appointed Actuaries of all UK life offices carried out by GAD in relation to reserving for annuity guarantees. HMT-ID stated that it was copying the memorandum to IBD on

¹ “A” Day is 29 April 1988, the day on which the relevant provisions of the FSAct 1986 came into force.

the basis that IBD would no doubt have an interest in some aspects of the issue such as:

“the extent to which companies are informing policyholders of the existence of a guarantee at the time when they come to make choices about annuities on retirement.”

5.6.2 The memorandum also noted that this was:

“an example of an issue on which we will need to work closely together to ensure a seamless regulatory approach.”

5.6.3 There is no evidence that a copy of this memorandum was passed to IB-PIA. Furthermore, IBD did not request a copy of the GAD survey on reserving for annuity guarantees or take any other action in response. Equitable Life’s response to the GAD survey on reserving for annuity guarantees had stated that Equitable Life did not advise GAR policyholders when they reached retirement of the existence of a GAO (see **Chapter 4, Part 1**). We have been told that no one within IB-PIA can recall having been aware of the GAD survey.

5.6.4 On 5 November 1998, HMT-ID sent a second memorandum to Michael Foot copied to, amongst others, IBD which attached draft guidance to companies about how to meet PRE in dealing with guarantees. The memorandum noted that HMT-ID’s preliminary view was that Equitable Life’s terminal bonus practice was permissible but that it was seeking further information to test the position further. It referred to a concern about the company’s ability to reserve adequately for these guarantees and reported that the information that had been received to date was unconvincing. It also raised serious questions about the company’s solvency. IBD did not follow up on this memorandum or copy it to IB-PIA.

5.7 Awareness of GAOs: IB-PIA

5.7.1 In September 1998, IB-PIA began to receive complaints about Equitable Life’s treatment of GAOs. The stance adopted by IB-PIA in a letter to a complainant dated 22 October 1998 was that:

“The FSA does not become involved in the application of final bonuses to policies due to the fact that these bonuses are not guaranteed, therefore the company can apply these as appropriate.”

5.7.2 On 2 December 1998 IB-PIA (Advertising) (apparently on its own initiative) prepared an internal memorandum regarding GAOs to IB-PIA management, copied to the Head of IB-PIA. The memorandum made reference to recent press articles about Equitable Life and other firms who had offered GAOs and noted that this “may well become a big issue, affecting a large number of Firms”. The memorandum referred to one suggestion that the industry could be looking at an overall bill of £7billion to £10billion and to speculation in the press about the ability of mutual companies to survive if they had to honour the guarantees which might, in turn, lead to speculation about take-over bids.

5.7.3 The memorandum explained that the GARs offered in the late 1980s were thought to be substantially higher than the annuity rates available now. However, it appeared that Equitable Life was “not upholding the Guarantee and including the maximum amount of terminal bonus allocated to the policies”, but, instead, offering two options: a GAR policyholder could either forgo the GAR and receive a full terminal bonus, or opt for the GAR and have a lower terminal bonus.

5.7.4 The memorandum also stated that IB-PIA (Advertising) had received some queries regarding the past performance figures used by Equitable Life in its advertising and whether the performance figures were acceptable, bearing in mind that the full terminal bonus was not payable in some circumstances.

5.7.5 It is clear from the memorandum that IB-PIA (Advertising) had also been in contact with HMT-ID and that HMT-ID was looking at the situation, particularly with regard to Equitable Life’s solvency “if the guarantees are enforceable”. HMT-ID also intended to look at the literature used by Equitable Life when the policies were issued and the wording used on bonus notices and other documents issued during the term of the policy, in order to form a view on what reasonable expectations a policyholder might have had from reading the literature. The memorandum records that IB-PIA (Advertising) had offered to assist HMT-ID in reviewing the literature, and requested to be kept informed of further developments. IB-PIA (Advertising) also noted that HMT-ID had sent a “Dear Managing Director” letter to companies authorised to carry on long-term business, outlining its views on the interpretation of GAOs in the light of PRE.

5.7.6 The memorandum commented on the difference in approach between prudential regulation, which focused on a firm’s ability to stay in business, and conduct of business which looked at what the firm had promised investors in their marketing literature and whether the firm should be “liable to pay the maximum figures”.

5.7.7 This memorandum was subsequently forwarded by the Head of IB-PIA to IBD together with a covering memorandum dated 8 December 1998. The covering memorandum noted that:

“As far as we know, these annuities were all sold before the 1986 Financial Services Act came into force and so are not “caught” by PIA rules (although we cannot be certain of this without some sort of survey of the firms concerned).”

We have been told that it was a well established policy that pre “A” Day business was not covered by PIA Rules.

5.7.8 Attention was drawn in the covering memorandum to the IFA queries regarding the impact of the GAO issue on past performance figures used by Equitable Life to promote current products. The memorandum explained that the issue here was that, if Equitable Life should have made provision for paying the GAR and the full terminal bonus but failed to do so, it may have been able to offer other investors greater returns in recent years than it would otherwise have been able to do, enabling it to ‘inflate’ its past performance figures. IB-PIA commented:

“this all depends on whether or not the Equitable are within their rights to interpret their obligations under these contracts in the way that they are; and if

they are not, it would require a fairly forensic historical analysis of what assumptions and provisions they made, and how and when they made them.”

- 5.7.9 IB-PIA therefore concluded that it would be necessary to await the outcome of HMT-ID’s review of how Equitable Life was interpreting its obligations against the test of PRE, before deciding whether to take action and what action to take. The memorandum concluded that, if action should be taken, it would be necessary to work very closely with HMT-ID. No further consideration was given to the issue of past performance figures during the Review Period.

5.8 IB-PIA’s initial assessment of jurisdiction

- 5.8.1 In January 1999, IB-PIA (Advertising) prepared two memoranda dated 18 and 20 January 1999 respectively. It appears from the first memorandum that the Head of IB-PIA had asked IB-PIA (Advertising) to produce a note exploring the GAO issues as far as the PIA was concerned. The memorandum records that, given the size of the problem, IB-PIA had decided that it was obliged to look closely at the subject of GAOs to check whether any of the activities of the life companies fell within the PIA’s jurisdiction. It was noted that IB-PIA might find that the companies had not done anything since 1998 which might fall within the PIA’s “selling and marketing” jurisdiction but that, on the other hand, they might find something which they felt obliged to pursue as part of “our general brief to protect investors”.

- 5.8.2 Concern was also expressed about the fact that the guidance which had recently been issued by HMT-ID represented the position of one part of the FSA, when other parts had not had opportunity to consider the matter properly.² It was remarked that this was particularly relevant when, as on this occasion, the position of IB-PIA may differ from that of HMT-ID and that:

“My instinct from a ‘selling and marketing’ point of view is to find out how these guarantees were promoted to investors and, if appropriate, to require firms to honour their promises.”

- 5.8.3 The memorandum expressed the view that the approach adopted by HMT-ID was to preserve the financial soundness of insurance companies by agreeing that bonus rates could be reduced to GAR policyholders and that this created “a clear conflict between conduct of business regulation and prudential supervision”. IB-PIA (Advertising) commented that this was particularly relevant to the wording of the press release about the guidance, which stated that the FSA was taking this action “in the interests of protecting policyholders”. In this respect the memorandum commented:

“I think this is a bit unfortunate - I would hate to have to explain to a policyholder how we are protecting him by agreeing that the insurer can pay him a substantially less pension than he was expecting.”

- 5.8.4 The memorandum concluded with the comment:

² The evidence suggests that the memorandum was referring to the guidance on reserving issued by the Government Actuary as opposed to the guidance on charging for GAO’s issued by HMT-ID in December 1998.

“Presumably there is some mechanism within FSA to co-ordinate regulatory activity. Should we be noting our interest in the subject at a higher level?”

- 5.8.5 The second memorandum dated 20 January 1999, considered what action IB-PIA could be taking in relation to GAOs. It was noted that the view to date was that the problem seemed to be with policies sold before “A” Day and therefore IB-PIA probably lacked jurisdiction. However, it was also noted that, as the subject was attracting increased attention in the media, it seemed sensible to consider the issues raised by Equitable Life’s treatment of GAOs in a bit more detail to see whether there was anything that IB-PIA should be doing in order to fulfil its regulatory obligations, or at least to justify its stance of non-involvement.
- 5.8.6 IB-PIA (Advertising) identified various sources of information available to IB-PIA (namely, press cuttings; a file of papers from IB-Policy; information from HMT-ID and liaison with the PIA Ombudsman). It also identified various activities after April 1988 which might fall within PIA’s jurisdiction as follows:
- (a) sales of, and top-ups to, GAO policies;
 - (b) investors being “switched” out of GAO policies into new products without the benefit of a GAR; and
 - (c) how the GAO was being presented on maturity.
- 5.8.7 In relation to sales and top-ups of GAO policies, the memorandum stated:
- “The obvious first step is to seek to establish whether any pension guarantees were offered on pension sales made after April 1988. It has been suggested that these guarantees died out with the introduction of personal pensions in July 1988 - that leaves a couple of months business which we might cover - although I recall that not all the rules came into force immediately in 1988. [IB-PIA (Advertising)] has researched this further with the Insurance Directorate and it appears that at least some firms were selling this type of policy during 1988 and afterwards. There may in addition be incremental or top-up business which may count as “new business” in terms of the rules and which may have generated regulated product disclosure material.”
- 5.8.8 In relation to switching, it was noted that there were rumours that firms had avoided liability by switching clients out of policies containing GAOs. If this was done after “A” Day, it might well fall within the PIA’s jurisdiction as “selling and marketing” and IB-PIA would be able to look at the presentation of the offer to switch contracts and whether the investor was provided with a balanced picture including the rights he or she was giving up.
- 5.8.9 In relation to advice at vesting, the possibility of looking at the “options on maturity” form was raised since this could fall within the “selling and marketing” jurisdiction if part of the purpose of the form was to generate sales in an alternative policy such as an annuity and IB-PIA could look at the way the GAO was presented.

- 5.8.10 IB-PIA (Advertising) made a number of suggestions about sources of information that could be explored if it was decided that the issues should be pursued, including the following:
- (a) “as a first stage we should certainly talk to the Insurance Directorate”;
 - (b) “alternatively, or in addition, we could send a questionnaire to firms” (although IB-PIA noted the possibility that some companies could not identify which policyholders had GAOs attached to their contracts and that there might also be difficulties ascertaining the number of policyholders who switched from GAO policies to other pension contracts and in obtaining documents such as instructions to switch and options at maturity forms going back possibly as much as 10 years); and
 - (c) “one way of addressing this may be through complaints” (IB-PIA had already contacted the PIA Ombudsman and had ascertained that eighteen complaints had been received against Equitable Life so far and that complainants might have retained documentation which could build up a picture of what insurers had been doing over the years. The PIA Ombudsman had confirmed that it would have no objection to doing a trawl through its records for such information).
- 5.8.11 In connection with the PIA Ombudsman, the memorandum also made reference to reports in the press about the complaints against Equitable Life and explained that Equitable Life’s solicitors had asked that these cases should be dealt with by legal proceedings rather than by the PIA Ombudsman.
- 5.8.12 The concern regarding the potential conflict between the obligations of IB-PIA and IFSD that had been identified in the memorandum of 18 January 1999 was repeated. In this context, it was also noted that IFSD had interpreted the PRE requirement to mean that GAR policyholders could reasonably expect to pay something for the benefit of the GAR in the form of reduced bonus rates.
- 5.8.13 In conclusion the second memorandum posed the question: “Is there at least enough for a meeting on the above?” There is no evidence that a meeting took place to consider the suggestions outlined in the memorandum but we have been told that the issues were probably discussed at an internal group managers meeting.
- 5.8.14 Of the three sources of information identified in the memorandum, only the PIA Ombudsman option was pursued at this stage. The advice which was being given to policyholders on maturity was not investigated. We were told that the reason for this was that, where there is a possible emerging problem, IB-PIA would not conduct an investigation unless it was satisfied that there was sufficient evidence to provide grounds for dedicating resources. We were told that, in the event that an investigation was warranted, consideration would be given to the most easily accessible sources of information. Whilst a review of complaints made to the PIA Ombudsman was a relatively quick and easy avenue to explore, a survey of the number of policies sold post “A” Day was not necessarily straightforward due to the lapse of time and the difficulty of establishing the numbers of policies sold where the firm’s record keeping was poor.

5.9 Visit to the PIA Ombudsman

- 5.9.1 On 9 March 1999, a meeting took place between IB-PIA (Advertising) and the PIA Ombudsman. In a memorandum dated 22 March 1999, prepared after the visit, IB-PIA noted, for the first time, that a case would be brought in the High Court and that, at that stage, around thirty cases relating to Equitable Life GAOs were being dealt with by the PIA Ombudsman.
- 5.9.2 In relation to “switching”, IB-PIA stated that it understood from the PIA Ombudsman that cases which involved investors who were originally sold GAO policies and were subsequently persuaded to transfer into a non-GAO policy were being “settled separately” by Equitable Life. We have not been able to determine what was meant by this.
- 5.9.3 As to the marketing of GAO policies, IB-PIA stated that one of its objectives in visiting the PIA Ombudsman was to review the literature that had been provided to policyholders in relation to GAOs after “A” Day in order to assess whether there was anything in the description of the policies that might be pursued with Equitable Life. However, apparently very few of the complaints received by the PIA Ombudsman (if any) related to sales (or “variations” to policies) made after “A” Day and IB-PIA was not in a position, therefore, to pursue Equitable Life regarding the descriptions of the policies and what an investor might have expected to receive.
- 5.9.4 IB-PIA’s memorandum concluded by querying whether it should be looking more closely at what Equitable Life was doing (given that it was the only company with a significant number of complaints lodged with the PIA Ombudsman). It was noted that:
- “The difficulty with taking this forward is that we would be basing any action on hearsay and reports read in the press, and not on any hard evidence. However, this is a significant issue and we are probably obliged to contact Equitable Life about this.”
- 5.9.5 It appears, however, that IB-PIA never did contact Equitable Life in relation to any of the issues identified. We were told in interview that it was thought appropriate to wait for clarification on the legal position before applying significant supervisory resource to the situation. A memorandum from IB-PIA to IB-Policy dated 29 April 1999 which referred to the visit to the PIA Ombudsman noted that most, if not all, of the complaints related to pre “A” Day policies and so there was little action IB-PIA could take. The memorandum stated that, according to press reports, the case in the High Court was likely to be heard in the late summer and concluded:
- “For the moment, the view here seems to be that there is little to be done from a supervision angle.”

5.10 Handling of complaints

- 5.10.1 Prior to the commencement of the Review Period, IB-PIA’s response to one particular complaint about Equitable Life’s treatment of GAR policyholders was that the application of terminal bonuses was not a matter for the PIA because these

bonuses were not guaranteed and therefore the company could apply them as appropriate.

5.10.2 In February and April 1999, IB-PIA received copy correspondence relating to further complaints regarding Equitable Life's treatment of GAOs from the FSA's Public Enquiries Department ("**Public Enquiries**"). Public Enquiries responded to the February complainant stating that there were no PIA Rules banning a change of policy on annuity guarantees although investors might point to the terms of their particular agreement if they believed it prevented a variation. In such a case they could either pursue the matter through the courts or activate the company's complaints procedure. At this stage, IB-PIA noted that the issue was "hotting up" and that it would need to be monitored.

5.10.3 In relation to the April complaint, Public Enquiries asked IB-PIA to assist in drafting a response. Public Enquiries also requested assistance from IB-Policy, IFSD and the PIA Ombudsman and asked IFSD to suggest a "FSA line" for Public Enquiries and other staff at the FSA who might receive telephone calls on this subject.

5.10.4 As a result:

- (a) on 5 May 1999, IFSD agreed with IB-PIA that IFSD would take responsibility for the handling of queries in relation to GAOs and the acceptability of insurers cutting terminal bonuses payable to those who exercised a GAO (on the grounds that it was largely a PRE issue) subject to calling on IB-PIA to advise on PIA issues raised by particular cases;
- (b) on 11 May 1999, IFSD produced a draft response to the complaint incorporating:
 - (i) a suggested response from the PIA Ombudsman to the effect that no investigation was being made by the PIA Ombudsman in respect of GAO complaints pending a decision by the High Court in the Equitable Life proceedings; and
 - (ii) a reference to the guidance issued in December 1998 about meeting the costs of GAOs; and
- (c) in July 1999, IFSD produced FSA press lines in connection with the Court case (see below).

5.10.5 A hand-written note prepared by IB-PIA in June 1999, indicated that IB-PIA's view was that:

- (a) GAOs were broadly a prudential issue to be dealt with by IFSD;
- (b) PIA issues related to marketing after "A" Day;
- (c) complainants should receive letters similar to the draft response produced on 11 May 1999 (to be dealt with by Public Enquiries); and
- (d) IB-PIA would await the outcome of the test case.

5.10.6 Also in June 1999, IB-PIA prepared a hand-written note headed "Action Plan" summarising issues that might be addressed with Equitable Life. The action points include reference to the guaranteed annuities position, how Equitable Life was dealing with complaints relating to GAOs, Equitable Life's assessment of regulatory issues surrounding GAOs (such as marketing) and when GAOs ceased to be sold. It was also noted that IB-PIA should be alert to the outcome of the Court case.³

5.11 Query received in relation to advice at vesting

5.11.1 On 28 May 1999, IB-PIA (Advertising) was contacted by IFSD in relation to general concern (not restricted to Equitable Life) raised by the Consumers' Association that, on vesting, policyholders were not being told that their policy contained a GAO and so may end up buying a lower value market annuity. IB-PIA initially informed IFSD that concealing information from policyholders was within the PIA's jurisdiction and would probably be addressed as part of IB-PIA's usual supervision visits. It was suggested by IB-PIA (Advertising) that IB-PIA management "nominate someone to take this forward if you think this is appropriate" and the IFSD contact was identified.

5.11.2 There followed an e-mail exchange within IB-PIA (also involving IB-Policy) regarding the application of PIA Rules to cases involving GAO policies taken out before "A" Day where, on maturity, an investor was not told that his or her policy contains a GAO. During this exchange, some uncertainty was expressed as to the application of PIA Rules to this situation. One view was that the answer depended on a number of factors such as whether the GAO policy was sold before or after "A" Day, and whether the sale was advised or not.

5.11.3 As a result of this uncertainty regarding the application of PIA Rules to such a situation, on 2 June 1999, IB-PIA sought the advice of GCD by "posing a couple of queries". It was also noted that IB-PIA would want to be clear about its stance on the issues before any meeting with the Consumers' Association. We have not been able to verify the nature of the advice sought from GCD as it is believed that the request was sent by e-mail and no copy has been retained.

5.11.4 On 14 June 1999, IB-PIA and IFSD attended a meeting with the Consumers' Association to discuss GAOs in general. The note of the meeting records that, amongst other things, it was explained that, shortly before a policy was due to vest, the insurer would inform the policyholder of the value of the annuity that was available under the policy and the cash fund value that was available as an alternative. Only if the GAO provided the "highest value annuity" would the rate it offered be quoted, although it might not be indicated that the rate offered was pursuant to the terms of a GAO. If a policyholder sought advice about the purchase of an annuity, PIA Rules required advisors to consider the merits of any GAO against the other alternatives. Any policyholders who were not correctly advised would be entitled to compensation. The particular circumstances of Equitable Life GAR policyholders were not discussed.

³ We have been told that the next meeting that was held between IB-PIA and Equitable Life was on 25 May 2000 (see below) but we have not been provided with any documentary evidence of this meeting.

- 5.11.5 On 15 June 1999, GCD responded to IB-PIA's request for advice in relation to the specific query raised by the Consumers' Association. GCD noted that the concern was that GAR policyholders were not being told that their policy contained a GAO that would probably provide a larger pension than the current annuity rate offered by the insurer. Without this information, policyholders might purchase a lower value market annuity, either in the open market or with their existing life company.
- 5.11.6 GCD advised that the application of the relevant conduct of business rules depended on the date on which the advice was given or withheld. Accordingly, advice given on the taking up or purchase of an annuity post "A" Day would fall to be regulated even if the policy was sold before "A" Day. If a life company was advising its representatives to withhold information about rights to GAOs on maturity, or failing to ensure its representatives were providing adequate advice, PIA Principles would "undoubtedly have been breached".
- 5.11.7 It appears from the response from GCD that IB-PIA did not request an opinion from GCD dealing specifically with the nature of the advice, if any, that should be given to Equitable Life GAR policyholders where, generally speaking, the value of a GAO was being negated by the company's terminal bonus practice. Having addressed the Consumers' Association query, IB-PIA took no further action to clarify the position regarding advice that should be given to Equitable Life GAR policyholders on maturity of their policy.
- 5.11.8 The memorandum from GCD was circulated within IFSD and copied to GAD with a comment by IFSD:

"As you can see, PIA have concluded their rules cover information provided to policyholders at vesting irrespective of when the policy was taken out."

5.12 Query received in relation to bonus notices

- 5.12.1 On 24 June 1999, IFSD contacted IB-PIA (Supervision) stating that IFSD had concerns about the format of certain bonus notices issued by Equitable Life because it was thought that the presentation of the terminal bonus was potentially misleading. IFSD's concern was that:

"A figure is quoted for terminal bonus and this is then added to the guaranteed benefits under the policy to give a total benefits number. You have to read the notes over the page to appreciate that terminal bonus is not guaranteed."

IFSD considered that it was arguable that the format of the notice may have encouraged a policyholder to believe that the GAR applied to the full fund including terminal bonus. IFSD queried whether the PIA had any relevant powers to require Equitable Life to change their bonus notices.

- 5.12.2 There followed an e-mail exchange within IBD regarding the bonus notices during which uncertainty was expressed regarding the application of the PIA Rules to these documents. One view was that, although the notices were not advertisements (because they did not have a sales purpose), they might be caught by Rule 4.1 (which

requires information provided to policyholders to be clear, fair and not misleading).⁴ Another view was that the notices were not within the scope of the rules because they related to the administration of existing business but that, where the notice contained additional information such as past performance information, the regulator had taken action in the past in relation to elements of the notice that could be regarded as an investment advertisement, particularly where the firm included a “mailer” for new business.

5.12.3 IB-PIA (Supervision) responded to IFSD also on 24 June 1999 concluding that it was worth looking at the current bonus notice. Later that day, IFSD replied stating that it would provide examples of the 1996 and 1997 bonus notices and that it would obtain a copy of the 1998 notice from Equitable Life the following week. IFSD further commented that the 1998 notice was expected to include a more clearly drafted note explaining that different levels of terminal bonus may be available depending on whether or not the GAO was exercised.

5.13 The Court case

5.13.1 Prior to the First Instance judgment, IB-PIA attended the following bilateral meetings with IFSD at which the case was discussed:

- (a) On 17 June 1999, in relation to guaranteed annuities it was noted that IFSD was awaiting the 1998 regulatory returns to review the basis of firms’ reserving for this product and that IB-PIA had received a legal opinion in relation to the pre versus post “A” Day debate. It was also noted that the key milestone would be the Court case on 5 July and its implications for PRE.
- (b) On 11 August 1999, IFSD reported that judgment was due on 9 September 1999, that a summary of the transcripts had been prepared and that the evidence suggested that the case could go either way.

5.13.2 In addition, IB-PIA was copied into the following documents relating to the case:

- (a) an internal IFSD memorandum dated 5 July 1999;
- (b) an internal IFSD memorandum dated 12 August 1999; and
- (c) a memorandum from GCD to IFSD dated 10 September 1999.

5.13.3 We will deal with each of these in turn.

5.14 Internal IFSD memorandum dated 5 July 1999

5.14.1 This memorandum explained that the case was due to commence and that IFSD had undertaken some simple scenario planning in order to be ready to react to the outcome of the case. This memorandum is described in **Chapter 4, Part 2** but, amongst other things, it recorded that:

⁴ Although it was noted that Rule 4.1 would only apply to notices issued since 18 July 1994 when Equitable Life became a PIA member (as Lautro did not have an equivalent “catch all” rule).

- (a) IFSD would need to monitor the impact of the judgment on the company's financial position and IFSD might need to intervene to ensure that Equitable Life's approach was consistent with PRE; and
- (b) IB-PIA was considering the presentation of Equitable Life's bonus notices which appeared to IFSD to be potentially "misleading to policyholders because of the emphasis they place on the projected total fund value which includes terminal bonus although it is not guaranteed".

5.14.2 The memorandum attached press lines for dealing with queries regarding the case which included consideration of the implications for Equitable Life if the company was to lose the case and stated that it would not be appropriate for IFSD to speculate or comment on individual companies' positions but that IFSD "would not expect the judgment to have a significant impact on the level of reserves the company needs to hold to cover its liabilities to policyholders".

5.14.3 Also attached to the memorandum was a "scenario planning" document (see **Chapter 4, Part 2**) which was of some relevance to the conduct of business regulator:

- (a) Under the heading "Implications for FSA" in respect of scenarios 1 and 2 it was, amongst other things, noted that, even if Equitable Life won the case, the PIA Ombudsman would still need to resolve complaints by individual GAR policyholders.
- (b) In respect of Scenario 1 (a win for Equitable Life) it was noted that a GAR policyholder might argue that he or she had suffered loss due to reliance on a bonus notice about the value of the GAO and so had not made additional alternative retirement provisions.
- (c) In respect of Scenario 2 (a partial win for Equitable Life in that reducing terminal bonus was acceptable but that past practice was not) it was noted that the PIA Ombudsman would probably follow the Court judgment where complainants raised similar issues.
- (d) In respect of Scenario 3 (a loss for Equitable Life) it was noted that Equitable Life would need to pay compensation to policyholders who had exercised GAOs and suffered reduced terminal bonuses as a result (or establish reserves to meet that cost). It also noted that IFSD would need to determine the solvency position of Equitable Life. If there was a significant risk that the company would be unable to meet its liabilities to policyholders/PRE, IFSD would need to consider closing the company to new business or suspending its authorisation. A take-over bid was also contemplated and a fall in new business was expected therefore reducing the new business strain on the company and bolstering the company's short to medium term financial position. The final implication listed was:

"Potential for allegations that FSA/IFSD should have prevented Equitable writing new business earlier so that lapses could have been avoided."

5.14.4 No input into the scenarios by IBD or IB-PIA was invited or given.

5.14.5 This memorandum was subsequently provided to a member of the PIA Board on 24 August 1999, when that member requested a brief run down of the PIA's assessment of the potential impact of the Court case on Equitable Life (despite the fact that IB-PIA had, by then, received a more recent note dated 12 August 1999 (see below)).

5.15 Internal IFSD memorandum dated 12 August 1999

5.15.1 This memorandum reported on IFSD's review of the transcripts of the High Court hearing and is dealt with in **Chapter 4, Part 2**. Of particular relevance to the conduct of business regulator was the following comment on the likely outcome of the case:

“Overall my conclusion is that the case could go either way. However, the most likely outcome still looks to be a win for Equitable but with criticism that they did not make their bonus practice clear to policyholders.”

5.15.2 This memorandum was copied to IB-PIA without the attached summary of the hearing which contained a reference to the illustrations provided to policyholders at vesting and the clarity of the bonus notices for 1995 and 1997.

5.16 GCD memorandum dated 10 September 1999

5.16.1 This memorandum summarising the High Court judgment is referred to in **Chapter 4, Part 2**. The following comments made by GCD were particularly relevant to the conduct of business regulator:

(a) The Court had decided there was nothing in the contract to prevent Equitable Life adopting the practice of reducing terminal bonuses when GAOs were taken up. In this regard, GCD commented:

“This on its face seems right, but I understand that the FSA has some evidence that, on maturity and when options were being discussed with policyholders, [Equitable Life] did not tell policyholders in terms that terminal bonus was conditional. This is not a matter for IFSD however and is before the PIA.”

(b) In relation to PRE, the Court had concluded that Equitable Life's communications with policyholders up to 1994 (and perhaps for a while thereafter) did produce in GAR policyholders a reasonable expectation that the GAR would apply to the total fund including the full terminal bonus declared for all policyholders.

(c) If the judgment was upheld, it was thought that IFSD would need to determine whether sufficient or due regard was had to PRE but the memorandum expressed the view that there would be real awkwardness in taking action against Equitable Life. GCD expressed the view that there was a “PIA ring” to the case (although GCD could not comment on the extent to which IB-PIA could or should get involved in light of the judgment or its appeal).

5.16.2 None of these notes was copied to those individuals within IB-PIA who were conducting a review of the bonus notices.

- 5.16.3 On 13 September 1999, receipt of the GCD memorandum dated 10 September 1999 prompted the conduct of business section of GCD to:
- (a) request a copy of the full transcript of the High Court hearing from the prudential section of GCD; and
 - (b) send a copy of the GCD memorandum to IB-Policy.
- 5.16.4 In the covering memorandum to IB-Policy, GCD drew attention to the references to the PIA which had appeared in the GCD memorandum and suggested that it might be helpful to have a discussion given that GCD might be asked to advise at short notice.
- 5.16.5 We have been told that the reason for sending this memorandum to IB-Policy was that IB-Policy contained the actuarial resource within IBD and GCD thought it would be useful for the actuarial team to have the judgment and to consider it from a number of angles.
- 5.16.6 On 14 September 1999, IB-Policy responded by memorandum (copied to IBD and IB-PIA) stating that the issue was more for IB-PIA since the principal issue was whether the marketing literature of Equitable Life could be regarded as compliant with the rules in force at the time, including the Key Features, Product Particulars and With-Profits Guides (although it was noted that the PIA Rules do not cover bonus notices). IB-Policy expressed the view that failure to explain that a terminal bonus was conditional would seem to fall short of the expected standards.

5.17 Action taken by IB-PIA

- 5.17.1 IBD was sent the GCD memorandum dated 10 September 1999 by IFSD by e-mail on 14 September 1999. On receipt, IBD forwarded the e-mail to IB-PIA expressing some puzzlement about GCD's reference to the fact that the FSA had some evidence that Equitable Life did not tell policyholders in terms on maturity that terminal bonus was conditional and that the PIA were aware of this. The e-mail states:
- “my understanding is that the contracts which have been the subject of the litigation were sold pre-1988. And I am not clear whether PIA has any real standing in relation to post-1988 communications between Equitable and its policyholders in respect of such contracts.
- But my speculations are so much chaff: would you please consult Enforcement and GCD and advise by the close on 20 September what if anything we should be advising PIA to do. If there is any point in our investigating I guess we should get ahead with that without necessarily waiting for the outcome of the appeal? None of the points at issue in the continuing litigation seem to bear on whether the company's communications with policyholders were compliant.”
- 5.17.2 We have been told that the reference in the GCD memorandum that was queried by IBD was based on what had been reported at meetings between HMT-ID and Equitable Life in November 1998 at which Equitable Life had explained the practice that was followed for maturing policies. GCD understood that:

“At the point at which policies matured, policyholders were coming in for their discussions with the Equitable adviser and were being presented with options which didn't necessarily include the GAR option at all, on the basis that the sales adviser had already decided that this was not the sensible option for the policyholder in question; it would always be the sensible option to take the money in fund form instead.”

5.17.3 IFSD also knew that not all policyholders were advised about their entitlement to a GAO from Equitable Life's response to the GAD survey on reserving for annuity guarantees in July 1998 and the further representations given to IFSD at the meeting on 13 October 1998.

5.17.4 This information was not passed on to IB-PIA, and we have been told that IB-PIA did not have any evidence that policyholders were being mis-advised.

5.17.5 IBD's e-mail to IB-PIA was also copied to IFSD which responded by agreeing that it was important to review whether the judgment threw any light on the PIA's interests and responsibilities and agreed that there was no reason why any analysis should wait until after the appeal and “indeed very good reasons why it should not”. However, IFSD also stated:

“That said I am keen that we should look at the issues from the perspective of all the FSA constituent bodies and we should consider any possible action in the same way. I think that will probably mean that we should not decide on, or initiate, any action until the appeal court's decision is known. If the judgment is overturned, particularly if the actions of [Equitable Life's] directors are heavily criticised, it is possible that it would be appropriate for us to take action under the Insurance Companies Act. I would not wish to be in a position where our room for action had been constrained, or possibly prejudiced, by earlier action by others.

But we can, of course, consider this further in the light of the analysis which I think we are agreed should now be undertaken.”

5.17.6 As requested by IBD, IB-PIA sent a memorandum to Enforcement and to GCD (copied to IBD and IFSD) by e-mail dated 20 September 1999 which covered much the same ground as had been covered in January 1999, setting out the implications of the judgment as far as PIA's Rules were concerned in order to determine what further action, if any, was required (the “September Memorandum”). The September Memorandum contained the following analysis:

- (a) Post “A” Day Sales: Notwithstanding the concerns which had been expressed about what may have been said to customers at the point of sale about GAOs and the impact they may have had on terminal bonuses, IB-PIA had been led to believe that most sales of GAO policies were made before “A” day and had concluded that there was little they could do because they were outside the PIA's jurisdiction. It was noted that there had been suggestions that some GAO policies had been sold after “A” Day but IB-PIA had received no evidence to confirm this, although the PIA Ombudsman and IFSD might have further information.

- (b) Advice at vesting: Following considerable internal discussion on the subject of advice at vesting, the conclusion was that the adviser was responsible for alerting a policyholder to any GAO which may apply. Equally, if the life company issuing the GAO was also advising the investor on their options at vesting, it too was obliged to set out all the available options and their consequences. IB-PIA had no evidence to suggest that clients were being mis-advised but it was suggested that they should check the current position with the PIA Ombudsman.
- (c) Switching: It had been suggested that some life companies had switched clients out of GAO policies into new products. If the life company did so without alerting them to what they were giving up they would be in breach of PIA Rules. It was said that IB-PIA had no evidence to support these assertions but it would be worthwhile carrying out some checks.⁵
- (d) Bonus notices: These might be caught by PIA Rule 4.1. However, it was noted that the bonus notices for 1997, 1998 and 1999 had been reviewed and it had been concluded that there was nothing seriously wrong with them.⁶

5.17.7 The September Memorandum stated that further action was required to ascertain whether any investors had suffered as a result of misleading literature regarding GARs; incorrect advice at vesting; switches made without advice about a GAR or misleading bonus notices, and concluded with a recommendation that:

- (a) consideration be given to establishing a small team to:
 - (i) conduct a review of complaints received by the PIA Ombudsman, including identifying any emerging trends and identifying those companies that are generating the most complaints;⁷
 - (ii) undertake focused visits to firms known to have issued GAOs to review their records in relation to bonus notices, post "A" Day sales, switching and advice at vesting; and
 - (iii) obtain and review bonus notices issued by firms known to have issued GAOs (having checked that PIA Rules apply); and
- (b) that IB-PIA chair a meeting of representatives from Enforcement, IB-Policy and IFSD to discuss and agree next steps.

5.17.8 On 23 September 1999, GCD responded by e-mail with the following advice:

- (a) sales made prior to "A" Day did not fall within the PIA's jurisdiction but could be raised with the PIA Ombudsman under his voluntary jurisdiction;

⁵ No reference was made to switching being "settled separately" by Equitable Life as referred to in the memorandum dated 22 March 1999 prepared by IB-PIA (Advertising) following the visit to the PIA Ombudsman (see paragraph 5.9 above).

⁶ The notices reviewed were for the years ending 31 December 1996, 1997 and 1998 but these notices were issued in 1997, 1998 and 1999 respectively.

⁷ No reference was made to the earlier visit to the PIA Ombudsman and review of complaints in March 1999 (see paragraph 5.9).

- (b) “You say that there is no evidence that, at vesting, clients are being mis-advised but this surely begs a question as to whether [Equitable Life] has the right to offset the value of the guarantee against the terminal bonus. This question has been determined in favour of Equitable at first instance but there is likely to be an appeal”; and
- (c) it would be an “uphill struggle” to bring the bonus notices within the PIA Rules which apply to “business which comprises marketing or business carried on in connection with marketing”. Accordingly IB-PIA would need to look at the context of the bonus notice statement to see “if a marketing point was present”.

5.17.9 Enforcement did not respond to the September Memorandum (but did attend the subsequent meeting to discuss the memorandum on 21 October 1999 (see below)).

5.17.10 Neither the September Memorandum nor the GCD response appears to have been copied to those individuals within IB-PIA who had been asked to review the bonus notices.

5.18 IB-PIA’s assessment of the bonus notices

5.18.1 In the meantime, IB-PIA (Supervision) who, in June 1999, had been asked by IFSD to review Equitable Life’s bonus notices, had received from IFSD the bonus notices for 1996, 1997 and 1998 and, on 31 August 1999, had forwarded them internally to IB-PIA (Advertising) with a note seeking a view but stating:

“My view is that (a) it’s unlikely that we can do anything under the advertising rules; (b) the 1998 bonus notice is quite clear anyway.”

5.18.2 IB-PIA (Advertising)’s view, as expressed in a memorandum to IB-PIA (Supervision) dated 21 September 1999 was that:

- (a) whilst the bonus notices were probably not an advertisement, notices issued since July 1994 would presumably be subject to PIA Rule 4.1 as they are issued in the course of relevant business;
- (b) it was possible to quibble about how clear the 1998 notice was, but “overall all the relevant information seems to be there”;
- (c) whilst the note in the 1996 notice relating to the cost of guaranteed annuities might serve to alert policyholders to the possibility of having their fund value reduced, it did not do so in a clear and fair manner;
- (d) it had not been possible to draw any conclusions in relation to the 1997 notice because the 1997 document provided by IFSD did not relate to a GAO policy; and
- (e) it would be interesting to review earlier bonus notices issued since July 1994 to see how the guaranteed annuity factor had “gradually been worked into” the bonus notices. However, it was noted that Rule 4.1 was not often used in disciplinary cases “probably because it is very non specific”.

5.18.3 Following the advice from IB-PIA (Advertising), IB-PIA (Supervision) reported back to IFSD by memorandum dated 23 September 1999 which stated:

“You may remember our earlier conversations about [Equitable Life’s] bonus notices. You kindly sent me some examples including the latest bonus notice (1998). We do not think that the bonus notice is poorly presented or inaccurate.”

5.18.4 We have been told by IB-PIA (Supervision) that this comment was intended to reflect its view on all the bonus notices (rather than just the 1998 notice). It was acknowledged in interview that IB-PIA (Supervision) had formed a different view of the 1996 notice to IB-PIA (Advertising), on the basis that the relevant information was included in the notice, and it was not unclear or unfair to such a degree that something needed to be done about it. In any event, the question from IFSD had been whether IB-PIA had powers to change the bonus notice and IB-PIA (Supervision) took this to refer to the current notice which had been changed by the time the notices were received and which was now compliant.

5.18.5 We have also been told by IFSD that IFSD was interested in all the notices and that IFSD understood the response from IB-PIA to relate to all the notices. IFSD explained that, if it thought that the PIA had powers to change the company’s bonus notices because they were misleading, IFSD would raise it with the company, although it would probably not take retrospective action. However, a conclusion that the 1996 bonus notice was misleading would have been relevant to PRE and, had there been a need to consider PRE further, IFSD would have gone back and asked IB-PIA for more information about why it had reached its conclusion. IFSD also said that it was more interested in IB-PIA’s reasoning and views of the bonus notices than whether there were grounds to intervene.

5.18.6 In any event, IB-PIA (Supervision) made it clear to IFSD that IB-PIA did not intend to pursue a breach of Rule 4.1. The memorandum concluded:

“We have not previously breached a firm on [Rule 4.1] in respect of documentation issued once the post sale information has been given. That is because our scope covers the activities of dealing, arranging deals in, managing and advising on certain types of investments. The ongoing servicing of policies does not seem to fit comfortably within these activities. And we would therefore have to have serious concerns about a document issued in the course of servicing a policy, to attempt to breach the firm concerned.”

5.18.7 We know that, at the same time, GCD was advising others within IB-PIA that it would be “an uphill struggle” to bring the bonus notices within PIA Rules (unless there was a marketing point present), but this was not copied to IFSD or those within IB-PIA who were reviewing the bonus notices.

5.19 The PFW investigation report

5.19.1 In March 1999, the findings from the pension-focused visits that had been conducted in mid-1998 were reported to the PIA Board and the PFW issues were referred to Enforcement. Enforcement undertook an initial data gathering exercise in order to identify the most active seller of PFW contracts. This exercise established that, between 1 May 1995 and 31 December 1998, Equitable Life had sold over 14,000

PFWs (which was 93.7% of all PFWs sold directly by a company's sales force (as opposed to through an IFA) and 35.4% of the total market). Enforcement had also confirmed that between 1 May 1995 and 31 May 1999 Equitable Life sold over 16,000 PFWs. Enforcement therefore restricted its investigation, as far as direct sales by companies were concerned, to Equitable Life and decided to review a 0.5% sample (which resulted in a sample of eighty one cases). The investigation had commenced on 22 June 1999 and had included a visit to the firm between 12 and 16 July 1999.

- 5.19.2 In October 1999, Enforcement produced an investigation report detailing its findings in relation to Equitable Life's sales of PFWs (the "October Report"). One of the issues in the October Report was whether Equitable Life failed to ensure that PFW contracts were suitable in relation to the investor's personal and financial circumstances. One of the concerns arising in relation to this issue from Enforcement's review of investor files was that there was insufficient evidence to show that an adequate investigation was made by the adviser as to the availability of a guaranteed annuity from the original provider prior to transferring funds to Equitable Life.
- 5.19.3 It is apparent from the October Report that the investigation into the availability of a guaranteed annuity prior to switching and buying a PFW was confined to those policyholders who transferred funds from another company. In other words, the investigation excluded investigation of this issue in respect of sales to existing Equitable Life GAR policyholders. Although the October Report found that, in twenty four cases where funds were transferred from another provider to Equitable Life for the purpose of effecting a PFW contract, there was no evidence that enquiries had been made as to whether a guaranteed annuity was available from the original provider, the investigation did not examine whether Equitable Life GAR policyholders were asked or advised about their GAO before they switched into a PFW.⁸
- 5.19.4 The October Report does not give any reason for this decision and there is no other documentary evidence about it. We have been told that Equitable Life's practice of paying differential terminal bonuses negated the effect of the GAO and so an Equitable Life GAR policyholder who bought a PFW using funds in an Equitable Life policy was not, at that time, giving up any value in relinquishing the GAO. Accordingly, he or she did not need to be advised about the loss of a GAO when buying a PFW. Enforcement was also aware that the position taken by Equitable Life was the subject of litigation and, to that extent, there would be uncertainty until the litigation was concluded. If the Court upheld Equitable Life's terminal bonus practice, there would be no issue.
- 5.19.5 The October Report recommended that further investigations be conducted including interviews with targeted investors. We have been told that consideration was given to interviewing Equitable Life representatives but interviews of investors was

⁸ It is not known how many of the 16,000 PFW sales were to existing Equitable Life policyholders and how many involved transfers from other providers. However, of the seventy six cases which involved advice from an Equitable Life sales representative, thirty of these involved policyholders transferring from another provider (the remaining cases involving sales to existing Equitable Life policyholders).

considered to be the most appropriate investigation method to obtain information about the suitability of PFW contracts for individual investors.

- 5.19.6 Enforcement did not provide IB-PIA with a copy of the October Report until requested to do so by e-mail on 14 January 2000 nor did it inform IB-PIA of the decision to confine the investigation of enquiries made about the availability of a GAO to GAR policyholders transferring from other companies.
- 5.19.7 We have been told that one of the ways in which IB-PIA is kept informed of the progress of all the cases which have been referred to Enforcement is by means of a document known as a "Key Case Update" which is circulated to IB-PIA. The Key Case Updates in January and December 1999 both include reference to the PFW investigation but neither mentions the GAO-related issues. We have also been told that Enforcement provided IB-PIA with oral updates on the progress of the Equitable Life PFW investigation at each monthly management interface meeting but that no minutes were kept of these meetings.
- 5.19.8 IB-PIA have told us that they were not aware of the detail of the investigation, including the decision to restrict the scope of the investigation as regards Equitable Life GAR policyholders and therefore did not make any connection between the PFW investigation and the switching issue.

5.20 Action taken by IB-PIA as a result of the September Memorandum

- 5.20.1 On 11 October 1999, IB-PIA attended a routine bilateral meeting with IFSD at which IFSD reported on the implications of the High Court judgment for both IFSD and IB-PIA. It was noted that the main implication was for other firms which had issued GARs and their reactions to the judgment would need to be monitored. Although the judgment was in favour of Equitable Life, IFSD's view was that Equitable Life had failed to meet PRE and so there remained a possibility of intervention. In terms of conduct of business issues, it was noted that there may be misleading bonus notices supplied to investors or firms may have switched investors into new contracts without GAOs. It was noted that a paper on this had been prepared by IB-PIA (i.e. the September Memorandum) and that this paper would need to be discussed at a meeting chaired by IB-PIA.
- 5.20.2 On 21 October 1999, a meeting was held to discuss the September Memorandum and the need for regulatory action by IB-PIA in relation to GAO issues generally and Equitable Life in particular. Although no minutes of the meeting have been located, we have been told that the meeting was attended by IB-PIA, IFSD, IB-Policy, Enforcement and GCD (conduct of business section). After the meeting, IFSD sent an e-mail to GAD reporting on the meeting. This e-mail indicates that, as a result of the meeting, IFSD understood that:
- (a) in relation to sales and top-ups of Equitable Life GAO policies, IB-PIA wanted to investigate whether a material number of policies fell within its remit to justify an investigation;
 - (b) the bonus notices fell outside IB-PIA's remit (such remit being described by IFSD as "broadly marketing literature"); and

- (c) IB-PIA was considering looking at the practices being adopted by companies other than Equitable Life in relation to advice and information at vesting and whether GAR policyholders were being switched into new policies so that they lost their entitlement to a guarantee. We have been told that the reason why these issues did not need to be investigated in relation to Equitable Life was that the advice given to GAR policyholders would depend on the outcome of the Court case (i.e. a GAO would only need to be drawn to the attention of a GAR policyholder if the decision attributed value to a GAO).

5.20.3 It was, however, resolved that IFSD would write to Equitable Life to enquire about the number of post “A” Day sales and top-ups after June 1988 (when Equitable Life stopped selling GAOs).⁹

5.20.4 Accordingly, on 29 October 1999, IFSD wrote to Equitable Life requesting details of the number of GAO policies sold and the number of top-ups made to GAO policies after “A” Day. Equitable Life’s preliminary response on 10 November 1999 was that Equitable Life would have no difficulty in establishing the number of individual GAO policies sold between 29 April and June 1988. However, Equitable Life requested a clearer definition of “top-ups” and explained that most “top-ups” would probably not have involved advice from an Equitable Life sales representative. IFSD forwarded this response to IB-PIA on 26 November 1999, stating that further consideration needed to be given to whether it would be helpful to have information on the number of top-ups given Equitable Life’s response that most would not have involved advice from an Equitable Life sales representative. IB-PIA did not respond to IFSD or Equitable Life on this.

5.21 The College Meeting and the OA-CSP

5.21.1 In the meantime, in June 1999, IB-PIA and IFSD had agreed to pilot lead supervision for eleven firms including Equitable Life and preparations had begun for the first college meeting concerning Equitable Life. The college and the OA-CSP are explained in **Chapter 2**.

5.21.2 On 27 October 1999, IB-PIA provided IFSD by e-mail with the following information to be included in the draft OA-CSP:

- (a) that IB-PIA’s risk rating of Equitable Life was “Average”;
- (b) that the last visit had taken place in June 1998 and the next was planned for the second quarter of 2000; and
- (c) that the latest supervisory activity by IB-PIA was “tracking” the Court case.

5.21.3 In relation to the risk rating, the FSA has been unable to locate a copy of the score sheet for the July 1998 risk assessment of Equitable Life (prepared following the previous visit). However, we have been told that the fact that Equitable Life had brought a test case to assess its past payment practice was seen as being a responsible

⁹ In fact the significant date for top-ups was not June 1988 when Equitable Life stopped selling GAOs but “A” Day when top-ups fell within the FSAct 1986 regime. The letter subsequently sent to Equitable Life correctly made reference to post “A” Day top-ups and not to June 1988 (see below).

move and there was no indication that, if the judgment went against them, they would not act appropriately to review past practice. Accordingly, the Court case was not necessarily an adverse factor in the risk assessment.

- 5.21.4 The OA-CSP that was subsequently prepared by IFSD indicated that Equitable Life was graded medium to high by IFSD and high by IMRO. We have been told that IFSD's risk rating was based on the fact that Equitable Life did not retain the levels of reserves that other companies may have done because of its low charging and high bonus distribution policy. IMRO's assessment was based on a particular IMRO-related factor. We have also been told that IB-PIA reviewed its risk rating in light of the rating given by IMRO and IFSD but that it was not thought appropriate to change it.
- 5.21.5 In relation to the timing of the visit, we have been told that Equitable Life was a large firm with a large client bank and IB-PIA felt that a visit would enable IB-PIA to get to know the culture of the firm and the way it operated. In addition, we were told that IB-PIA was aware that Enforcement had concerns about PFWs and it was felt that it would be useful to assess the process by which policies were sold.
- 5.21.6 The college meeting was held on 26 November 1999 and attended by IFSD and IMRO but IB-PIA was unable to attend. Although this was regarded as unfortunate by IFSD and IB-PIA accepted that attendance would have been preferable, IB-PIA did review the draft OA-CSP and provide comments on it to IFSD and also received a copy of the minutes of the meeting and amended OA-CSP.
- 5.21.7 The minutes record the fact that IFSD informed the college that the appeal against the High Court judgment would be heard at the end of November 1999, that recent supervisory activity had been concentrated on the GAO issue but that IFSD planned to fill in some of the gaps in its knowledge about Equitable Life as part of its 6 December 1999 visit.

5.22 Response received from Equitable Life regarding post "A" Day sales

- 5.22.1 Equitable Life responded to IFSD's request for information about the number of post "A" Day sales on 3 December 1999 stating that the company wrote 22,224 policies containing GAOs between "A" Day and 30 June 1988. Equitable Life explained that it was likely that most of the policies would have been purchased on clients' own initiative rather than through Equitable Life's sales force noting:
- "At that time, exceptional levels of business were generated by the imminent withdrawal of the product. In the whole of the previous year, 1987, we sold 18,247 such policies in total."
- 5.22.2 We have been told that the sudden rush to buy GAO contracts prior to their withdrawal cannot necessarily be attributed to any perceived value attaching to a GAO because (a) it appears that policyholders were not generally aware of the existence of GAOs; (b) most sales were probably not advised; and (c) investors may have wanted to take advantage of the opportunity to buy established policies rather than investing in the new personal pensions that were being introduced.

- 5.22.3 On 10 December 1999, a bilateral meeting took place between IFSD and IB-PIA. At the meeting reference was made to the meeting held on 21 October 1999 to discuss the need for further regulatory action in relation to GAO issues and to the fact that IFSD now had information on the number of GAO policies sold post “A” Day which would be passed to IB-PIA.
- 5.22.4 The information was provided to IB-PIA under cover of a memorandum to IB-PIA dated 12 January 2000 which attached a copy of Equitable Life’s response regarding post “A” Day sales. The covering memorandum stated that, in view of the fact that only a few of the sales would have been advised and it would be difficult to identify them, it was arguable that IB-PIA could justify not pursuing this further. It was noted that the query raised by Equitable Life in relation to the definition of a “top-up” remained outstanding and it would be necessary to reach a view on whether this issue was worth pursuing given that, again, only a small proportion of them were likely to have been advised sales.
- 5.22.5 Although IB-PIA accepted that 22,224 sales was quite a large number, IB-PIA did not take any action upon receipt of this information. We have been given two different reasons for this:
- (a) that there would have been a discussion about when the rules applied and that since the Lautro Rules may only have come into effect on 1 July 1988, the PIA might not have had jurisdiction over policies sold prior to that date¹⁰; and
 - (b) that, although the response confirmed that there was some business that fell within IB-PIA’s scope, IB-PIA could not act on the information until the outcome of the Court case was known.

5.23 The Judgment of the Court of Appeal

- 5.23.1 On 21 January 2000, the Court of Appeal gave judgment against Equitable Life. On the same day, an e-mail was circulated within IB-PIA suggesting that IB-PIA should liaise with IFSD to obtain information to be discussed the following week.
- 5.23.2 Later that day, IFSD sent an e-mail to IB-PIA stating that the judgment was no cause for panic; Equitable Life had been given permission to maintain its payment practice pending an appeal to the House of Lords and the financial position of the company was “largely unaltered” by the judgment (although there was no way of knowing whether the decision might spark a hostile take-over bid).
- 5.23.3 In response, IB-PIA told IFSD that it would keep a “close eye” on how things progressed.
- 5.23.4 On 24 January 2000, IFSD sent an e-mail to the college stating:

¹⁰ This reason is not entirely correct; Lautro Rules came into force on 29 April 1988. Some rules were phased in and came into effect on 1 July 1988. These related to advertising and product disclosure. Although advertising might affect an investigation of how GAO policies were marketed, the best advice and general suitability requirements came into force on “A” Day and applied to policies sold between “A” Day and 1 July 1988.

“Despite the armageddon scenario painted in some of the papers, we do not think that the judgment affects the statutory financial position greatly as [Equitable Life] already has to fully reserve in the Annual Returns for biting GAOs.”

5.23.5 IB-PIA told us that the response from IFSD was seen as “placatory”. Although the Court of Appeal judgment affected IB-PIA’s view of the likely outcome of the case because it was an indication that “it was not a clear cut case that [Equitable Life’s] past payment practice was appropriate”, certainty had not yet been established and it was IB-PIA’s understanding that the financial position of the company was unaltered.

5.24 The PFW investigation continued

5.24.1 On 8 February 2000, having seen a reference to the PFW investigation in the monthly report from Enforcement to ExCo, IFSD requested, by e-mail, further information from Enforcement regarding the investigation and the potential implications for Equitable Life. This request was copied to IB-PIA which responded by e-mail setting out the background to the visit and stating:

“My understanding is that Enforcement did not find too many problems (so discipline case unlikely)... . Apologies if IB-PIA has not kept you in the loop... .”

5.24.2 When IFSD responded to IB-PIA stating that Enforcement was going to provide it with an update, IB-PIA further commented:

“my general feel is that Enforcement don’t have an appetite for this one. As it was not the normal style of referral - i.e. we did not pass them a visit report with rule breaches etc. - this is probably why it was not mentioned before.”

5.24.3 On 8 March 2000, Enforcement attended a meeting with IFSD to discuss the PFW investigation. The note of the meeting records that the issue of advice leading to the loss of a GAO was raised and that Enforcement had “left this to one side for the time being because of the uncertainty about companies’ obligations as a result of the Equitable Court case”. IB-PIA was not included in the meeting.

5.24.4 Following the meeting, on 9 March 2000, IFSD circulated the note of the meeting within IFSD (and to GAD) by e-mail stating that the investigation did not look too good but was not disastrous from a solvency perspective.

5.24.5 In March 2000, Enforcement prepared a further report on the PFW investigation summarising its findings in relation to Equitable Life’s sales of PFWs (the “March Report”). The March Report included details of the sample investor interviews conducted since the October Report. Interviews had been conducted with twenty investors who had received advice from an Equitable Life sales representative and seven of those investors had transferred to Equitable Life from another company (the remaining thirteen cases involving sales to existing Equitable Life policyholders). When asked whether the representative had discussed the availability of a GAO only one of the seven investors answered “Yes”. Three answered “No” and three were unsure. Enforcement had also ascertained that in 45% of the twenty four transfer cases (identified in the October Report), the policyholder was in fact entitled to a GAO. The March Report recommended a review of contracts where funds were

transferred to Equitable Life as these might have contained guaranteed or beneficial terms. The purpose of the review would be to ascertain whether investors were informed about the option of a guaranteed annuity or other beneficial arrangement.

5.24.6 The March Report concluded with consideration of the wider implications of the investigation, namely the impact on other firms and the future impact of the House of Lords' judgment in the Equitable Life Court case, and stated:

"If the House of Lords' decision is in [Equitable Life's] favour, then this could have an effect on the decisions of other product providers causing them to also reduce their terminal bonuses. The effect of this could potentially cause all investors who have the option of a guaranteed annuity in their contracts to lose the benefits of their guaranteed annuities. Therefore the investigation team considers that senior management should consider the wider implications before further work is undertaken."

5.24.7 The March Report did not consider the implications of an adverse judgment either for Equitable Life or for other companies and no further thought seems to have been given to this either before or after the House of Lords' judgment.

5.25 The June 2000 supervision visit

5.25.1 Following the judgment of the Court of Appeal, the principal supervisory activity carried out by IB-PIA in relation to Equitable Life was a monitoring visit to Equitable Life in June 2000. This visit was a routine visit which was not triggered by the GAO issues. It had already been planned and recorded in the OA-CSP prepared in October 1999 (as set out at paragraph 5.21 above).

5.25.2 Prior to the visit, on 22 May 2000, IB-PIA contacted IFSD by e-mail to inform it of the visit and to ask whether there were any "sensitive issues" of which it should be aware. IFSD responded asking whether IB-PIA would like any background on the company's financial position before the visit. However, IFSD stated that there was no immediate prospect of the company becoming insolvent and asked whether there were any particular issues that IB-PIA wanted to address. IB-PIA did not follow up on IFSD's offer to provide background financial information.

5.25.3 We have been told that, on 25 May 2000, IB-PIA attended a meeting with Equitable Life. In June 1999, GAO issues had been identified as a subject for discussion with Equitable Life (see paragraph 5.10.6 above). However, we have been told that, although GAO issues were discussed at the meeting, it was agreed that the forthcoming supervision visit would not assess any aspects of supervision relating to GAOs pending the outcome of the case. The supervision visit also refrained from looking at any PFW issues during the visit.

5.25.4 The supervision visit lasted from 12 June 2000 to 28 June 2000 and focused on a review of complaints and selling practices, in order to get a general picture of the company's compliance performance.

5.25.5 After the visit, on 29 June 2000, IB-PIA contacted IFSD to report that the visit had concentrated on selling practices and complaints and that, whilst there were "systemic issues" found in both areas, IB-PIA was confident that the issues arising

could be resolved by maintaining a “close and regular working relationship through a period of change”. The visit report indicates that the “systemic issues” related principally to deficiencies in record keeping (such as records of advice given to customers) and to the handling of complaints generally.

5.26 The Judgment of the House of Lords

5.26.1 Following the House of Lords’ judgment on 20 July 2000, IFSD circulated a number of e-mails regarding the outcome of the case to IB-PIA attaching FSA press lines and making reference to Equitable Life’s press release. The conduct of business section of GCD also received copies of two notes relating to the judgment prepared by IFSD on 20 and 21 July 2000.

5.26.2 One particular e-mail dated 20 July 2000 which was sent by IFSD to the Equitable Life college and to Enforcement stated that the company was still solvent but that its asset base was weakened, which would affect the bonuses payable to with-profits policyholders, and that it had decided to put itself up for sale. IFSD also took the opportunity to ask for information from the college regarding future activity or visits in relation to Equitable Life and to ask Enforcement whether there was any update to report regarding the PFW investigation, stating “we are now even more sensitive to any financial implications that may come out of this”. Enforcement did not provide a progress report in relation to the investigation until 1 September 2000.

5.26.3 On 21 July 2000, IB-PIA responded to IFSD stating that there were no issues arising from the June supervision visit that were expected to lead to discipline, but that IB-PIA would conduct quarterly visits to Equitable Life in the future combining short focused visits and continuing management dialogue. We have been told that this was a suggestion from IFSD to allow regular contact with Equitable Life and to enable the issues arising from the visit to be addressed.

5.26.4 IFSD subsequently prepared an “Action Plan” dated 24 July 2000 which indicated that the company’s financial position was “tight”. This was not provided to IB-PIA.

5.26.5 On 24 August 2000, IB-PIA attended a bilateral meeting with IFSD at which IFSD reported that the House of Lords’ judgment against Equitable Life would have implications for the company and the industry more widely. The minutes of the meeting state:

“The process of finding a buyer for Equitable Life was underway and it was hoped that a preferred candidate would be identified by December. It was envisaged that demutualisation would take place by June 2001, how achievable this was would depend to some extent on what were the intentions of the purchaser and hence how complicated the transfer scheme became. In the meantime, [Equitable Life] was just covering its solvency margin. The company had renegotiated a reinsurance agreement the continuation of which had been dependent on the company winning the Court case and this had given the company a bit more breathing space. However, the solvency position remained tight.”

5.26.6 In relation to this meeting, we have been told:

- (a) by IFSD, that the House of Lords' judgment and its implications for Equitable Life were discussed at some length at the meeting; and
- (b) by IB-PIA, that, as a result of the meeting, IB-PIA received the impression that Equitable Life was continuing to meet its solvency margins (although the buffer was relatively thin) and, on the basis of information received, IB-PIA did not have any reason to believe that Equitable Life should be required to make specific disclosures to new policyholders.

5.26.7 Following this meeting, IB-PIA was not aware of the continuing review of Equitable Life's position or subsequent meetings between IFSD and Equitable Life. For example, IFSD and GAD met with Equitable Life on 1 December 2000 and the note of the meeting (which was not shared with IB-PIA) indicates that there was only one realistic potential bidder and that the mode of sale proposed by that bidder caused concern both to Equitable Life and to the FSA. The meeting note also indicates that Equitable Life's lawyers at that time were considering the effect of insolvency on its members, in the light of the fact that Equitable Life is an unlimited liability company. However, the note further states that Equitable Life had not considered whether, after the House of Lords, with-profits policyholders could be excessively disadvantaged in a closed fund (due to the preferential treatment of GAR policyholders).

5.27 Consideration of GAR policyholders: Post "A" Day sales

5.27.1 No consideration was given to post "A" Day sales after the House of Lords' judgment until 16 October 2000 when some misdirected DTI papers relating to Equitable Life (but apparently unrelated to GARs) prompted IB-PIA to consider whether any action was required in relation to these. An internal hand-written note dated 17 October 2000 reads:

"Is there anything we should now be doing on this? I know we were going to about a year ago (my delay) - has the time passed?"

5.27.2 The conclusion reached by IB-PIA was that no further action was necessary by IB-PIA to establish the population of clients sold GAO policies by Equitable Life after "A" Day and assess how they had been dealt with, given that GAR policyholders could now exercise their GAOs and receive the same bonuses as other with-profits policyholders. Accordingly, on 3 November 2000, IB-PIA informed IFSD that it did not propose to take this potential conduct of business issue any further.

5.28 Consideration of GAR policyholders: Vesting and switching

5.28.1 No consideration was given by IB-PIA as to the impact of the House of Lords' judgment on the other issues that had previously been identified by IB-PIA such as advice at vesting and switching. We were told that existing GAR policyholders who had been disadvantaged (in light of the House of Lords' judgment) would be included in the GAR rectification scheme; that the liability for redress would total £200million for which Equitable Life had reserved; and that the total liability for GARs was estimated to be £1.5billion, which would be paid for by the retention of seven months bonus from existing policyholders and made good as a result of the sale.

- 5.28.2 We have also been told that IB-PIA assumed that IFSD was dealing with the implementation of the GAR rectification scheme for which Equitable Life was responsible and that IB-PIA did not contact Equitable Life during the Review Period to discuss or comment on the GAR rectification scheme.

5.29 The PFW investigation continued

- 5.29.1 Following the House of Lords' judgment, Enforcement's continuing investigation into sales of PFWs proceeded on the same basis as before. In particular, the part of the investigation which related to whether enquiries had been made about the availability of a GAR continued to be confined to policyholders transferring to Equitable Life from another company. The position of Equitable Life GAR policyholders was not reconsidered.

5.30 Consideration of Equitable Life's new sales and advertising

- 5.30.1 We have been told that IBD was not party to any discussions as to whether Equitable Life should be permitted to continue to write new business after the House of Lords' judgment because this was a matter essentially for the prudential regulator.
- 5.30.2 As for advertising, IB-PIA (Advertising) did not pay any special attention to Equitable Life's advertising after the House of Lords' judgment but, between the House of Lords' judgment and the closure to new business on 8 December 2000, certain complaints were forwarded to IB-PIA in connection with Equitable Life's advertising.
- 5.30.3 On 4 October 2000, Public Enquiries sent an internal memorandum to IB-PIA (Advertising) attaching a copy of a complaint letter that had been sent to Equitable Life about the fact that the company was spending money advertising products to new investors (when the "with-profits annuity is to remain at the same level as the previous year") and that advertisements made reference to the fact that Equitable Life had delivered consistently strong results since 1763. The memorandum from Public Enquiries stated that the letter had presumably been copied to the FSA for comment and asked IB-PIA to comment on whether Equitable Life's advertisements were misleading given the current situation of the company.
- 5.30.4 IB-PIA (Advertising) responded stating that, although it could see why the Equitable Life's advertising could cause annoyance to policyholders and may therefore be unwise, the company had all sorts of business activities of which guaranteed annuities was only one part:
- "Over the years the company has achieved a record of success and has a good reputation. I don't think the annuity issue totally overshadows that. I have not seen the advertisement in question and it is always difficult commenting in the abstract. But it looks like the claims are based on the past rather than the current position ..."
- 5.30.5 Public Enquiries subsequently drafted a response and sent it to IB-PIA by e-mail for comments. IB-PIA pointed out that the complaint letter had only been copied to the FSA (not addressed to the regulator) and stated:

“I guess we have a conflict between our general wish to be open and responsive and the practical issue that if we don’t see a problem, we don’t want to spend any time on it. ... I don’t think we need opine on whether the advertisement is misleading - if we aren’t asked the question, do we need to answer it?”

- 5.30.6 On 27 October 2000, Equitable Life sent a letter to one of its policyholders which appeared to be a response to a complaint about advertising. The letter pointed out that past performance figures were a matter of record, that the company was fully solvent and that “the temporary period for which bonuses were not allotted would be made good as a result of the sale of the Society”. The letter stated that it was Equitable Life’s intention and expectation, in negotiating the sale of the company, that the House of Lords’ judgment should not have any long-term adverse effect on the expectations of the policyholders (whether or not they held GAOs). The letter concluded by stating that Equitable Life was of the opinion that the advertisements complained of met the “relevant rules of the Financial Services Authority and the Advertising Standards Authority”. This reassured IB-PIA that Equitable Life was reviewing the content of its advertisements in the context of PIA Rules and considered them to be fully compliant.
- 5.30.7 On 3 November 2000, an internal IFSD e-mail referred to complaints received about recent press advertisements by Equitable Life, including allegations that the advertisements were misleading. At this stage, IFSD took the view that the company was solvent and so there was no reason why it should not advertise, so long as IFSD did not intend nor have any grounds to use intervention powers to stop the firm writing new business. The e-mail attached a draft letter in response to the complaints which explained that Equitable Life continued to maintain the required margin of solvency over its liabilities as required and that the FSA did not share the view that it should be prevented from marketing its products since this could be damaging to the business. The letter further stated that, given that there was “a realistic chance of a successful sale of the business”, newspaper advertisements inviting potential customers to request additional information from the company were not misleading.
- 5.30.8 The e-mail was copied to IB-PIA (including to IB-PIA (Advertising)) because of “the PIA interest in misleading advertising”. IB-PIA responded approving the draft letter. IB-PIA (Advertising) also commented that, although IB-PIA had received a few letters requesting that Equitable Life’s advertising campaign be curbed, it was not reasonable to seek to suspend legitimate advertising activity. However, the position could be affected if Equitable Life was believed to be in breach of its prudential requirements.
- 5.30.9 On 10 November 2000, IB-PIA concluded that it would “keep an eye on this issue” but that it did not believe it could act and agreed with the view expressed by IFSD.
- 5.30.10 On 13 November 2000, IB-PIA and IFSD were informed by Media Relations that newspapers had contacted the FSA about Equitable Life suggesting that there would need to be regulatory intervention if a buyer could not be found. The line that had been given by the FSA to the press was that, on present information, a profitable run-off was the worst that could happen and there was no disaster in the making.

- 5.30.11 In addition, Media Relations mentioned that the FSA had received several enquiries about how Equitable Life's advertisements could be anything other than misleading when "they quote the wondrous past without mentioning the more difficult present". However, Media Relations understood that Equitable Life had volunteered to withdraw its campaign. IB-PIA (Advertising) expressed surprise that Equitable Life was withdrawing its campaign and said that it was only aware of one complaint which had been forwarded to IFSD. IFSD responded confirming that it had not placed any pressure on Equitable Life to withdraw its campaign and stated "I don't think we should show anything but disinterest in response to public enquiries - it is a matter for the company". IFSD also approved the FSA line to be used if there was no successful bid stating "If we say anything else, we will simply be asked why we have not intervened already to protect policyholders in case a bid fails".
- 5.30.12 The following day, on 14 November 2000, Media Relations sent a further e-mail stating that the information regarding the withdrawal of Equitable Life's advertising campaign had been received from a journalist and so may not be accurate. IB-PIA (Advertising) suggested that the position should be checked with Equitable Life. IFSD subsequently checked the position and confirmed that the campaign had been dropped due to the negative publicity it was generating, but that this did not mean that Equitable Life had stopped advertising altogether. IFSD also reported that it had told Equitable Life that it had been giving a robust response to those who approached it, stating the company was solvent and continuing to trade so it was not a matter for the FSA to be concerned about. IFSD concluded by commenting that, hopefully, any future advertising would "recognise the sensitivities and be presented with a little more tact".
- 5.30.13 Later that day, IB-PIA (Advertising) confirmed to Media Relations and IFSD that the Equitable Life advertisements which had appeared in the "weekend papers" had been reviewed but that they contained nothing contentious, that Equitable Life's website was down for maintenance and that IB-PIA would take no further action. We have been told that, in accordance with standard practice, no copies of the particular advertisements reviewed have been retained.
- 5.30.14 On 23 November 2000 an internal IB-PIA e-mail indicated that, amongst other things, IB-PIA 'had its eye on' advertising issues regarding Equitable Life's "past performance and poor present".

5.31 Consideration of non-GAR investors

- 5.31.1 On 17 November 2000, IB-PIA was contacted by IFSD regarding a query from one of the potential bidders for Equitable Life. IFSD explained that, if the bidder acquired Equitable Life, it would close the with-profits fund to new business which would mean that no new policies would be issued but that existing policyholders would be able to make additional payments to top-up their existing policies. This was likely to be an attractive option to GAR policyholders who might seek to pay in as much as possible in order to maximise the value of their GAR and IFSD commented:

"This is expected to shift the Equitable GAR liability significantly upwards although, according to [the bidder], a figure can't be put on this because there are

too many unknown variables in the calculation. As things currently stand this means that other policyholders in the Equitable fund would have to meet these additional GAR costs. Therefore any additional payments to policies made by with-profits policyholders who don't have a GAR option are likely to end up subsidising those who do have GARs on their policies. The question that [the bidder is] asking is whether this would be regarded by FSA as mis-selling to those policyholders who don't have GARs."

- 5.31.2 IB-PIA referred this query to IB-Policy which advised, on 20 November 2000, (copied to IFSD) that this was difficult territory and it was not aware of the scope of Equitable Life's problem but that:

"If a firm has a series of GA and non-GAs so that future premiums must be accepted on the same basis and that the effect of paying for the liability for the GA is spread across all policyholders, then this will affect the reasonable expectations of future sales both GA and non-GA.

I think the key issue is whether the reasonable expectations for the new sales to existing policyholders is greater or less than asset share given that the firm knows about a possible strain on the funds. If it is less then the firm has serious problems since, I would suggest, the minimum PRE is asset share. If it cannot "promise" asset share, then the warning that you could get back less must be disclosed and I suspect would make it unsellable."

- 5.31.3 There was no apparent follow up with Equitable Life or with IFSD about this.

5.32 Reports and meetings

- 5.32.1 An explanation of meetings and reports as they form part of the structure of regulation is provided in **Chapter 2**. Set out below is a description of meetings attended by IBD or IB-PIA during the Review Period at which Equitable Life was discussed and reports within the FSA which referred to Equitable Life.

5.33 Reports to the PIA Board

- 5.33.1 In accordance with the PIA SLA, IB-PIA provided reports to the PIA Board. However, none of the reports which we have reviewed includes any mention of the issues arising in connection with GAOs either in general or in connection with Equitable Life.
- 5.33.2 As set out above, the only information that was provided to a member of the PIA Board about Equitable Life and GAOs was provided as a result of a request from that member on 23 August 1999. IB-PIA's response to the request was to provide a copy of the memorandum prepared by IFSD dated 5 July 1999 (despite the fact that IB-PIA had received a more recent note dated 12 August 1999).
- 5.33.3 It is evident that discussions took place in March and May 1999 between IB-PIA and the PIA Board in relation to the issues that had arisen in connection with the sale of PFWs and that the PIA Board was consulted in relation to the referral to Enforcement. Enforcement did not thereafter make any interim reports on the progress or findings of the PFW investigation to the PIA Board. We have been told

that it is not Enforcement's role to report ongoing investigations to the PIA Board. The Board only receives reports when an investigation has been completed.

5.34 IBD Quarterly Reports (to ChairCo)

- 5.34.1 IB-PIA also provided quarterly reports to the Board of the FSA. None of the reports that we have seen includes any mention, in the section which deals with regulatory issues, of GAO issues either in general or in connection with Equitable Life.

5.35 ExCo meetings

- 5.35.1 At ExCo meetings, IFSD reported on developments concerning Equitable Life and the progress of the Court case as part of the "Tour de Table" and assumed responsibility for action points relating to Equitable Life. No similar report appears to have been made by IBD on any of the conduct of business issues.

5.36 IFSD / IB-PIA bilateral meetings

- 5.36.1 These meetings were attended by the two heads of department and their managers. They were viewed as a chance to get together at managerial level "with an agenda of exchanging views on current issues" and were a means of improving the mutual understanding of what each other was each doing, at an informal level. GAO issues relating to Equitable Life were discussed at five meetings during the Review Period (in June, August, October and December 1999 and then in August 2000). These meetings are all dealt with, in context, above but the key points are summarised here:
- (a) In June 1999 IFSD reported that it was waiting for the end June regulatory returns to review the basis of reserving by firms against guaranteed annuities. IB-PIA reported it had received a legal opinion in respect of the PIA's jurisdiction over pre "A" Day sales.¹¹ It was noted that the key milestone would be the Court case and the implications for PRE.
 - (b) On 11 August 1999, there was a very short reference to the expected judgment to be delivered on 9 September 1999 with a comment that the case could go either way.
 - (c) On 11 October 1999, IFSD reported on the implications of the Equitable Life judgment. Notwithstanding the fact that the judgment was in favour of Equitable Life, IFSD reported that its current view was that Equitable Life had failed to meet PRE and so there was a possibility of intervention. Reference was also made to the fact that, in terms of conduct of business issues, there might, for example, be misleading bonus notices supplied to investors and firms may "have churned investors into new contracts without guarantees". It was noted that a memorandum on this had been prepared by IB-PIA and would be discussed at a meeting to be chaired by IB-PIA.¹²

¹¹ This was a reference to the advice received from GCD in June 1999, following the query received from the Consumers' Association referred to at paragraphs 5.11.5 and 5.11.6 above.

¹² This was a reference to the September Memorandum dealt with at paragraph 5.17.6ff above and to the meeting on 21 October 1999 referred to at paragraph 5.20.2 above.

- (d) On 10 December 1999, there was reference to the meeting which IB-PIA had held to discuss the Equitable Life GAO issue. IFSD now had information from Equitable Life regarding the number of GAO policies sold after "A" Day which would be passed to IB-PIA.
- (e) On 24 August 2000, IFSD reported that the House of Lords' judgment would have implications for the company and the industry more widely and that the process of finding a buyer for Equitable Life was underway. It was hoped that a buyer would be found by December. In the meantime, Equitable Life was "just covering" its solvency margin and had renegotiated the reinsurance agreement (which had given it a bit more "breathing space") but the solvency position "remained tight".

5.37 The FMC and the weekly notes

- 5.37.1 The FSA has only been able to locate one weekly note during the Review Period which mentions Equitable Life. This note is dated 7 December 2000 and refers to revised guidance that IFSD was considering issuing in relation to GARs after the House of Lords' judgment.

5.38 The College meeting

- 5.38.1 There was one college meeting during the Review Period, held on 26 November 1999 (referred to at paragraph 5.21 above). It was attended by IFSD and IMRO. IB-PIA was unable to attend. We have been told by IFSD that IB-PIA's non-attendance at this meeting was unfortunate. We have been told by IB-PIA that attendance at the college meeting would have been preferable but that IB-PIA commented on the OA-CSP and received a copy of the minutes.

5.39 Enforcement

- 5.39.1 In relation to communication between Enforcement and IB-PIA we have been told that, at the end of each month, a full print out of progress on cases being dealt with by Enforcement is provided to IB-PIA which forms the basis for the Enforcement/IB-PIA monthly management interface meetings. We have been told that Equitable Life was always the subject of an oral report at that meeting from Enforcement but the meetings were not minuted since they were internal liaison meetings which it was not considered justified to minute. As set out above, we have seen copies of two progress reports which include the PFW investigation (for December 1999 and January 2000). Neither document makes reference to any GAO related issues.
- 5.39.2 In relation to communication which involved IFSD, we have been told that it is for IB-PIA to update IFSD on the progress of Enforcement cases (unless there are special circumstances such as the possibility of using IFSD's powers to address a particular issue). We have also been told that there are no specific procedures for keeping IFSD informed in relation to matters referred to Enforcement but that college meetings and IB-PIA/IFSD bilateral meetings allowed for the exchange of relevant information and Enforcement also made a monthly report to ExCo. We note that, on 25 October 2000, a meeting was held between IFSD and Enforcement (but not attended by IB-PIA) to discuss the PFW investigation and that Enforcement did

not attend IB-PIA/IFSD bilateral meetings or the college meetings held as part of lead supervision.

Chapter Six

Overall Assessment

6.1 Preamble

- 6.1.1 Life insurance is, by its nature, a long-term business and, on the whole, problems tend to emerge slowly. Similarly, corrective action can often take time to deliver a solution. But, unlike banks, life insurance companies cannot re-price their products to reflect market changes.
- 6.1.2 To a large extent, the prudential regulatory requirements reflect these features of the life insurance industry and the need to maintain a strong solvency position that covers not only current conditions but can cushion adverse changes in the future. This is achieved by prudent valuation of the assets and liabilities, and the need to ensure that solvency can still be demonstrated in the event of a fall in equities and/or changes in interest rates. On top of this, most with-profits life companies hold substantial free assets which allow the company, despite the guarantees it offers, to invest in equities in the expectation that they will generate a higher return for their policyholders over time.
- 6.1.3 The weakness of a company with a low level of free assets can ostensibly be repaired by subordinated loans and accelerating the recognition of future profits by the use of implicit items and financial reinsurance agreements. These latter features may be viewed as mortgaging the future to strengthen the present and, when in place concurrently with little or no free assets, render the company poorly placed to withstand a major financial shock.
- 6.1.4 The scale of Equitable Life's potential liability from the unmatched interest rate exposure, which it created when it wrote its GAR business, and the scale of the future profits it had already taken into account combined to leave Equitable Life seriously exposed to any further financial shock.
- 6.1.5 Against the above background, the prudential regulator has to exercise judgements so that it is confident that the company will remain solvent and meet the reasonable expectations of policyholders, without intruding unreasonably into the management of the company.
- 6.1.6 Concurrently with, but in such circumstances subsidiary to, prudential regulation, conduct of business regulation will seek to ensure compliance with its rules, which are in the main aimed at ensuring that policyholders are properly advised about a company's investment products, and are not misled.

6.2 Introduction

- 6.2.1 In this Chapter we give an overall assessment of the discharge by the FSA of its functions under the ICA 1982 and by the FSA of its functions on behalf of the PIA under the FSAct 1986 during the Review Period. For this assessment of the FSA's performance to be understood in its proper context, certain important considerations about the nature of the problem and the environment in which the regulator was then operating should be borne in mind.

- 6.2.2 When responsibility for the prudential regulation of Equitable Life was transferred to the FSA, the treatment by Equitable Life of its GAOs was already a high profile, “live” issue and was the subject of discussions which had been initiated by HMT-ID. In late December 1998, Equitable Life had decided, on its own initiative, to commence proceedings in the High Court to test the lawfulness of the terminal bonus practice which it had adopted in respect of the GAOs.
- 6.2.3 The guarantees had been included in policies which had been written many years before the FSA assumed responsibility for the prudential regulation of the insurance industry. It is important to recognise that, once the GAR took effect (which, being leveraged, it did rapidly), there were no quick solutions or cures for a company in the position of Equitable Life, a mutual with-profits insurer which had limited free assets. In the event of such a contingent liability crystallising (which was the effect of the House of Lords’ judgment), the only viable option open to it was to raise external additional capital by putting itself up for sale.
- 6.2.4 Accordingly, applying hindsight, it is fair to say that, by 1 January 1999, the “die was cast” and we have seen nothing which the FSA could have done thereafter which would have mitigated, in any material way, the impact of the outcome of the Court case as far as existing policyholders were concerned, or made any material beneficial difference to the final outcome so far as Equitable Life was concerned.
- 6.2.5 That said, our assessment does identify a number of things which the FSA could have done better. There were occasions when both the prudential and the conduct of business regulators did not spot issues to be addressed or, having spotted them, did not follow them up. The significant instances of these we set out below. One of the reasons why issues were missed was the poor level of communication and co-ordination between the two arms of regulation, prudential and conduct of business. We look at this in more detail at the end of this Chapter.

6.3 The Regulatory Environment

- 6.3.1 As is set out in the FSA publication “New Regulator for the New Millennium”, the FSA is developing a new risk-based regulatory approach to deliver its statutory objectives effectively and efficiently. This new way of working is being introduced progressively in preparation for N2.
- 6.3.2 Therefore during the Review Period the process of integrating the various regulators and creating a new regulatory culture was in its infancy. Until FSMA 2000 comes in to force at “N2” and with the old regulatory structure, including the continued existence of the SROs, still in place, the *de facto* integration of the regulatory structure remains subject to constraints. The new approach is intended to provide greater focus of the FSA’s monitoring of and influencing those institutions and activities which are likely to pose the greatest risk to consumers and markets, and the FSA will take account of the proper responsibilities of consumers themselves and of firms’ management. The Review Team recognises that it takes time for both structural and cultural changes, which the FSA has determined to adopt, to be implemented and to take effect.
- 6.3.3 We also acknowledge that the FSA has finite resources and, as a consequence, is continually exercising its judgement of risks to determine how to deploy its resources

to best effect, having regard to “proportionality”, “economy” and “efficiency”. During the Review Period, in addition to “business as usual”, its senior management was also heavily engaged in preparing for the new regulatory regime and other projects. Representations have been made to us, particularly in the context of IB-PIA where the ratio of “client base” to resources is very much higher than in other divisions, that this was a distraction from the routine work of supervision.

- 6.3.4 Without undertaking a review of all other work for which the FSA was responsible it is not possible to comment except to say that (a) IFSD did not see lack of resources as an issue in the prudential regulation of Equitable Life, and (b) we do not consider that the points we make in this assessment necessarily require anything other than a moderate increase in resource, but rather a better application of resource. However, additional resources will be needed by the prudential regulator of insurance companies if it is to meet the demands of the new post N2 regulatory regime. This matter is referred to in our recommendations of lessons to be learned.

6.4 The Review Team’s Approach

- 6.4.1 The purpose of the FSA Board in commissioning this Review was to learn the lessons from this episode. This necessarily requires us to form conclusions about how the task of regulation was managed during the Review Period. Comments which are critical of the FSA, any person or entity, may have been informed by hindsight, which we have not sought to exclude, and are included only for the purpose of identifying how things can be done better in the future.
- 6.4.2 Any assessment of the FSA’s and the PIA’s discharge of their respective functions can only be done by reference to their respective duties and powers. These are set out in detail in **Chapter 2**. This Chapter assesses the performance of each of the regulators separately. In each section a short summary of the relevant regulator’s duties and powers is set out and its performance is then assessed. The Chapter concludes with some general comments about the co-ordination and communication between the two regulators.

Prudential Regulation

6.5 The FSA’s duties and powers

- 6.5.1 The FSA’s general responsibilities are set out in the Schedule to the Treasury SLA:

“[To protect] policyholders against the risk of company failure and, more specifically, to protect them against the risk that UK authorised insurers might be unable to pay valid claims. In the case of life insurance companies this includes the risk that they will be unable to meet policyholders’ reasonable expectations. The Treasury and FSA agree that it is neither realistic nor necessarily desirable in a climate which seeks to encourage competition, innovation and consumer choice, to seek to achieve 100% success in avoiding company failure. The FSA will therefore pursue its supervisory objectives by aiming to minimise, but not eliminate, the risk of company failure by identifying early signs of trouble, and taking preventative action.”

6.5.2 The Schedule further states that the supervisory resource will be focused on the following:

“Monitoring the financial soundness of insurers, to see that they are run in a sound and prudent manner by fit and proper people, based mainly on the scrutiny of financial returns and other information (with the assistance of the Government Actuary’s Department particularly in the case of life companies), and site visits.”

“While these objectives [of FSMA 2000] are not yet enacted they serve to inform the general approach the FSA proposes to take during the period prior to the new legislation coming into force.”

6.6 Assessment - Prudential Regulation

6.6.1 At the outset IFSD, advised by GAD, (“**the prudential regulator**”) addressed the issue of reserving for the guarantees in a resolute manner. There were, however, some particular issues which the prudential regulator missed or failed to follow up, with which we deal below. Subsequently, the prudential regulator and the senior management at the FSA were surprised by the outcome of the Court case and then by the failure of Equitable Life to find a buyer.

6.6.2 Because the outcome of those events could not be predicted with any certainty, it was important to be prepared for all likely eventualities. In respect of this episode, we believe that if the prudential regulator had been more proactive and adopted a more challenging, carefully co-ordinated and researched approach, then it would have allowed itself more time and been better informed, to consider in conjunction with Equitable Life, how best to manage the consequences for the policyholders of the judgment of the House of Lords. It would also have been in a position to reflect more carefully on what information Equitable Life should have been giving to policyholders, both existing and potential, before and after the House of Lords’ judgment.

6.6.3 Although we have already said the “die was cast”, this does not absolve the prudential regulator from its duty to consider what possibilities there might have been to mitigate the effect of any “fall out” for policyholders. In different circumstances there may have been other opportunities or more difficult choices to be made.

6.6.4 Nor do we believe that the approach, which we have suggested should have been adopted, would necessarily have involved committing anything other than a modest increase in resources over those already deployed by the regulator at the time.

6.6.5 We now turn to more specific issues.

6.7 Reserving

6.7.1 Throughout the discussions with Equitable Life, HMT-ID and, after 1 January 1999, IFSD (both advised by GAD) maintained that the level of reserves which Equitable Life had established for GAOs was inappropriate and that Equitable Life needed to establish reserves at, or close to, 100% of the full value of the GAOs. In the regulator’s view, prudence required that GAOs be fully reserved.

6.7.2 We believe that the position adopted by the prudential regulator was appropriate and that it was right to require that this level of reserves be established.

6.7.3 We consider that the prudential regulator addressed the issue of reserving for the guarantees in a resolute manner notwithstanding the stance adopted by Equitable Life in defence of its views on reserving. In the event, the regulator's view prevailed and Equitable Life agreed to establish higher reserves in its 1998 regulatory returns.

6.8 Reinsurance Agreement

6.8.1 Equitable Life was to a large extent assisted in establishing these higher reserves for the year end December 1998 by entering into a financing reinsurance agreement. The agreement was only effective as long as Equitable Life did not change its terminal bonus practice. If such a change occurred the reinsurance offset would collapse, reducing the level of solvency significantly. It is not for the regulator to decide whether or not to accept a reinsurance agreement entered into by a life company as a means of complying with its statutory reserving requirements. The Appointed Actuary's reserving decision is his own and is one which is required to be prudent and is governed by his statutory and professional duties. The regulator may intervene if it considers that the Appointed Actuary's decision in relation to reserving or reinsurance is a breach of the criteria of sound and prudent management. Reinsurance agreements are permissible under the reserving regulations. In the circumstances of this case, we do not consider that it would have been reasonable for the regulator to have intervened on the grounds that there was a breach of the criteria of sound and prudent management.

6.8.2 However, in its regulatory returns, Equitable Life did not disclose that the reinsurance cover effectively remained in place only for as long as Equitable Life did not change its terminal bonus practice. We consider that IFSD should have required the disclosure of this condition of the reinsurance agreement in the regulatory returns for the following reasons:

(a) One of the reasons for requiring Equitable Life to make early submission of the 1998 returns was to ensure that policyholders and potential policyholders were not misled as to the company's financial strength. Accordingly, we consider that a decision not to require disclosure of this condition of the treaty was inconsistent with the reasoning behind the requirement for early submission by Equitable Life of its 1998 regulatory returns.

(b) It was also inconsistent with the view taken by HMT-ID in December 1998 when, in a letter to Equitable Life in December 1998, it had expressed an expectation that an appropriate statement on contingent liabilities should appear in its 1998 returns related to the risk of a successful challenge to its terminal bonus practice. This statement itself never appeared in the regulatory returns and IFSD did not pursue this point with Equitable Life, despite the fact that in the meantime Equitable Life had commenced court proceedings to determine whether the practice was lawful.

6.8.3 The reinsurance agreement was not signed by IERC until 30 September 1999 and by Equitable Life until 11 October 1999. Credit had been taken for the reinsurance agreement in the 1998 regulatory returns, which were submitted to the FSA in March

1999. IFSD was confident that Equitable Life had a clear intention to enter into it and knew that heads of agreement had been discussed before the end of 1998. However, we are concerned that reliance should be placed by the regulator on an agreement which was material to Equitable Life's ability to comply with its statutory solvency requirement when that agreement had not been executed by both parties.

6.9 Resilience test

6.9.1 We were told that GAD reviews the regulatory returns, and will seek "to clarify points, which are unclear" but does not audit them. During the Review Period, in Schedule 4 paragraph 7(8)(a)(ii) of the regulatory returns for 1998 and 1999, it was stated that:

"for all accumulating with-profits business, an annual loading of .25%o [*this figure varied year on year*] increasing by 4% per annum compound of the basic benefit was reserved which is considered to be a prudent allowance for ongoing expenses: for accumulating with-profits pensions business, ½% pa of the benefit value has been deducted for each year up to the date it is assumed that benefits will be taken as a charge for expenses."

6.9.2 The second part of this disclosure (following the colon) is unclear in the context and therefore in our view should have been questioned. It described practices that did not conform to the expectations of GAD. Eventually GAD was alerted to the issue in late 2000 when it requested and was provided with copies of the Ernst & Young reports which were prepared to assist potential purchasers in the bid process. We understand that it was amended in the regulatory returns for 2000. The negative impact on solvency of removing the ½% pa was estimated by Ernst & Young to be just under £1 billion.

6.9.3 Had the prudential regulator enquired about the wording, it would have recognised sooner a significant weakness in Equitable Life's solvency position. Fortunately, when it was identified, there was a significant compensating adjustment in respect of a different hypothecation of assets in the sum of £800 million within the resilience test.

6.10 Increments

6.10.1 During the Review Period, GAD was aware of the existence of entitlements in GAO policies to pay additional premiums (or "top-up" the policies), which themselves would attract the GAR. However, the prudential regulator did not question the reserving basis for these, despite information received from Equitable Life in response to the GAD survey in 1998 that such entitlements were available. The issue of exposure to top-ups was considered further at a meeting in November 1998, in a telephone conversation between GAD and the Appointed Actuary on 29 January 1999 and later in October and November 1999 in the context of a question from IB-PIA regarding the number of top-ups to GAO policies. Further, neither IFSD nor GAD appear to have appreciated the significance of the fact that the exposure could neither be reliably quantified nor capped.

6.10.2 Had IFSD or GAD identified this issue sooner, it might have heightened their awareness of the possibility that Equitable Life's liability to GAR policyholders

might be significantly increased by top-ups after the House of Lords' judgment and they might have recognised a potentially significant obstacle to the sale of Equitable Life.

6.11 Operation of the Insurance Supervisory Committee

- 6.11.1 Shortly after the House of Lords hearing and before the judgment, Equitable Life requested a Section 68 Order permitting a proportion of future profits to be counted towards solvency in the regulatory returns for 2000. Prudential Guidance issued in 1984 states that such Section 68 concessions "will be readily available" and it is our understanding that it had been the practice to grant them, provided that the requirements in the regulations had been satisfied.
- 6.11.2 A paper was prepared by IFSD, after the House of Lords' judgment, incorporating advice from GAD, to the ISC inviting them to approve a recommendation to HMT to grant approval of this item. However, this was a short paper and only summarily dealt with the wider background. It did not consider the cumulative effect that this implicit item, the subordinated loan and the reinsurance agreement had on alleviating Equitable Life's weak regulatory capital base and the impact this in turn may have on its ability to meet the reasonable expectations of potential policyholders.
- 6.11.3 The paper did not mention that the summary figures for solvency provided by Equitable Life were based on an older, weaker resilience test than the one GAD considered appropriate for current conditions. Although the adoption of any particular resilience test is not compulsory, it is notable that, had the normal test been used, Equitable Life would have failed to meet its RMM without the implicit item requested. Also the paper did not mention that GAD's advice had been given before the House of Lords' judgment even though the decision was being taken after that judgment. Without meeting (although with an opportunity for members to comment) the ISC approved the Order.
- 6.11.4 In the circumstances, we do not disagree with the approval of the Order. For the ISC to have refused the application would have been exceptional and inconsistent with allowing Equitable Life to continue to write new business while seeking a buyer. However, we consider that the process leading up to the decision was flawed, because important issues were not highlighted or explained to the ISC.

6.12 The Court case

- 6.12.1 Equitable Life had already decided to embark on the Court action when the FSA assumed responsibility for its prudential regulation. The decision to bring the proceedings in late December 1998 was taken, so HMT-ID was told, on the advice of Leading Counsel, in order to "confirm that the Society's directors had acted entirely properly and within powers in adopting the terminal bonus practice."
- 6.12.2 We have considered whether the FSA should have sought to become involved or intervened in an appropriate way in the Court case given the potential implications for the industry. We were told that this possibility was considered, albeit briefly, by IFSD, GAD and GCD following a meeting with Equitable Life, but it was not pursued. In interview we were told that it was perceived that there would be real resistance from the Court in allowing a public body to intervene in what was

essentially a contractual dispute between private parties. The Order which was made by the Court on 23 February 1999 provided that Mr Hyman was to represent the interests of all policyholders or former policyholders of Equitable Life who had an interest in a policy containing a provision for GARs. The Court also ordered that Equitable Life was to represent the interests of all other with-profits policyholders and so all the relevant interests were represented before the Court.

6.12.3 It was suggested that one possible role which the FSA could have played in the Court case was to set out its views on PRE, in particular the balance which needed to be struck, within a mutual fund, between the expectations of the GAR and the non-GAR policyholders. However, in its application to the Court, Equitable Life had sought confirmation that it was entitled to adopt its differential terminal bonus practice either as a result of the discretion afforded to the directors in the Articles of Association or as a matter of contract. PRE was not one of the issues which was directly raised by Equitable Life's originating summons. Given the terms of the Court's Order of 23 February 1999, namely that Mr Hyman represent the interests of all GAR policyholders and Equitable Life represent the interests of all other with-profits policyholders and given the issues raised on the face of Equitable Life's originating summons, we find it difficult to identify either on what basis the FSA could have sought to become involved in the case or what value would have been added by its involvement.

6.13 The decision to defer consideration of PRE

6.13.1 In the latter part of 1998, HMT-ID had been provided with various examples of communications sent by Equitable Life to its policyholders to enable it to consider whether Equitable Life's terminal bonus practice was consistent with PRE. However, Equitable Life's decision to initiate the Court case caused the regulator to defer reaching a conclusion on its consideration of PRE until after the Court case. The view was taken that, in order to reach a decision on PRE, it would have been necessary, amongst other things, to reach a view on the terms of the contract and this was one of the questions which was before the Court. We agree that this was the right decision.

6.13.2 However on a number of occasions, most notably at the time of the hearing at First Instance, it was recognised by IFSD and others that, if the Court did not definitively resolve the matter from the PRE perspective, then the FSA would have to undertake a significant exercise to determine whether there was a risk that Equitable Life would be unable to meet PRE. If such a risk was identified then the regulator would have grounds to intervene. IFSD therefore recognised that in the circumstances it was desirable that work be undertaken ahead of the judgment to ensure they were in a position to reach a preliminary view within a reasonable time period thereafter. We have seen little evidence of any concerted effort to complete that preliminary review, although IFSD did initiate an exchange with IB-PIA seeking their views on their powers in respect of bonus notices and as to whether the notices were misleading or not. PRE was viewed as a particularly nebulous concept and the absence of a framework within which to determine the issue undoubtedly added to the difficulties facing IFSD in assessing Equitable Life during this period.

6.13.3 We believe that a more concerted effort to carry out that preliminary work on PRE would have been beneficial for three reasons. Firstly, it would have informed the

regulator so as to enable it better to judge the PRE implications of any decisions taken by the Equitable Life following the outcome of the Court case. Secondly, it would have assisted in identifying earlier and more conclusively the appropriate division of responsibilities as between the prudential and conduct of business regulators for monitoring and, if appropriate, reacting to information disseminated by Equitable Life to its policyholders during the currency of the policy. Thirdly, work undertaken on this topic would have been valuable input to the development of the new regulatory regime.

6.14 Financial Projections

- 6.14.1 When the FSA assumed responsibility for the prudential regulation of Equitable Life, a number of financial issues remained in play which had been the subject of discussions between HMT-ID and Equitable Life in late 1998. These issues included the low solvency cover of Equitable Life in general and, in particular, the appropriate level of reserves which Equitable Life should establish for GAOs.
- 6.14.2 IFSD wrote to Equitable Life in early 1999 requesting further information to help form a better understanding of the current financial condition and resilience to changing investment conditions. Over a period of time, some, but not all, of this information was supplied, including certain projections indicating that in a “low” investment scenario (albeit with benign equity performance) taken together with the loss of the Court case (although not in the worst case scenario that eventually transpired), the position would become “unacceptably tight”.
- 6.14.3 Although the information indicated a potentially serious situation, it was not enough to give IFSD or GAD a full and sufficient understanding of:
- (a) the potential impact of volatile investment conditions in the short and medium term on Equitable Life’s weak financial position;
 - (b) the risk of Equitable Life failing to meet its RMM;
 - (c) Equitable Life’s ability to declare bonuses under less benign investment conditions; and
 - (d) the risks faced by incoming policyholders.
- 6.14.4 In circumstances where Equitable Life had substantially exhausted its ability to recognise future profits implicit items, a better understanding of the matters set out at (a) to (d) above would have enabled the FSA more appropriately to assess the threat not only to Equitable Life’s future solvency and but also to its ability to meet PRE. Such an understanding would have better informed any consideration by IFSD as to whether it needed to take any further action, whether informally or formally, to protect policyholders or potential policyholders. It would also have better informed the scenario planning done for the outcome of the Court case.

6.15 Planning for the Court judgments

- 6.15.1 Although we agree with the FSA’s decision not to become involved in the Court case, we do think that IFSD was insufficiently prepared for the House of Lords’ judgment to be able to react appropriately to events and to any decisions of Equitable

Life which might have flowed from the judgment. The lack of preparedness stemmed from a lack of scepticism about the outcome of the legal proceedings, based partly on a misconstruction of the legal briefings which had been received about the nature of the decisions of the judges in the Court of Appeal, and partly as a consequence of being influenced by Equitable Life's confidence in its case.

- 6.15.2 The scenario planning document produced by IFSD in consultation with GAD and GCD in July 1999 was perceptive. It recognised the possibility that the Court Order would mean that Equitable Life would have to reduce substantially the bonus paid to all with-profits policyholders if "ring-fencing" was not accepted by the Court. This was the effect of the House of Lords' judgment. It also predicted the possibility that a reduction in bonus might precipitate, amongst other possibilities, a take-over bid. It did not go so far as to envisage Equitable Life being forced to put itself up for sale. That was where the scenario planning process stopped.
- 6.15.3 GAD had suggested that these scenarios be considered alongside the financial projections as presented by the Appointed Actuary to his Board in April 1999. GAD had remarked on the Appointed Actuary's concerns that, in certain conditions (not a "worst case" outcome), "the position (of Equitable Life) would become impossibly tight" and expressed the view that worse results could arise if further "tweaks" were applied to these projections. Further information from Equitable Life was provided, and although this gave no comfort, nothing more of any substance was done on scenario planning until the meeting with Equitable Life on 18 July 2000, which was just two days before the judgment of the House of Lords.
- 6.15.4 We believe that closer and more informed scrutiny, at an earlier stage, of the financial implications of the possible outcomes of the Court case, which had been foreseen in the scenario planning, would have given the regulator more time to reflect on how to react appropriately to any courses of action proposed or taken by Equitable Life in response to any ruling of the Court. It was recognised that this could either have a materially adverse financial impact on Equitable Life or leave the PRE issue to be resolved by the regulator.
- 6.15.5 Following the Court of Appeal's ruling that Equitable Life's terminal bonus practice was unlawful, IFSD, in its analysis of the risks for Equitable Life and accordingly in its conduct of the company's regulation, appears to have focused too much on the *obiter* statements made by Waller LJ which suggested that Equitable Life was permitted to "ringfence". If the FSA had not placed such reliance on the statement of Waller LJ, it might have seen more clearly that the letter which Equitable Life had sent to its policyholders in February 2000, following the judgment in the Court of Appeal, required review to ensure it was not misleading. On the information available to us, we cannot and do not express a view as to whether the contents of this letter were misleading or not, but the letter should have been sent by IFSD to IB-PIA to be reviewed and discussed; in particular, IFSD should have raised with IB-PIA what action, if any, either of the regulators could or should take to protect the interests of policyholders. It may have triggered an investigation into whether other statements made by Equitable Life to potential policyholders at that stage were misleading.
- 6.15.6 That Equitable Life might lose as it did in the House of Lords first became a real possibility for which IFSD needed to plan in detail, at a very late stage,

notwithstanding the fact that it had been identified earlier in the scenario plans prepared in the middle of 1999. As a result, IFSD was not prepared for the outcome in the House of Lords.

- 6.15.7 We would have expected IFSD to have adopted a more sceptical approach to Equitable Life's assertions about its prospects of success in the case and to have been more proactive in considering the implications of the possible final outcome; in particular, even though, albeit late in the day, it appears that the FSA was aware on 4 July 2000 that Equitable Life had received an indication that it might lose in the House of Lords, it did not arrange an internal meeting to discuss the implications of this news nor was a meeting with Equitable Life arranged as a matter of urgency. In the event, a meeting only took place with Equitable Life on 18 July 2000 at Equitable Life's request by which time Equitable Life had already committed itself to the decision to put itself up for sale in the event that it lost in the House of Lords.
- 6.15.8 Representations have been made to us about the risks of a regulator being too interventionist and that a regulator's responsibilities are confined by the legislation to "allowing the company to determine its own strategy, intervening (whether by persuasion or by use of its statutory powers) only where that strategy was inconsistent with its regulatory obligations". We acknowledge that within the existing regime these are real constraints on actions which the regulator may otherwise wish to take, but we would add that a regulator also has to have regard to situations where there is a risk of a breach of the regulations.
- 6.15.9 We do not go so far as to suggest that the regulator should necessarily have intervened in this case, *i.e.* objected to Equitable Life's proposal to put itself up for sale but, in the meantime, to continue to write new business, as this would depend on there being appropriate grounds. In any event, the decision to allow it to do so was supported by valid reasons. But to be certain of making the right decision in the circumstances we do say that it is for a regulator to keep itself properly informed in such a situation. If the FSA had been better informed it would have been better prepared to react to any course of action proposed by Equitable Life and to assess its compliance with the regulations and the impact on the reasonable expectations of existing and potential policyholders.

6.16 The Bid Process

- 6.16.1 At the meeting on 18 July 2000 Equitable Life sought confirmation from IFSD that it would not take any "precipitous action" in the event that the House of Lords held that Equitable Life could not pay a different rate of bonus on GAO policies. Equitable Life noted particularly the importance of remaining open to new business in order that the value of the sales force was maintained. IFSD's response was to "reassure" Equitable Life that it would not rush to take remedial action in these circumstances although it would need to be convinced that a suitable buyer for the Society could be found quickly. It is not clear that the impact of this stance on policyholders, existing and potential, was given full consideration either ahead of this reassurance or immediately afterwards.
- 6.16.2 The FSA worked hard to ensure that all regulatory queries raised by potential bidders were answered promptly, but the FSA was subsequently surprised by the failure of Equitable Life to find a buyer. We consider that a lack of detailed financial

information about Equitable Life (particularly as to the implications of the House of Lords' judgment), combined with over-reliance on statements made by Equitable Life and in the press, contributed to IFSD adopting an optimistic view of the saleability of Equitable Life both immediately preceding and following the House of Lords' judgment.

- 6.16.3 It should be said that most of the rest of the market shared IFSD's view and was also surprised by the failure of the bid process, but equally, at least at the outset of the bid process, IFSD had access to more information about Equitable Life's true financial state than the rest of the market and so it would not be unreasonable to expect the regulator to have a more informed view.
- 6.16.4 When it came to scenario planning for the House of Lords, we consider that, if IFSD had obtained from Equitable Life earlier more detailed financial information, including an analysis of PRE and had appreciated the implications of the entitlement in GAO policies to pay additional premiums, it would have been more alive to the possibility that no buyer would emerge and the resulting consequences for policyholders, existing and potential. As a result it would have been in a better position to react appropriately to any proposals from Equitable Life emanating as a consequence.

Conduct of Business Regulation

6.17 The Conduct of Business Regime

- 6.17.1 The conduct of business regime relates primarily to the marketing and sale of retail investment products and advising investors on their rights in relation to such products. The PIA Mission Statement defines the aim of the conduct of business regulator to be to "protect investors by the regulation and supervision of the retail investment sector, enabling investors to make properly informed decisions in an open competitive and innovative market place."¹

6.18 Assessment: Conduct of Business

- 6.18.1 The issues concerning the GAOs were generally perceived by all at the FSA to be principally a matter for the prudential rather than the conduct of business regulator. The potential relevance of these issues for the PIA was identified and notified by HMT-ID to IBD soon after GAOs had been identified as a regulatory problem, in September 1998, but the significance of the matter was never picked up within IBD or IB-PIA at a sufficiently senior level for it to be accorded a suitably high profile. The supervision of the conduct of business aspects of the Equitable Life case which followed thereafter was impaired, both as regards procedure and substance.
- 6.18.2 We have attributed this to the lack of a suitably planned and structured approach and a poor level of communication and co-ordination between IFSD, IBD/IB-PIA and Enforcement. We also detected a reluctance by the staff to get involved and take

¹See PIA Press Release 1995 entitled "PIA Issues Report and Financial Statements for 1994/95" at Note 2

“ownership” of the GAO issue. The consequence of this was that there was little or no continuity of management and an absence of any individual or team who would be responsible for seeing a matter through to its proper conclusion.

- 6.18.3 IB-PIA's responsibilities in this case are most conveniently dealt with by reference to the monitoring of the advice and information given (a) to existing GAR policyholders regarding the value of a GAO and (b) in relation to new investment in Equitable Life's with-profits fund.

6.19 Advice and information regarding the value of a GAR

- 6.19.1 The potential value of a GAR was a matter of material interest to a policyholder investing in a GAO policy either for the first time or subsequently by way of top-up.
- 6.19.2 The actual value of a GAR was also a matter of material interest to an existing GAR policyholder who was (a) considering switching his investment to a new product which would mean he would relinquish his entitlement to a GAR (such as a PFW) or (b) deciding whether and when to purchase an annuity at vesting.
- 6.19.3 After the issue of the GARs first confronted it in 1999, IB-PIA subsequently came to the view that, until the uncertainties about matters concerning the GAR were resolved by the Court, there were no grounds for suspecting any breach of PIA Rules, and accordingly there was little for IB-PIA to do pending the outcome of the case. Some preliminary steps were taken to find out the size of the potential issue for IB-PIA, particularly given that most GARs had been sold well before the FSAct 1986 came into force, and how this product had been marketed. After the House of Lords had resolved the issue in a way which attributed a value to the GAR, the associated issues for the conduct of business regulator, which had been postponed pending the Court's decision, were not restored for further consideration.
- 6.19.4 Our examination of how IB-PIA (with Enforcement) reached its views and the steps it took discloses a process which was symptomatic of the lack of a planned and structured approach. Issues raised tended to be dealt with in isolation and other potential issues concerning advice and information about the value of the GAO were missed.
- 6.19.5 As to process, by January 1999 IB-PIA was aware of the problem. The memorandum of 20 January 1999 had identified the issues and suggested that the 'obvious first step' would be to find out the scale of the problem, in particular the number of sales which had occurred after the FSAct 1986 had come into force. But, apart from an inconclusive visit to the PIA Ombudsman and despite concerns raised by the Consumers' Association, nothing was done to follow through on the suggestions in the memorandum until in September 1999 IB-PIA was prompted to review this matter by the circulation of a note prepared by GCD explaining the decision of the Court of First Instance, which made some oblique references to issues for the PIA. It was only following this note that a meeting was arranged in October 1999 between representatives of all divisions of the FSA. This was the first such meeting dedicated to matters concerning Equitable Life.
- 6.19.6 At this meeting it was agreed that no action could be taken in respect of advice and information given to a GAR policyholder about the value of a GAR until the Court

case was resolved but that the number of post “A” Day sales and top-ups should be ascertained. As a result of the meeting, for the first time, the number of post “A” day sales was elicited from Equitable Life by IFSD in correspondence. The information about the number of top-ups was not provided by Equitable Life nor pursued by IB-PIA.

- 6.19.7 The substantive decision taken in October 1999 was to seek information regarding the number of post “A” Day sales and top-ups but to postpone any review of the advice and information provided to GAR policyholders regarding the actual value of the GAO (whether at the point of sale or on vesting or switching) pending the outcome of the case. This approach was, in our view, correct. However, in the case of advice being given at vesting and on switching, IB-PIA’s consideration of the issues was not sufficiently thorough because it did not take into account the further possibility that the uncertainty regarding the outcome of the litigation and the potential value of a GAO might itself be something which merited disclosure to a GAR policyholder. The PIA Rules require that representatives should, in the course of any relevant business dealings with an investor, give the investor all information relevant to those dealings and we take the view that the fact that the value of a GAO was the subject of a current court action was information which would be relevant to an investor who was deciding whether to vest or to switch.
- 6.19.8 We note also that, concurrently with IB-PIA’s consideration of possible switching by Equitable Life of GAR policyholders out of GAO policies, Enforcement had themselves been tasked by the Board of the PIA to investigate Equitable Life’s marketing of PFWs, which involved GAR policyholders relinquishing their entitlement to GARs. We understand that, for the same reasons as IB-PIA (i.e. that advice to Equitable Life GAR policyholders about the value of a GAO could not be assessed pending the outcome of the case), this investigation was confined to switches from GAO policies issued by other life companies. However, no link appears to have been made between the possible switching of Equitable Life GAR policyholders and the Enforcement investigation. Subsequently, Enforcement did not provide IB-PIA with a copy of the investigation report produced in October 1999 until requested to do so in January 2000 and provided IFSD with no information on the matter until requested to do so in February 2000. Nor did Enforcement subsequently consider the potential impact of a decision against Equitable Life on the scope of the investigation.
- 6.19.9 After the House of Lords’ judgment, when the uncertainty as to the value attributable to the GAOs had been resolved, the queries concerning the advice given about the GAR at the point of sale or when topping-up fell away. For GAR policyholders who had relinquished their GAOs on switching or vesting, there remained the possibility of an entitlement to compensation. The House of Lords’ judgment did not trigger a review by IB-PIA of its earlier decisions to postpone consideration of these particular issues pending the outcome of the Court case. Furthermore, no steps were taken to consider whether the judgment might give rise to new issues for IB-PIA or Enforcement to address.
- 6.19.10 When IB-PIA did revisit the issue of post “A” Day sales, it was only as a result of being prompted by a chance misdirection of papers. As to the matter of compensation for those who had switched or vested, IB-PIA never raised this with

Equitable Life or IFSD during the Review Period in order to satisfy itself that due consideration was being given to the structure of the GAR rectification scheme.

- 6.19.11 We accept that IB-PIA would normally be entitled to assume that, in the absence of any evidence to the contrary, a life company would provide adequate compensation to all investors so entitled. However, in the circumstances of such a high profile case as Equitable Life, where the potential compensation issues were so complex and where IB-PIA was told that the company's free asset base was weakened and that the solvency position was "tight", we would have expected IBD and IB-PIA to have sought some assurance from IFSD that Equitable Life was intending and able to provide adequate compensation to all classes of investors who were so entitled.
- 6.19.12 Equally Enforcement was not prompted to consider the impact of the House of Lords' judgment on the PFW investigation which continued on the basis that enquiries about the availability of a GAO were only relevant to GAR policyholders transferring from another provider. Nor did Enforcement take any steps to seek reassurance from IB-PIA that Equitable Life GAR policyholders, who had been switched out of GARs in the past, would be compensated as part of the rectification scheme. This is noteworthy because it was known to Enforcement that Equitable Life had stated that it would be inappropriate to review cases involving sales by Equitable Life of PFWs to GAR policyholders transferring from other providers.

6.20 Bonus Notices

- 6.20.1 The consideration by IB-PIA of the issues concerning information provided by Equitable Life to its policyholders during the currency of the policy (in particular bonus notices) illustrated the existence of what is, and was recognised at the time to be, a gap in the PIA Rules. This did, however, represent a matter of potential concern to both IFSD, which was responsible for PRE issues, and IB-PIA, which in the very broadest terms was responsible for certain communications between the life company and its policyholders.
- 6.20.2 There were exchanges between IFSD and IB-PIA during 1999 on this issue following a review by IFSD of the notices in the context of consideration of PRE. In June 1999, IFSD asked IB-PIA to advise as to whether the presentation of the terminal bonus in the bonus notices issued by Equitable Life for 1996, 1997 and 1998 was misleading and whether the PIA had any powers to require Equitable Life to change these notices. IB-PIA informed IFSD that the notices were acceptable although, unhelpfully, did not disclose a countervailing view held by IB-PIA (Advertising) in respect of the 1996 notice. As to powers, IB-PIA reiterated the prevalent view within the FSA (independently confirmed by the conduct of business section of GCD) that the ongoing servicing of policies did not sit comfortably with the PIA's remit, which was confined by existing legislation to dealing, arranging deals, managing and advising on investments. We were told that, only if IB-PIA considered that there was a risk that documents being sent to policyholders were seriously misleading, would IB-PIA investigate the situation and consider whether it was possible to intervene (possibly by adopting an "influencing approach", rather than by reference to PIA Rules).
- 6.20.3 Notwithstanding the exchange that took place about this issue, we feel closer co-operation between IB-PIA and IFSD on the issue of bonus notices (and generally in

relation to information provided to policyholders). would have enabled the regulator to have taken a more co-ordinated approach to considering and, if necessary, dealing with bonus notices issued by Equitable Life.

- 6.20.4 We recognise that the extent of the PIA Rules is constrained by the terms of the FSAct 1986. However, given that the regulator accepts that information provided to existing policyholders, such as bonus notices, can influence PRE and also trigger investment decisions by policyholders (such as deciding to top-up a policy), we question whether the exclusion of this sort of information under PIA Rules is consistent with PIA's statutory obligation to have adequate rules for the protection of policyholders. We understand that routine communications with policyholders, including bonus notices, will be covered under the new regime which will be implemented under FSMA 2000.

6.21 Advice and information in relation to new investment during the Review Period

- 6.21.1 Consistent with the aims expressed in its mission statement, one of PIA's responsibilities during the Review Period was to take appropriate steps to ensure that the advice and information being given to new investors was such as to enable them to make properly informed decisions in an open, competitive and innovative market place. One of the key questions concerning Equitable Life during the Review Period was the extent to which the outcome of the Court case would impact on the solvency margins of a with-profits fund with little estate and to what extent, being a mutual, liabilities owed to one class of policyholders would have to be funded by other classes of policyholders. While these were all principally a matter for the prudential regulator, IB-PIA ought to have satisfied itself that these issues did not give rise to questions concerning disclosure of information to new investors (in compliance with the PIA Rules which require a representative who has dealings with an investor to use his best endeavours to enable the investor to understand the nature of any risks involved).
- 6.21.2 Prior to the decision of the House of Lords and, in particular, immediately following the Court of Appeal judgment, IB-PIA was given comfort by IFSD in terms "we do not think that the judgment affects the statutory financial position greatly as Equitable Life already has to fully reserve ...for biting GAOs". In the circumstances (and in view of the fact that it was by no means clear at that stage how the outcome would impact on the non-GAR investors in the with-profits fund), it seems reasonable that IB-PIA should merely, as it said it would, "keep a close eye on how things progressed".
- 6.21.3 Immediately following the House of Lords' judgment, IFSD informed IB-PIA by e-mail that the company was still solvent but that its asset base was weakened, which would affect the bonuses payable to with-profits policyholders, and that it had decided to put itself up for sale. A month later, at the bilateral meeting on 24 August 2000, IB-PIA was told that Equitable Life was just covering its solvency margin, but that the solvency position remained "tight".
- 6.21.4 As a result, when issues and complaints concerning advertising were referred to IB-PIA after the House of Lords' judgment, IB-PIA agreed with the approach adopted by IFSD which was that the company was solvent and there were therefore no

legitimate grounds at that stage to seek to suspend the company's advertising activity.

6.21.5 We acknowledge that, once the decision had been taken by the prudential regulator, who had primary responsibility for the assessment of the potential financial impact of the case following the House of Lords' judgment, to allow Equitable Life to continue to write new business, it would have been inconsistent with that decision to require Equitable Life to suspend advertising or to require it to give any special health warnings to new investors about the operational risks faced by it. However, given the delicate financial state in which Equitable Life found itself following that ruling, we consider that throughout this period IB-PIA should have been alert to the need to monitor both:

- (a) Equitable Life's advertising; and
- (b) information and advice being given to new investors,

to ensure that they complied with the PIA Rules and, in particular, that they were clear, fair and not misleading.

6.21.6 IB-PIA did receive further reassuring messages from IFSD that the company was solvent and there was no reason why it could not continue to advertise. As a result of this, IB-PIA concluded it would "keep an eye on this issue". We note however that within a week Equitable Life had withdrawn its advertising campaign.

6.21.7 We also believe that more active consideration should also have been given by IB-PIA as to the effect on existing non-GAR policyholders of GAR policyholders making further investments in the with-profits fund by means of top-ups and the need to monitor what, if anything, Equitable Life was saying to its new policyholders about this.

6.21.8 This is illustrated by the fact that, on 17 November 2000, IFSD raised with IB-PIA the possibility that (a) GAR policyholders might seek to top-up their policies as much as possible in order to maximise the value of the GAR; (b) that this was "likely to shift the Equitable Life GAR liability significantly upwards" and (c) that additional payments made by non-GAR policyholders would be used to subsidise GAR policyholders. IB-PIA never properly considered the nature of the advice that should be given to non-GAR policyholders about the liability for GARs. Nor did IB-PIA contact Equitable Life to make enquiries about what advice had been given about this or to discuss it further with IFSD after getting advice from IB-Policy to the effect that, if the company could not "promise" asset share, then investors would have to be warned that they "could get back less".

6.22 Management Issues

6.22.1 In May 1999, it was suggested that someone be nominated to take forward the issue raised by the Consumers' Association and, in September 1999, there was a further recommendation that a small team be established to gather relevant information. Neither of these suggestions was implemented as part of IB-PIA's subsequent consideration of the particular issues. Although the particular issues in each case were taken forward within IB-PIA, in general, the lack of a single point of contact for

all GAO issues adversely affected IB-PIA's ability to liaise effectively with IFSD and deal properly with new issues as they arose.

- 6.22.2 Throughout the Review Period, IB-PIA made relatively little use of the actuary employed by IBD. This resource might have been able to provide useful input in relation to areas of common interest between the prudential and conduct of business regulators and might have provided a useful point of contact between IFSD and IB-PIA.

Co-ordination

6.23 Management Issues

- 6.23.1 We have attributed the deficiencies which we have identified in part to what we describe as a poor level of communication and co-ordination between the two 'arms' of regulation. We have sought to identify where this went wrong.
- 6.23.2 We acknowledge that steps were, and are, being taken more generally within the FSA to improve the co-ordination between its constituent parts. In particular, we welcome the FSA announcement in its Plan and Budget for 2001-02 of its plans to integrate prudential and conduct of business regulation. We also welcome the steps which have already been taken by the FSA to bring actuarial expertise "in-house" by arranging the transfer of the relevant teams from GAD to the FSA.
- 6.23.3 We also recognise the steps which were taken to improve inter-division communications such as lead supervision. But this initiative was in its formative stage during the Review Period and there is no evidence that, in relation to the Equitable Life episode, it served to improve, in any material way, the level of communication about the issues arising in that case.
- 6.23.4 In relation to the management of the Equitable Life GAR issue, we feel that an opportunity was missed at the outset to ensure that a properly co-ordinated "new style" approach was adopted to managing a problem which was clearly high profile and which obviously crossed the boundaries between prudential and conduct of business regulation. This could have been achieved by forming a team which included representatives from all relevant divisions within the FSA, supported by the necessary expertise. This is particularly noteworthy given that it was recognised within FSA that the level of communication between these two regulators had, in the past, been negligible and was in need of improvement.
- 6.23.5 We would have liked to have seen evidence of an initiative being taken at an early stage and at a sufficiently senior level within the FSA to get the two regulators and the relevant in-house specialist advisors around a table to "brainstorm" this matter and make the necessary arrangements for this matter to be managed appropriately thereafter. We consider that such a meeting would have assisted in ensuring that each of them was well briefed on the other's functions, duties and requirements; would also have helped to raise the profile of the issue in the minds of the conduct of business regulators who, in our view, never fully appreciated the scale of the

potential problem both in monetary and reputational terms; and would have saved time and avoided duplication.

- 6.23.6 It is significant that, although there was a series of routine bilateral meetings between IFSD and IB-PIA at which reports were given on the Equitable Life matter, the first (and only) meeting dedicated to the Equitable Life matter which was attended by the two regulators and also by the Enforcement team did not take place until 21 October 1999, more than a year after the issue was first recognised.

6.24 Exchange of Information

- 6.24.1 While there is evidence of IFSD seeking to keep IB-PIA informed of certain matters, particularly the progress of the Court case, we have identified a number of examples, throughout the Review Period, of inadequate co-ordination or lapses in the exchange of information between the prudential and the conduct of business regulators. For example, we think it would have been helpful if IB-PIA had been included in the meeting to discuss the scenario planning which was held in June 1999. It would also have been better to have included IB-PIA in the discussions following the House of Lords' judgment so that views on how to manage the issues about sales after that decision and, in particular, whether and how these should be monitored, could have been properly co-ordinated. Finally, we would have expected to see some liaison between IFSD and IB-PIA as to the scope of Equitable Life's proposed rectification scheme.
- 6.24.2 There is evidence, particularly in the context of bonus notices, that neither of the two regulators fully appreciated the issues which the other was required to address and the information which the other would find useful; and neither was properly and consistently aware of what the other was doing.
- 6.24.3 This poor level of communication and co-ordination between IB-PIA and IFSD contrasts with the closer and more effective liaison which IFSD had with GAD with whom it obviously had a longer standing and more mature connection, notwithstanding the fact that they were operating from different locations. Familiarity with the others' roles and responsibilities is as important an ingredient of successful integration as working under the same roof.

Chapter Seven

Lessons to be Learned

7.1 Introduction

These recommendations are directed at the regulation of the life insurance industry. The FSA Board, as it moves towards the formation of the single regulator, may wish to consider whether these apply to other areas of regulation (or may, indeed, be constrained by such), but we are only in a position to make specific recommendations in respect of the life insurance industry.

In making these recommendations we acknowledge:

- (a) the scale of the task of creating a single regulator, and the constraints and inhibitors to the introduction of change imposed on the FSA by the transitional regime;
- (b) that, where appropriate, the FSA will have to follow the requirements of its established practice of consultation and cost benefit analysis, to ensure that any proposed changes have regard to the statutory principles of proportionality, economy and efficiency; and
- (c) that the FSA will also have to have regard to the desirability of maintaining a “level playing field” for those whom it regulates and who also form part of a wider international insurance and financial services industry and operate in an internationally competitive environment.

The Regulatory Structure

7.2 Solvency standards

The current prudential framework for life assurance companies does not adequately reflect the nature, diversity or scale of the risks in the business.

We recommend that the current framework needs to be restructured so that the required minimum capital reflects all the risks in the business.

It is proposed that, in the longer term, fair value accounting will provide the basis for statutory accounting. This, together with risk-based capital measures, would provide an appropriate solvency framework. There would be significant advantages in both transparency and cost in having such a common basis.

However, the introduction of such a framework will take some time to achieve, not least because of their need to reach agreement with other European regulators.

Therefore, **some interim measures** are required, which themselves may need phasing in because of their financial impact on individual companies.

7.2.1 Guarantees and options within policies

As has been described in this Report, the issues of the timing and level of reserving for the GAOs were central to the problems of Equitable Life. We recognise the need to consider the effect on the prudential treatment of guarantees and options elsewhere in financial services, but we believe the current rules for life insurance companies are inadequate.

We recommend that financial guarantees and onerous options in life insurance policies should be valued stochastically and consistently with traded option prices in the market.

7.2.2 Future profits implicit items

The regulator has discretion over whether to grant Section 68 Orders which allow future profits to count towards solvency, but has long indicated that such concessions will be readily available. Equitable Life made extensive use of future profits implicit items over a number of years. This allowed it to meet the minimum solvency requirements and to improve the external perception of financial strength. Taken together with its subordinated loan facility and the financial reinsurance arrangements, there was the possibility that potential investors could have been misled as to Equitable Life's true financial strength.

We recommend that the exercise of discretion over the use of implicit items should be reviewed.

7.2.3 Financial reinsurance

The current solvency regulations define provisions that contain prudent margins. These margins provide an opportunity to arbitrage against economic reality particularly through the use of some forms of financial reinsurance. This arbitrage undermines the margins of prudence in the current solvency framework and could pose a threat to the financial system.

We recommend that a review be undertaken of the extent to which the financial strength of the industry is eroded by the amount of such financial reinsurance in place.

We also recommend that full disclosure of these arrangements, including the material contingencies to which they are subject, should be made in the regulatory returns.

7.2.4 Control levels

The regulator has commented that its powers of formal intervention are, in some areas, restricted by a requirement that the required minimum margin of solvency is breached before any direct action can be taken.

We recommend that the regulator review the possibility of introducing multiple control levels as a basis for triggering proportionate regulatory action.

These might include, for example, the ability of the regulator to require independent investigations, reports or plans to be created where an insurer provides substantial investment guarantees and or its free assets fall below some multiple of the required minimum margin.

7.3 The role of the Appointed Actuary

The Appointed Actuary system has worked well for a long time. However, the reliance on one individual with no external, detailed check of his work inevitably poses risks.

We recommend that Appointed Actuaries should be subject to independent external review. This may be carried out by the FSA or by independent firms, but must be conducted to a level which would provide comfort equivalent to that of an external audit.

7.4 Disclosure

The framework of the regulatory returns was designed many years ago to allow the regulator and other market professionals to review the assumptions and bases adopted by the Appointed Actuary when valuing the liabilities. Although the regulations and guidance have been amended, the disclosures required have inevitably lagged behind developments in the industry.

In addition, the current regulatory returns merely provide a snapshot of an insurer's financial strength at a point in time. This does not give a clear picture either of the financial trends of the insurer or of the risks to which it is exposed.

We recommend that the purpose, content and frequency of the regulatory returns be reviewed. The information provided by all firms must be both timely and sufficient to assess the risk of customer detriment which might arise from issues relating to either solvency or PRE issues.

The assessed financial risk must be an integral part of an overall risk assessment which is consistent, and consistently applied, across the FSA.

The regulator must also have the ability to obtain further relevant information when appropriate, and perhaps routinely for higher risk firms, and may want to conduct its own review in appropriate circumstances.

We believe that this information could include, for instance:

- (a) changes in free capital, identifying material changes in the methodology or bases of valuing liabilities and divergences from assumptions;
- (b) how claim values satisfy PRE including the development of asset shares and how these relate to claim values;
- (c) quantification of guarantees, options and all other potentially material contingent liabilities; and

- (d) other information in a revised “Financial Condition Report” which should include analysis of expected financial trends, use of stochastic modelling where appropriate and the possible effects of environmental developments in areas such as politics, the law and the environment.

It is recognised that some of this information is commercially very sensitive and could have a destabilising effect on public confidence, if published. The FSA will have to consider how to strike the right balance between (a) preserving the confidentiality of such commercially sensitive material in the interest of maintaining financial stability; (b) operating in a preferred transparent manner; and (c) satisfying consumer information requirements through meaningful public disclosure.

7.5 Industry review

The information obtained under 7.4 above would facilitate a deeper understanding within the FSA of the operation of the insurance industry.

We recommend that the FSA consider the feasibility of producing on a regular basis a review of issues and trends that may pose a regulatory risk to the industry.

The Regulatory Approach

7.6 Introduction

It is acknowledged that the role, style and approach of the FSA has been the subject of review, consultation and reform since 1999. The Review Team has seen no evidence to suggest that any aspects of the proposed new approach need to be reconsidered. However, we do recommend, in the light of what we have seen occur in the context of Equitable Life, that the FSA satisfies itself that, in a certain number of respects as identified below, the new approach has been adopted and is being applied in practice.

The lessons to be learned under this heading fall into three broad categories: culture, process and tools.

7.7 Culture

The Review Team’s impression of the style of the prudential regulation of the long-term insurance industry inherited by the FSA, when compared with its prudential regulation of the banking industry, is that it is less intrusive and involved. While the FSA is understandably concerned to guard against unnecessary intrusion into firms’ businesses or being seen to influence inappropriately management decisions, and particular concerns have been expressed in this context about the consequences of the regulator acting as a shadow director, it should also be recognised that the management of a life company may have a number of competing interests to balance, only one of which will be the interests of their policyholders, both current and prospective.

We therefore recommend that the FSA, in its regulation of the long-term insurance industry:

- where appropriate to do so, be prepared to act more proactively in pursuance of its statutory objectives to ensure that the interests of customers are properly protected;
- forms and articulates a clear view of what are the permissible boundaries of proactive regulation;
- reviews its approach to the use of its powers of investigation, influence and intervention so that it acts in a way proportionate to the perceived risks; and
- adopts a more proactive, risk-based approach so that the frequency, depth and breadth of contact with firms is related to the risk category of that firm.

The Review Team recognises that these recommendations are in line with the FSA's stated intentions.

The Review Team has detected a culture within IB-PIA in which there is little appetite and capacity to examine the wider implications of an issue and a reluctance to pursue any matter without clear evidence of a breach of the Rules. We believe that this is born of a need to prioritise relatively scarce resources and may be appropriate when dealing with the mass of routine work for which it is responsible. But this approach is inappropriate when dealing with a high profile and reputationally sensitive cases such as Equitable Life. More encouragement to IB-PIA staff "to spot and tackle" the issues would serve to move this culture away from what appears to be very much a rule-based regime to one more aligned with the FSA's new risk-based approach.

It is not necessary for us to make a specific recommendation in this regard as we believe this concern is sufficiently addressed by the other recommendations we have made.

There was limited communication and poor co-ordination between divisions of the FSA regulating the life industry. As a consequence, there was a lack of awareness about what issues the different teams needed to address.

We recommend that the FSA devotes more resources to developing internal awareness between teams both as to what functions each team performs and the information each team requires to assist it to do its job. We welcome the FSA's creation of one division, comprising prudential and conduct of business regulators and GAD, to deliver integrated supervision of the insurance industry.

7.8 Process

The Review Period covers the very early days of the integration of the regulatory structure. In the case of Equitable Life, some of the newly adopted procedures and systems did not work.

Wholly integrated regulation of the insurance industry is being introduced. The FSA should remain alert to the difficulties of implementing change and, in particular, be alive to the risk that such structural change may facilitate better communication and co-ordination within the FSA, but it will not necessarily achieve it.

When any matter emerges which is of a certain size and scale and/or has potentially significant reputational issues, the FSA management should not assume that the existing team structures will deliver the required result.

We recommend that in such cases, the FSA management take steps to ensure that:

- **the existing team structure includes all those with a relevant interest in and the necessary expertise concerning the matter; or**
- **a special team is formed to handle the matter; and**
- **in both cases, the team is properly constituted with persons with the necessary expertise and knowledge and thereafter works cohesively exchanging all relevant information and managing issues in a consistent and comprehensive way.**

In a situation where customers' interests are damaged or put at risk, such as in the case of Equitable Life, there is always a sense on the part of customers that the regulator has failed them. The Review Team recognises that this will probably always be the case. The publication "A New Regulator for the New Millennium" seeks to promulgate the message that the objective of maintaining market confidence does not imply "aiming to prevent all collapses or lapses in conduct in the financial system."

We recommend that this message be reinforced by making it clear to customers that non-intervention or no comment by the FSA, where a company's difficulties are attracting press coverage, should not be taken as an endorsement of the company's financial well-being.

The Equitable Life episode has revealed uncertainty about the interpretation of the conduct of business rules and the standards of disclosure that should be expected of firms where customers are potentially exposed to significant operational risks (as opposed to the more common investment risk), such as Equitable Life losing the Court case.

We recommend that the FSA considers what standards of disclosure should apply in this area and the extent to which these can be codified.

The role of Enforcement in the matters under review deserves some attention. The Review Team's impression was that once an issue had been referred to Enforcement, there was limited communication between the investigating team and the team responsible for monitoring Equitable Life. This is partly due to the complex interim structure which prevails pending the implementation of the FSMA 2000. However the lack of effective interaction between the regulator and Enforcement during the currency of the investigation meant that the opportunity to use Enforcement as a source of information regarding Equitable Life's treatment of policyholders was lost and the implications of the House of Lords' decision on the investigation were never fully considered either by Enforcement or IB-PIA.

We recommend that steps be taken to rectify the shortcomings and, in particular, to ensure that information in the hands of the Enforcement team is made available

to the regulator and vice versa in a timely way in order to improve management of the matter and thereby overall consumer protection.

In the context of long-term insurance business, the prudential regulator has responsibilities relating to PRE and customers' interests, which are created and shaped by communications with policyholders. This represents a matter of potential concern, which it shares, with the conduct of business regulator who has responsibility for ensuring that relevant communications with customers comply with its rules. In the context of the Equitable Life case, this area of common interest was not effectively managed.

We recommend that as part of the integration of these two regulatory divisions, the FSA takes steps to ensure that responsibilities in this area are comprehensive and properly co-ordinated and managed.

7.9 Tools

Throughout the Review Period, a principal focus of the regulator's attention was directed at ensuring that Equitable Life would continue to be able to meet its statutory reserving requirements. There was very little, if any, assessment of the financial implications to Equitable Life of losing the case and the consequential impact on existing and potential policyholders. We commend the FSA's stated aim of identifying, assessing and prioritising risks, both in the sense of grading firms and assessing the potential impact of and likelihood of industry-wide risks. This risk assessment would be enhanced by discussion with the insurer's own risk management function and its internal and external auditors.

We recommend the FSA gives consideration as to how to apply a more rigorous risk assessment process to specific situations where certain risks have escalated or crystallised, and where it is particularly important to plan for all reasonably considered outcomes. We welcome the FSA's stated intention to adopt a more proactive risk-based approach so that the frequency, depth and breadth of contact within firms is related to the risk category of that firm.

'PRE' is a statutory concept without a definition. Apart from the ministerial statement, which sought to give guidance as to the factors to be taken into account in determining PRE in respect of the attribution of surpluses in with-profits funds, there is no universally accepted framework to assist those with the responsibility for assessing it. With the introduction of the new prudential sourcebook, PRE will be subsumed within the FSA principle that "a firm must pay due regard to the interests of its customers and treat them fairly".

We recommend that in situations where regulators have to have regard for concepts such as PRE, which are undefined or capable of more than one interpretation, FSA should develop policy templates so as to ensure consistency of interpretation and application across the regulatory process.

In particular, we encourage the FSA to carry through to completion its current work on clarifying the meaning of customer interests and PRE.

The old style and approach to the regulation of the long-term insurance industry, which was operating during the Review Period, is to change at N2. As the FSA introduces “the New Regulator for the New Millennium”, additional resources will be needed if it is to bring the prudential regulation of insurance companies more in to line with the prudential regulation of banks and building societies. The crude comparator of “staff resources deployed per institution regulated” shows banks and building societies having more than double the resources of those that are deployed on life insurance companies. When the one-off tasks involved in preparing for N2 are substantially complete, more resources will become available for “business as usual” regulatory activity. However, this is unlikely to fill the envisaged gap in additional resources required.

The new approach as set out in the “New Regulator for the New Millennium” will require consideration to be given by the FSA to the level of resources committed to this area and to the mix of competencies and skills required in order to give effect to the more proactive and interactive approach which is planned.

We acknowledge that the FSA has already taken steps to address this by introducing in-house actuarial expertise with the transfer of the relevant staff from GAD to the FSA and the commencement of the integration of prudential and conduct of business regulators.

7.10 General

The Equitable Life case has industry wide implications. Our Terms of Reference have allowed us only limited insight into the FSA’s consideration of these. There are issues and FSA initiatives which have continued beyond 8 December 2000 which have not been examined by the Review Team. Accordingly, we are not able to comment on the sufficiency of these exercises.

We mention this only to say that we would expect the FSA to have progressed such exercises.



The Managing Director
All companies authorised by the Treasury
to carry on long-term business

18 December 1998

Dear Managing Director

**GUARANTEED ANNUITY OPTION COSTS AND POLICYHOLDERS'
REASONABLE EXPECTATIONS**

As you will know the Government Actuary's Department undertook a survey of life offices' exposure to guaranteed annuity options (GAOs) earlier this year. The results of that survey indicated that the exposure to GAOs was relatively widespread within the industry and had the potential to have a significant financial impact on a number of companies. The nature of the guarantees offered by companies varied widely, but one issue that needed to be addressed by all companies was how the concept of policyholders' reasonable expectations (PRE) should be interpreted in the context of GAOs. The purpose of this letter is to provide some guidance to companies on the Treasury's interpretation of PRE in these circumstances.

As a starting point, we take the view that policyholders entitled to some form of annuity guarantee or option on guaranteed annuity terms could reasonably be expected to pay some premium, or charge, towards the cost of their option or guarantee.

Charging for the cost of providing a guarantee or annuity option

For linked contracts, any charge would have to be included within the normal explicit charges levied under the terms of the contract, and these charges could clearly only be raised to cover the costs of guarantees to the extent that this was permitted under the contract. Any cost arising to the office in respect of meeting the guarantees over and above the accumulated charges, would therefore have to be covered by the insurer from other available resources.

In the case of participating policies, any charge could be deemed to be met out of each premium received (or the investment return to be credited by way of bonus), and hence would impact on the assessment of bonuses, including in particular any terminal bonus that would normally be payable to the policyholders. Generally we consider that it would be appropriate for the level of the charge deemed to be payable by participating policyholders for their guarantee (or annuity option) to reflect the perceived value of that guarantee (or option) over the duration of the contract. This could be achieved in some cases through some reduction in the terminal bonus that would be payable if there were no such guarantee (or option) attached to the policy. However the selected treatment by each office would need to depend on the wording of the contract involved and how it had been presented to policyholders.



Under the majority of participating policies which have been written it appears that any guarantee or annuity option is applicable to at least the guaranteed initial benefit under the policy and any attaching declared bonuses. As a consequence of this, we would expect that for most companies the present guaranteed cash benefits (including declared bonuses) would be converted, as a contractual minimum, to the annuity on the guaranteed terms. However as indicated above, it would appear possible, depending on the particular circumstances relating to the contract, that any terminal bonus added at maturity may be somewhat lower than for contracts without such options or guarantees, and that this terminal bonus could in some cases be applied at current annuity rates.

Apportionment of costs of GAOs not recovered under the relevant contract

In the case of both participating and non-participating contracts any residual cost for the insurer in respect of annuity options and guarantees will need to be recovered from available resources within the long term fund or from shareholder funds.

Where the long-term fund is to be used, we would in the first instance expect to see the cost met out of any 'estate' held by the company. However, where the cost is significant relative to the estate available, then an insurer may wish to consider adjusting the future bonus allocations for some or all of its participating policyholders, or making a transfer to the long term fund from the shareholders' fund.

The appropriateness of any such adjustments to bonus allocations for participating policyholders would need to be assessed by each office in the context of the reasonable expectations of all their policyholders. This assessment will be influenced by their policy documents and any representation made through marketing literature, bonus statements or elsewhere.

The above is the Treasury's considered view, and is without prejudice to any decision of the courts which may affect it.

Please supply a copy of this letter to your Appointed Actuary.

Yours sincerely

Martin Roberts
Director, Insurance

Your reference :
Our reference : 0199-01

DAA 11

The Appointed Actuary
All companies authorised by the Treasury
to carry on long-term business

11 January, 1999

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Dear Appointed Actuary

RESERVING FOR GUARANTEED ANNUITY OPTIONS

Further to Martin Roberts' letter of 18 December regarding the costs of guaranteed annuity options in the context of policyholders' reasonable expectations, he has agreed that it would be helpful if I were to provide some guidance to Appointed Actuaries of companies on the advice I have given him on the application of the existing reserving requirements in respect of contracts containing a guaranteed annuity.

2. I consider that Part IX of the Insurance Companies Regulations 1994 (ICR 1994) requires a life office to calculate its liabilities (and hence to reserve) on the basis of all the benefits offered under the contract. Regulation 64 of the Regulations requires long-term liabilities to be determined "on actuarial principles", and to "make proper provision for all liabilities on prudent assumptions". Regulation 64(2) makes clear that the determination must "take account of all prospective liabilities as determined by the policy conditions".

3. Contracts providing for a guaranteed annuity typically take two main forms - either:

- a contract to provide an annuity with an option to secure a cash fund; or
- a contract to provide a cash fund with the option to convert the benefits into an annuity at a guaranteed rate.

4. I would expect the reserving requirements to be very similar (if not identical) irrespective of whether the guaranteed annuity is the principal benefit under the contract or only an option. This is on the basis that in substance a policyholder will be entitled to the same choice of benefits irrespective of which is the principal benefit and which is the option.

5. In my view it is clear that, where a contract provides for a guaranteed level of annuity, then the effect of Part IX of the ICR 1994 is to require the company to reserve fully for its liabilities to provide annuity benefits to the value guaranteed under the contract. In addition it will be necessary to reserve fully in respect of any facility for policyholders to select an alternative form of benefits.

6. In assessing the extent of these liabilities, the company will need to make a prudent assessment of the extent to which any options are likely to be exercised. In this context I consider that, where the cost of meeting the guaranteed annuity benefits at maturity is significantly greater than the value of any alternative benefits, prudence will require the company to reserve for the contract at a level close to the full value of the guaranteed annuity. In general it would not in my view be prudent to assume that policyholders will choose a benefit form that is of significantly lower nominal value to them, although some limited allowance (of a few percentage points of the reserve) could in some cases be made for a reduction in the liability on the grounds of the additional flexibility or other perceived advantages to policyholders of any alternative benefits.

7. Where the levels of terminal bonus are to be adjusted with the aim of bringing the value of the guaranteed annuity option closer to the value of the alternative benefits, there might at first sight appear to be some room for argument that it was not necessary to reserve on the assumption that almost all policyholders will take the guaranteed annuity benefit. However, it needs to be remembered that, although the benefits formally "guaranteed" under the alternative form of benefit may be lower than those under the guaranteed annuity option, the company's discretion in setting the value of terminal bonus applied to the alternative benefit is limited as a result of the existence of the guaranteed annuity. It is likely that close to 100% of policyholders will exercise the annuity guarantee unless the company maintains terminal bonus at a level which ensures that the value to the policyholder of the alternative benefit is at least equal to the value of the guaranteed annuity. Accordingly, this constraint will need to be reflected in the valuation assumptions made about either the proportion of policyholders opting for the alternative benefit or the value of that alternative benefit. Consequently any reduction in the reserves held by the insurer by more than a few percentage points below the full value of the guaranteed annuity for this reason would require very careful justification by the actuary.

8. I am aware that many policyholders have in the past exercised their right to take up to 25% of the benefits of their pension policy in the form of a tax free lump sum. However, I would not consider it prudent to use past experience alone in this regard as a basis for reducing the percentage of benefits assumed to be taken in guaranteed annuity form. In my view there is a significant risk that there may be a marked change in policyholder practice if policyholders and their advisers view annuity guarantees as valuable and something that should be utilised to the full. For instance, there is the possibility that in future individuals with more than one pension policy will seek to maximise their benefits by exercising in full any guaranteed annuity option and only taking cash from those policies that do not carry a guarantee. In addition any further increase in the value of the annuity benefits relative to cash has the potential to lead to a significantly greater take up of annuity guarantees. As a result I would only consider it prudent to make significant allowance for a proportion

of available policy proceeds to be taken as cash, to the extent that policyholders are obliged to take some of the benefits as cash. Where policyholders are not obliged to take some of the benefits in cash, then the principles described in the above two paragraphs of this letter would apply.

9. In addition to holding mathematical reserves to cover their liabilities for annuity guarantees, companies will need to assess the extent to which a resilience reserve is required. I would expect companies to apply the recommended resilience tests and other general advice in my letter (DAA6) of 30 September 1993 (as amended slightly in my letter of 24 November 1998 - DAA10) in determining the need for a resilience reserve. The need to hold substantial mathematical reserves to cover guaranteed annuity options would not in my view be a sound argument for reducing the stringency of the resilience test applied.

10. The level of reserves established for guaranteed annuity options is likely to be one of the features of companies' 1998 annual returns which FSA and GAD will want to review particularly closely. It should be remembered that Schedule 4 of the Insurance Companies (Accounts and Statements) Regulations 1996 requires the actuary's report in the annual returns to include detailed information about the contracts written.

11. In particular, paragraphs 4(1) and 5(1) of the Schedule require the provision of a description of the benefits of the contracts written, including any material options. I would expect such a description to provide an indication of the form of any annuity guarantee offered. In addition, in accordance with paragraph 6(1)(h), actuaries should provide a description of the way in which reserves for any annuity guarantees and options have been determined (including an indication of the interest rate and mortality assumptions used). I would also expect that, in accordance with Instruction 9 to forms 51-54, categories of contracts containing annuity guarantees would be shown separately in those forms.

12. The annual returns should include sufficient information for the FSA and GAD to make an assessment of the extent of the guarantees offered, the reserving basis adopted by the company and hence the scope for guaranteed annuity options to impact on the financial position of the company.

13. The above is my considered view and is without prejudice to any decision of the courts which may affect it.

Yours sincerely

C D Daykin
Government Actuary

DAA13

22 December 1999



**GOVERNMENT
ACTUARY'S
DEPARTMENT**

NEW KING'S BEAM HOUSE
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Dear Appointed Actuary

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RESERVING FOR GUARANTEED ANNUITY OPTIONS

FROM THE
GOVERNMENT ACTUARY
CHRIS DAYKIN
CB Hon DSc MA FIA FSS ASA

As you will recall, I wrote to you and other Appointed Actuaries on 13 January this year regarding the application of the reserving requirements in Part IX of the Insurance Companies Regulations 1994 in respect of contracts containing a guaranteed deferred annuity and a cash or other alternative.

Having now reviewed, at least provisionally, the majority of companies' 1998 annual returns, it is apparent that some aspects of this guidance have been interpreted in a variety of ways. It is clearly important that there should be consistency in the approach taken, and therefore the FSA has concluded that it would be helpful if I were to provide some further clarification on the reserving standards that would normally be expected to be seen in future HMT/FSA returns.

In my view, in determining the reserve for a contract containing a guaranteed annuity it would not generally be prudent to assume that policyholders will choose a benefit form that is of significantly lower nominal value to them than the guaranteed annuity. I indicated previously that I would expect any allowance for the reduction in the liability on the basis of policyholders making such choices to be limited to "a few percentage points" of the reserve. I would like to clarify that I was referring here to the total aggregate allowance that might prudently be made for all other benefit forms (whether cash or other forms of annuity) and that in my view an allowance in excess of 5% would not be considered to represent "a few percentage points".

There may be considered to be a stronger case for making an allowance for policyholders choosing to take a proportion of their benefits in the form of a tax free cash lump sum. However, I would not consider it prudent to assume that more than 20% of policyholders exercised the option to take the maximum cash lump sum permitted under the terms of the contract. In the case of most pension contracts, such an assumption would equate with a 5% reduction in reserve, the maximum aggregate allowance indicated above as likely to be accepted as prudent.

I am also reviewing the level of disclosure made by each company in their 1998 annual returns regarding the assumptions made to determine the level of reserve for contracts containing a guaranteed annuity. For the avoidance of any doubt, we would expect to see full disclosure of the proportions of policyholders assumed to take any available guaranteed annuity, along with the underlying mortality and interest rate assumptions. I should also add in this context that we would expect to see prudent allowance made for future mortality improvement both before and after the assumed retirement date, taking proper account of the recommendations in the latest CMI reports.

Yours sincerely

A handwritten signature in black ink, appearing to read 'C D Daykin', with a horizontal line underneath the name.

C D DAYKIN

THE EQUITABLE LIFE ASSURANCE SOCIETY

V

ALAN DAVID HYMAN

High Court, Chancery Division, 9 September 1999

Originating summons – Allocation of final bonuses – Breach of contract – Exercise of discretionary powers – Policyholders' 'reasonable expectations'

Facts

- This was an originating summons seeking declarations on the question of whether the Equitable Life Assurance Society (**the Society**) is entitled, on allocating final bonuses among its with-profits policyholders, to allocate bonuses to one class of policyholders (whose policies included a guaranteed annuity rate, or **GAR**) at a lower rate than the rate at which it awards bonuses to other policyholders (whose policies were without such a GAR provision), and more specifically whether the Society can award reduced bonuses – or no bonuses at all – to policyholders whose policies contain GAR provisions.
- It was contended on behalf of the policyholders that to award lower bonuses to these policyholders than are awarded to others would be in breach of contract and that to do so would be an improper exercise by the Society of its discretionary power to allocate such bonuses.

Law

- In cases such as the present, the Directors should take into account the collective and reasonable expectations, objectively ascertained, of policyholders as a class.
- A reasonable expectation does not become a contractual right.

Held

- There was nothing contractually improper in the allotment of final bonuses on the conditional footing adopted by the Society in the 1994 to 1998 bonus declarations, or in the 1999 bonus declaration.
- The Society's decision to reduce the final bonus of a policyholder who took his benefits in GAR-based annuity form did not deprive the policyholders of part of their asset shares, and therefore was neither irrational nor inconsistent with the object the Society purported to be trying to achieve.
- The 'cost of the contract GAR commitment' is the same as the current value of the GAR-based annuities. The current value of the GAR-based annuity is a measure of the benefits funded by the Society's assets which the policyholder receives. The amount, if any, of the top-up can be calculated accordingly.
- There was no contractual obligation on the Directors to allot the final bonus in such a way as to aim to bring the policyholders guaranteed funds up to the notional asset share. Since there was no contractual obligation to do so and their decision to allot final bonuses on a different basis, a basis that used asset share as the yardstick for the value of benefits taken rather than as a yardstick for the capital sum by reference to which the amount of the annuity taken was calculated, was a decision well within their discretion.
- In such cases as the present one the policyholders' reasonable expectations should play a part in the Directors' decision as to which bonus policy to adopt and that the reasonable expectations which should be taken into account will be the collective reasonable expectations of the policyholders as a class.
- There was no basis on which the manner in which the Directors exercised their discretion can be categorised as irrational. There were no irrelevant factors that they took into account or any relevant factors that they should have taken, but failed to take, into account.

Cases referred to:

- Edge v Pensions Ombudsman* [1998] PLR 15, [1998] Ch 512
- Piglowska v Piglowska* [1999] 1 WLR 1360, *The Times*, 25 June 1999
- Scott v National Trust* [1998] 2 All ER 705

Legislation referred to:

- Insurance Companies Act 1982
- Insurance Companies Amendment Act 1973

a Equitable Life Assurance Society v Hyman

COURT OF APPEAL, CIVIL DIVISION

LORD WOOLF MR, MORRITT AND WALLER LJ

30 NOVEMBER, 1, 2 DECEMBER 1999, 21 JANUARY 2000

b

Pension – Retirement annuity contracts – Final bonus – Policy providing policyholders with various options including annuity at guaranteed rate – Policy-provider deciding to pay policyholders opting for guaranteed annuity rate lower final bonus than other policyholders – Whether policy-provider entitled to declare differential final bonuses.

c

In 1979 the appellant, H, entered into a retirement annuity policy with the respondent life assurance society, entitling him to membership of the society and to participate in its profits. H's policy, like all such policies entered into before 1988, entitled the policyholder, on maturity, to 'the annuity increased by Related Bonuses (if any)', an annuity at a guaranteed annual rate (GAR) applied to a fund

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composed of three elements, including a final bonus. Schedule 4 gave the policyholder two alternative options to the GAR, namely an option to take an annuity from another provider (para 1.1) or an option to take an annuity from the society calculated by reference to its current rates rather than the GAR (para 2). Those options were expressed as a right 'to renounce all or any part of the annuity increased by Related Bonuses (if any) and in lieu thereof to have' the

e

alternative annuities, calculated by reference to 'the Policy Annuity Value' (PAV). The definitions schedule provided that 'Related Bonuses' meant 'in relation to the annuity ... such amounts (if any) as shall' under the society's rules and regulations 'have been allotted by way of addition to or bonus thereon'. The PAV was defined as meaning 'in relation to all or part of the annuity increased by

f

Related Bonuses (if any) ... the Policy Annuity Value attributable thereto' calculated in the manner set out in schedule 6. That schedule provided first for the calculation of 'the Accumulation Value ... of the premium paid in respect of the annuity', and then set out in para 1.5 the mechanism for calculating the amount of the GAR annuity. The society's initial practice was to pay the same final bonus to all policyholders, irrespective of the option they had chosen.

g

However, after the current annuity rate fell below the GAR, the society's board decided to pay to those policyholders who had opted for the GAR a lower final bonus than that paid to those who had taken the other options, thereby reducing the size of the fund to which the GAR applied. In introducing that policy, the board purported to act in exercise of the discretion conferred on it by art 65 of the

h

society's articles of association, namely a discretion to determine how any surplus was to be apportioned by way of bonus to policyholders. In proceedings brought to test the validity of the differential bonus policy, H contended, on behalf of all the pre-1988 policyholders, that such a differential was precluded by the terms of the policy or fell outside the scope of the art 65 discretion. Those contentions

j

were rejected by the Vice-Chancellor who accordingly upheld the validity of the differential bonus policy. H appealed.

Held – (Morritt LJ dissenting) The appeal would be allowed for the following reasons—

(1) (Per Lord Woolf MR) The declaration of a differential final bonus was not a permissible exercise of the discretion conferred by art 65 of the society's articles.

The powers contained in that provision were not conferred for the purpose of treating a policyholder differently depending on the manner in which he sought to exercise his rights under the policy. Yet that was precisely the result of the policy adopted by the society, and that was a collateral purpose designed to negative a benefit to which the policyholder would otherwise have been entitled. Although the society had no obligation to pay the final bonus, that did not mean, if it decided to do so, that it could make the payment in a manner which deprived the policyholder of a share of the society's investment return that would be conferred on him if he selected other options available under the policy (see p 345 g h and p 346 h to p 347 b, post).

(2) (Per Waller LJ) On their true construction, the terms of the policy precluded the allotting of different bonuses on the GAR policies depending on whether the beneficiary took the annuity or a capital sum with which to purchase an annuity elsewhere. Differential 'Related Bonuses' were impermissible since, in view of the wording of para 1.1 of schedule 4, the 'annuity increased by Related Bonuses' could not be different depending on whether it was being taken as an annuity or used as a basis for calculating the PAV. Furthermore, para 1.5[ii] of schedule 6, which set out the means of calculating the PAV, did not allow for the payment of a top up sum. Rather, the terms of the policy required the society (i) to calculate the annuity plus related bonuses that would be payable if an annuity was taken, and (ii) calculate back from that resulting annuity its capital equivalent. Accordingly, the board had conducted an exercise that was not permitted by the policy (see p 359 h, p 363 b to j and p 364 d, post).

Notes

For retirement annuity contracts generally, see 44(2) *Halsbury's Laws* (4th edn reissue) paras 677–709.

Cases referred to in judgments

Associated Provincial Picture Houses Ltd v Wednesbury Corp [1947] 2 All ER 680, [1948] 1 KB 223, CA.

Bromley London BC v Greater London Council [1982] 1 All ER 129, [1983] 1 AC 768, [1982] 2 WLR 62, CA and HL.

Company, Re a (No 00709 of 1992) [1999] 2 All ER 961, [1999] 1 WLR 1092, HL.

Edge v Pensions Ombudsman [1999] 4 All ER 546, CA.

Motor Oil Hellas (Corinth) Refineries SA v Shipping Corp of India, The Kanchenjunga [1990] 1 Lloyd's Rep 391, HL.

O'Reilly v Mackman [1982] 3 All ER 1124, [1983] 2 AC 237, [1982] 3 WLR 1096, HL.

Padfield v Minister of Agriculture Fisheries and Food [1968] 1 All ER 694, [1968] AC 997, [1968] 2 WLR 924, HL.

Prescott v Birmingham Corp [1954] 3 All ER 698, [1955] Ch 210, [1954] 3 WLR 990, CA; *affg* [1954] 3 All ER 299, [1955] Ch 210, [1954] 3 WLR 600.

Roberts v Hopwood [1925] AC 578, [1925] All ER Rep 24, HL.

Appeal

The appellant, Alan David Hyman, acting on his own behalf and in a representative capacity on behalf of approximately 90,000 holders of retirement with profit policies with the respondent, the Equitable Life Assurance Society (the Society), appealed from the decision of Sir Richard Scott V-C on 9 September 1999 rejecting Mr Hyman's challenge to the validity of the Society's policy of paying differential

a final bonuses on such policies. The facts are set out in the judgment of Lord Woolf MR.

Jonathan Sumption QC, Sarah Asplin and Simon Salzedo (instructed by Norton Rose) for Mr Hyman.

b Lord Grabiner QC, Brian Green QC, Andrew Lenon and James Ayliffe (instructed by Denton Hall) for the Society.

Cur adv vult

a Equitable Life Assurance Society v Hyman

HOUSE OF LORDS

LORD SLYNN OF HADLEY, LORD STEYN, LORD HOFFMANN, LORD COOKE OF THORNDON
AND LORD HOBHOUSE OF WOODBOROUGH

b 12 JUNE, 20 JULY 2000

Pension – Retirement annuity contracts – Final bonus – Policy providing policyholders with various options including annuity at guaranteed rate – Policy-provider deciding to pay policyholders opting for guaranteed rate lower final bonus than other policyholders –

c *Whether policy-provider entitled to declare differential final bonuses.*

d Before 1988, the appellant mutual life assurance society issued a large number of with-profits pensions policies, entitling policyholders to an annuity, on maturity, to which a guaranteed annual rate (GAR) was applied. Rather than taking that annuity, the policyholder could instead elect to take an annuity from another provider or an annuity from the society, both calculated by reference to the society's current rates rather than the GAR. Under art 65 of the society's articles of association, the directors had a discretion to apportion surpluses by way of bonus among policyholders 'on such principles, and by such methods, as they may from time to time determine'. Initially, the society paid the same final bonus on maturity to all policyholders, irrespective of the option they had chosen. e However, after the current annuity rate fell below the GAR, the society decided to pay those policyholders who had opted for the GAR a lower final bonus than that paid to those who had taken the other options. Following complaints by a number of GAR policyholders, the society brought proceedings to test the validity of the differential bonus policy. The Vice-Chancellor held that it was f valid, but his decision was reversed by the Court of Appeal which concluded, inter alia, that the art 65 discretion had been exercised improperly. The society appealed to the House of Lords, relying on the wide terms of the discretion.

g **Held** – Article 65 of the society's articles of association contained an implied term precluding the directors from exercising their discretion in a manner which deprived the relevant guarantees of any substantial value. Such an implication was essential to give effect to the reasonable expectations of the parties, namely that the directors would not exercise their discretion in conflict with contractual rights. In any event, the directors were not entitled to exercise their powers, no matter how widely expressed, for a purpose which subverted the basis of the policies. The GAR policy was based on the assumption that, when current rates fell below the GAR, the annuity received by the policyholder would be higher than if there was no GAR. However, the differential bonus policy treated the right to a GAR as working to the disadvantage of a policyholder who took the annuity. h Thus the differential bonus policy was not consistent with the purpose of the GAR policy. j It followed that the directors were not entitled to adopt a principle of making the final bonuses of GAR policyholders dependent on how they exercised their rights under the policy. In adopting such a principle, the society had acted in breach of art 65. Accordingly, the appeal would be dismissed (see p 962 g, p 970 j to p 971 d g to j and p 972 c h to p 973 c, post).

Decision of the Court of Appeal [2000] 2 All ER 331 affirmed.

Notes

For retirement annuity contracts generally, see 44(2) *Halsbury's Laws* (4th edn reissue) paras 677–709. a

Cases referred to in opinions

Luxor (Eastbourne) Ltd v Cooper [1941] 1 All ER 33, [1941] AC 108, HL.

Padfield v Minister of Agriculture Fisheries and Food [1968] 1 All ER 694, [1968] AC 997, [1968] 2 WLR 924, HL. b

Sally v Southern Health and Social Services Board (British Medical Association, third party) [1991] 4 All ER 563, [1992] 1 AC 294, [1991] 3 WLR 778, HL.

Smith (Howard) Ltd v Ampol Petroleum Ltd [1974] 1 All ER 1126, [1974] AC 821, [1974] 2 WLR 689, PC.

South Australia Asset Management Corp v York Montague Ltd, United Bank of Kuwait plc v Prudential Property Services Ltd, Nykredit Mortgage Bank plc v Edward Erdman Group Ltd [1996] 3 All ER 365, [1997] AC 191, [1996] 3 WLR 87, HL. c

Appeal

The claimant, the Equitable Life Assurance Society (the Society), appealed with permission of the Court of Appeal from its decision (Lord Woolf MR and Waller LJ, Morritt LJ dissenting) on 21 January 2000 ([2000] 2 All ER 331, [2000] 2 WLR 798) allowing an appeal by the defendant, Alan David Hyman, acting in his own behalf and in a representative capacity on behalf of approximately 90,000 holders of retirement with profit policies with the Society, from the decision of Sir Richard Scott V-C on 9 September 1999 upholding the validity of the Society's policy of paying differential final bonuses on such policies. The facts are set out in the opinion of Lord Steyn. d

Elizabeth Gloster QC, Brian Green QC, Andrew Lenon and James Ayliffe (instructed by *Denton Wilde Sapte*) for the Society. f

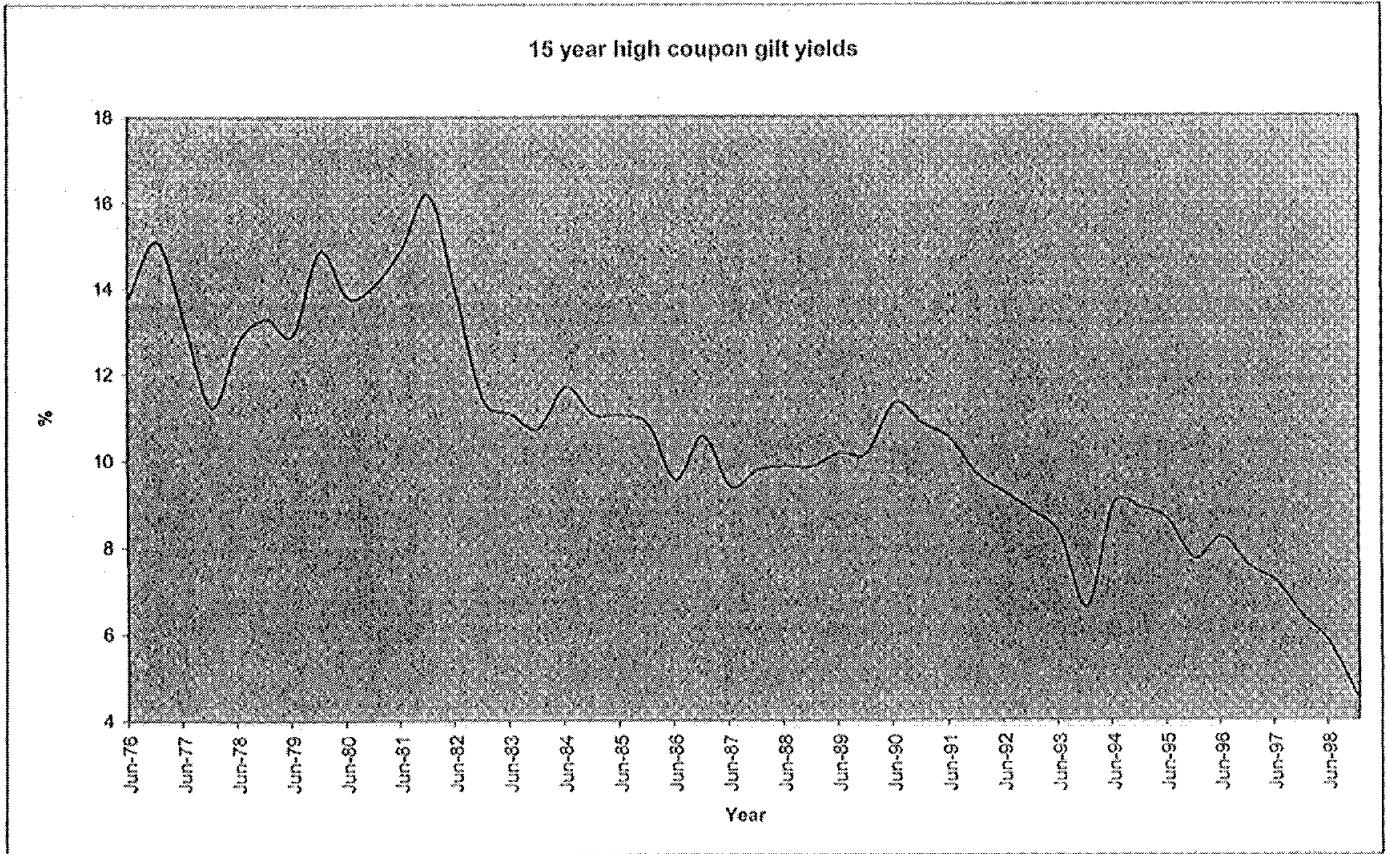
Johnathan Sumption QC, Sarah Asplin and Simon Salzedo (instructed by *Norton Rose*) for Mr Hyman.

Their Lordships took time for consideration. g

Appendix 7

Gilt Rates

This graph shows levels of 15 year high coupon gilt yields from 1976 to 1998. The steep drops around 1993 and 1999 correspond with drops in annuity rates at those times.



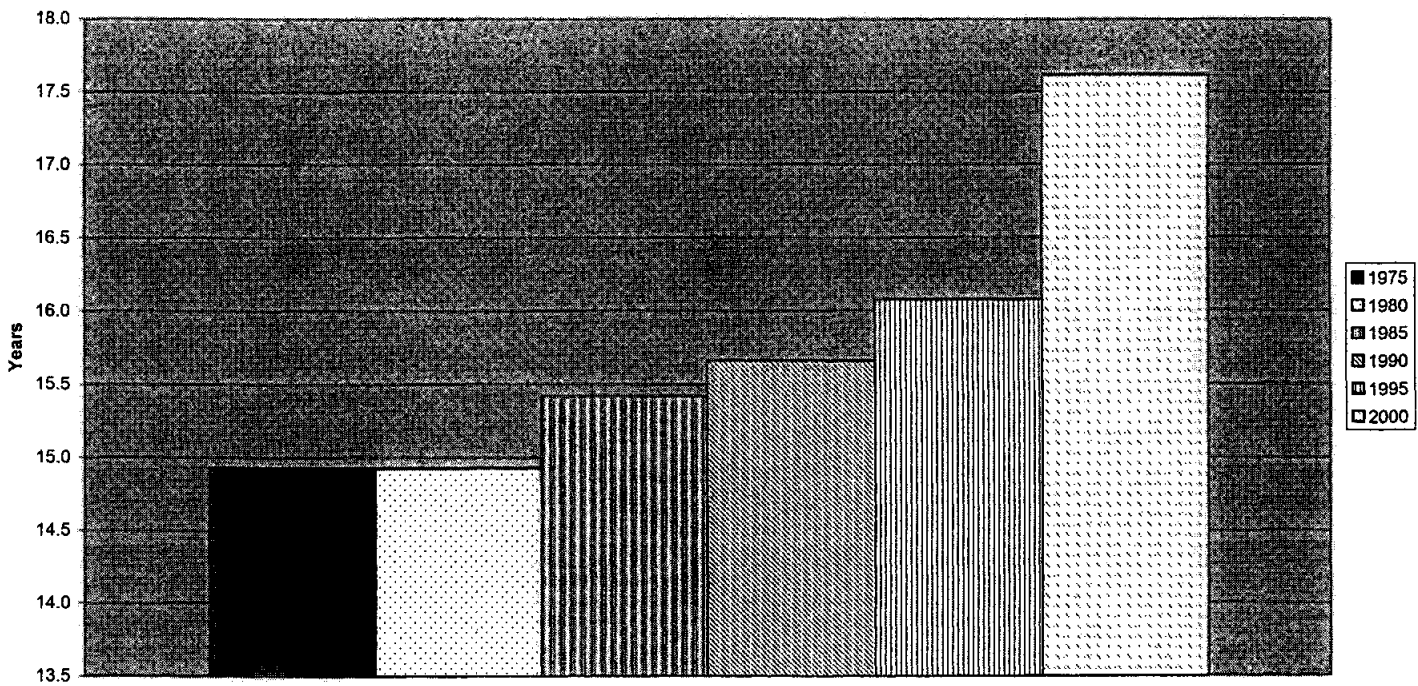
Appendix 8

Mortality Rates

This chart shows, at five-year intervals from 1975 to 2000, the life expectancy of a 65-year-old male holder of a retirement annuity policy in the course of payment. The expectancies are based on mortality rates derived from Continuous Mortality Investigation Bureau reports, which would have been available to life insurers at the given dates.

The chart shows that life expectancy has increased in recent years, which would have contributed to the decline in annuity rates.

**Complete expectation of life of male aged 65
(Retirement annuity in payment)**



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Appendix 9

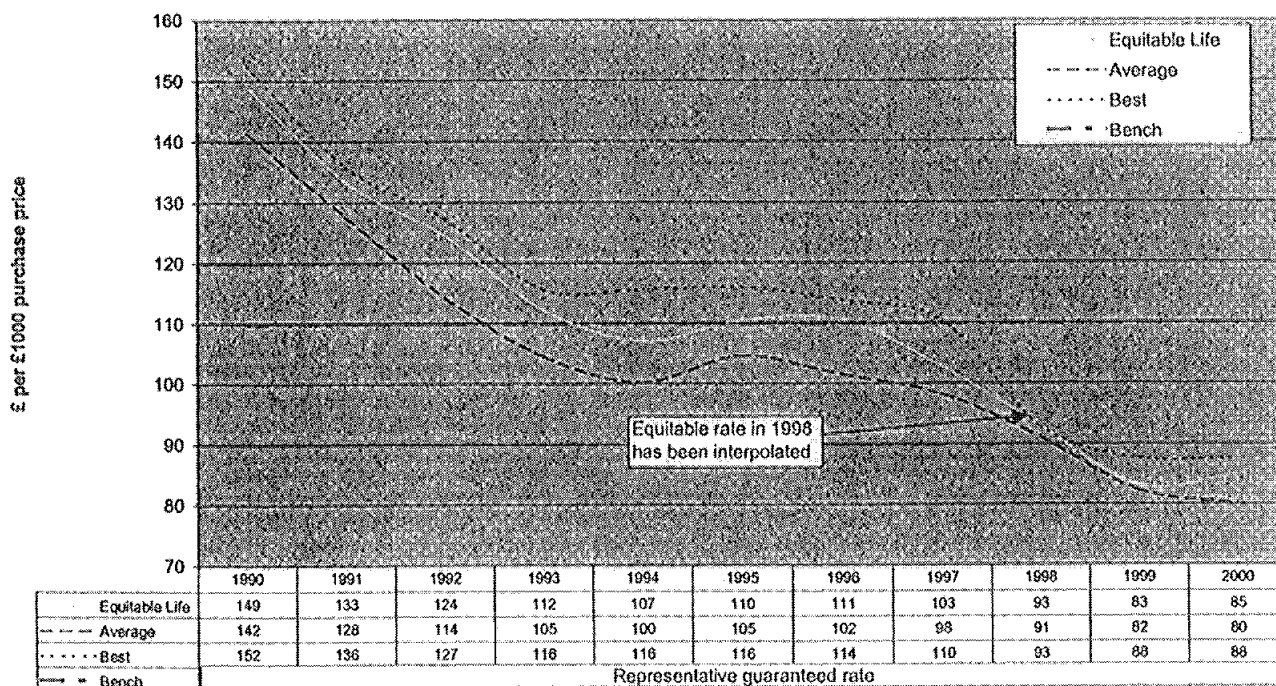
Annuity Rates

This graph provides an indication of the total annuity payable annually per £1000 purchase price from 1990 to 2000. The graph includes rates for Equitable Life and the best and average rates from the top providers each year. Since no comparable rate was available from the sources researched, the 1998 rate for Equitable Life has been interpolated from the rates for adjacent years.

Equitable Life offered a number of different levels of guarantee at different times. The guaranteed rate included in the graph is representative of a typical guarantee.

The graph shows that the value of annuity payments dropped below the representative guaranteed rate offered on some Equitable Life policies.

Annuity rates



Appendix 10

Year	Date of Application	Amount applies for	Est. future profits (retrospective calculation)	Amount granted	Amount used in Returns
1994	15.12.94	£500m	£2,141m	£500m	£250m
1995	28.06.95	£500m	£1,163m	£500m	£264m
1996	26.06.96	£600m	£2,213m	£600m	£313m
1997	30.06.97	£700m	£2,252m	£700m	£371m
1998	26.06.98	£850m	£2,674m	£850m	
	22.12.98	£1,900m	£2,674m	£1,900m	£850m
1999	14.10.99	£1,000m	£2,960m	£1,000m	£925m
2000	27.06.00	£1,100m	£3,304m	£1,100m	

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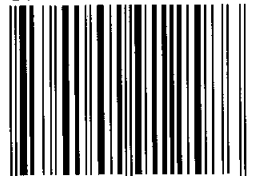
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